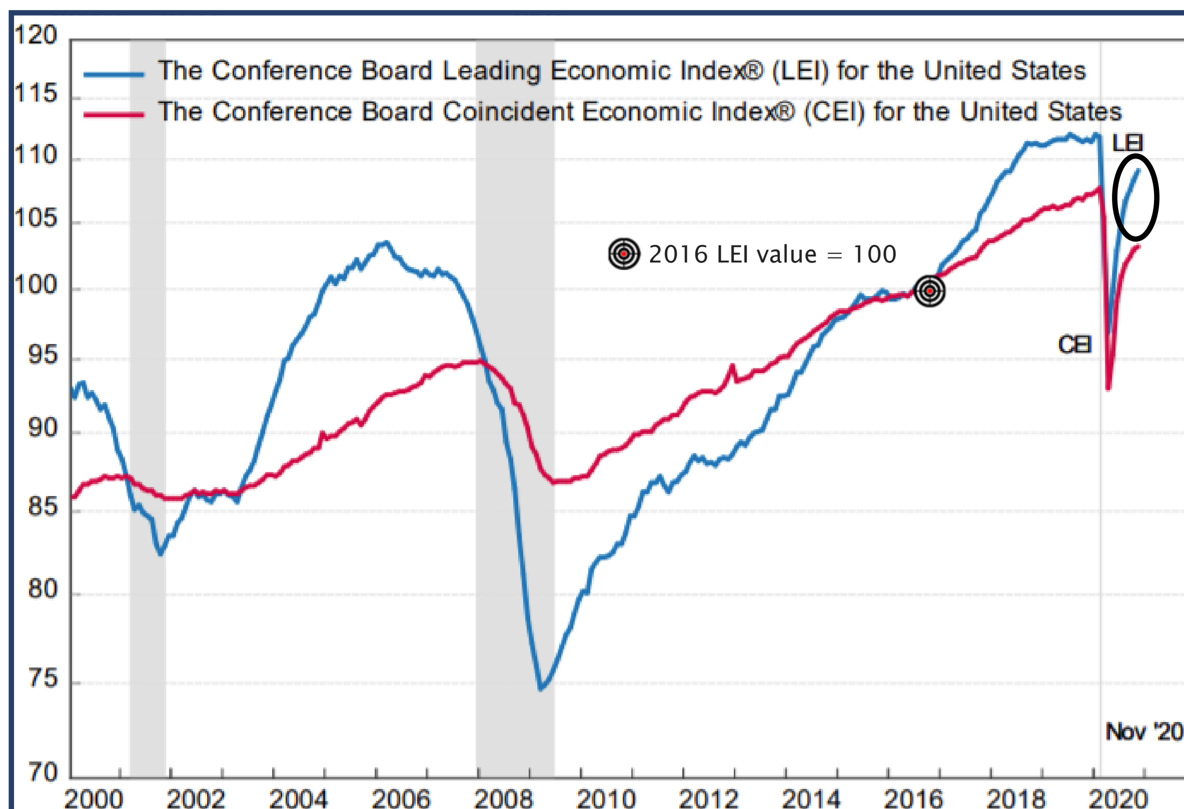
EQUITIES OVERVALUED AS PANDEMIC INTENSIFIES

This quarter, I'd like to address the apparent disconnect between the adverse impact the pandemic continues to have on so many human activities and the apparent oblivion of the stock market, the behavior of which reminds me of that scene where the naïve little girl hands a daisy to Frankenstein while inviting him to play with her … just before he throws her in the lake.

LEADING ECONOMIC INDEX® SUGGESTS CONTINUED EXPANSION

Actually, quite a few economic indicators seem to be disconnected from the pandemic's havoc. The Conference Board's Leading Economic Index (LEI) is designed to predict future economic activity. Only to the extent political anxiety, human suffering, or other "soft" metrics affect the hard data captured by this index will they influence the level of it. As my babysitter used to say, money talks and B.S. walks.

An upward inflecting LEI (circled) portends continued economic expansion. That expansion certainly does not guarantee rising capital asset valuations, but it usually helps blow the wind in the right direction. The LEI remains beneath its pre-COVID level, but its shape and trajectory are clear positives.



