Retirement Income Solutions

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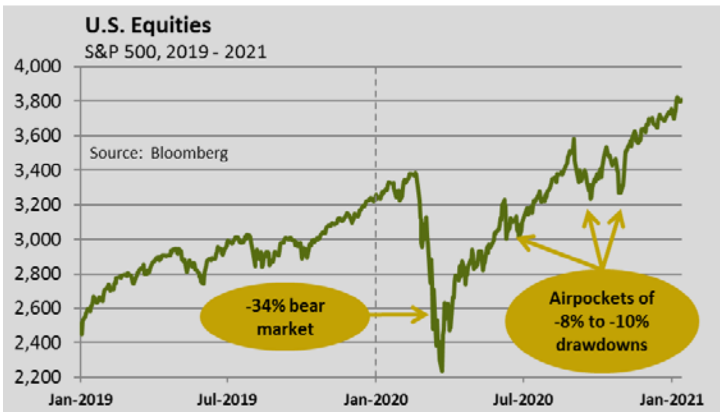
Favorable Trade Winds

January 2021

Summary

The term "trade winds" originated in the 17th century and is generally defined as "blowing steadily in the same direction." The original meaning had nothing to do with "commerce." Over time, common usage grew to include trade routes and implied some form of business or exchange. Those favorable trade winds are an interesting metaphor for the current investment environment, which has many supports lined up in the same positive direction. However, just as the term trade wind is not really about commerce, the stock market is not the same as the economy. While it can be uncomfortable to see the two diverge, it is best to analyze them separately. In addition, variable conditions are applicable in both contexts; just because the winds are favorable does not mean that an occasional storm will not appear.



U.S. Government Stimulus Has Been Effective

It took a while for government to roll out various stimulus measures and for financial markets to digest them, but such efforts seem to have been quite effective at bridging the gap brought on by the pandemic. Many of those favorable factors will continue. This complex environment is illustrated by the following:

- **2020 saw the fastest market decline and fastest recovery in history.** The S&P 500 fell by -34% and then recovered back to new highs within six months.
- **Bull market recoveries after a recession are robust** but shorter than average.
- **Economic data are surprisingly strong.** Unemployment is still a challenge, but the stimulus measures were successful at stopping the downward economic spiral. During the pandemic, delinquencies dropped, housing was strong, and spending recovered. However, those with the lowest incomes suffer the most during a recession, and 2020 was no different.
- **Pent up demand** will help propel the economy forward. Those with low incomes did not alter spending patterns much, but those with higher incomes held back.
- **The $886 billion stimulus package passed in December will continue to bridge the gap.** The funds will be directed primarily to households and small business which are most in need.
- **Monetary policy from the Fed remains very accommodative.** Past periods of easy policy have yielded double-digit returns, 4x the returns of periods without such accommodation, and fewer drawdowns.
- **Mortgage and other borrowing rates are near all-time lows.** The Fed significantly reduced the cost of borrowing through directly lowering interest rates, buying securities, and clearly articulating that those policies would continue for years.

Summary of Investment Positioning

The economic situation is obviously still a challenge. Those with low incomes were most at risk to be hurt by the recession, but their spending did not change much last year. Those with higher incomes were the ones that reduced spending the most – because they had discretionary spending that could (or had to be) cut. However, that also indicates that there is pent up demand that will be released as worries about the virus fade.

Unemployment is still at 6.7%, but significantly better than the 14.8% in the spring. There is no question that many people, especially those in the service sector that cannot work from home, are still struggling. While the economy may take longer to heal, it does not mean that recovery in stocks is unwarranted. In fact, recoveries after a recession are more robust than the average bull market. While the post-recession bull generates a 9% larger gain per year, the window for such returns is only 16 months on average.

Post Recessionary Bull Markets

Bull Market	Months	Return	Gain per annum
Post-recession bull	16	66%	37%
Non-recession bull	26	81%	28%

Source: Ned Davis Research

Congress passed multiple forms of fiscal stimulus worth trillions of dollars, and the Biden administration is likely to pursue additional packages, including infrastructure. Tax rates are relatively low. The vaccine rollout may encounter some bumps, and there are concerns over new strains of the virus, but the vaccine will be widely available early in the year. Household debt burdens are declining, and loan delinquencies remain quite low. The conditions for continued stock market gains are still in place.

