MARKET OPTIMISM: WHAT CLIENTS NEED TO KNOW

A New Way to Address Post-Pandemic Economics and Outlook

2020 was a personally challenging year for many investors, despite a select few stocks driving growth and technology stocks higher. As we move through 2021, it is even more vital to keep investors engaged and informed—with straightforward, authentic insight that addresses topics that are both important to them and to the markets.

CAMBIAR INVESTORS

MARKET OPTIMISM—WHERE COULD THIS ALL LEAD US?

Key Takeaways

1. How money supply growth is helping fuel a lot of the market optimism
2. Why we might be on the cusp of a new regime for interest rates and inflation
3. How digitized currencies such as Bitcoin create the possibility of a monetary revolution
4. Some unavoidable risks in US equities and what to make of the current market environment

Start with the Positive: Optimism & Fuel

The environment in early 2021 was a continuation of strong market conditions from late 2020. This includes massive money supply creation from the Fed, very high corporate and household liquidity, and extremely high readings for forward-looking industrial indicators, such as the ISM Manufacturing Index, the ISM Services Index, and the Philly Fed Survey. All of these hit the highest levels seen this century and, in some cases, the highest since the 1950s.

Basically, there's a lot of optimism and a lot of fuel in the form of money supply growth to permit that optimism to express itself in stock prices and in actual business activity. This has led to massive capital raising in capital markets—to the point where junior investment banking staff are pleading for mercy (and at least a day off here and there) from senior staff who don't seem particularly amused by any of this.

Take a Big Picture View and Explain

Markets are generally forward-looking and thus companies that are more geared to the physical economy have performed better while some of the pandemic beneficiary companies in more defensive type of stocks that dominated performance in 2020 have lagged. Our big picture views in the near term are not very different from the general consensus. We see an economic reopening happening in the U.S. starting now and outside of the U.S. over the balance of the year.

The government seldom get much praise for making good decisions, but the U.S. government should get some credit for a smart vaccine procurement strategy.

The United States went with a multiple 'shots on goal' approach to vaccines and made sure it reserved a lot of early production even if this cost more money. Outside the U. S., governments tended to go with the 'cheapest is best' approach, making them very dependent on the AstraZeneca COVID vaccine (which is not having a very good rollout), leading to longer lockdowns and avoidable health issues. But this situation overseas seems to be improving now as vaccine capacity by Pfizer and Moderna keeps growing rapidly, helping supply.

As 2021 progresses, reopening will occur and that should translate into a bulge of economic activity, as more than a year's worth of pent-up consumer and industrial demand are quenched. Given practical realities, this bulge of activity is likely to continue well into 2022. There are already a number of industrial production bottlenecks showing up, such as semiconductors for cars, building materials for homes, copper and rubber among base commodities—even disposable ketchup packages in fast food shops are somehow in short supply.

Since the first successful vaccine trials were announced, stocks more geared to the physical economy have outperformed, as these stand to benefit greatly from the reopening and all the very visible pent-up demand issues. Large physical footprint businesses tend to be more heavily clustered in value stock indexes, so value as a category has performed quite strongly recently. It is also true that physical economy and value stocks were priced very punitively during the peak pandemic, giving them ample room to rise. Alongside these developments, bond yields have risen anticipating higher economic activity and some inflation.

IMPORTANT FINANCIAL TOPICS TO CONSIDER

As we move into 2021 and beyond, there are a couple of important financial topics that are on investors' minds.

1. Whether the confluence of reopening the economy and the massive monetary actions by central banks mean that we are on the cusp of a new regime in interest rates and inflation (where both of these move up considerably from the low levels of the last ten years), or is the COVID recession and reopening just a very big one-off event such that by 2023, when all the supply and demand disruptions wash through the world economy, the world will wind up back in the same low growth, low inflation and low money velocity reality that has persisted since 2009?

