Making Sense of Finance

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Fourth Quarter 2020 Review

STOCK MARKET

The stock market had a banner quarter to finish up a tumultuous year. After experiencing the fastest bear market (a drop of over 20%) in history earlier in 2020 (Feb.19-March 23), the S & P 500 index came roaring back to close out the year at a record high. The index gained 11.8% in the fourth quarter and 16.3% for all of 2020. However, three stocks Apple, Amazon and Microsoft, accounted for more than half of this gain in an index of 500 stocks. This outsized influence on performance can occur because the S&P 500 index is a market cap weighted index, meaning that the larger the market capitalization (outstanding shares times market price) of the stock, the larger the influence of their return on the index. Without these three mentioned stocks, the S & P 500 would have only increased 8% for the year, and without the top 30 stocks in the index, the return for the year would have been slightly negative! Notably the high-flying Tesla stock was not added to the S & P 500 until Dec. 21st, and immediately became one of the top ten largest stocks in that index. Other widely followed indexes had double digit percentage gains last quarter. The Dow Jones Industrial average increased over 10% last quarter, which now put it in positive territory for the year with a gain of 7.3% for 2020. The tech heavy Nasdaq Composite index (index of over 2,500 stocks also market cap weighted) rose 15.4% in the fourth quarter, adding to previous gains and closing out the year with a huge increase of 43.6%. Rising stock prices have caused the S&P 500 dividend yield to decline to 1.55%, (still above the 0.93% yield of the 10-year Treasury at year end) and has resulted in a trailing price/earnings ratio of 31. The market has high expectations for the economy and future corporate earnings growth in 2021.

Energy stocks, which were the worst performing sector for the year, rallied at the end of 2020 to become the best performing sector last quarter. The rise in oil prices last quarter of over 20% contributed to the shift in optimism in energy stock sentiment in addition to the anticipated increase in demand for 2021 as the world economy reopens. Financial and industrial stocks also outperformed the general market in the fourth quarter. All stock sectors had positive returns in the last quarter, but real estate, utility and consumer discretionary stocks lagged the broad market averages. In early November, stocks began a sector rotation, "value" stocks and dividend stocks rebounded in the

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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fourth quarter but still trailed growth stocks for the whole year.

Foreign stock markets significantly lagged their US counterpart for all of 2020 but outperformed in the final quarter. The MSCI EAFE index which measures the performance of stock markets in developed countries rose 15.8% in the fourth quarter as measured in US dollars. The similar dollar-based return of the Emerging Market index was over 19% last quarter. The weakening dollar tends to benefit emerging markets. Companies in developed markets are forecasted to grow their earnings faster than US companies in 2021; this is in large part due to a higher percentage of financial and cyclical publicly traded companies in foreign indexes relative to US stock indexes with more technology and healthcare companies. Most foreign stock markets performed at least as well as the US market or better. Some of the more noteworthy gains last quarter were in Korea, Brazil, and Spain. The United Kingdom also had a strong fourth quarter but was negative for all of 2020. (The FTSE 100 dropped 14% in 2020, the worst performance amongst the largest international stock indexes.)

BOND MARKET

Bonds continued to have relatively flat returns in the fourth quarter as measured by the 0.72% total return of the Bloomberg Barclays Bond index. High yield, lower quality bonds were the best performing bond category as riskier fixed income assets proved more attractive to investors. Emerging market sovereign bonds, again a riskier security, also did well last quarter. Regarding quality corporate bonds, longer term bonds outperformed mid-term or short-term bonds as spreads tightened. However, the Treasury yield curve is starting to steepen (bond prices and yields move in opposite directions), and this long running trend may be coming to an end. The 10 Year Treasury yielded 0.69% at the end of the third quarter, ended the year at 0.93% and is now 1.15%. Inflation is still low (latest CPI showed an increase of 1.4% over the last twelve months) but the outperformance of TIP (Treasury Inflation Protected) bonds in the past year can be a sign that investors are expecting greater inflation in the future. Regardless, the short end of the yield curve probably will not have much change in the current exceptionally low yields as the Federal Reserve will keep the Fed fund rate at a minimum for the foreseeable future. This translates into the continuance of extremely low rates on money market funds and savings accounts making it difficult to get any “real” (adjusted for inflation) return without taking on some risk.

OUTLOOK

As the pandemic lingers on, some harsh realities will likely set in. What is the threshold for empty buildings, greatly diminished travel and the countless jobs lost?. Stimulus checks soften the blow, but less so over longer time spans. We would not be surprised if markets underperformed their historical averages when the economy starts to show some meaningful recovery since much of it has likely been priced in already.

The subject of Bitcoin remerged in 2020. Despite the tremendous gains in value since inception, we still find the volatility disturbing and unappealing. Delving into crypto currencies should only be for the most adventurous speculator and although we do believe in the future of the technology, we liken it to the early 2000s dot com era. We currently can identify nearly 40 crypto currencies, and indications are that there are actually several hundred that have been created. Will they all become the next digital currency. And, it may be called a currency, but who would use it as such? It lost 80% of its value from its highs in 2018 and now with greater acceptance has surged to new highs. Still, barring any regulatory involvement, the asset will probably continue rising in value with tremendous volatility. Our concern about Bitcoin and other crypto currencies are that early adopters used it to stay anonymous, usually for criminal activity, which is the reason that the government is unlikely to leave it alone. Currently, it seems to just be an asset that is being hoarded but has no real-world use.

Stocks still remain the most attractive asset class given the low interest rate environment. An S&P 500 dividend yield of 1.55% still easily beats a ten-year treasury of 1.15% if you consider that the likelihood of stock appreciation over a 10-year period is high, albeit with much more volatility. Furthermore, the current stock dividend rate is likely to increase over that 10-year period while we know that bond coupon payments are fixed. If we assume the pandemic is coming to an end, commercial real estate should gradually recover too, but it will likely take time to absorb recent losses. Finally, high quality bonds remain attractive only as a form of value preservation, and even then, only mildly, as inflation rates are above the 10-year Treasury bond rate just over 1%. For those reaching for yields, High Yield bonds are not the solution either, in our opinion, as they usually have a closer risk profile to stocks but historically return less over time.