DICKMEYERBOYCE
FINANCIAL MANAGEMENT, INC.

2020 Year End Review: Vaccines Point to Hope

Executive Summary

- The recovery in the economy has been strong, although uneven. Spending on services is down while spending on goods exceeds the pre-pandemic level.
- **The future path of the recovery will be largely dependent upon the path of the coronavirus.**
- Completion of vaccination is possible by the end of this summer.
- The support via the Cares Act and the Federal Reserve was very successful. Additional fiscal support was passed in December and is currently working its way into the economy. More fiscal support is likely to occur in Q1 2021.
- Collectively, management of personal balance sheets has been very good which will help in getting through this pandemic and will offer a springboard of service consumption when public activity increases.

Macro-Economic Perspective

It is mind numbing to think back on the course of events experienced in 2020. Economically speaking, the ending point of 2020 is well beyond any expectation when we were learning about Covid-19 and anticipating a partial economic shutdown in March. **In addition to massive fiscal and monetary support, personal and corporate effort and innovation was in high gear**.

Path of the coronavirus on the one hand and stimulus impact on the other: The quickening pace of pandemic infections, hospitalizations, and deaths at the end of 2020 took some of the wind out of the sails of the recovery. Consumer spending rose 4% in Q3 but declined 0.6% in the final quarter. With the holiday gatherings ended and the vaccination project underway, coronavirus numbers are declining and round two of stimulus checks are arriving. The first bit of evidence of a better course comes from January retail sales which increased 5.3% following three months of declines.

Fiscal Support and Vaccinations:

- Clearly, the fiscal and monetary support in 2020 worked very well. Securities markets recovered profoundly and there was plenty of evidence of a V-shaped recovery in most of the economy. Personal income rose from $19.11T in February to $19.57T in December, an increase of 2.4%. But the gain was a result of government transfer payments that exceeded recent norms by $2.8T.
- Disposable personal income (income after taxes) was up 5.5% in 2020. This is the highest rate of growth since 1984.
- The savings rate was 13.7% last year. This exceeds recent norms of 8%.
- In the third quarter, we saw evidence that goods expenditures exceeded levels achieved in February 2020 before the impact of the coronavirus by over 7%. But services spending was still down 6+% from February levels. **Services spending normally accounts for 64% of consumer spending. Vaccinations need to provide a significant assist to other CDC recommended measures to bring the coronavirus under control to minimal levels, if not eliminated, if we are to attain a full economic recovery.**
- Without containment of the virus, we would be in a cycle of partial shutdowns and fiscal stimulus.
- **It is clear that the securities markets have faith that the vaccination project will be successful, and that fiscal and monetary stimulus will remain in place until that time.**

Key Economic Data Points:

First quarter real GDP decreased at a 5% annual rate. Second quarter real GDP decreased at an annual rate of 31.4%. Third quarter real GDP <u>increased</u> at an annual rate of 33.4%. Fourth quarter real GDP increased at an annual rate of 4%. The annual result was a decline of 3.5%. This is half of the decline projected in June**. 2021 GDP projections for the USA and the World vary widely but assume additional fiscal support. The World Bank projections are 3.5% for the USA, 3.6% for Europe, 5% for Emerging economies, and 7.9% for China. <u>With poor vaccine distribution, projections are halved.</u>**

All other major economies in the world except China (+2.2%) experienced significant declines in real GDP. Far East Asian nations fared the best (Korea -2.2%, Japan -4.8%) as they did a better job containing the virus. European nations ranged from a decline of 5% in Germany to a decline of 9.9% in the U.K.

Employment: The unemployment rate and the number of unemployed in February 2020 was 3.5% and 5.8 million, it was 6.7% at year end and is now 6.3%. The unemployment rate is projected to be 5.3% by this year end. 10.7 million people remained unemployed at last year end. 5.5 million people left the workforce. There are 6.5 million job openings. Forecasts call for 5.3 to 6.7 million jobs to be gained this year. The employment participation rate is expected to remain subdued given retirement of Baby Boomers and parents of young children leaving the workforce. **Full job recovery is anticipated by 2022 to 2024. This is about a year longer than forecast three months ago.**

Consumer spending (70% of GDP): Personal consumption expenditures (annualized) topped out in February 2020 at $14.88T. They bottomed out in April 2020 at $12.1T, a decline of 18.7%. For comparison purposes, the decline in personal consumption expenditures during the Great Financial Crisis was 3.9%. **As of December, personal consumption expenditures are within 2.6% of the February level at $14.49T.** This exceeds the level last experienced in May of 2019. The Institute of Supply Management (ISM) reading for service rose to 58.7 last month and has been rising every month since a reading of 56.6 in October from a low of 41.8 in May. A reading of 50 is the dividing line between decline and growth. We are heading in the right direction.