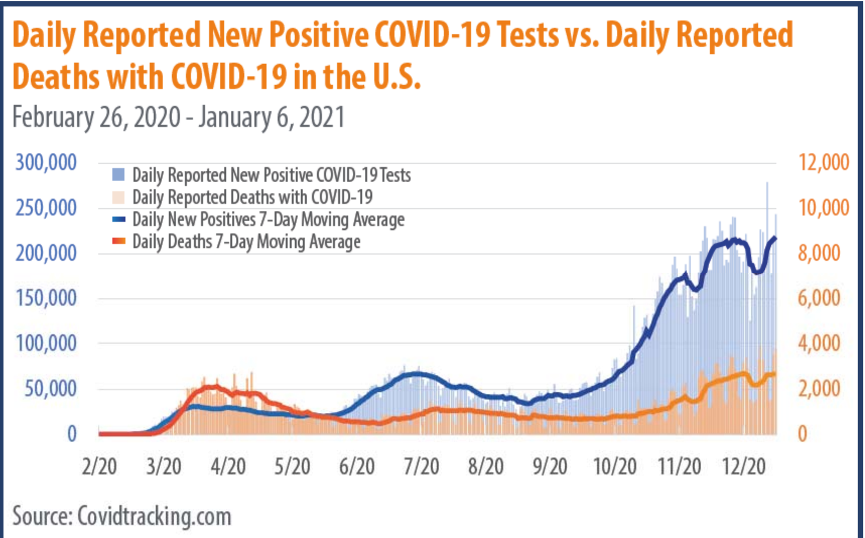
4 KEYS TO ECONOMIC RECOVERY ... *ALL* COVID-RELATED

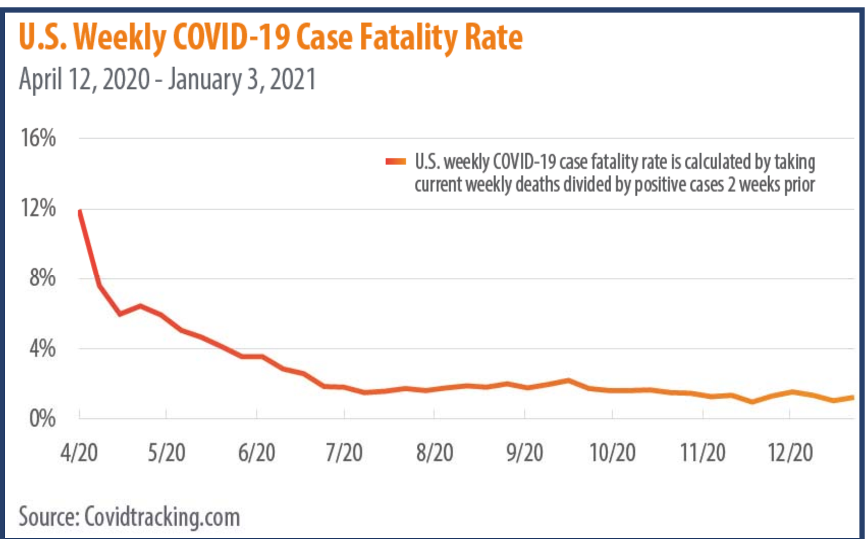
In December, Conference Board economist Dana Peterson outlined four factors she believes are likely to determine the pace of global economic recovery: The widespread availability of coronavirus treatments and vaccines, continued fiscal and monetary policy supports, and government policy to control outbreaks.

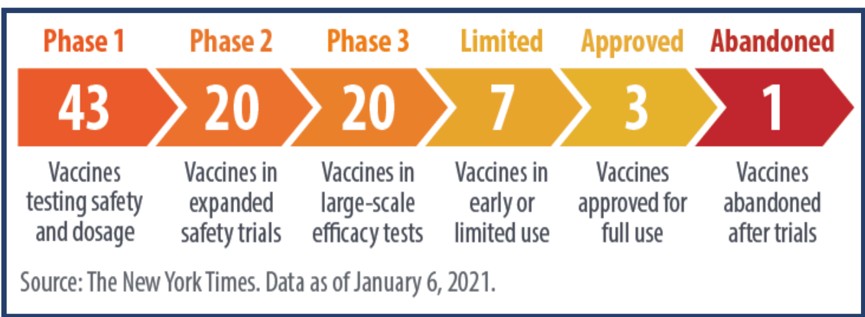
#1 TREATMENTS/VACCINES

With respect to her concern about the pandemic's evolution and the widespread availability of treatments and vaccines, the image to the right shows COVID cases raging throughout the holiday and winter months just as the medical community feared. However, it is also apparent in the next image that through a greater understanding of COVID-19 and the use of therapeutics such as Remdesivir, monoclonal antibodies and convalescent plasma, the medical community can now treat COVID infections far more ably than it could near the onset of the pandemic.