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2. Perhaps the more interesting topic is whether we are on the cusp of a monetary revolution where digitized currencies become widely accepted as a means of storing wealth and paying for things. The Bitcoin phenomenon is just a very loud first cannon shot in this battle. During the first quarter, China had its plan to issue a digital Renminbi, creating an immediate question as to whether this amounts to some kind of one upmanship game versus the U.S. dollar. Fed Chairman Jay Powell appeared on 60 Minutes in early April saying the Fed is studying this issue closely as are several other European countries. Earlier in January, when asked about the overall threat posed by financial technology businesses to traditional banking, JP Morgan's very visible CEO, Jamie Dimon answered colorfully that the risk and gravity of FinTech startups should scare all traditional banks.

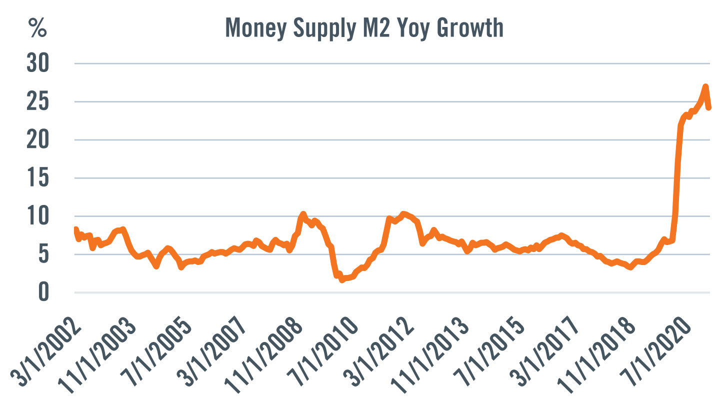
   The era of digital currencies seems likely in the next few years, with the world's economic superpowers (understandably) not wanting or planning to be laggards as this develops.

Be Direct - The New Inflationary Regime

If the New Inflationary Regime Thesis proves correct, inflation and interest rates are heading much higher than today. If you were a bond manager and you believe the New Regime Thesis, you would want a very short duration portfolio. Conversely, if you believe the New Regime Thesis is some form of wishful thinking, you would probably want to sustain some duration of your portfolio until this all shakes out. Equity investors are facing a similar dilemma right now.

The New Regime Thesis favors rate-sensitive stocks like banks, commodities, manufacturers, and even physical retailers. These are the stock market equivalent of short-duration bonds. Secular growth, technology, and internet stocks that have dominated the markets for the last 15 years should compress in value or at least perform less well as they embed very high duration assumptions and don't benefit as directly from economic reopening.

Bond proxy stocks like REITs and stable, but slow-growing consumer stocks would also seem very vulnerable. On the flip side, if you believe the new era of inflation and rates thesis sounds dangerously similar to a 'this time it's different' thesis, which almost never proves to be true, you would want to be very careful about overestimating the fundamentals in these short duration stock categories.



Source: Bloomberg as of 3/31/21

It's hard to imagine that short duration stocks not experiencing a period of outsize profits as pent-up demand is unleashed, but beyond the next 12 months, the forces that most people believe cause slow-flation, which are digitalization, globalization, poor demographics, and persistent industrial efficiencies, none of these are going into reverse.

In the digital era, money velocity has tended to fall because banks are not able to channel all of the money supply growth into the physical economy. A large portion of the Fed's extravagance stays trapped in the financial system, leading to financial excesses, such as we have been seeing in the stock market lately. Money velocity has consistently decreased since the mid-1990s and fell acutely in the pandemic. It will probably recover a bit as the economy reopens, but to achieve durable inflation, the slope of this line needs to turn in a positive direction.

HOW TO BRING IT ALL TOGETHER

We're electing—for now—to straddle the new inflation regime issue and not attempt to make a big call about it. We want to let the stocks come to us where we can clearly parse their fundamentals. In other words, we don't wish to depend on a narrative where central banks need to succeed in objectives that they have failed to achieve many times over in the past because of secular deflationary forces that have shown clear persistence.