Client portfolios remain at the maximum equity level. Numerous risks exist, and, despite good news from the various vaccines, the pandemic is still unpredictable. However, it is difficult to see the catalyst that could tip the U.S. economy back into recession against the favorable trade winds of substantial monetary and fiscal accommodation. The market's advance since the election has been steady, but air pockets will continue to appear. There is a good chance that stocks take a breather or even fall off a bit sometime in the next few months, but existing and future stimulus should bridge the gap until the economy can become self-sufficient.

> BCA Research strategist Doug Peta summarized the outlook succinctly, *"Policymakers threw everything they had at shielding the economy from COVID-19, and their efforts will turbocharge the boom once the pandemic is convincingly beaten. A considerable amount of pent-up demand waits to be unleashed."*

Returns of Major Asset Classes

2020 compressed an entire market cycle, which typically lasts two to five years, into a one-year period. The year started with a slow drift upward. When the pandemic hit, all major stock markets around the world fell by -30% to -40%. As the stimulus restored confidence in the economy and financial markets, the S&P 500 recovered to where it started the year within about six months. Over the first nine months of the year, the S&P 500 was up by +4% while mid-caps, developed international and emerging markets were down by -10%, -9%, and -3%, respectively. Growth stocks, propelled primarily by tech oriented companies, were up +24%. Many technology companies benefitted from the pandemic economy (more demand for computing, e-commerce, etc.). By September 30, tech companies such as Facebook, Microsoft, Netflix, and Amazon were up +28% to +70%.

Market leadership changed in the fourth quarter and early 2020. Those companies that were out of favor in the first nine months rallied after the election. Expectations of a broad (but delayed) global recovery pushed mid-caps stocks up +30%, emerging markets by +26%, and develop international by +18%. Bonds saw a solid year of gains in 2020 due to declining interest rates but lost -1% in the first few weeks of 2021 as interest rates rose.

Fastest Major Decline in History

2020 was unlike any other year, as financial markets saw the swiftest decline and the fastest recovery in history. The year also seemed to go on forever. It understandably feels that way since financial markets completed a major drawdown and recovery in roughly 1/10th the time it has required in the past.

The typical market cycle for such a major drawdown (defined as a 30% decline or larger) would include a 1.5-year decline and a 4-year recovery. The pandemic drawdown and recovery occurred in under 6 months, compared to the 5.5-year median associated with major declines.

Major Declines (30%+)

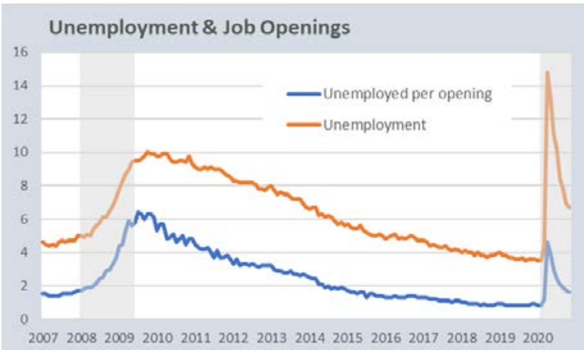
S&P 500 (1970-2020)

Year	Bottom Date	Peak Date to Bottom (months)	% Decline	Bottom Date to New High (months)	Peak Date to New High (months)
1970	5/26/70	17.8	-36.1%	21.4	39.2
1974	10/3/74	20.7	-48.2%	69.5	90.2
1987	12/4/87	3.3	-33.5%	19.7	23.0
2002	10/9/02	30.5	-49.2%	55.7	86.2
2009	3/9/09	17.0	-56.8%	48.6	65.6
2020	3/23/20	1.1	-33.9%	4.9	5.9
Median		17.8	-48.2%	48.6	65.6

