STRATIGRAPHIC ASSET MANAGEMENT, INC.

JAYUSIA P. BERNSTEIN
ALAN S. BERNSTEIN

January 15, 2021

Investment Outlook

2020, a Year to Forget

We have just completed an *annus horribilis*—one for the record books! The world was rocked by the worst pandemic since the influenza outbreak of 1918. Tragically, in the United States in 2020, there were nearly 20 million confirmed cases, about 6% of the population, and 335,000 deaths.[1] While it seemed that the COVID-19 virus was beginning to be contained over the summer and early fall, in late October through the end of the year the rate of new cases surged. Many healthcare facilities are operating at full capacity and their personnel are exhausted. Notwithstanding some complications arising from mutations of the virus, two effective vaccines are being rolled out with more to come. In 2021 the country will be largely immunized, and the pandemic should abate. Years from now, our children and grandchildren will recall the tragic war stories of the pandemic of 2020 and what it was like to wear a mask and maintain social distancing!

From a macro-economic standpoint, the onslaught of the pandemic initially looked to be a disaster. Consider that because of the outbreak, the economy in the second quarter seized up. Over 20 million people lost their jobs, and whole sectors shut down or were severely impacted—travel, hospitality, entertainment, and real estate to name a few. In the third quarter, however, the economy rebounded sharply. Contributing factors were the passage in March of the $2.3 trillion stimulus package by Congress, aggressive easing of monetary conditions and additional financial support by the Fed, and some reopening of the economy as the rate of new cases of COVID-19 stabilized. The improvement in economic conditions, however, was not sustained because coronavirus cases and deaths rose sharply in the fourth quarter. Employment in the United States declined in December while initial unemployment claims rose. Nevertheless, the eventual economic recovery of the United States is certain, even if the rate of the rebound is less predictable.

Against this backdrop, understanding the behavior of equity markets is particularly challenging. The S&P 500 Index plummeted in March by one-third, but almost miraculously, by mid-year recovered to nearly its yearend 2019 level. How could the market ignore that in 2020 the U.S. economy will fall an estimated 3% to 4% and corporate profits by 15% to 20%? As we noted in our July report, it was as if the pandemic had not happened! Accordingly, our expectations for the market over the balance of the calendar year were tempered, feeling that the risks were to the downside. So much for forecasts based on fundamentals—the market instead roared ahead. The total return on the S&P 500 Index in the second half was a whopping 22.1%. This level of performance was too high to justify predictions of long-term GDP growth of around 2% and mid-single digit earnings growth.

Investors were handsomely rewarded for maintaining their equity exposure. While we did cut stock positions in the second quarter during the market decline, we added some exposure during the recovery. In most accounts, our equity allocation ended the year in the high end of their target range. Growth companies were by far the best performers last year. Our positions in information technology at December 31 largely accounted for our good performance in the second half of 2020.

---

[1] As of January 14, 2021, the WHO reported 22.6 million cumulative cases and 377,446 deaths. World Health Organization, https://covid19.who.int/region/amro/country/us.

DOUGLAS ENTRANCE, 804 DOUGLAS ROAD, SUITE 363, CORAL GABLES, FLORIDA 33134
TELEPHONE (305) 447-0300 • FAX (305) 447-0385 • WWW.STRATIGRAPHIC.COM

Interest rates plummeted in the first half of 2020 because of actions taken by the Fed to support the economy and the influx of foreign capital seeking safety in U.S. Treasuries. Rates rebounded in the second half as capital market conditions normalized. The 10-year Treasury benchmark fell from 1.9175% on December 31, 2019, to 0.6561% at June 30, 2020. In the second half, the yield recovered to 0.9132%. As of this writing, rates have moved above 1%. Our bond portfolio maturities are generally under three years compared to over eight years in the U.S. Aggregate Bond Index. Hence, our returns lagged when interest rates fell, but outperformed when interest rates rose. At the current level of interest rates, it is virtually impossible to find investment grade bonds with meaningful yields. The potential for interest rates to rise makes us cautious.

