

Review & Outlook

FOURTH QUARTER 2020



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Review and Outlook

The stock market increased nicely in the fourth quarter of 2020, despite uncertainty around the election, increasing COVID infection rates, and delays in passing another stimulus bill. Small cap stocks outperformed large cap stocks for the first time in quite a while, with growth-oriented, small cap stocks enjoying strong returns since summer, making that class the best performer for the year.

One reason small cap stocks have done well of late is that many investors anticipate stronger economic activity with a vaccine becoming available in 2021, and they are looking to benefit from that growth when the economy reopens. With historically low interest rates, stocks are their investment of choice. As more money flows into stocks, investors are putting more and more money into big tech companies, while also looking for new opportunities. As such, some smaller companies that have been overlooked for a while received more attention this quarter.

The flow of money into the stock market has also pushed some stock prices to worrisome levels. Tesla comes to mind, with its stock price at 1,150 times its earnings. For comparison, the average company in the S&P 500 Index currently has a price that is roughly 37 times its latest reported earnings. But Tesla is in a different universe, and its valuation should give people pause.

The average P/E (price-to-earnings ratio) of 37 is very high by historical standards, as the long-term average is closer to 15. The only times it has been higher was at the start of the financial crisis in 2009, and during the “dot com” bubble of 2001. But investors have a reason to pay more for stocks right now. Bonds, a key alternative to stocks, have historically

low yields, and corporate earnings are expected to increase in the coming year, which helps make stocks attractive.

Most economists are calling for modest growth in 2021, however, the first quarter could be rough. The National Bureau of Economic Research (NBER) has not declared an end to the current recession, and though it never really materialized for some people, it is very real and ongoing for many others. It has not been like most recessions of the past; this one has hit service sector jobs the hardest, with the largest impacts falling on women and communities of color.

There is some debate among members of the NBER about whether a dip in the coming months would be a new recession, or part of the recession that started last February.

Holiday spending in 2020 was running slightly ahead of spending in 2019, with obvious increases in online shopping. Spending will slow, as

always, in the start of the year, and we can only hope that infection rates and associated challenges slow as well. If not, we could see GDP fall in the first quarter of 2021. We expect GDP will be rather stagnant, with no dip in Q1, followed by reasonable growth as more and more people receive the vaccine.

We believe the markets will look past the near-term turmoil, knowing that a vaccine has been approved and corporate earnings will improve in the summer and fall. Though we still expect volatility through the winter, we think the general trend will be positive going into spring. One reason we have that view is the possibility of an infrastructure investment package coming out of Washington DC.

In November, we started increasing our holdings of smaller cap stocks, with an eye towards that infrastructure package.

Index Performance Data
Total Return as of 12/31/2020

Indices ¹	Q4 2020	Trailing 12 Months
CRSP U.S. Total Stock Market Index	14.70%	20.90%
MSCI Global ex-U.S. Total Stock Market Index	14.79%	16.75%
Bloomberg Barclays U.S. Aggregate Bond Index	0.67%	7.48%

We continued to rebalance and reduce our cash buffer through the quarter as it became clear that vaccines with high efficacy would be available in 2021, more stimulus was likely, and the Federal Reserve was going to continue to keep interest rates low for an extended period of time.

In Focus

Many of the biggest headlines in economics and finance right now include some reference to the fact that interest rates are at historic lows. Rates today present challenges for savers and people living on fixed incomes, as well as new opportunities for borrowers.

You can buy a 2-year Treasury Note, and they will pay you 0.13 percent in return. That's not much better than putting your money in a jar and keeping it at home. 10-Year Treasuries are currently paying a little less than one percent per year. That's not a lot of return to tie up your money for a decade.

It is easy for people to see how low interest rates tie into discussions about housing prices; lower mortgage rates make it easier to afford a more expensive house. But it is also true, and not discussed as often, that low interest rates help firms survive when maybe they should not.

Investopedia defines a “zombie firm” as one that earns just enough money to service its debt, but is unable to pay other obligations. They barely scrape by when it comes to covering overhead (wages, rent, and debt), and they have no additional capital to invest to spur growth. As interest rates have steadily declined over the past few decades, more and more firms have been able to refinance their debt, surviving only because they reduce their debt payments, not because they've become profitable or more successful.

These zombie firms are not just obscure companies you've never heard of, and many were in trouble prior to COVID. Macy's, for example, can barely service its debt. They are

surviving by refinancing, and cannot even cover their interest expenses at the moment.

Bloomberg estimates that 200 firms have joined the ranks of the living dead since the start of the pandemic. Those firms have added almost \$1 trillion in debt to their balance sheets, bringing their total obligations to almost \$2 trillion. That's higher than the roughly \$1.6 trillion owed at the peak of the financial crisis of 2008. Ultimately, it is not clear how much we should worry about zombie firms. Some of them are growing firms that aren't yet profitable, some of them are quality businesses languishing in the midst of the pandemic. But some represent business models that should be allowed to fail.

JC Penny was a zombie that fell into bankruptcy, like Sears and Toys-R-Us. AMC Theatres was barely alive prior to the pandemic, failing to cover its interest payments several times over the past few years, and it, too, may be headed for bankruptcy. Macy's may follow. But the path to bankruptcy is a slow one when you can borrow from banks at very low rates, which means resources remain tied up in companies that are not profitable. One implication of this misallocation of resources is slower economic growth. Some economists describe the problem as one of congestion. By draining capital and labor, zombie firms make it more difficult for profitable companies to grow.

The takeaway when thinking of zombie firms is that they are one more reason to imagine slower growth on the horizon. Demographics and our national debt are the leading factors, but we can add a growing number of zombie firms to the list. The low interest rates needed to help the economy have allowed companies to survive when perhaps they should not. The response is to plan ahead for the potential of slightly lower returns in the stock market. US economic growth has slowed to below 3% per year over the past decade, and stock market returns could follow with a small decline as well.

1. Index price and performance data is provided by Black Diamond Wealth Platform, an SS&C Advent product.

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