Economic Updates and Outlook



"Cup of Joe"

Nirvana: a state of perfect happiness; an ideal or idyllic place. This is a great way to describe the current state of the stock market. In this Market Update, we will address some client concerns and then present our assessments of the economy, the stock market and how we have done over the past year.
What is in store for markets now and moving forward? Here are the positives:

- Extremely low interest rates
- Accommodative Federal Reserve
- A dovish Treasury Secretary
- $5-7 trillion in stimulus
- A booming housing market (the entire country has also locked in historical low mortgage rates)
- Gas prices that are low enough to benefit the consumer, but high enough to allow energy companies make money
- Historical, pent-up consumer demand
- Savings rates at all-time highs (no one can spend any money, so it is all in the bank)
- Great rotation out of bonds and into stocks could begin very shortly
- Possible trillion-dollar infrastructure bill (fiscal policy being coupled with monetary policy)

The above items would equate to what some have called "Market Nirvana". So, what could derail this bull market? Here would be the concerns:

- Lack of "targeting" with stimulus money ($1,400 checks being sent to everyone) could cause hyper-inflation (cost of goods going up very quickly)
- Higher taxes (would only affect people making over $400,000)
- Increase in capital gains rate (client sells stock, they pay higher tax on the gain than in the past)
- Interest rates rising quicker than expected (when interest rates rise, this takes money out of the economy and your pockets)
- Vaccines take longer to distribute, delaying the recovery
- Irrational exuberance (think Gamestop)

In response to the concern of whether the market is worried about the changing political landscape, keep in mind that 90% of the market's valuation is looking forward one year or more. Looking at the market performance from (November) to today -- not even 3 months -- the S&P 500 has gained over 13%. So, to answer the question, the stock market does not look to be worried and is very optimistic

about the longer-term economic picture.

Another common question that we are getting is if we are currently in a stock market bubble? I would agree that certain sectors of the market are a bit overpriced. Tesla is up over 600%; SPACs, or "blank check" shell corporations and IPOs (initial public offerings) are out of control; Bitcoin is parabolic; Gamestop; etc. Having said that, I would describe the overall market today as pricey, but rightfully so. The stock market knows that we could have an earnings boom like we have never seen before. The stock market knows we have a dovish FED who is not planning to raise rates and is willing to let inflation run for a year or more. It knows we have an administration ready to deploy massive stimulus and an infrastructure bill in the not-so-distant future. And it knows that we have 340 million people ready to get out of their houses and spend their savings that has been building up for over a year. Having previewed all the market catalysts, this provides credence for our opinion as to why we feel the market's valuation is warranted. Now, don't get me wrong, markets do not go up in a straight line. Remember, "markets go up the stairs, and down the elevator". So, when markets do get a little crazy and go straight up like they have been, we want our clients to be aware that we could have a pullback. All this means is that things may have gotten a little ahead of themselves, people take profits, the market dips and the bull market recharges. When the market pulls back during a bull market, it allows investors sitting on the sidelines to deploy new capital. Right now, people have been waiting and waiting for a chance to get in. If a 10% pullback were to happen, we would view this as a great time to buy!

Another scenario that could have an enormous effect on the market would be "The Great Rotation" out of bonds and into stocks. Very simply, investors view bonds as safe assets. In retrospect, a bond can lose money when interest rates rise – "when rates go up, bonds go down". Let us look at the following example:

If you hold a 10-year government bond today that is paying 1% and interest rates on the open market were to rise to 2%, your bond is no longer as attractive to a buyer on the open market. The buyer can just as easily go on an exchange and purchase a 2% bond directly from the government, making your bond paying 1% not as attractive. This forces you, the holder of the 1% bond, to "discount" your bond in order to sell it. Using numbers, if you owned the 10-year treasury bond paying 1% that's worth $1,000 and interest rates rise to 2%, that bond is now worth $900 - a loss of 10%!

Based on this scenario, we feel that one of the biggest bubbles may exist not in the stock market, but in the bond market. We feel that when the economy starts roaring back, we could see a decent rise in the inflation rate and the result would naturally be an increase in interest rates, causing fund managers to rotate out (sell) of bonds and re-allocate (buy) into stock. We have witnessed this happening with some of the largest sovereign wealth funds (investment portfolios held by whole countries), changing their existing 60/40 (60% stock, 40% bonds) allocations to 70/30 (70% stocks, 30% bonds) in their portfolios. In a trillion-dollar fund like Norway for example, this would be a monumental shift out of bonds and into stocks. If this were to become a trend - and it just may - we could have a massive boom in the stock market that's being labeled as "The Great Rotation".

All in all, we are very optimistic in our long-term outlook. As I mentioned, we do expect a pullback of some kind to take place. Note: one never knows. When it does happen, we are advising clients not to be worried, but instead, use this as a chance to invest new capital that you may have sitting in the bank earning as little as 1% or less!

Finally, we want to provide a summary of Chapel Hill's portfolio performance for 2020. Keep in mind, the S&P 500 garnered a 16% return last year.

- *Reduced Volatility* portfolio (30% stock and 70% Fixed Income/cash): 5-8%

- *Intermediate Volatility* portfolio (70% stock and 30% Fixed Income/cash): 16-19%
- *Increased Volatility* portfolio (up to 100% stock): 25-27%

In 2019, our portfolio performances, on average, did the following:

- *Reduced Volatility* portfolio: 10%
- *Intermediate Volatility* portfolio: 26%
- *Increased Volatility* portfolio: 32%

***Disclaimer: Past market returns are not indicative of future results.

As always, we feel great about our performance over what was historically one of the most difficult years on record. We hope everyone stays safe as we look forward to returning to a sense of normalcy and to another great year of returns.

-Joe, Ryan, and the Chapel Hill Investment Team

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