The Economy and Corporate Profits

Although the U.S. economy and corporate profits have been on a rollercoaster ride, the forecasts for 2021 appear to reflect a high degree of confidence. The consensus estimates[2] hold that real GDP declined in 2020 by around 3.5% but will rebound in 2021 and 2022 by 3.9% and 3.1% respectively. If the projections are generally correct, the economy should regain 2019 levels by the end of 2021 or early 2022. The decline in corporate profits was much deeper, but the recovery will be steeper. Last year, S&P 500 earnings declined around 23%, but are expected to rise by 30% in 2021 to about the same level earned in 2019. The consensus for 2022 implies a further increase of 17%. We believe this forecast is not realistic. Corporate margins will likely come under pressure. The combination of the lower value of the dollar and the disruption of global supply chains raises the costs of imported intermediate goods. Additionally, earnings estimates do not consider a possible hike in corporate income taxes, which is a risk factor.

While the economy and corporations have lost about two years between the pandemic decline and recovery, they should be back to a reasonable pattern of growth in 2022. The critical assumptions reflect the $900 billion support package passed by Congress in December, the likelihood of stimulus legislation by the Biden administration in the first half of the year, and the control of the coronavirus in the second half.

Table 1				
United States GDP & S&P 500 Index Earnings Forecasts				
Consensus Estimates*	2019	2020	2021	2022
Real GDP Growth	2.2%	-3.5%	3.9%	3.1%
S&P 500 EPS Forecast	$163.50	$125.58	$163.72	$191.70
Annual Change		-23.2%	30.4%	17.1%
* Consensus data as reported by Bloomberg				

Current Equity Valuations and the Possibility of a Bubble

There are many ways of assessing the S&P 500 Index that lead us to believe the Index is not in a bubble, although certain stocks may be. In determining performance, the component companies are weighted in accordance with market capitalization (shares outstanding x market price). As a result of

[2] Current Bloomberg survey of around 80 economists, consulting firms and institutions, January 2021.

their size and appreciation, five companies have come to represent 22% of the total index at December 31, 2020: Facebook, Apple, Amazon, Microsoft, and Alphabet (Google), known as the FAAMG stocks. Their weighted forward average price earnings ratios (P/Es) on 2021 and 2022 consensus earnings are 36.4x and 30.5x versus the Index P/Es of 22.9x and 19.6x. Excluding the FAAMG companies, the P/Es of the Index would decline to 19.1x in 2021 and 16.5x in 2022. These are not bubble P/Es. Our portfolios include Apple and Microsoft. While we are satisfied that their fundamental outlook supports their current relative valuations, the shares of both companies are not without price risk.

A recent institutional survey of leading market strategists found that their median forecast for the S&P 500 Index at year-end 2021 was 4000, which based on the December 31, 2020, close of 3756, implies appreciation of around 6.5% this year. The highest and lowest forecasts were 4400 and 3800. None of the analysts expect that the Index will experience a loss. We should add that none of the strategists correctly projected (before the advent of the pandemic) how the market would end up in 2020![3]

Table 2				
S&P 500 Index Levels, Earnings and Price/Earnings				
Current Price Earnings Ratios	2019	2020	2021	2022
S&P 500 Index	3,231	3,756		
S&P 500 Index Year-Over-Year Change*	28.9%	16.3%		
S&P 500 Earnings (2020 Estimated)	$163.50	$125.58		
S&P 500 Price/Earnings	19.8	29.9		
Forward Price Earnings Ratios				
S&P 500 Index			3,756	3,756
S&P 500 Earnings, Estimated			$163.72	$191.70
S&P 500 Price/Earnings			22.9	19.6
Based on December 31 S&P 500 Index		*Price appreciation only.		

Bubbles are not just defined by high price earnings ratios. Irrational exuberance by investors is an essential component, but measurement is fuzzy at best. One astute portfolio manager defined a bubble market as reflecting extreme overvaluation, explosive price increases, frenzied issuance, and hysterically speculative investor behavior.[4] We are not there yet, although clearly some common stocks have bubble characteristics and the new issue market of late has been especially frothy.

[3] Bloomberg, Strategists' S&P 500 Index Estimates for Year-end 2021, December 12, 2020.
[4] Jeremy Grantham, "The Hazards of Asset Allocation in a Late-Stage Major Bubble," January 5, 2021.

Market Risks

Political Risks. Bear in mind that a major strength underlying U.S. capital markets is the enduring stability of the political system. Equity markets thus far have brushed over the illogical, irrational dispute regarding the election results that culminated in the insurrection at the Capitol on Wednesday, January 6. While these developments are very unsettling, our political institutions are strong and holding firm, the perpetrators are being aggressively prosecuted, and President Trump may be held accountable for his role.

