During 2020 we faced yet another new landscape in the stock market and economy with limited or no precedent to compare or look to for guidance. The market hates uncertainty. With no experience to draw from investors were left to guess at the economic impact and eventual end of this pandemic. The last pandemic was 100 years ago with the Spanish flu.

Because the global economy was forced into a recession by this very unusual outside event many expect the economy will return to its former growth pattern once the public becomes vaccinated. But the way that we have had to adjust in how we work, how we shop and how we are entertained will have lasting changes.

While the office will not go away, work from home will most likely become a part of everyone's life. Online shopping, grocery delivery, curbside pickup, streaming concerts and first run movies have staying power and may alter the way we live for the foreseeable future. Technological innovation that was coming in the next 5 years has been compressed into 1 year. We had no choice. The world needed to adapt.

The demand for technology to support the new ways of working, shopping, socializing and just doing business was a huge winner for technology companies. Remote meeting services, cybersecurity, online shopping, telehealth were some of the best performing stocks. Additionally, homeowners decided to make their home their castle and home improvement stores of all stripes have been winners. City dwellers fled to the suburbs depleting the already low housing inventory with bids over asking prices.

Is this a lasting trend?

While technology will always be in demand and zooming will probably be much more prevalent in the future not all trends that were born of COVID will be long lasting. Employees will go back to an office; for some it will be a blessing, others will go grudgingly. Demand for gasoline will go up. Getting lunch and coffee out will help local spots. Restaurants will begin to fill up. New restaurants will open. Businesses that closed may reopen. Being able to freely move about will unleash a flurry of activity.

There are many opinions about how consumers will respond to the reopening of the economy. Some are convinced we will see a boom in travel and leisure activities. Others say we will see a welcome return to the office for productivity as well as social reasons. Unless you have a deep knowledge of human behavior, especially after pandemics, it is anyone's guess. So, we follow the data. The facts on the economy are as follows:

GDP: In 2019 real GDP growth was 2.33% 2018 3.18%. 2017 2.22% 2016 1.57% 2015 2.88%. Second quarter real annualized GDP growth during 2020 was -31.7% followed by real GDP growth of +33.4% in the 3rd quarter. These figures are comparing the prior year quarter with the current quarter. When the whole year is reported for 2020 GDP will most likely be down 4.5% from 2019.. As the above GDP growth figures from 2015-2019 show GDP growth is running about 2.5%. Potential GDP growth is defined as population growth plus changes in productivity. As the economy opens up we may see big jumps in GDP that are temporary. Once we are past this crisis GDP growth should settle into its long run pattern.

Unemployment: After peaking at over 14% in April 2020 the unemployment rate has declined to 6.7% in December 2020. In February 2020 unemployment was at an incredible 3.5%. Since 1948 the average rate has been 5.7%. As vaccines get distributed and the economy continues to open up employment should continue to improve. Good news.

ISM Manufacturing: November PMI 60.7%. PMI stands for Purchasing managers Index. This is the 8th month of improvement in this index. A reading over 50 means expansion. New orders were up to 67.9% clearly in expansion. Manufacturing Employment index is at 51.5% and therefore is in expansion. Inventories came in at 51.6% also in expansion. This is good news and shows the economy is growing.

ISM Non Manufacturing: Services PMI came in at 55.6% in November**.** New orders 57.2% and Non Manufacturing Employment 51.5%. Services are growing more slowly over the past 6 months although prices have been going up for the last 8 months. Services are in expansion and employment has entered expansion as well. Good news.

Capacity Utilization: Prior to COVID capacity utilization hit a high of 79.5. In April 2020 utilization hit a low of 64.2% and has recovered to 73.3% in November 2020. This tells us we have slack in the economy and that we are not using all of our manufacturing capacity. This will keep a lid on inflation for goods.

Interest rates: Interest rates are extremely low with the 3 month treasury bill yielding .09%, 10 yr yields .93% and 30 year 1.66%. Upward sloping yield curve is expansionary. Low rates support growth.

Consumer Income: For the period March 2020 to November 2020 wages declined $43 billion. Unemployment benefits, stimulus checks, small business income totaled $804 billion. Source BEA

Consumer spending: Consumer spending accounts for about 70% of GDP. From 1 year ago, home spending is up 9%. Groceries up 1%. Restaurants down 1%. Apparel down 21%. Department stores down 30%. Travel and transport down 54%. Events and attractions down 72%. From March 2020 to November 2020 total consumer spending was $535 billion. Overall spending is down and savings are up.

