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Assessing Our Thoughts and Adjusting For 2021

We continue to share our thoughts and prayers for individuals, family, friends, and associates who have been afflicted by the current virus.

In 2020 the S&P 500 Index had a total return of 18.40% for the year and 12.15% for the fourth quarter of 2020. The MSCI EAFE (USD) Net Index returned 7.82% for the year and 16.05% for the fourth quarter of 2020. The MSCI World (USD) Net Index returned 15.90% for the year and 13.96% for the fourth quarter in 2020. Approximately 90% of stocks in the S&P 500 Index are in an uptrend and reflective of how broad this advance has been. U.S. equities continued to outperform Europe and Japan in 21 out of the last 28 quarters. Since January 2010, U.S. equities generated total returns of 319% versus 124% for Japan, 87% for Europe, and 73% for Emerging Markets.[1] In Japan, if financials are stripped out of its returns, the Japanese equity markets have had a decent past decade, primarily as an efficient export producer with companies such as Toyota, Sony, and Nintendo. For Europe, its lack of an army, space program, or a serious technology sector has impeded its economic growth and innovation. The continent has vast differences between north and south, due to the currency, as well as east and west, due to immigration policies. After Brexit, its financial center will be outside its immediate borders. The Emerging Markets are often based on the Material sector and indebtedness. Because their debt is usually priced in U.S. dollars, their markets can be more volatile although individual countries vary significantly, particularly China.[2]

The global economy appears poised to recover in the second quarter of 2021 from a tremendous shock a year earlier. Because of the monetary and fiscal stimulus in the developed world, the investment outlook for 2021 and beyond looks more promising. Governments combatted the physical and economic fallout from Covid-19 with large budget deficits that have added up to approximately $11 trillion in 2020, according to McKinsey & Co.[3] Developed countries are projected to have vaccine capacity of 1.5 to 2.0 times their vulnerable populations by the second quarter of 2021, which is expected to help restore economic growth. To pay for these interventions, central banks plunged back into printing money and buying corporate as well as government debt. Interest rates hit new record lows and will remain low as the central banks wait to see major inflation before rates rise. Governments also offered credit as a lifeline during the pandemic, and businesses grabbed it. The Bank for International Settlements calculates that nonfinancial companies borrowed a net $3.36 trillion in the first half of 2020. With revenues plunging in many industries because of lockdowns, consumer caution, and corporate balance sheet losses, corporate solvency has become a worry. Because governments are now spending more than they are collecting in revenues, there is already a debate about how long such spending can continue, and when taxpayers will have to start paying the bill. Some experts see a danger in offering too much support indiscriminately over who receives aid. "Zombie firms" may survive in a free market supported by the government's free money, making the whole economy less productive. The Leuthold Group calculates approximately 15% of large U.S. companies are in some form of Zombification.[4]

The pandemic is the biggest economic event in decades, but it has not had the same impact everywhere. Covid-19 continues to widen a wealth gap as it decimates some individuals working for industries with face-to-face contact with customers, severely affecting low paying service workers, retail, restaurants, travel, events, and hotels. About 20 million households in the U.S. are suffering, as many businesses began to fail in 2020.[5] The damage does not end there as households and businesses have landlords that are not getting paid. Goldman Sachs produces a monthly Current Activity Indicator to assess the economy's short-term condition. Unlike gross domestic product, which has rebounded since dropping in the spring of 2020, it has not come close to recovery in December of 2020 and has become negative again for the first time since April of 2020.[6] In the fall of 2020 credit card usage, total payroll, and consumer confidence were all below the February 2020 levels in the Conference Board's latest survey.[7]

