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MWM Market Corner: Valuations, Inflation and Apollo 1

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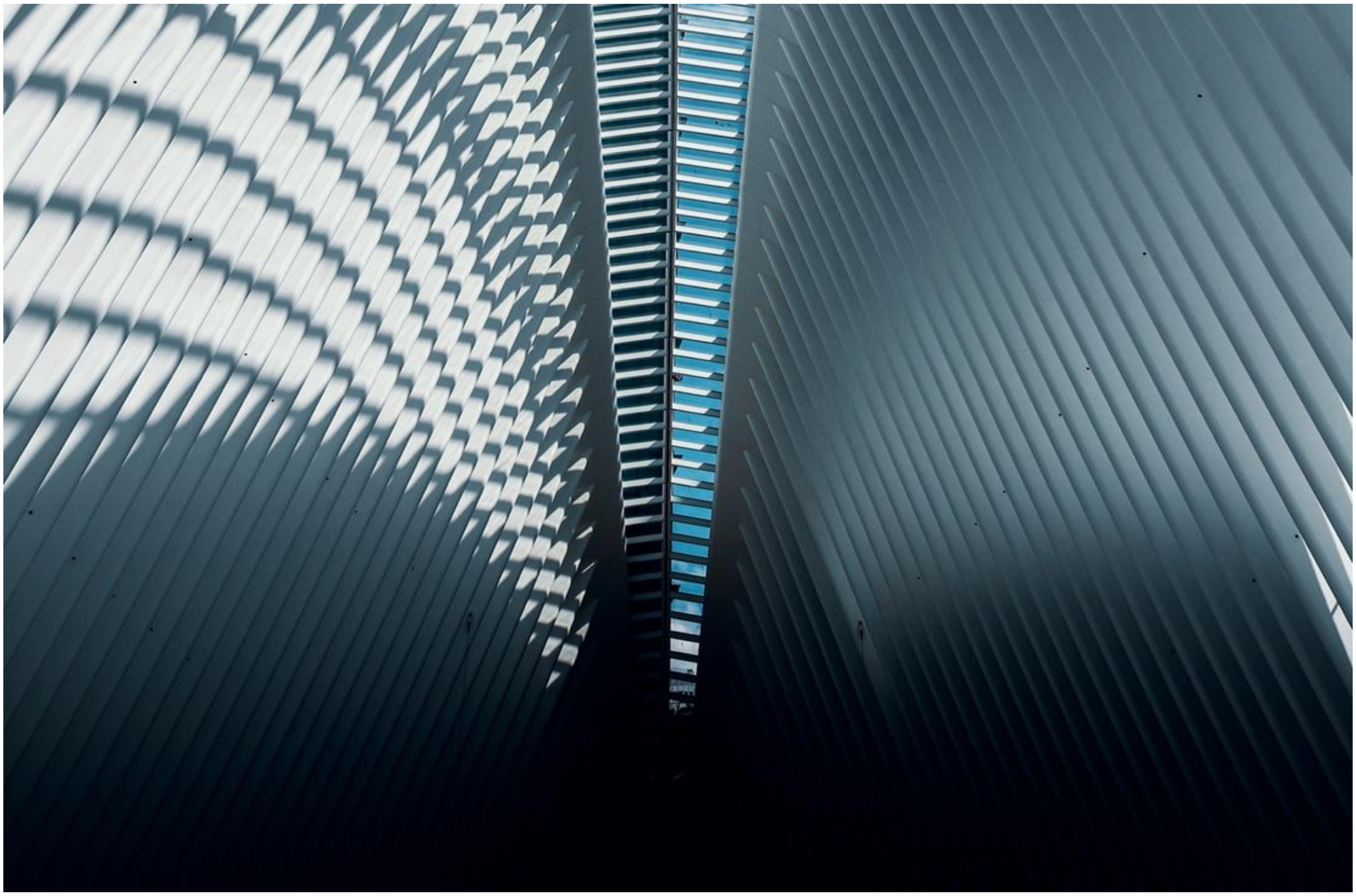

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2020 will almost certainly go into the books as a highly unusual year. It featured a massive pandemic that crushed the global economy, hitting the U.S. and Europe especially hard. Protests and violence punctuated widening political and social divisions in the U.S., and an evident deterioration in already problematic U.S./China relations continued. Lastly, the UK (finally) made its exit from the European Union after years of bitter negotiations.

In that context, a "rear-view mirror" look at the S&P 500 Index's total return of +18.4% for 2020[i] seems absurd. Especially, when you consider the fundamentals: S&P 500 constituent earnings per share declined 15.5% for 2020 (falling to $137.10 versus $163.10 for 2019[ii]), as the government shut down the economy to slow the spread of the pandemic.