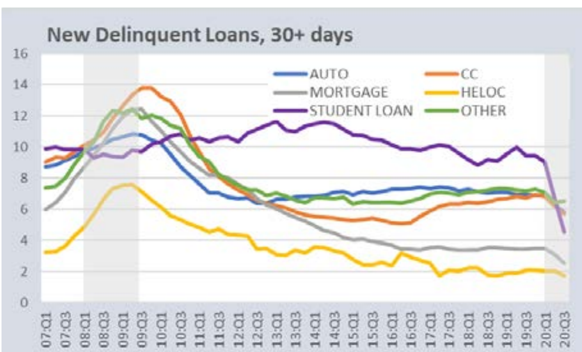
Source: Ned Davis Research

Putting the Economic Impacts of the Year in Perspective

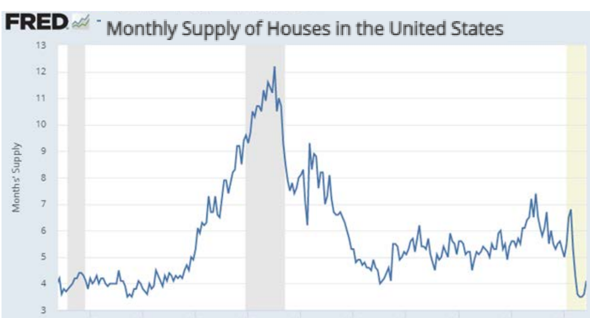
The Covid-19 virus is obviously the single most influential factor of the year. The virus's impact on the economy and financial markets was clearly damaging, causing the swiftest recession in history. However, the economy and financial markets appear to be holding up very well. There are still many areas struggling to recover, but several data points seem to indicate a surprising resilience during such a challenging time.



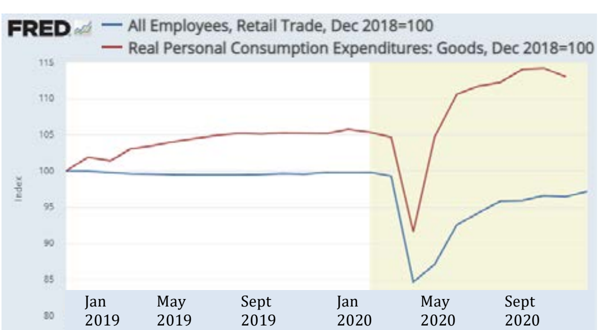
A recession caused by a pandemic or natural disaster generally creates a faster economic cycle. In 2020, unemployment spiked from a near-historic low of 3.5% to almost 15%. However, the number of unemployed per job opening did not jump at nearly the same rate, indicating that most expect to get their job back.



It is common for loan delinquency to increase during a recession. During the financial crisis in 2008, most types of loan delinquencies increased by at least 50% and some doubled. During the pandemic, new delinquent loans went DOWN across all types of loans (auto, mortgage, student, credit card, home equity and other). This is a sign of the effectiveness of stimulus programs.



Record low interest rates fueled a boom in the housing market. Inventory of homes for sale hit levels not seen since the early 2000s. The monthly supply, which is the ratio of houses for sale to houses sold, declined dramatically in 2020.



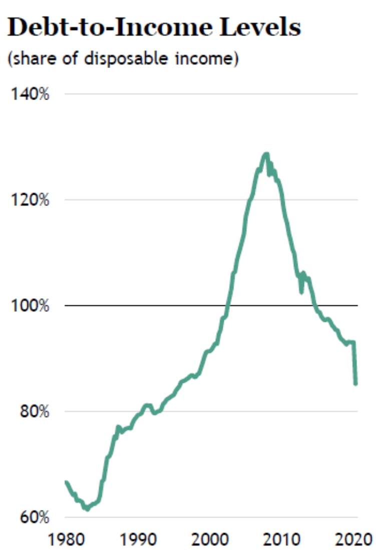
E-commerce drove a swift recovery in goods consumption, but employment in retail sectors continues to lag. Technology companies benefitted from the pandemic, while traditional workers did not. A two-tiered recovery continues, highlighting the difference between Wall Street and Main Street. Despite continued struggles on Main Street, publicly traded stocks remain on a path to recovery.