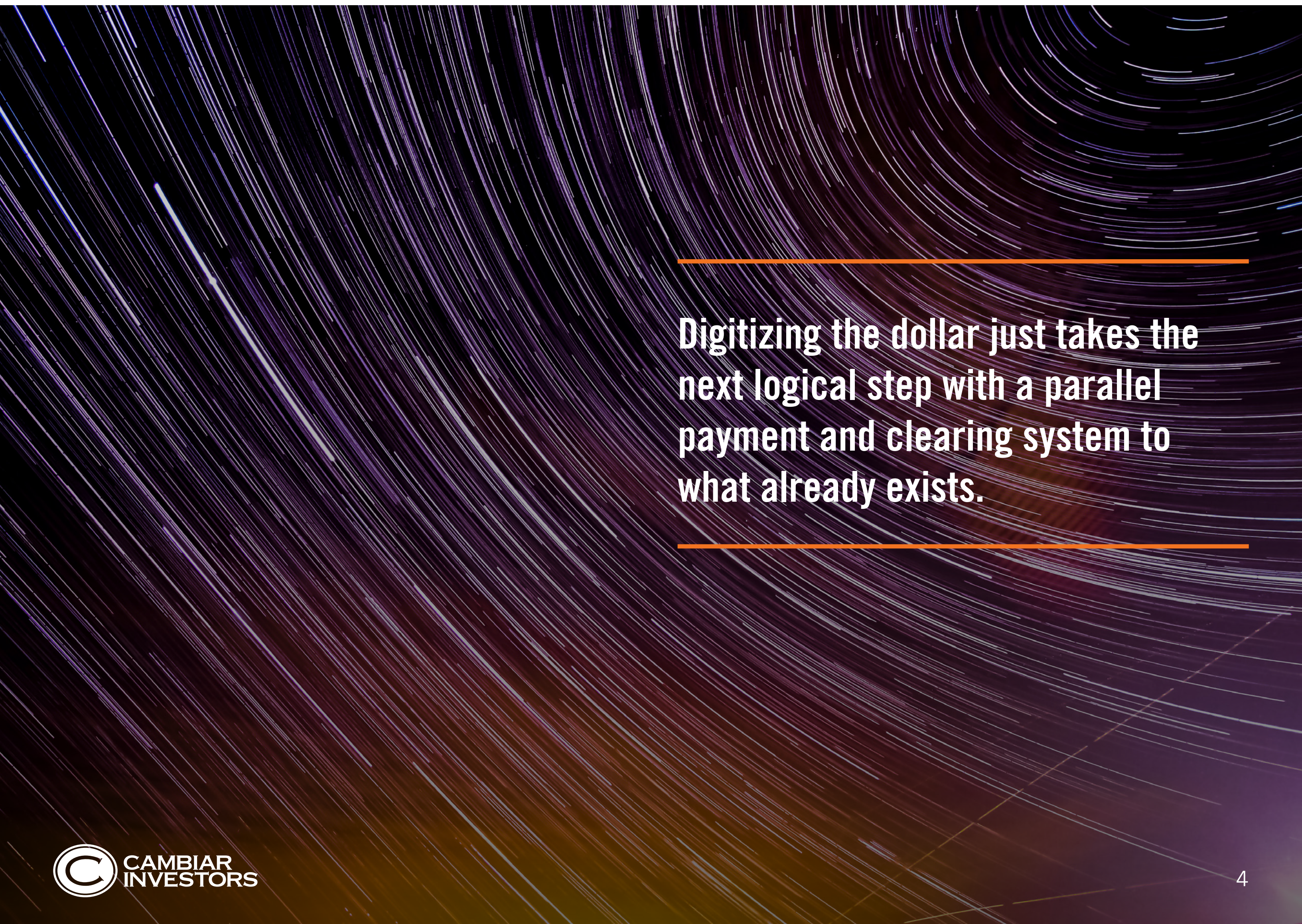
We do not see a path back to the industrial economy of the 20th century, where bank lending to grow the physical asset base of the economy suddenly accelerates relative to intellectual property formation and digitization. On the other hand, central banks are very powerful and seem ideologically motivated to push inflation expectations higher than they currently are. If they are successful (and we really won't know this for a couple of years), labor price inflation could become persistent, creating a form of durable inflation through wage growth expectations.

