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A Recovery Like No Other?

The year 2020 will be one that no one will forget, but few would like to relive. Pandemics, lockdowns, unemployment, riots—there was a lot of craziness. If I told you all those factors would lead to a solid year for stocks you would have looked at me like I had a third eye. But that's exactly what happened.

The difficult compartmentalization for the average investor is that sometimes the market can be completely divorced from the general headlines. Sure, the headlines may affect market sentiment on any given day, but over time the market has a much more keen focus on monetary policy and corporate profits. In 2020, the Fed cut interest rates to zero (overnight) and injected trillions of dollars of liquidity into the financial markets. Additionally, the digital transformation that has been taking place in corporate America for years was sped up into overdrive once the general population was forced to work from home. Those last two points are what really provided the tailwind for stocks to recover from their March lows and not look back.

As we head into 2021, not only do those tailwinds remain but investor sentiment is getting downright giddy. Speculation in small-cap stocks is running rampant, bitcoin mania is growing, surges in new IPOs is reminiscent of 1999, and valuations in many parts of the market are stretched (FOMO: fear of missing out). That doesn't mean the party has to end tomorrow. In most cycles, bullish action can continue until the Fed raises interest rates and takes away the proverbial punch bowl from the party. That still seems a few years off according to Fed forecasts.

But as with most aspects of investing, managing risk and paying attention to valuations remain key to successful results. Folks who pay too much for a stock, a house, etc. are often happy to get in on the 'action', but in hindsight usually regret not being more disciplined when it comes to the price they paid. So when clients call and want to chase the stock du jour, our job is to temper enthusiasm and keep the focus on the benefits of a long-term investment plan and not short-term speculation.

Last year there was a wide discrepancy in the performance of 'growth stocks' relative to 'value stocks'. The former had an outstanding year while the latter had a difficult time due to the fact that many value stocks need the backdrop of solid economic growth to propel them higher. As we enter 2021, the focus has shifted to the upcoming economic recovery and that is leading to a comeuppance for value stocks.

Expectations of a strong economic recovery in 2021 are to a large extent predicated on the successful rollout of Covid vaccines and antivirals. The thesis is that a population with enough inoculations to reach "herd immunity" will be less fearful about resuming normal activities. Moreover, said population will actually be eager to get out and travel, see concerts, attend sporting events, and go out to dinner, movies, etc. In a normal economic recovery, there is a certain amount of pent-up demand that gets released and spurs economic growth.

If the vaccine rollout is successful, we could see the mother of all pent-up demand scenarios get unleashed and cause a real surge in demand.

$SPX – S&P 500 Large Cap Index INDX

Source: © StockCharts.com

While a strong economic recovery would portend solid returns from stocks, it would likely be a headwind for fixed income investments. Bond yields are sensitive to the pace of economic growth. As such, a stronger than expected recovery and rise in GDP would push yields higher and weigh on bond prices. Additionally, the Fed has been printing money and holding short-term rates at zero in hopes of spurring a little bit more inflation in the economy. Well, careful what you wish for. A surge in demand would likely cause a bit more inflation and provide an additional headwind for income investments.

In sum, we have a positive outlook for the year ahead. We think stocks should perform well in an ongoing economic recovery. But like most markets, things usually don't rise in a straight line. With an uneven economic recovery plus an uncertain vaccine rollout and response, we expect some bumps along the way. But those should provide opportunities to add exposure where warranted.

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Sources: Stockcharts.com; Seeking Alpha; Raymond James; Briefing.com; Standard & Poors; Barron's; Charles Schwab; CNBC.com

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