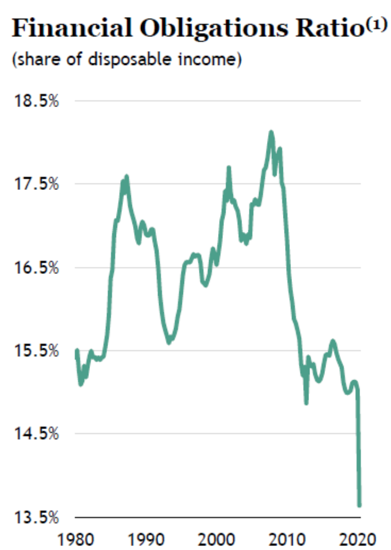
Sources: FRED, New York Federal Reserve, BLS

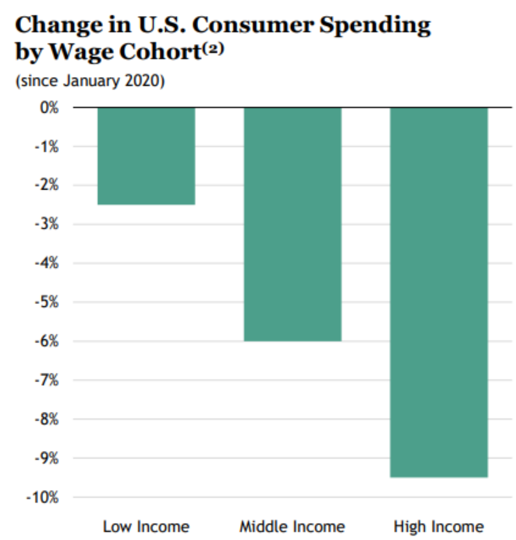
Despite the Recession, Household Debt is in Good Shape

Despite the massive spike in unemployment, a -8% drop in economic output, and severe limits on major sectors of the economy, household debt is in good shape. In a typical recession, debt obligations and delinquencies increase. Total household debt did hit a new high in 2020, but the biggest increase was in mortgage debt due to new and refinanced mortgages at record low interest rates.

When compared to income, many debt measures continue to improve. The financial obligations and debt-to-income ratios are shown below. Debt-to-income levels have been falling since the Financial Crisis in 2008 and continued that trend in 2020. The financial obligations ratio, which is like to a debt service ratio but more comprehensive, is at its lowest level in 40 years. It includes required payments on mortgage and consumer debt as well as other non-discretionary obligations such as automobile lease payments, rental payments on tenant-occupied property, homeowners' insurance, and property tax payments. There are some debt measures that are concerning, such a student loans, but the overall debt burden is improving.