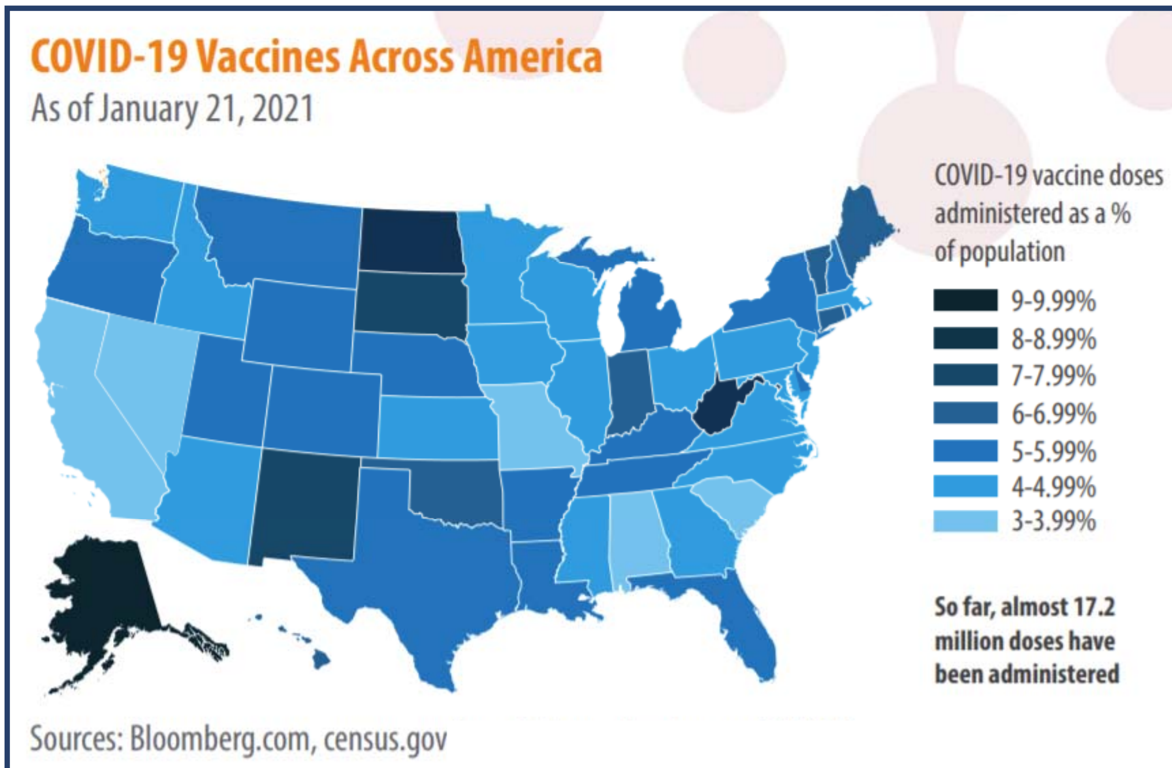
Despite the well-publicized problems associated with vaccine distribution, vaccine supply is likely to continue to increase as more vaccines migrate though the approval process and as distribution problems are solved.