Manufacturing (11% of GDP): The ISM reading for manufacturing has steadily risen to 60.7 in December from 41.5 in May. **Manufacturing output (data recorded quarterly) at Q3 and Q4 end has recovered significantly but remains 6% and 3%, respectively, below the peak which was attained in Q4 2019.** Again, we are heading in the right direction.

Construction (4.1% of GDP): This data is less volatile than other economic measures, but **total construction spending at Q3 end is 1.5% higher than the year ago level**. Residential spending is up 10.1% and non-residential spending is down 4.4%. Q4 data has not been reported yet.

Home sales: New single-family home sales in 2020 were up 30+% over 2019 levels. As of September, existing home sales are at the highest level since 2006! Supply stands at a record low 1.9 months. Six months is considered a balanced marketplace for buyer and sellers. Interest rates are quite helpful, and the Federal Reserve intends to keep them lower for longer. Building permits remain high. **This data bodes well for construction prospects and home prices**.

Securities Market Perspective

By the end of 2020, a 100% stock portfolio with 20% invested in international was up approximately 16.25% with dividends reinvested. Intermediate term bonds were up 7.53% (Barclay's Aggregate Bond Index) and short-term bonds were up 3.33% (Barclays US Gov't Credit 1 to 3 Year Bond Index). The highlighted trends in manufacturing, construction and consumer spending have driven a considerable recovery in equities; even while investors continued to value the relative safety of fixed income. On the year net money flows were out of stock funds into bond funds.

Valuation discussion points:

- By the end of the 2020, as measured by price to book value, growth stocks were 144% above their long-term average of 4.83 at 11.78 (up from 128% at the end of the 3rd quarter). Value stocks were 9.6% above their long-term average of 2.18 at 2.39.
- By the end of the year, growth stocks were up 38.33% and value stocks were up 2.96%.
- Statistically speaking, the performance of growth stocks relative to value stocks over the last 14 years is now at a plus 4.5 standard deviation event. For perspective, one would expect this to happen once in 400 years. The limited mobility environment has further inflated this return advantage divergence for growth.
- Although, there appears to be a rotation beginning from growth investments into value investments. Beginning on July 10th, we noticed a trend towards higher returns for value investments as compared to growth. The trend is noticeably more prevalent in mid-cap stock and small cap stock asset classes. With the introduction of highly effective vaccines, the trend for greater return with value stocks gained steam and included large cap stocks as well. Will this trend continue? It is difficult to predict, but if the vaccination project proves successful, it is likely the economic recovery will strengthen in traditional value-oriented industries.
- <u>Low interest rates continue to validate higher valuations</u>. 10-year Treasury is presently yielding about 1.2% (or 0.012). So, a company with a P/E ratio of 50 would have an earnings yield (E/P ratio) of 2% (or 0.02), exceeding the yield of the 10-year Treasury. Therefore, this hypothetical company could be considered reasonably valued on a relative basis. A company with a P/E ratio of 83 (1/83 = 0.012) would have an equivalent yield to the 10-year Treasury. For comparison, Amazon and Tesla have P/E ratios of 78 and 1,244, respectively. The P/E ratio for the Dow Jones Industrial Average and S&P 500 are 32 and 45, respectively. During the Dot.Com era, the market index E/P ratios were in line with the 10-year Treasury yield.
- The stock market rise has not created economic excesses.
- The Federal Reserve's zero bound interest rate policy is forcing investors to increase risk via investing in stocks and pursuing lower quality bonds. There are plenty of high-quality companies with dividend yields well in excess of interest rates available in bonds.

Valuation conclusions:

- The valuation of certain growth stocks is made more reasonable based upon their enormous success in this COVID-19 environment. Although, there are plenty of examples where valuations have lost touch with reality.
- Low interest rates continue to provide cover for higher valuations.
- Near term evidence points to a rotation into less expensive or lower valuation stocks with the prospect greater freedom of movement that would be possible through successful immunization.
- As interest rates rise modestly, stocks will look more expensive. This will increase the interest in lower valuation stocks.

Bonds:

- Yields on all types of bonds are being anchored at very low levels by Federal Reserve policy action of holding the Federal Funds rate at nearly 0% and monthly bond purchases. DBFM is pursuing additional avenues to enabling greater bond return and portfolio income in this low interest rate environment.
- With successful vaccination of America, the economy and interest rates will likely trend up. Avoidance of intermediate and long-term bonds will become the order of the day in the investing world. DBFM is positioned for such an environment.

Wrap up: Major pieces of our economy have more than healed from the restrictions put in place to contain the spread of coronavirus. Services spending (45% of the economy) remains restrained by the continued need to try to contain the virus. Successful immunization is required to win this battle and return to full strength.

Please be safe and stay healthy.

Please feel free to contact us with any questions, or if you would like to schedule a virtual, face to face, or phone meeting.

Thank you,

Dave Dickmeyer, M.B.A.
Wealth Advisor
Principal Owner

Ian D. Boyce, CFP®
Certified Financial Planner™
Principal Owner

Drew Lanphear, CFP®
Certified Financial Planner ™