A durable, more stable, and healthier political and investment environment requires bipartisan leadership, which as of this writing seems uncertain. We fear that the Democrats by impeaching the President without meaningful Republican support may widen further the partisan divide to the detriment of the country.

There is concern that if the Biden Administration rescinds the corporate and individual tax reductions of 2017 and reimposes burdensome regulations, the economy will be depressed. The additional stimulus to be provided, coupled with the general improvement in the business and financial environment should enable the economy to absorb some additional taxes and regulation. In any case, the new Treasury Secretary, Janet Yellen, and Fed Chairman Jerome Powell will be especially careful to protect the recovery.

Inflation. At present, inflation is not a concern because unemployment remains high and industrial capacity is underutilized. Low commodity prices (they are rising), a relatively strong dollar (our currency is getting weaker), and the availability of cheap imported goods have also restrained price increases. However, as conditions normalize, look for the consumer price index to rise. The Fed's goal "to achieve inflation that averages 2 percent over time" suggests that the Fed anticipates inflation moving above 2%. The Fed will allow a higher rate for some period of time before tightening monetary policy.[5] It is possible that the significant expansion in the U.S. money supply since last spring could cause inflation to rise above 2%. In the 12-month period ended November 2020, the consumer price index only increased 1.2% (1.6% excluding the more volatile items of food and energy), which was relatively benign.

Interest Rates. There is palpable fear that interest rates will rise despite the Fed's policy to keep short-term rates very low. Rates in the second half of 2020 began to recover and in the last few days the increase has accelerated. While the Fed does control short-term rates, it cannot easily hold down longer-term rates, which are governed by investor expectations of future interest rates. We believe the risk in interest rates is to the upside, which is why the average maturity of our bond portfolios is short, generally under three years.

Federal Deficits and the Ballooning Federal Debt. Many economists and investment managers are concerned about the huge Federal deficit the United States incurred last year, representing around 16% of GDP versus a more reasonable target range of 3% to 5%. In its September 2020 forecasts (that do not include the recent $900 billion pandemic package or any future stimulus), the Congressional Budget Office (CBO) projected that the ratio of Federal debt in public hands will rise from around 79% in 2019 to an estimated 104% of GDP in 2021. A level above 100% ordinarily is worrisome. The reason why the deficit is not an immediate concern is that Fed monetary policy last year significantly lowered interest

[5] "Federal Open Market Committee Announces approval of updates to Its Statement on Longer-Run Goals and Monetary Policy Strategy," Federal Reserve Press Release, August 27, 2020.

rates for what may be an extended period. The CBO projected the average interest rate on Federal debt declining from 2.5% in 2019 to a low of 1.2% in 2023 and 2024, rising gradually thereafter. As a result, through 2027, interest on government debt will be less than 2019 levels.[6] We worry, however, that if inflation forces the Fed to raise rates, Federal debt will be immediately impacted. An increase in interest by 100 basis points (1%) in 2025 based on the CBO model would raise the federal budget deficit by more than 20%! That is negative leverage in the extreme!

Summing Up

Equity markets are fully valued. While we do not believe we are in a bubble, common stocks could decline unexpectedly and meaningfully if triggered by events or financial conditions that we don't anticipate. Major market strategists expect a reasonably stable or moderately rising stock market but take note: market forecasters (including us) are often notoriously wrong. Unfortunately, bonds offer no yield and may be riskier than stocks if interest rates rise.

Since the turn of the century, investors have lived in an idyllic world: we survived the Dot Com bubble in 2000; the great Financial Crisis of 2007–2008; and more recently the COVID-19 pandemic. It is easy to become complacent. The lesson is to have adequate liquidity on hand to see through extended periods of depressed security prices. In this environment, the cost of holding cash is low.

We are confident that the pandemic will be overcome and that the U.S. economy and American businesses will get back on track. We are optimistic that the Biden Administration will restore a measure of stability and predictability in U.S. government operations. We just wish we could be as optimistic about portfolio returns over the next few years.

Jayusia P. Bernstein
Alan S. Bernstein

[6] Congressional Budget Office, "Long Term Budget Outlook," September 2020.