4Q 2020
Market Commentary

The COVID-19 pandemic along with all of the healthcare, governmental, corporate, and personal responses to it clearly was the dominant theme in 2020. Few events will rival the impact the pandemic has had on our lives perhaps for a generation to come. All of the stock and bond market movements can be interpreted primarily in this light, and for much of the year, there was only a “theoretical” light at the end of the tunnel. 2020 started with the market’s panic selling and overcorrection in the first quarter. Even with the market’s rebound from the bottom through the end of August, stay-at-home/work-at-home stocks vastly outperformed everything else. It was only in the fourth quarter, particularly as the first two vaccine trials proved their efficacy, that the rest of the stock market took the lead and rebounded.

Now, the unprecedented logistical challenges, particularly with Pfizer’s vaccine that requires critical temperature control, have hampered the rapid rollout of vaccinations that will bring an end to the pandemic. Yet, as inoculations ramp up in January and over the coming months, we estimate the pandemic should come to an end in the summer/fall of this year. The duration of protection from the vaccine is not yet known, but if it is relatively short, administration of booster shots will become an annual event similar to that of flu shots.

With this in view, the stock market’s fourth quarter rally virtually ignored the November and December surge in cases, the tragedy of rising deaths, and the renewed state-administered economic lockdowns that have for now slowed the pace of the economic recovery. With the valuation of the S&P 500 having once again reached exuberant levels, this portends risk for the broader stock market.

Yet as we have repeatedly chronicled, the greatest stock risk remains in companies that benefited from the stay-at-home/work-at-home environment. Companies that need real demand from open economic activity suffered greatly. This dichotomy is clearly demonstrated by just two stocks. Exxon, for many years the largest market capitalization in the S&P 500, plunged -36% in 2020 to a dwindled yearend market capitalization (in today’s terms) of $174 billion. In contrast, Apple’s return surged 82% making it the king of the heap with a $2.26 trillion market cap. OK, even if you look at more direct comparison of staying at home and not consuming energy, Netflix rose 67% to a market cap of $239 billion and Amazon gained 76% to reach a market cap at $1.6 trillion!

We believe the capitalizations and valuations of the winners of 2020 are where the greatest risk lies in 2021. Just as it did in 2020, the world is about to change again in 2021. How much this reminds us of 1999.

One cannot view what happened in 2020 without also considering the Federal Reserve Board’s response. While one of its important mandates is to prevent panic, the semi-permanent return to ZIRP (Zero Interest Rate Policy) and the adoption of Modern Monetary Theory (MMT) policies portend renewed future price inflation. With Fed Chairman Powell’s statements that this policy will be sustained into 2023, regardless of the economic consequences or pace of the recovery, we expect monetary policy is likely to become less effective in preventing the return of price inflation or in supporting stock and bond prices.

So far, the Fed’s actions to monetize (via money creation and the massive purchases of Treasury bonds and even junk-level corporate bonds) the stunning government deficits created by this economic crisis will be hard to unwind without periodic market “tantrums.” Negative real interest rates, much less negative nominal rates, distort economic decision-making. The plunging exchange value of the U.S. dollar could be just one result.

Just one quick Treasury yield example is in order. The table to the right compares the yearend yields on the 5-year Treasury Note on December 31st of both 2019 and 2020. If you bought the bond at each point, the nominal yield is what you would receive in income. The "real yield" is the yield on 5-year TIPS (Treasury Inflation Protection Securities), and the expected future inflation rate is the difference.

Treasury Bond	**Yields 12/31/2019**	**Yields 12/31/2020**	**Difference**
5-Year Nominal T-Note	1.69%	0.36%	-1.33%
5-Year TIPS	0.01%	-1.59%	-1.60%
Implied Price Inflation Rate	1.68%	+1.95%	+0.27%

At a yield of 0.36%, no wonder investors don't find much comfort in owning bonds for income—there is none! And yet fixed income funds still experienced significant inflows during the year. For this Treasury, the 133 basis point plunge in nominal yield resulted from the Fed's actions and the market's response that drove the 160 basis point plunge in real yields into negative territory. In contrast, inflation expectations actually rose by 27 basis points. While the Fed restored functioning in credit markets, its actions triggered the fall in the exchange value of the U.S. dollar and the rise in inflation-protection assets like TIPS, gold, silver, and other commodities. Yet the suppression of Treasury yields was accompanied by the purchase of non-investment grade corporate ETF's (tradeable bond mutual funds), that also distorted the market's allocation of credit by credit risk. We believe the result is likely to be higher future inflation rates, at a time when stock market valuations have been pushed to unsustainable levels.

The new year also sees a change in presidential administrations, and with the Senate runoff races in Georgia won by the Democratic candidates, Democrats have captured both the executive and legislative branches of government. Financial markets tend to prefer a divided government, which forces compromise on policies that otherwise might be implemented by a party that holds both the executive and legislative branches of government. Yet, this is not always the case. Given the combination of the pandemic coming to an end and the massive federal stimulus likely to be passed by the new Congress, we think the market will focus on the cyclical recovery of economic activity, not future policy initiatives. The eventual impact will depend on what actual policies get passed into law or by executive order.

As the latest government-imposed shutdowns come to an end, the rebound in the economy should continue as employment recovers, depleted inventories are rebuilt, and pent up demand for services and travel is unleashed. After the 33% real GDP gain in the third quarter is combined with a 4-5% gain in the fourth quarter, by yearend 2021, the economy could actually see the recovery return the pace of economic activity back to that experienced before the arrival of the pandemic.

Instead of Main Street suffering while the Fed action boosted Wall Street, as was the case in 2020, this year we could see the reverse. There are plenty of reasons the economy could face headwinds this new year as well, including the burden of government deficits, trade impediments from relations with China or the UK with the EU, aggressive Chinese threats toward Taiwan, or U.S. bankruptcies by small firms unable to survive through the end of the pandemic. Yet we believe the continued economic recovery of Main Street seems more likely, with real GDP growth in 2021 possibly topping 4%. The recovery of corporate revenues and earnings associated with the vast majority of companies (by number not market cap), the reinstatement of dividends suspended during the shutdown, and renewed world trade and capital expenditures is something we all desire. With a few mega-cap stocks driving the broad market with valuations that rival 1999, value-based investment strategies along with Main Street could do far better than Wall Street in 2021.

As we wrote in our holiday letter to clients and friends, we look forward to experiencing the blessings of "the value of family and friends, camaraderie at the workplace, the freedom to go where we please, and the simple pleasures of dining out, dancing, watching movies at a real theater, or attending a religious service." Such events should become a reality in 2021.

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