For now, there's little question that we will see some elevated inflation readings in coming months as the initial phases of the pandemic, which were outright deflationary, are anniversaried.

Don't Avoid This Discussion - The Digital Money Front

On the digital money front, it is similarly difficult to say what digital dollars will really mean to the average American, but it looks like they will inevitably be coming to your wallet. At some level, if you are using Apple Pay to buy groceries at the store, or pay with a QR code at a restaurant, or use a tap-to-pay Visa card to buy coffee, your payment is already taking a digital form. Digitizing the dollar just takes the next logical step with a parallel payment and clearing system to what already exists.

Creative minds with big imaginations see a fully digitized payment system as offering far more expansionary possibilities than these examples. We'd say, we don't really know. We think that things like Bitcoin and some of the other cryptocurrencies are sort of a very loud first gunshot in this development. It's hard to say exactly what this will look like. If we'll use digital dollars, just the same way as we use traditional physical dollars. And there's just a different payment and clearing system.



FREQUENTLY ASKED QUESTIONS FROM INVESTORS

Here, we take a look at some of the common questions that both retail and institutional investors have been asking...and we provide some sound bites for the informed advisor.

Q: Where are we in the cycle?

A: We're likely early in a new economic cycle. The COVID recession was not like a normal recession that was brought about by business conditions being unsustainable. It was brought about by an unprecedented global health development. As we're emerging from it, it's important to understand that going into 2020, we had had two consecutive years of decreases in global trade and a lot of reductions in industrial activity. Much of that was a consequence of political noise from Trump and tariffs and related uncertainties, but nonetheless, you already had some quasi-recessionary activity. So, the new economic cycle and probably long economic cycle assessment is likely to be correct.

Q: What are some near-term and eventually unavoidable risks facing U.S. equities?

A: The biggest risk that is anticipated is a policy error of some kind by the Fed or by the Federal government. The Fed policy error possibility is a greater one. Fed Chairman Jay Powell has indicated that they plan to simply look through short-term elevated inflation readings and not taper asset purchases for a long time. They plan to hold off of raising interest rates for a very long time, despite some very strong evidence of overheating in a number of parts of the overall economy.

Powell commented at a meeting in the first quarter that the main risk to that outlook, as he saw it, was if inflation expectations became "unanchored," and at that point, the Fed would need to do something. The way we look at it is, it's a pretty good way to cause inflation expectations to become unanchored, which is to tell everybody that you're going to blow off short term and medium-term economic data, because you have some preconceived notion of how this is all going to go. Is it likely that you're going to want to wake up and walk into the office and look at your screen the day that inflation expectations truly become unanchored?

There's a flip side to this, which is that by being so accommodative, by using such aggressive monetary policy, we are in effect creating an asset bubble. There is a lot of moral hazard behind that asset bubble, and that has its own form of dangers.

Q: How do you sum up the current environment?

A: It's hard not to miss the speculative froth that enveloped the stock market in early 2021. This is a direct consequence of the Fed injecting truly massive amounts of liquidity into the system with a limited capacity for it to be put to work in, until the physical economy reopens. We don't know where this is all going. It could be a Roaring '20s boom that is just starting or an asset bubble that will one day hit the wall as these things tend to do, with very costly consequences. However it goes, we intend to be disciplined as to price, business quality, and the capital discipline of the companies that we invest in for clients.

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