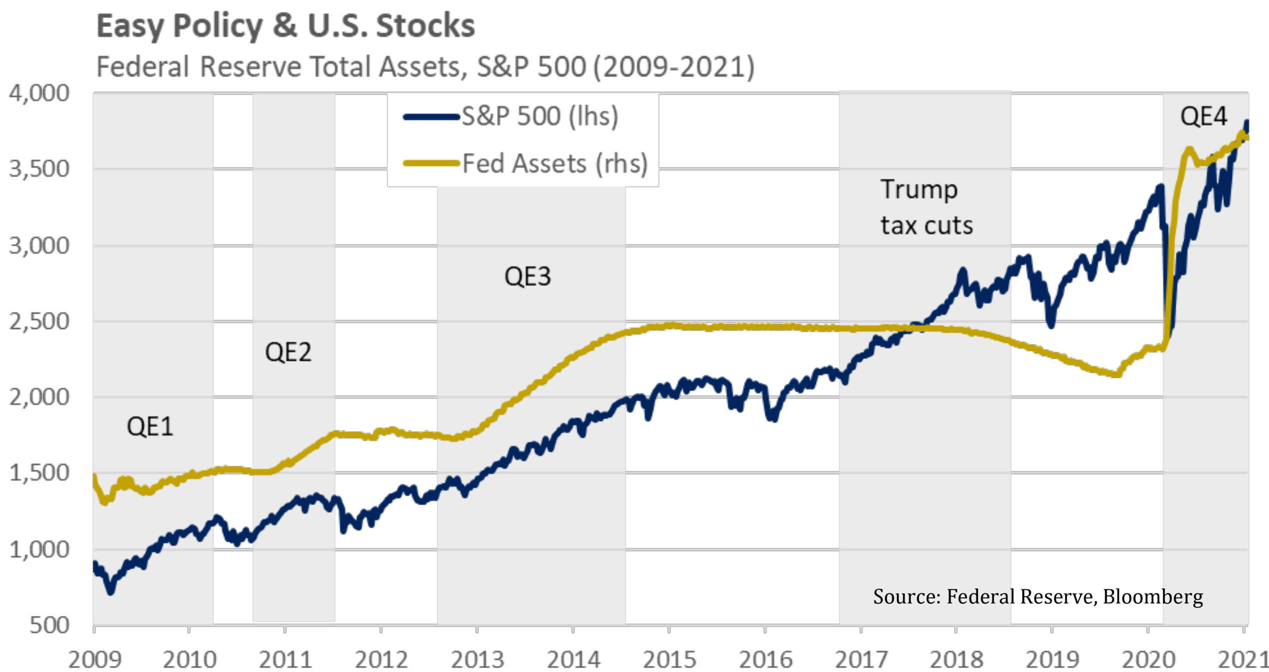


Source: Federal Reserve, Haver Analytics, Blackstone

Due to the pandemic and associated restrictions, consumer spending fell dramatically. An analysis of consumer spending by wage type (see above, right), shows there is a silver lining in how spending was reduced. Those with low incomes were hurt the most by the recession, but their spending did not change much last year (mostly because not much was optional). Those with higher incomes were not threatened much by the recession but were the ones that reduced spending the most – because they had discretionary spending that could (or had to be) cut. As restrictions are lifted, steady progress continues with the vaccine, and worries about the virus fade, there is pent up demand ready to be released.

Easy Policy Should Continue and be Supportive for Stocks

Since the 2008 financial crisis, the Fed has utilized quantitative easing (QE) to support the economy. QE is the buying of securities to infuse money into the economy, encourage lending and stimulate investment. Such an approach seems opaque; however, in times of distress, QE can be a major support to the economy. Interest rates stay low, and many companies (even those that may be on the verge of bankruptcy) can obtain financing at low rates. Tax cuts are another form of easy policy that is stimulative to the economy and stocks.



In 2020, the Fed doubled its holdings in only a few short months and communicated its plan to maintain easy policy for years. The correlation with U.S. stocks should not be overlooked (see chart, above). It is easy to spot the increases in volatility of the stock market. During periods of easy policy and large asset purchases, the stock market rises with low volatility. When the Fed slows or stops buying securities, market returns are lower and corrections in the stock market are more prevalent. The majority of recent stock market corrections occurred during periods without QE or stimulus from tax cuts. There are many factors that influence stock returns, but the correlation to easy policy is strong. In periods with easy policy, U.S. stock returns average 14%. In periods without, U.S. stocks average 3%.

U.S. Stocks During Easy Policy

S&P 500 (2009-2021)

