Investment Commentary

HANOVER ADVISORS

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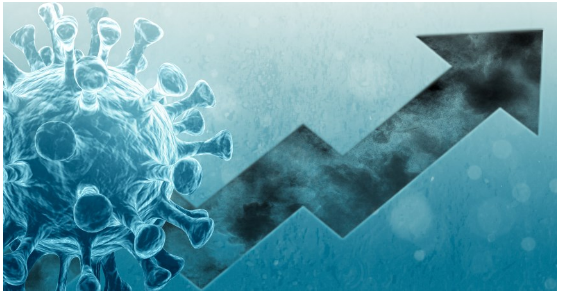
The Year Ahead: Optimism Despite Uncertainty



Despite a severe economic downturn caused by the coronavirus and ensuing shutdown, the U.S. economy staged an impressive comeback in the second half of 2020. At the end of the year, the economy was just 2.5% smaller than at the end of 2019, an impressive feat few would have predicted during the initial downturn. The stock market has seen a similarly impressive rebound from the early days of the pandemic. Optimism about the vaccine rollout, economic reopening, and expectations for more stimulus have driven the market higher, and the S&P 500 has seen 10 record closes in 2021.

As economic restrictions lift, consumers return to their usual business, and Americans get back to work, we expect economic growth in the near term to remain robust, albeit in an uneven and varied way across different regions and industries. There are growing concerns that speculation is driving the stock market and that the rally may soon run out of road. Additionally, there are fears that the accommodating fiscal and monetary policy we have seen since the pandemic are setting up a spike in inflation and may impede long-term growth. Despite these concerns, we remain cautiously optimistic. A major correction remains unlikely without an increase in interest rates, and so long as the economy does not overheat, rates are likely to remain low. That said, uncertainty does remain, and here are a few of the important issues that investors should be aware of in the coming year.

A Bubble Waiting to Burst?

Some investors look at the stock market’s post-pandemic rally and see more than a rebound, they see a bubble in the making. Valuations that far outpace earnings, frenzied issuances, and speculative retail investors looking to get rich with GameStop and Bitcoin recall the fervor of previous bubbles, such as the 2000s-era dotcom boom. Pessimistic analysts are forecasting a double-digit correction on the horizon.

While we are of the mind that such worries are overblown, there is some cause for concern.

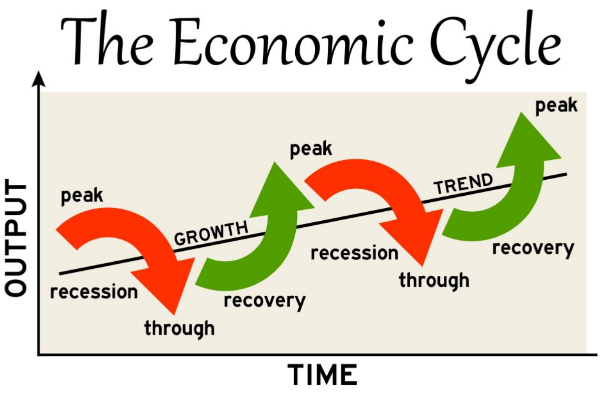
The "Buffett Indicator," a ratio that compares total stock market capitalization to GDP, reached an all-time high last year, topping the previous record set in 2000. Last year there were 480 initial public offerings, topping the 406 offered in 2000. Perhaps the most notable signal is the Shiller price-to-earnings (P/E) ratio, which provides a broader overview than a standard P/E ratio by looking at earnings, adjusted for inflation, over a 10-year period instead of just one. The Shiller P/E for the S&P 500 has historically averaged 16.78. Recently, it has been as high as 35. This is only the fifth time that the Shiller P/E has climbed above 30. Two of the previous times were in the run-up to the Great Depression and the dotcom bubble, and the other two preceded declines of 20% and 34% in the S&P 500.

All of this suggests that there will likely be a large correction eventually. The key word to keep in mind, however, is "eventually." Corrections and bear markets are an inevitability, and they often come on unexpectedly. Attempts to time them are almost always a losing game, but there is reason to doubt the bears who think we are on the precipice of a major crash.

