Making Sense of Finance

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First Quarter 2021 Review

STOCK MARKET

The U.S. stock market continued in 2021 where it left off at the end of last year as the S&P 500 continued to hit new highs. The S&P 500 index gained 5.8% in the first three months of 2021. Other widely followed indexes also increased in the first quarter. The Dow Jones Industrial Average rose 7.8% and the Nasdaq Composite gained 2.8%. Greater-than-expected government stimulus and the quick Covid-19 vaccine rollout fueled investor enthusiasm for equities. However, rising earnings expectations was the primary driver of increasing stock prices. At the beginning of this year, S&P 500 company earnings were expected to increase 16% for the first quarter. Currently estimates for first quarter earnings are projecting an increase of 23%. Stocks rose in accordance with rising estimates. Some companies that have already reported their first quarter earnings have confirmed this rosy outlook. The forward next twelve months S&P 500 P/E (price/earnings) multiple is currently at 21.8. Again, earnings have risen to drive the market up, as the P/E multiple has remained the same as it was in June 2020. However, the ten-year average forward P/E is 15.9. Extremely low interest rates have investors justifying the expensive valuations. Interest rates, while still low, have increased on intermediate and long-term debt though not on the short end. Eventually P/E multiples may need to come down.

Stock sectors that led in the last quarter of 2020 also continued their leadership into the first quarter. The energy sector gained 31% as oil prices continued to rise (+22%) with increasing demand. Other sectors that outperformed the overall market the last quarter of 2020 and the first quarter of 2021 were financials (+16%) and industrials (+11%). Financial companies such as banks benefit from a steeper yield curve and a strengthening economy. Industrials are looking to gain from increased government stimulus spending. Energy stocks were the worst performing sector for all of 2020 and started 2021 as the best performer. On the other hand, technology stocks which dominated 2020 were among the laggards in the first quarter of 2021. Other sectors which trailed the aggregate market were consumer staples and utilities, although all stock sectors were in positive territory. Rising bond yields and an increased appetite for risk led investors to not be as attracted to the typically higher dividend paying stocks such as those in the staples and utility sectors. Mid cap and small cap stocks far outpaced the gains made in larger cap stocks last quarter.

Foreign developed markets measured by the MSCI EAFE index lagged the performance of the S&P 500 index in the first quarter with a gain of only 2.8% in US dollar terms.

Making Sense of Finance

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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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However, when measured in local currency terms the increase was almost 6.9% as the strengthening US dollar this year detracted from returns for the US investor in foreign securities. Emerging markets lagged last quarter although had positive returns. When measured in their local currencies, many European stock markets outperformed the U.S. In particular, the Netherlands, Italy, France and Germany recorded greater returns than the S&P 500. However, when translated to US dollars their returns were diminished somewhat as the Euro declined in value versus the US dollar. Much of Europe is still behind the U.S. in terms of vaccine distribution leading to slower reopening of their economies.

BOND MARKET

Bonds for the most part had negative returns in the first quarter with the exception of high yield (non-investment grade) bonds which had a slightly positive total return due to their higher coupon rates. The Bloomberg Barclays Aggregate Bond Index which is a proxy for the investment grade bond market had a negative total return of 3.4% last quarter. The yield curve steepened as short-term interest rates continued to remain low and intermediate and long-term bond rates increased (bond prices in turn decreased). The Federal Reserve held steady on their stance to keep the Fed Fund target rate near zero which in turn forced the continuance of other extremely low short-term rates (yet forcing savers to accept negative inflation adjusted returns from bank and money market accounts). Rising inflation expectations from increasing consumer demand has contributed to the rise in the long end of the yield curve.

Long term Treasury bonds were the worst performing bond sector last quarter. The yield on the 10 Year Treasury rose from 0.93% at the end of 2020 to 1.74% at the end of the first quarter, the largest quarterly gain in the rate since the fourth quarter of 2016. Even though the 10 Year Treasury yield has increased by over 100 basis points in a year, the yields on corporate bonds have barely increased due to the tightening of credit spreads. Credit spreads (difference in rates between corporate bond yields and similar term Treasury yields) are at multi-decade lows. Foreign sovereign debt yields increased in the first quarter; and the amount of negative yielding debt globally decreased. Negative rates in certain areas have caused foreign borrowers (particularly in Japan) to still be attracted to investments in U.S. Treasury bonds which has somewhat offset the increase in issuance. Most fixed income sectors presently offer underwhelming cash flows and negative "real" (inflation adjusted) rates of return. A large reason why the stock market is currently still attracting investors.

OUTLOOK

With the roll out of vaccinations, the economy is facing an ironic dilemma; recovering too quickly. The business practices adopted during this pandemic are reversing which could adversely hurt the economy if businesses can not keep up. We think that interest rates will remain near historic lows for the next 18 months, which should continue to be a positive for equities. However, we have seen a spike recently, which could lead to some short-term volatility. The challenge going forward for the Fed will be to allow the economy to grow at a reasonable pace.

Earnings will likely be the driver of stock prices in 2021. Marginal companies were mostly taken out during 2020 and will likely never return due to new patterns in behavior. For instance, with the push for more cinematic release via streaming services directly to one's home, we doubt movie theaters will ever see the same draw as pre-covid.

The commercial real estate sector has been a concern of ours since the beginning of the pandemic, although we are hearing anecdotally that leases are being re-negotiated or that new tenants are taking advantage of discounted rental rates. Low interest rates and government stimulus continue to keep landlords in business, and while the bottom has been hurt, it allows a reset in the market that may have been necessary anyway.

In the past year, we identified pockets of excess in the markets, which included EV (Electric Vehicle)-related stocks and crypto currencies. While we do believe in the industry and think that there is a future for both, the unrealistic valuations kept us away. In the case of bitcoin, we don't even know how one would value such a commodity. In addition, we think it's a bit of a misnomer to call bitcoin a currency since, for the most part, it is just being traded or hoarded and rarely used as a currency. Tesla (TSLA) had a strong 700% -plus return in 2020, but so far in 2021, it has shed over 30% of its total value. Bitcoin had a similar run and is slightly off its most recent highs, but historically the pattern has been high peeks followed by massive loss in value, and then eventually recovering and reaching new highs. Much of this has to do with the gradual acceptance of crypto currencies. Often, when something becomes so pervasive that the general population demands it, the government tends to "change the rules" letting it become an exception even if it does not conform to current laws and regulations and we see this as the likely case with crypto currencies.

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