Policy	Days	Annualized Return	Corrections
QE	2576	14%	2
No QE	1855	3%	5

Source: Federal Reserve, Bloomberg

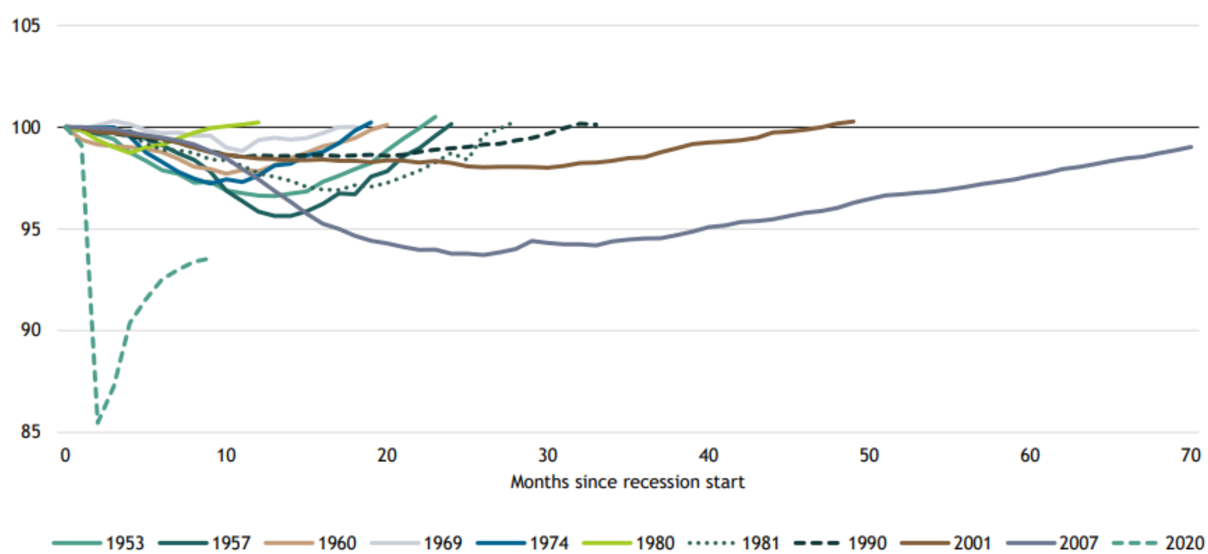
Many Risks Exist that Could Derail the Recovery

While stimulus from the Fed and Congress is an important factor in assessing the outlook for financial markets, many issues remain. Acknowledging that most major drops in the stock market come after unforeseen events, below is a short list of potential risks for the year:

- Optimism is very high. When consumers are confident there is a higher likelihood they will be surprised or disappointed. For this reason, most market turmoil comes on the back of a "feel good" environment.
- Corporate earnings are expected to increase by 38% in 2021. Even though earnings in 2020 were lower than any of the prior three years, expectations may be overly optimistic.
- Stock valuations are very high by historical measure, although bond valuations are probably even more excessive. High stock valuations imply "the future appears to be strong" and thus create more opportunity for disappointment if the future does not meet expectations.
- Many technology companies benefited from the pandemic; however, the gains over the last year may be unsustainable. The top five stocks (Apple, Microsoft, Amazon, Facebook, and Google) represent 21% of the S&P 500, a ratio that exceeds even the highs of the technology bubble in 2000-2001.
- The virus could mutate in such a way as to render current vaccines ineffective.
- There is some legislative risk due to potential changes to personal and corporate tax policy from the Biden administration. A new regulatory focus and changes to international relations could also be disruptive.
- The Fed and Congress overstimulate the economy which causes inflation and interest rates to spike.
- Stimulus could be removed too early in Europe or China.
- In some areas, the economic recovery could take years. After the recessions in 2001 and 2008, gains in employment were stubbornly slow; unemployment took 4 and 6 years to recover, respectively. Financial markets could be assuming an overly optimistic recovery in employment.

U.S. Employment During and After Recessions

(indexed to 100 at respective recession start)



Source: Federal Reserve, Haver Analytics, Blackstone

Final Thoughts

Goodbye 2020! Business conditions are gradually returning to normal, and, when vaccines become more widely distributed, the pace should accelerate as more people return safely to the workforce. Government stimulus around the world has been successful at bridging the gap in the economy so far. Low interest rates are not only friendly to the economy but also provide minimal competition to stocks in terms of expected returns. It is far from a sure thing, but financial markets should continue to respond to these favorable trade winds.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727. To find an electronic copy of this document and other recent commentaries, please visit our website at www.risadvisory.com.

Griff Brock Larry Karen Todd Pam Evan John Megan

Brock E. Hastie
Managing Partner

Karen Chapell
Managing Partner

Todd Kephart
Managing Partner

John Goff
Managing Partner

R. Griffith McDonald
Managing Director

K. Larry Hastie
Managing Director

Pamela Loduca-Massa
Sr. Vice President

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Portfolio Manager

Megan Flynn
Portfolio Manager