Marketline January 2021

Stocks:

January's returns were mostly negative – the first time we've seen lower stock indices during a month since October of last year. Still, the decline was modest – about 2% for the Dow and 1.1% for the S&P 500. The Nasdaq, reflecting continued popularity of technology stocks, rose by 1.4%. Overseas, all three major markets we follow – Mexico, Canada, and Europe – were also slightly negative. The worst of these was the decline of 2.3% on Mexico's Bolsa reflecting the dominance of recession-sensitive stocks in its top holdings. Difficulties around the world with vaccinating citizens, the emergence of new virus variants, and high expectations tempered investor enthusiasm last month. Earnings season began a couple weeks into January and while reports have been strong, investors were expecting even better. Apple, which had a blowout quarter, is barely up since its announcement. Qualcomm had a stupendous quarter but fell on soft future guidance. A large majority of companies have beat estimates but sounded a note of caution going forward, contributing to the January pullback.

We can't finish this piece without a mention of GameStop. The speculation in stocks like this – with slender or zero fundamental prospects - has brought questions about the whole market, namely is the market in a 'bubble'? Day trading is 'in' again. Margin debt has been rising, which often presages at least a short term decline in stocks.

We think of bubbles as a significant excess of capital flowing into a narrow segment of the economy – in 1999 it was internet companies; in 2008 it was homes. Both instances were associated with market declines, but both were also associated with Federal Reserve action to hike interest rates, to rein in 'exuberance'. The outcome tends to be a nasty recession and crashing prices.

The stock market is not quite in the realm of excess capital inflows. If it were, we would not likely be seeing rational reactions like price declines when earnings are reported. And the Fed has made noises about keeping interest rates very low as well as avoiding blunt instruments like rate changes for specific problems like GameStop. Instead, it wants to use regulations to deal with excesses, rather than hammering the entire economy for the sins of a few. We can hope they will be so wise. However, in the meantime, we think 'bubble' does not describe stocks currently, though that doesn't mean we can't have a negative return this year.

Bonds:

Rates rose again last month; the long bond ended at 1.89%. As we write this, it's closer to 2%, which is where we started, pre-pandemic, one year ago. The ten year is around 1.07%. During 2019 before anyone even knew about the virus, the long bond fluctuated between 2% and 3%. Ten year bonds, which represent the benchmark rate for most 30 year mortgages, sold well in excess of 2%.

Government officials are planning to borrow trillions to goose the economy, hoping that prevailing low interest rates will keep the interest portion of the budget low. So far, that has been true. However, rates can be expected to rise close to pre-pandemic levels while we inflate the deficit. The hope is that fiscal spending will bring growth, and the debt burden will then moderate. The last time the US ran this experiment was during WWII. However, back then, the US had growth potential in the 4% per year area; currently we think prospective growth is in the 1% to 2% area, far lower. Furthermore, the dance between deficits, interest rates and growth is complicated by time leads and lags. For instance, bond investors are not necessarily going to stand around putting up with only 1% on the ten year if deficits rise dramatically. Instead, investors may demand 2%, which will defeat growth by making mortgages and other loans more expensive before the government's stimulus programs take hold.

Rising rates diminish bond prices, but also allow us to swap into higher yielding issues with funds from maturities, called bonds, or the occasional deliberate sale. Currently, we've been selling municipals in intermediate maturities to buy corporates or more niche-y municipals – sometimes non rated, sometimes small town issues. So although the value of bond portfolios might fall through this shift in rates, the silver lining will be higher income over time.

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