In contrast to those hit the hardest economically by Covid-19, part of the U.S. population has an increased personal savings rate up 302% in the second quarter of 2020 and 142% in the third quarter of 2020 compared to 2019.[8] In fact, those individuals who are able to work from home, spend less, invest in the equity market, and hold hard assets such as real estate have increased their net worth during this time. The market value of household real estate as a percentage of home mortgages has reached the highest levels since the fourth quarter of 1990.[9] Most of the savings has worked its way into the short-term money supply, where households are holding cash in checking and savings accounts as a precautionary move. The U.S. is experiencing an increasingly bifurcated economy where the wealthy are becoming richer while the lower-income population is falling further behind. As a response, the December 2020 relief package directs $286 billion to workers and households of which $120 billion is in unemployment insurance and $166 billion is in economic impact payments. Additionally, the package provides one-time $600 payments to adults and children in January for those with incomes under $75,000 or $1200 for married couples filing jointly making up to $150,000 per year as well as $600 payment for each dependent child and provides an extra $300 in benefits per week to the unemployed. All of these measures imply that a family of four can receive up to $2,400 in direct one-time payments.[10]

Many small companies are struggling to survive while many large companies are seeing strong growth in 2020.[11] This is an odd situation where something from nature, the virus, is generating unnaturally negative economic outcomes for small businesses in some sectors while simultaneously some large companies are gaining sizable revenues from the same pandemic. At the outset of the pandemic, nonfinancial businesses were in great shape with $1.4 trillion of cash. These same companies had already received a huge tax reduction in 2017 with the Tax Cut and Jobs Act, and in 2020 the CARES Act empowered the Federal Reserve to provide up to $5 trillion in subsidized loans for large businesses. The increased scale of large companies eventually creates monopoly pricing power for the giants and suppresses start-ups, mobility, and innovation among the smaller firms. The largest companies ultimately may be able to underprice or buy out smaller competitors.[12]

Since 2018, six stocks (Facebook, Apple, Amazon, Netflix, Google, and Microsoft) constitute almost 25% of the S&P 500 Index market capitalization and have returned over 130% compared to a mere 35% gain for the S&P 500 Index. Over the past three years, almost 1.1. billion shares have been bought back by the FAANGM companies keeping a lid on their supply and helping stock prices rise further.[13] The combination of possible increased antitrust enforcement, high valuations, and increased leverage and trading caused by financial innovations such as Robinhood are signs that mega-cap technology stocks may be overvalued although their valuations are still below 1999 levels. While these factors are a concern, easy monetary policy and Covid-19 related winning products/services elevate their profitability in the near term. The valuation of equities and other assets are inextricably linked. When interest rates are low, future cash flows are discounted at lower rates, which means that multiples tend to be higher. There is a pervasive impact of zero interest rates on the investment landscape.[14]

While the virus originally emerged in China, its aggressive response seems to have contained the virus and its own economic damage. In 2020 China's 6.0% year over year real GDP growth rate fell less and is expected to recover more than either the U.S.'s 2.0% GDP growth rate or Europe's 1.2% GDP growth rate for the same period. This will have a long ranging effect for the world. While China is an emerging market for equity investors, it is usually considered a developed market for fixed income investors. Compared to other liquid global bond markets, China compares favorably with respect to current yield and volatility. Chinese net external debt to GDP is at just 15% while the U.S. is at 95% of GDP.[15] The People's Bank of China wants to establish a new parallel operating system to challenge the U.S. dollar with a digital renminbi, focusing on fintech firms such as Alipay and Wepay, which help Chinese consumers and other emerging market consumers with payments and cash transfers that bypass SWIFT or U.S. control.[16] U.S. and China trade and military risks are at their highest level in years. At the same time that their trade and military conflicts are intensifying, U.S. companies are doing almost the same amount of business in China as Chinese companies are doing in the U.S. but through local subsidiary sales rather than exports.[17]

Martin Investment Management, LLC continues to view fundamental analysis as its primary means to judge the quality and health of a company in which we invest. Our focus is to understand a company's profitability (Is a company making money from its business?), its liquidity (Is the company able to operate without borrowing?), and its capital structure (Is the company structured to reward investors?). We believe that investment risk is reduced as profitability increases, debt decreases, and capital is allocated wisely. We hold that company fundamentals, which are backward looking, have a predictive value in providing information that is critical to making an investment decision to buy, sell or hold a company's stock. While fast momentum may thrust an investment to lofty heights, without solid fundamentals the investment becomes a pure speculative play.

Wishes for a bright and energetic 2021!

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