Thus, during 2020 we saw a higher "P" and a lower "E" in the P/E ratio of the market, coming from an already elevated level in 2019.[iii] Essentially, the market looks expensive. Notably, we are not using the term "overpriced" because that might indicate an imminent pullback, and we do not think we are (or most market participants are) prescient enough to make that kind of call consistently. Expensive markets can stay expensive or even get more expensive for a very extended period, especially with factors helping to drive that persistence.

Indeed, there are several factors favoring market prices staying stable or possibly moving higher. The economy and corporate earnings should see continued recovery as vaccines reach sufficient distribution to reopen all businesses. This recovery appears to be baked into expectations with consensus looking for S&P earnings for 2021 back in line with 2019 in the mid-$160 range.[iv] Additionally, and perhaps more importantly, is the unprecedented level of federal spending with roughly $5 trillion appropriated between the 2020 stimulus packages and the package proposed by President Biden. The federal spending is being done in tandem with massive asset purchases by the largest central banks globally. These massive asset purchases are best illustrated by the ballooning balance sheet of the Federal Reserve relative to U.S. GDP, as it purchases bonds to support market stability and lower interest rates.

The WWII market and policy backdrop may provide the analog to this powerful run amid the awful global experience during the pandemic. During the war, the government ran record deficits to finance the military, while the Fed and the Treasury set interest rates at historically low levels on both the short and long end of the yield curve. Today we are using different mechanisms, but the Federal Reserve's promise to keep short-term rates at zero and buy bonds until better employment and higher inflation are achieved is serving a similar purpose. Then, there is the market behavior. "The U.S. had little military success in the first months after entering the war. All knew it was going to be a dauntingly long, uncertain, and painful ordeal. Yet as soon as the U.S. had its first military success in the Pacific in 1942, the market bottomed decisively and ran almost straight up- even as the bulk of the war, casualties, and expenses lay ahead."[v] Sound familiar?

We enter 2021 optimistic on fundamentals improving (the "E") but cautious on valuations (the "P"). That is why we continue to carry higher than expected cash/hedging levels in all three MWM Equity Strategies. But since the high valuations may persist for a while during central bank largess, we continue to stay focused on our core competency of looking for quality companies with excellent business moats, strong balance sheets, and good long term growth prospects. Essentially "margin for error," as we believe this is the best way to drive strong performance with managed risk, whether conditions are stormy or fair.

Given the risk for a substantial market pullback seems less likely while the Federal Reserve is printing money and buying assets, the real threat to the system, in our view, appears to be when the Federal Reserve changes course on that strategy. Such a change is likely to be driven by the direction and velocity of inflation.

Why inflation? The Fed explicitly targets some inflation to keep the economy working smoothly, more specifically around 2% using the core Personal Consumption Expenditure ("PCE") measure.[vi] Yet, inflation has been persistently below this target for most periods since 1995. Having too low inflation is like an athlete starving for oxygen: things are sluggish and not quite performing up to potential. We saw this in late 2019, where we hit 3.5% unemployment, but inflation remained persistently low. The economy was good, but probably not as good as one might have expected given the lowest unemployment in roughly 50 years.

The flipside also holds true: too much inflation is highly dangerous, just like too much oxygen. A generation of Americans grew up seeing the successes of the Apollo space program, but most probably do not remember Apollo 1. That is because it is the mission that never happened. Apollo 1 used a 100% oxygen atmosphere in the capsule, which somehow caught fire and immediately immolated everything inside, tragically killing the three astronauts on board before anything could be done to save them.

So, while the Federal Reserve has been clear on maintaining low rates until employment recovers and inflation is clearly above long-term targets, (somewhere North of 2% on the PCE Price Index), the Federal Reserve will inevitably have to start reassessing when to raise rates to avoid the problem of too much inflation in the economy. That is a triple threat to equity markets because once we hit that point; 1) the Fed stops buying assets; 2) the resulting higher rates will almost certainly slow the economy again and 3) higher rates imply a higher discount rate for equity markets, which in turn means a lower valuation.

We are aware that a call for higher inflation is early (to be kind), or perhaps more like the boy who cried wolf. Nevertheless, our "margin for error" mindset drives us to start thinking about the sectors, companies, and specific investments we may want to entertain in a higher inflationary environment. While it is more likely than not that the valuations of growth assets will pull back somewhat, due to higher inflation, we still believe that companies who have demonstrated an ability to consistently grow earnings and cash flow, maintain some level of pricing power, and continue to take market share in their industries, will prove to be winners in the next year and beyond.

i Standard & Poor's Factsheet S&P 500® - S&P Dow Jones Indices (spglobal.com)

iiFactset Microsoft Word - Earnings_Insight_011521.docx (factset.com)

iiiBloomberg trailing P/E ratio as of 12/31/2019 versus average of 1995-2019

ivFactset Microsoft Word - Earnings_Insight_011521.docx (factset.com)

v 2021 Markets: Investors See similarities to 2010 Recovery and 1999 Risk Binge (CNBC.com)

vi Why the Fed Targets a 2 Percent Inflation Rate | St. Louis Fed

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