Consumer Debt levels: Mortgage debt comprises 68% of all consumer debt. Auto and student loans plus credit card debt totals 18% of consumer debt. The absolute level of debt is irrelevant. What matters is how easy or hard it is to pay the outstanding debt. One way to measure this is looking at how much of consumer disposable income is going toward debt payments. In the 3rd quarter of 2020 9.1% of household disposable income was going toward debt payments. This compares to over 13% in the 4th quarter of 2007 just prior to the housing crisis. In the 4th quarter of 2001 debt service payments were 12.6% of disposable income. 9% is a very manageable number although is rising. From a debt perspective, the consumer continues to be in good shape.

Margin Debt: When investors borrow money to invest from their brokerage firm they are investing on margin. There are requirements for the value of the underlying investments the investor must meet. If the stock you purchased on margin declines in value and you no longer meet the "margin requirement" the brokerage firm will issue a margin call. You will be forced to come up with additional money to deposit to your account to meet the margin requirement. Generally, investors sell their investments to raise the cash rather than depositing more cash to their account. When margin debt gets extreme there is a risk that there will be a large selling event caused by an unforeseen event. Investors become complacent about risk and think stock prices only go up. While headlines tell us margin debt has hit a record that statistic by itself means nothing. If we look at margin debt as a percentage of total market value then we can see if margin debt is really a problem. Currently margin debt as a percentage of total market value is at a 15 year low, so margin debt levels are not concerning but bears watching.

Stock Market P/E: Earnings for 2021 are estimated to be $165. The S&P 500 is currently at 3700. P/E is 22.4x. The 25 year average P/E is 16.5. Current valuation is almost 2 standard deviations away from the average. We can understand this by looking at the limited choices of where to put your money. Savings accounts earn nothing. Fixed income yields are very low. Dividend yields are higher than treasury yields and about equal to corporate bond yields. Dividends for many companies grow every year unlike bond interest payments which stay the same. In the search for return investors have chosen to put their money in the stock market. While the stretched valuation is definitely a concern we must remember that earnings estimates for 2020 were notoriously too low, resulting in actual earnings coming in higher than estimates. If earnings come in higher than expected for 2021 then that 22.4x multiple is lower and the valuation is not as stretched as we think. Nevertheless, valuation is a concern.

The election: The Democrats took the Senate with the run off election in Georgia. With a Democratic government many believe more stimulus is forthcoming to support the economic recovery. Many also believe higher taxes will be coming in 2022. Both the general election and the Georgia runoff were close races. Because they were close races the Democratic government understands it has not been given a mandate by the American people in support of any extreme policies. Centrist policies are the best bet for the mid term elections and to bring the country together.

What does all this mean for my financial plan?

Your portfolio reflects your specific time horizon, risk tolerance and goals. A moderate portfolio is 35-40% bonds and cash and 60-65% stock. For those who have a longer time horizon and are more risk tolerant we have a lower allocation to fixed income and cash.
Within the Large, Mid and Small company asset classes we have been tilting toward growth for clients where it makes sense. We have also been adding small, focused positions in cutting edge technology, clean energy, industrials and materials.

It is reasonable to expect bouts of volatility in 2021. No matter what happens we are managing your portfolio to meet your specific goals. We have structured portfolios to withstand corrections. Retirees who are taking distributions will continue to receive their distributions without having to sell stock.

We know corrections and bear markets can be scary and cause anxiety. We know investors want to "do something" and regain control. We also know that emotion gets in the way of making cogent, sound decisions. Scientifically our pre frontal cortex shuts down, our amygdala takes over and fear overcomes reason.

We are emerging from a severe downturn that was inflicted upon us by an outside force. Many of the economic indicators are close to pre pandemic levels. Parts of the economy are still operating at a fraction of their former selves. As the vaccine gets distributed, we do expect those parts of the economy that are struggling such as airlines and hotels as well as entertainment will boost employment and overall economic activity. We will remain vigilant in following the facts as they emerge and applying our more than 25 years of experience as financial planners and portfolio managers.