For one, despite the soaring equity prices and headlines about speculation, the market as a whole remains cautious. The Vix volatility index, sometimes called the "fear index," remains elevated above its historical average of 20. At the time of writing, the Vix read 23, much higher than the 14 it read a year prior. Low interest rates are also a sign of risk-aversion on the part of investors. Furthermore, the Federal Reserve's accommodating attitude and commitment to keeping rates near zero make a major correction less likely. Barring a nearly unimaginable pivot by the Fed away from their policies, a massive surge in inflation that roils the bond market, or a dramatic economic downturn, a major downturn is unlikely.

Upswings and Downturns

The primary reason that a major correction is unlikely is that the broader economic trends do not support it. According to the Economic Cycle Research Institute (ECRI), the economy is still on the upswing of the growth cycle. ECRI looks at leading economic indicators in an effort to chart larger macroeconomic cycles. This allows them to forecast recessions and recoveries, and to determine the shift from accelerating growth to decelerating growth. They have a strong track record. Last April, in the early days of the pandemic, their data signaled that the recession was already over, and the recovery had begun. Many economists thought the downturn would drag on for much longer, but history proved ECRI correct.



While we remain in a growth cycle upturn, the risk of a major correction remains low. The market remains event driven, and things like the coronavirus, political debates around stimulus, or an increase in inflation could lead to volatility or a market correction. However, so long as we remain in an upturn, the risk of a major double-digit correction remains diminished. The hitch, of course, is that we will not remain in an upturn forever. ECRI does not expect the cycle to turn in the immediate future but does anticipate the cycle reaching a peak later in the year, after which growth will decelerate and the markets will be more vulnerable.

It should be pointed out, however, that just as being in an upturn does not make a major correction impossible, being in a downturn does not make one a certainty. It simply means that investors should be aware there is additional risk in the market and adjust their portfolios accordingly. During a growth cycle downturn, investors should avoid being overweighted with stocks and reassess the level of risk they are comfortable with.

Is the Fed Feeding Inflation?

The Fed's commitment to rock-bottom interest rates and purchases of notes and bonds did so much last year to stabilize the financial markets and ensure liquidity. Now, as the economy recovers, there is concern that they are leading to a spike in inflation. The excess supply of money means that too much money is chasing a fixed supply of assets, resulting in rising prices for not just equities, but commodities and real estate, diminishing the buying power of the dollar. We are already seeing this result in higher prices for consumers. Year-over-year increases in prices for food consumed at home have topped 3.5% every month since last April. Some of this is due to increased demand, as people are eating at home more during the pandemic, but some of it is due to inflationary pressures on commodities like sugar and wheat. Additional stimulus coming from congress could further fuel inflationary pressures and the Fed may be facing an overheating economy in the second half of the year.

At some point, the Fed will need to begin tapering off their bond purchases, but the timing of such an action could lead to volatility in the bond market. The Fed has signaled that the unemployment rate will determine the timing, but with some analysts predicting that unemployment could fall below 5% by the end of the year, the Fed may move sooner rather than later.

The bond market may be already showing the early signs of mounting inflationary pressure. The yield curve between the 2-year and 10-year Treasury notes is the steepest it has been since 2017. A steep yield curve is generally seen as a positive sign for the economy but may also signal inflation. A separate metric of inflation expectations in the Treasury market, the 5-year breakeven inflation rate, recently rose to 2.3, the highest level since 2013. This means that the market expects inflation over the next five years to average 2.3%. This is higher than in recent years, but hardly runaway inflation.

The Fed has also stated that it will allow inflation to run above their standard 2% target, so 2.3% would not likely cause them to reconsider their policies and raise interest rates. There may well be a sharp spike in inflation, but it will likely be short-lived. Fears about a return to a prolonged inflationary period like the 1970s strike us as hyperbolic. In fact, the spike in inflation may be more accurately referred to as reflation, which is when prices and economic output are both increasing, and the economy is returning to a baseline norm after a period of low inflation.

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- We invite all clients to schedule an online portfolio review. Because we respect your time, we offer three different meeting formats that vary in length and level of specificity. For more information or to schedule a meeting, please contact us.

- Since the start of the pandemic, Hanover employees have been working remotely, conducting meetings online or over the phone. However, we would like to remind our clients that we still have our main office in Greenville, SC and conference facilities in Atlanta, GA. We are happy to hold in-person meetings at either of these locations or any other that works for you.

- The Hanover Advisors website can be accessed at hanoveradvisorsinc.com. There you will find our latest newsletter and investment commentary, articles, our blog, and videos. You can also learn more about our services, access both the Black Diamond performance reporting system and your Pershing brokerage account(s).

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