

Read the Signals

By Jeff Otto, CFA

Exiting the one year anniversary of the economic shutdown due to COVID-19, there is a growing feeling we are entering a new “Roaring ‘20s” type period. The urge to make up for lost time and experiences could certainly play out similarly to when the end of World War I and the flu pandemic ushered in a period of euphoria and excess. As we begin to see the post-COVID economy take shape we will read the signals provided by the market to exploit attractive investment opportunities. It is very likely that some of these opportunities may be similar to that period nearly a century ago while other, completely new ones, may emerge.

Today’s Backdrop

Current economic and market data points indicate we are at the early stages of a new economic and market cycle. Weekly initial jobless claims, which are still hovering around 700,000 per week, have collapsed from a peak of nearly seven million a year ago. Consumer confidence measures have bottomed and are improving from lows. Finally, the spread between short-term and long-term interest rates, a classic indicator of the business cycle, is steepening out to levels seen at the beginning stages of an economic recovery.

Perhaps the most bullish indicator for the economy right now is that consumers are flush with cash, and probably itching to spend as vaccination rates increase and the economy re-opens. The U.S. consumer, the stalwart of our economy, is currently sitting on a personal savings rate of over 20% of personal income. This level has not been seen since the 1970s when, unlike today, high interest rates actually encouraged saving, and is well above the low single-digit levels in the early 2000s. To add fuel to the fire, the recently passed \$1.9 trillion stimulus package gives \$1,400 checks to individuals and significantly more to families. This all has the potential to unleash a multi-year spending boom on travel, dining out, entertainment, housing and much more.

History Rhymes

There is a saying that history doesn’t repeat, it rhymes. Investors are paying heed as virtually no one today has direct investment experience during the last pandemic nor the ensuing Roaring ‘20s bull market. Even though it is tempting to make a historical comparison to today’s market, the reality is that each market cycle will have its own unique characteristics as well as similarities to other cycles. Looking at the current environment, we have recently dealt with a pandemic like the 1920s, extreme outperformance of growth stocks like the 1990s, rising long-term interest rates like the 1970s and extraordinary fiscal and monetary policy similar to the last decade.

However, the structure of today’s economy is markedly different than during most of these time periods, and this could influence how markets perform going forward. Unlike the last two decades, it seems that performance of both growth and value styles in this new market cycle could be on more equal footing.

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One reason for this could be that the business models of both growth and value stocks have merged closer than ever before. For example, Disney and Netflix are now both delivering streaming video content. Wal-Mart, a traditional retailer, is investing heavily in e-commerce while Amazon, the e-commerce pioneer, is entering physical retail space. Tesla is the frontrunner in electric vehicles but, after years of investment, Ford is also launching their own electric vehicles to much fanfare.

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more digital world going forward? Sure enough, despite the ups and downs of the last year, the performance

of the Russell 1000 Growth and Value Indexes is within a handful of percentage points of each other since the market low on March 23, 2020. It seems like today's market is signaling a broadening of participation across both investing styles.

Pockets of Excess

Like all bull markets, there are certainly pockets of the market that could be in a bubble. The cult popularity of Bitcoin and other cryptocurrencies has pushed the asset class to over \$1 trillion in value. New innovations like commission free trading at Robinhood have driven retail day traders into stock options and heavily shorted stocks like GameStop. The number of new special purpose acquisition companies (SPACs), which are blank check companies meant to take yet to be identified companies public, has already shattered issuance records this year. Finally, the emergence of digital files called non-fungible tokens that have a unique identity and ownership are the latest innovation to attract capital. This speculative behavior is likely to continue as a recent Deutsche Bank survey of 430 investors showed that about half of 25-34 year olds plan to spend 50% of their stimulus payments on stocks. While this may end poorly for some investors, it is somewhat reassuring that this activity is largely outside the bounds of the high quality stocks and bonds in which we seek to invest.

The bond market, which has had a remarkable 30-year bull market, is also seeing notable weakness to start this year. The re-opening of the economy has driven a bond selloff with rates rising almost 1% from the lows last year. This is normal coming out of a recession as investors flee from safe haven assets into riskier assets like stocks or the asset classes mentioned above. However, with the yield on the 10-year Treasury bond at just over 1.7% there is minimal juice left to squeeze out of bonds. Rather than a large income producer, bonds' role in a portfolio for the foreseeable future may be confined to a hedge against stock market corrections or economic recessions.

Risk and Reward

The scars of the COVID-19 recession and ensuing bear market are still fresh for many investors. It is common behavior for investors to avoid taking risks in the aftermath of such a negative event, similar to the financial crisis in 2008. Our investment discipline seeks to take advantage of this market volatility through portfolio rebalancing and upgrading, which we have done several times in the last year. We will also seek to identify and position portfolios to benefit from the potential new opportunities that will be unique to this market cycle. One year later, the market signals are flashing green after a very difficult ride in 2020. While the path may not be linear, history shows a new business cycle can last for years and be very rewarding for disciplined investors.

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