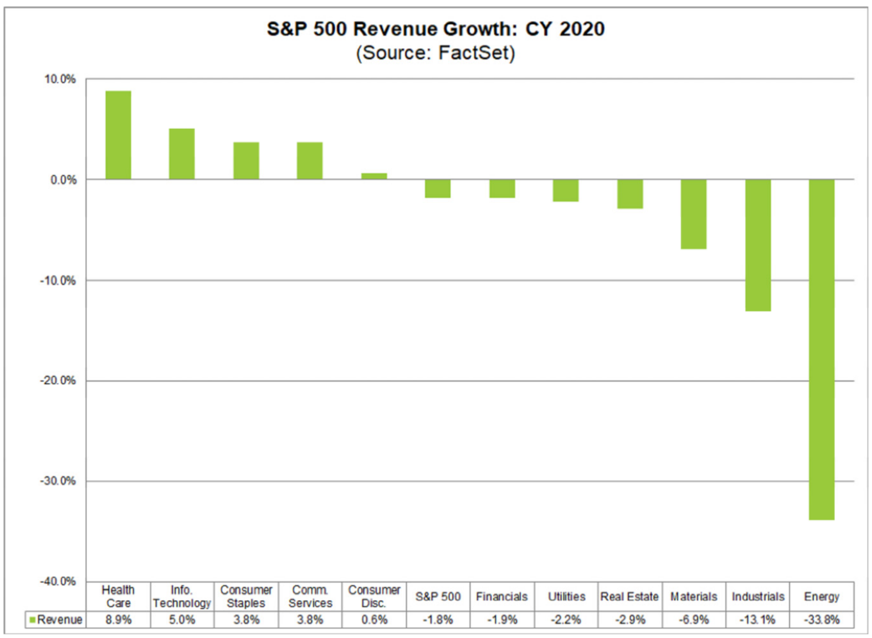
Notes From the North: Market Outlook

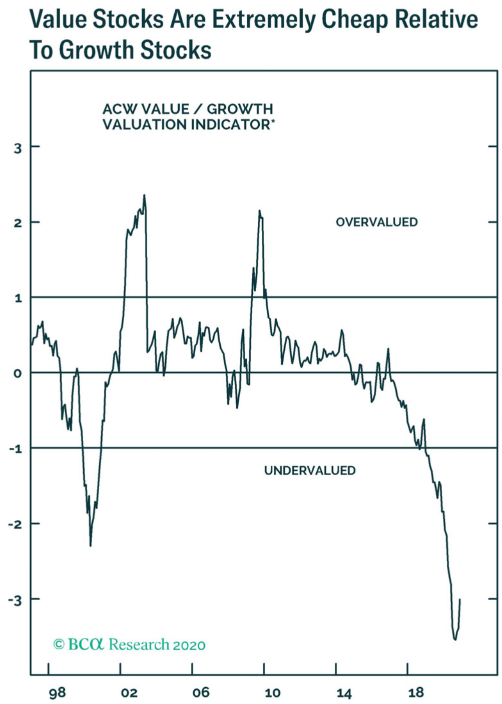
December, 2020

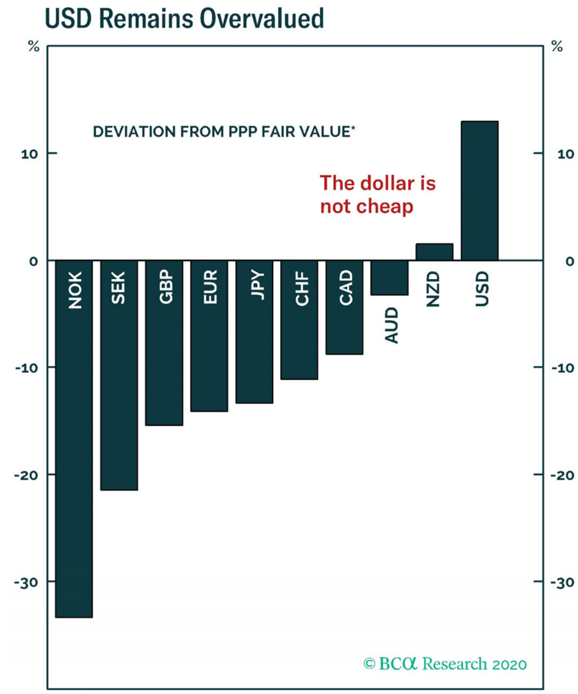
Shutdowns related to the Covid-19 crisis will cause profits for the S&P 500 to fall an estimated 13.7% for the year and some small businesses will probably never reopen. The Chart below shows the wide range of the impact of the pandemic on revenues of different sectors in the S&P 500 Index. Energy experienced a revenue shock, while industrials and materials saw significant declines. Healthcare, consumer staples, and technology and communication services were able to grow revenues in the pandemic environment, and consumer discretionary spending was flat, likely in large part due to the fiscal stimulus programs. The recent spike up in Covid cases suggests that the first quarter of 2021 could also be a down quarter, but the rollout of vaccines promises much better revenue prospects for 2021 as a whole. Compared to 2020, most sectors of the economy will have easy “comps” (comparisons from one year to the next).



While the market is always looking forward, its strength in the face of 2020’s wide ranging economic difficulty has been remarkable. There is some concern that the recent strength in the market for IPO’s (initial public offerings), which are often companies that are still unprofitable, is indicative of an increasingly speculative environment. Citicorp's sentiment model shows we are in what they call the “Euphoria” mode. Euphoria feels good, but the best buying opportunities present themselves when we are in the “Panic” mode. The option market's put to call ratio also signals unusual optimism. Corporate insiders have been heavy net sellers. Note, however, that in recent weeks the market’s breadth has broadened and it is no longer just the FAANGM stocks driving positive trends. Is this another head fake or a sustainable trend?

