JANUARY 21, 2021

"Never in recent memory have the events of a single 24-hour period so shaken two presidencies, the very Capitol of the United States and the nation itself as they did on Wednesday."
– Gerald Seib, *The Wall Street Journal*, January 7, 2021

"U.S. stock futures rose Thursday as investors looked past the political unrest to focus instead on prospects for higher government spending."
– Joe Wallace and Xie Yu, *The Wall Street Journal*, updated January 7, 2021 at 8:45am ET

"The central, befuddling economic reality of the United States at the close of 2020 is that everything is terrible in the world, while everything is wonderful in the financial markets."
– *The Upshot*, January 1, 2021

The first two passages above appeared in the online edition of *The Wall Street Journal* on January 7, just hours after order was restored on Capitol Hill. The juxtaposition somehow falls neatly in line with the last year of extraordinary extremes. The third paragraph pinpoints the issue that we have been addressing in these commentaries since the second quarter of 2020: the apparent, jarring disconnect between financial markets and the "real" economy. The explanation remains consistent: money.

We have written about the explosion in the money supply. There is simply more money than can be absorbed by the economy. It has found its way into financial markets leading to rising asset prices. For this we can look to two key policies of the Federal Reserve, the setting of short-term interest rates and the bond buying program known as Quantitative Easing (QE). As we know, the Fed has set the short-term rate at near-zero. In its QE program, the Fed has been purchasing $80 billion of U.S. Treasury securities and $40 billion of U.S. Government sponsored securities every month. By injecting $120 billion in cash every month back into financial markets, QE keeps interest rates low and investors flush with cash.

We can think of this as the first dose of an economic vaccine, aimed at steadying markets and protecting the financial system. The booster shot came in the form of fiscal stimulus; government programs that put money directly into the hands of citizens and businesses. The Cares Act, with its Paycheck Protection Program, enhanced unemployment benefits and stimulus checks injected stunning sums. While some of this money went into the economy, much of it found its way into personal savings and into financial markets.

Largely thanks to government programs, disposable personal income actually increased by about $1 trillion from March through November of 2020[1]. At the same time, personal consumption

1 U.S. Bureau of Economic Analysis

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dropped by more than $500 billion[2]. The total increase in personal savings was greater than $1.5 trillion.

We can trace this money into the stock market in several ways. According to some estimates, individual investors (so called "retail investors") opened more than 10 million new accounts in 2020 and accounted for approximately 25% of average daily trading volume since the pandemic began. Three million of those accounts have been attributed to Robin Hood Markets, the app-based trading platform aimed at first-time investors. Even staid old firms like Morgan Stanley and Charles Schwab are trying to increase their exposure to individual traders by acquiring firms like E-Trade and TD Ameritrade, respectively.

As might be expected, inexperienced investors and traders have introduced a more speculative tone to the market. In 2020, nearly 400 stocks increased more than 100%, more than half of which are expected to lose money for the year. Privately held companies rushed to take advantage of this environment; there were nearly 500 initial public offerings over the year. Some were household names like Airbnb. Some were unfamiliar like QuantumScape or XPeng. Still others had no stated business at all. 248 Special Purpose Acquisition Companies (with the unfortunate moniker "SPAC" and referred to as blank check companies) raised a total of $83 billion (nearly twice as much as the previous ten year combined) to invest in undisclosed or undetermined businesses at some point in the future). All in all, more companies went public in 2020 than in 1999 at the height of the dot-com bubble.

To be sure, not all retail investing was speculative; individuals also directed their increasing savings into more orthodox investments. Robin Hood discloses the 100 most popular holdings of its clients. Among the top twenty, Amazon, Alphabet (Google), Microsoft, Facebook, Coca Cola, Nike and GM join Virgin Galactic Holdings and Peloton Interactive.

As has been the case since stocks began to rebound in late March, the overall strength of benchmarks like the S&P 500 has claimed the headlines. But market leadership in the fourth quarter shifted. As we noted in our last Investment Commentary, stock performance had been dominated by a small handful of the largest technology companies. With the nearly back-to-back announcements of two effective vaccines, investors seemed to factor in a more robust economic recovery. In the period since the first announcement (November 9), former laggards became leaders. Small stocks outperformed large; economically sensitive sectors like financials (particularly banks), energy and industrials showed signs of life. Longer term interest rates even crept higher as the yield on the ten-year U.S. Treasury note rose from 0.77% to 0.92% at year end.

Looking forward, we remain guardedly optimistic for two reasons.

The primary factor is that monetary conditions have not, nor are likely to change. Central bankers, especially in the U.S., have explicitly noted no plans to raise interest rates or to reduce bond purchases for at least twelve months. Even then, we believe the removal of accommodation will

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2 U.S. Bureau of Economic Analysis

be slow and well telegraphed. The mountain of money they have created will continue to grow and find its way into financial assets.

Despite this, at some point we will likely hear the sounds of speculative bubbles popping. Eventually, first time investors will learn the hard lesson that valuation does in fact matter. Many will withdraw from the market, seeking safer havens for what remains of their capital.

But in their place, we are likely to see reinvigorated corporate buying. Since the onset of the pandemic, companies spent less money purchasing their own shares (down 41% through the third quarter) or acquiring businesses (down 30%). This was the result of prudently safeguarding liquidity in the face of great uncertainty.

However, new or increased stock buyback plans are already in the works. In December alone, JPMorgan and ten other companies announced plans to repurchase shares for a combined total of more than $75 billion. Likewise, merger and acquisition (M&A) activity is picking up with new deals almost daily. M&A bankers are reporting strong deal pipelines, as well. With sponsor firms like Carlyle, Blackstone and others flush with investor cash, private equity activity should pick up as well, creating further demand for stocks.

Secondly, we see a broadening set of attractive investment opportunities. A generally improving economy should benefit many more than just the largest handful of companies. We believe investors will be less desperate to chase "new" business models at any cost and more inclined to weigh valuation and financial productivity.

The pandemic has changed many habits and routines (this letter is being written and edited from bedrooms, living rooms and basements). Some changes will endure; some will not. It will be unusually difficult to forecast many behaviors, which creates the kind of uncertainty that leads to opportunity.

We believe this environment favors our approach. We think our intensive research, whether focused on stocks or bonds, will be rewarded. Rather than becoming enamored with high-flying story stocks (cloud-computing, electric delivery vans, e-commerce platforms, etc.), we will maintain the discipline of long-term investing in real businesses with strong and growing earnings and cash flow. We firmly believe this is the best way to grow capital in good times and preserve it during challenging periods.

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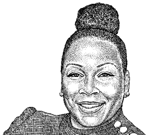
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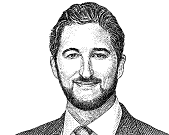
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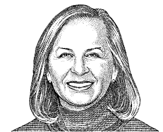
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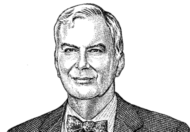
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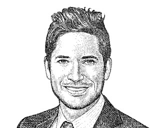
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