REGISTERED INVESTMENT ADVISOR

DENEWILER

Capital Management Inc.
1600 Stout Street
Suite 1690
Denver, CO 80202

303.832.7475 / 888.808.7475
Fax 303.832.7484
greg@growmydollar.com
www.growmydollar.com

Jan. 25, 2021

OBSERVATIONS ON THE MARKET

No. 355

By Greg Denewiler, CFA

The more things change, the more they stay the same. The beginning of 2021 leaves us with the benefits of 2020 – yes, 2020 had some positives. The Fed's aggressive stance of growing M2 money supply (money in checking accounts and money market accounts) by 27% last year carries into 2021. This is the largest increase since the 1870's, and it shows no signs of reversing yet. This has kept corporate bond rates low which fueled a stock market rally. It probably saved us from a much more severe recession. Last year ended better (financial asset prices) than anyone expected. Can this year be as good?

There are several factors that will affect how 2021 ends, as is always the case. The growth of money supply continues to be the elephant in the room. Janet Yellen, our new Treasury Secretary, has stated that she is committed to the same strategy. When money is plentiful and cheap, it is hard to see any substantial declines. Staying on this concept, it gets easy to connect the dots for a positive year for stock prices when you also consider that saving rates have a lot of run to fall. The last reported number from the Federal Reserve shows the rate is still at 12%. If it falls back to the mid-single digits which is the decade average, the economy will get a substantial boost from the consumer. If the second half of the year allows us to start moving around more, consumers are going to spend more money. This is confirmed by Standard and Poor's who estimates corporate earnings will rebound this year to $165 from $120 in 2020. If the economy rebounds, consumer confidence almost always follows. Then you have momentum feeding on itself. Can it really be that simple? The real question is, are expectations of an improving economy already reflected in prices? The short answer is yes. Corporate earnings are expected to end the year at $165. This leaves us at 23 times the consensus earnings estimate which is above the long-term average of about 17 times earnings. However, with the current low interest rate environment, not unreasonable. Will interest rates stay this low?

The Fed does control short-term rates and has indicted they have no interest in changing course anytime soon. Longer-term interest rates have historically been in the hands of the marketplace. However, recently the Fed has been in the market buying longer term corporate bonds. This is most evident with CCC corporate bonds. This sector now yields 7.7%, a near record low, leaving some investors to think it is attractive in a world of .1% CD's. Do you still want to buy them if you know the average annual default rate is 26%? It gets worse in a recession, because then up to 50% of these companies default. Investors are not playing the long game here, because long-term this market is a train wreck waiting to happen. The same thing could have been said last year even though the CCC market has continued to perform well. Timing is a very inexact science. Memories are short when times are good, investors fail to remember that if a security defaults, there is no recovery.

Every year Barron's, the weekly financial paper, interviews 10 experts in the financial world and publishes their picks for the year. If you weighted each pick equally last year, four of the experts beat the market and six did not. Three of the six had a flat or down year. If you think you have any special forecasting ability, think again. What made last year challenging for prognosticators was that just a handful of companies created most of the return in the market.

Another head wind for this year will be higher corporate tax rates. It appears they are going higher, and that does directly impact profits. This is not to say they should or should not, but that it does affect the value of a company when it earns less. There is also much debate around the political impact the large tech companies may face, potentially limiting their growth going forward. This year may be a tossup, but if your time horizon is 10 years, the choice is easier. Buy a 10-year Treasury note at 1.04%, or by a dividend index that yields 2.5%? This is the time to steer towards the middle of the road and focus on the consistent long-term growth of the economy. It most likely will grow this year. If you would have purchased a 3.4% 10-year Treasury note in January 2011, would you have earned 3.4% on your bond when it matured this month? Find out next month why the answer is no.