Overall, what might investors expect in 2021? Peter Berezin, chief global strategist at BCA, thinks stocks are overbought and subject to a short-term correction but also that they will outperform bonds over the next 12 months. The equity risk premium, i.e. the relative appeal of stocks versus bonds, is quite high. The key factor in this measure is the historically low yield on bonds. We are interested in Berezin’s view that last year's relative losers are likely to be next year's winners. In his view, international stocks are expected to outperform U.S. stocks. Small U.S. stocks should do better than large ones. Banks will outperform technology stocks and value stocks will do better than growth





stocks. The chart above, left, shows that value stocks are extraordinarily cheap versus growth stocks.

BCA expects the economy to strengthen in 2021 once we get past the first quarter. They further expect inflation to remain contained for the next 2-3 years, after which it may rise sharply. Once investors begin to anticipate that trend, inflation-protected bonds should do better than traditional bonds. Stronger growth and a widening U.S. trade deficit will reduce the value of the dollar. The chart on the right, above, suggests that the dollar is currently 13% overvalued. As investors seek a hedge against inflation and a falling dollar, commodity prices (including gold) are likely to rise. An area much maligned right now is energy. BCA's commodity strategists expect the price of Brent crude oil to exceed market expectations by $14 per barrel in 2021.

Strategists at JP Morgan have a similar outlook. With supportive monetary policy throughout 2021, the global recovery is likely to broaden out and strengthen. This would favor cyclical U.S. stocks over growth and defensive issues. Based on forward price/earnings multiples, JP Morgan finds foreign stocks to be trading at a 23% discount to U.S. stocks. Over the last 20 years, the discount has averaged 13%. Foreign stocks provide an average dividend yield of 2.8% versus 1.7% for the S&P 500. The expected depreciation of the dollar should provide an additional currency boost to total returns from foreign stocks. JP Morgan suggests an overweight in U.S. small caps, emerging markets, European and Japanese equities. If you were fortunate enough to have owned nothing but the FAANGM stocks over the last ten years, it looks like this might be a very good time to take another look at diversification.

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