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Not So Fast

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Market Performance

Election results and vaccine announcements from Pfizer, Moderna and AstraZeneca have made this the best November for the S&P 500 since 1928, with the index (SPY) gaining 10.93% through Monday, November 30th. The Russell 2000 (IWM), the primary index of US small company stocks, had its best month ever, gaining 18.44% over the same period.

Vaccine Development

All major investment research firms factored a vaccine into their 2021 market and economic forecasts. The general working premise was that a vaccine would be available by the middle of the year with an effective rate somewhere between 60% and 70%. The news of the past three weeks suggests that these assumptions were too conservative. Analysts are now recalibrating with more favorable assumptions: 1) medical personnel and high-risk individuals may have access to a 90% effective vaccine early next year, 2) higher effective rates should help offset skepticism in the population as humanity races toward herd immunity and the end of the pandemic, 3) three pharmaceutical firms manufacturing successful vaccines should help lower production and distribution bottlenecks.

Market Leadership

Reassessment of the COVID-19 recovery timeline has caused dramatic shifts within leadership of the equity markets. For the first time this year we are seeing smaller, more economically sensitive cyclical firms outperform those that have benefited from the COVID stay-at-home economy. The financials, industrials, and consumer discretionary sectors have recently outperformed big tech and consumer staples. The stage appears to be set for a lasting recovery to begin next year as a vaccine allows pent-up demand to return to the economy while central banks and governments maintain their supportive policy measures.

Sentiment

Investors have collectively decided that the future will be bright. Major investment research firms have increased their 2021 equity return targets, and survey data on individual and professional investor sentiment levels have hit new highs. Mutual fund cash allocations are at a record low of 2.19% (typically this figure is between 5 and 10 percent). Margin Debt in individual investor brokerage accounts, a measure of how willing investors are to use borrowed funds to buy stocks, is nearing record levels. Low cash and high margin levels suggest mutual fund managers and individual investors believe the market can only go up. This optimism has pushed the “Buffett Indicator” (S&P 500 relative to US GDP) to an all-time high, topping even the tech-bubble record.

A Word of Caution

Market positioning, sentiment, valuations, and leverage all speak to a very complacent, if not dangerous, investment backdrop. There is an old rule in investing that is worth remembering now; if all the experts and

forecasts agree, then something else is going to happen. When retail and institutional investors are "all-in", as they are now, even small disruptions can have dramatic consequences. A recent example is December of 2018 when the S&P 500 dropped 20% with little reason at a time when analysts were universally calling for strong returns.

There are still many hurdles remaining for the recovery to begin in earnest. At 180,000 new COVID-19 cases per day, dangerously high hospital utilization rates, and new lockdowns being enacted, there seems to be little question that the US economy will contract into the new year. It is worth noting that if not for government support the U.S. economy would have contracted 6% last quarter, rather than experience 33% growth (both figures annualized).

Government programs from the March 2020 Coronavirus Aid, Relief and Economic Security Act (the CARES Act), a rare bipartisan effort designed to lessen the financial impact of COVID-19, end with the turning of the calendar or have recently been discontinued by the Treasury Department. Some of these programs will be extended by the new administration, and additional stimulus measures seem likely, though the timing is unknown. Nobody fully understands what a post-COVID-19 world will look like. It seems hard to believe that changes in consumer behavior in response to the pandemic will be fully reversed in six months. Studies of past pandemics show elevated consumer savings rates for a decade after the initial disease comes under control.

There are reasons to be skeptical of the bullish sentiment in the U.S. equity market and its renewed interest in cyclical S&P 500 sectors. Other markets, from currencies to bonds to commodities are showing more cautious optimism. If the "all clear" sign was just over the horizon we would expect the yield on the ten-year Treasury to be above 1% or higher, a clear indication of improving economic strength. For all the optimistic news over the past month the yield on this important bellwether is yielding 0.87%, slightly lower than before recent vaccine progress was announced. This suggests that the bond market is indifferent to the equity market bulls and their arguments for above average economic growth moving forward.

This skepticism is based on the consequences of COVID-19. Rising debt levels, aging demographics and wealth inequality are all factors economists pointed to when explaining why the recovery from the 2008 financial crisis was so sluggish. All these concerns are present today, but at higher more troubling levels. Total debt in the US, from the consumer to the Federal government, is now 392% of GPD. This is a record. More total debt was added in the first six months of the year than in the previous ten years combined. High debt levels portend slower growth, as more current income is needed to pay debt service costs and is therefore unavailable to fund new purchases.

The US equity market seems willing to overlook the troubling health metrics of today in favor of anticipated robust growth in six to nine months, once wide-spread vaccine distribution has been achieved. The bond market is looking past the initial recovery and sees sluggish growth over the next three to five years due to record debt levels, cautious consumers, and an uncertain job market. From this perspective, November equity market returns and sector rotation, along with improved retail and institutional investor sentiment seems perhaps irrationally exuberant, to borrow a phrase from former Fed Chair Alan Greenspan.

Current Investment Strategy

Just as the market overreacted to COVID-19 in March and April, it appears to be overreacting to vaccine news in November. Our current portfolios, regardless of custodian, have enjoyed strong returns over the past month. Year-to-date performance has exceeded expectations. This was driven by systematic factors and by specific allocation modeling and investment selection decisions.

Our view more aligns with that of the bond market, cautious optimism. When enthusiasm for future equity market returns is not fully grounded in economic fundamentals, then it must be based largely upon sentiment

and bears increased risk of being transitory. Positive sentiment should not be ignored, which is why we will take no immediate action to reduce portfolio risk across the board. However, nor will we jump on a bandwagon that may lose a wheel traversing this bumpy road to recovery. The return to "normal" social and economic conditions is a process, not an event.

Closing Comments

As this is the last written economic commentary that we will deliver this year, and with Thanksgiving recently having passed, we offer our sincere gratitude for your trust and for the opportunity to continue to serve you with investment management, planning and general financial counsel. As fiduciaries, and as people, our duty of loyalty is to you exclusively.

From our families to yours, enthusiastic best wishes for a peaceful and joyous holiday season.

Personal Investment Management, Inc.