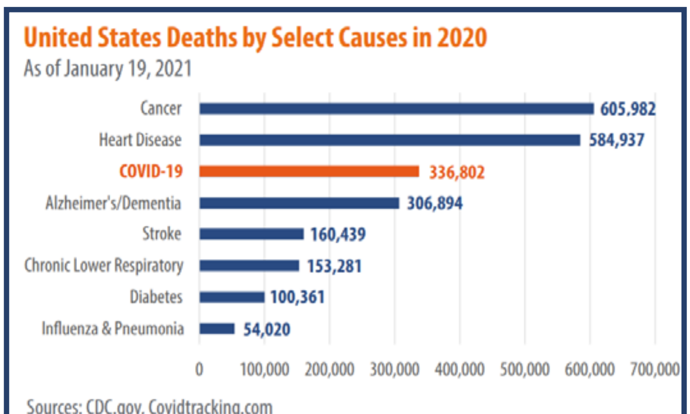


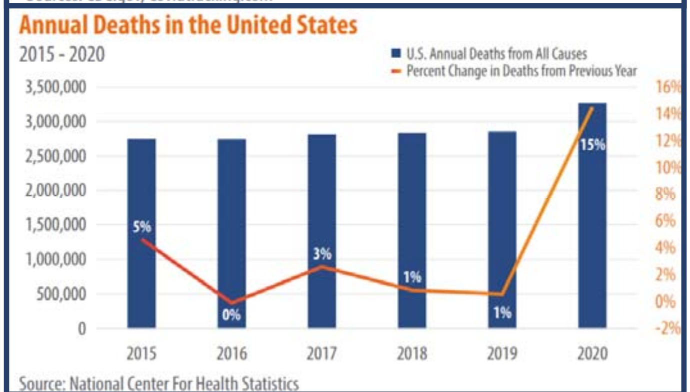


As of this writing, over 17 million vaccine doses have been administered within the U.S. The following heat map shows of how each state is progressing.



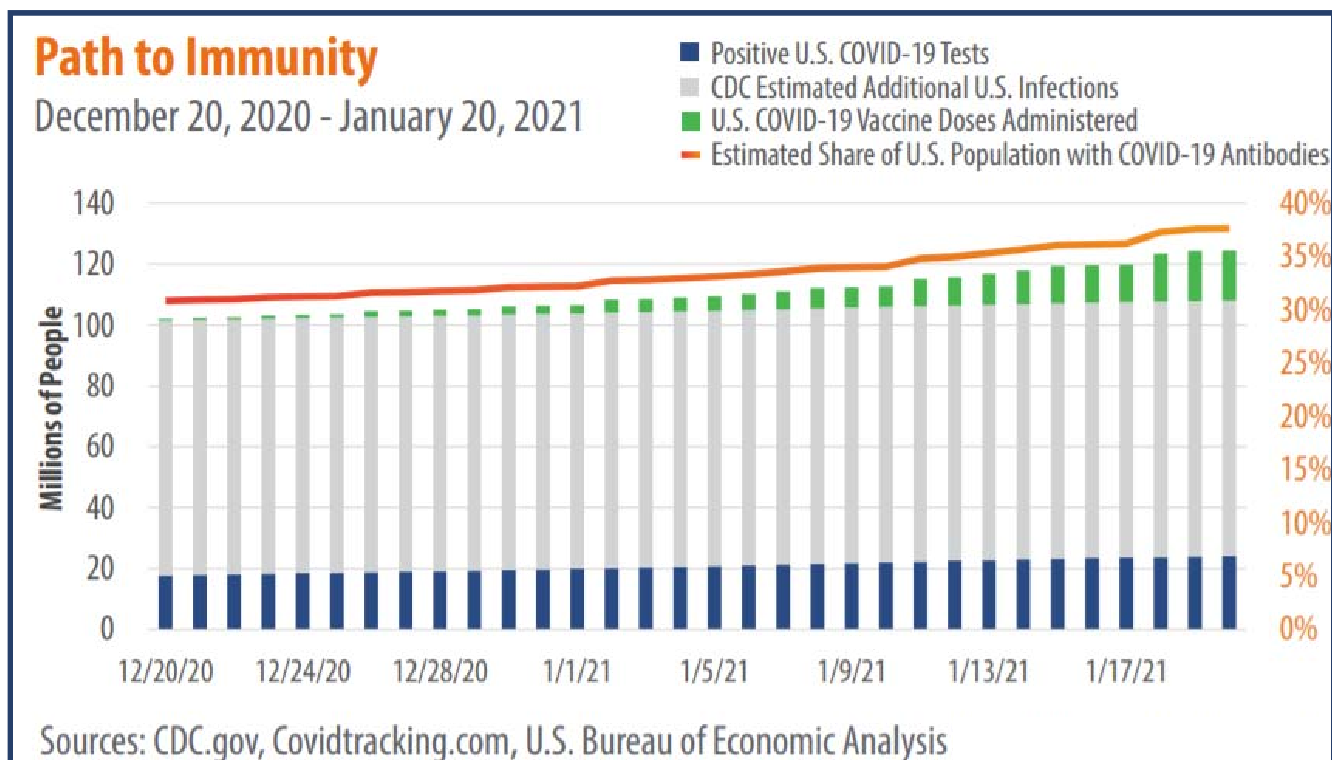
COVID-19 has undeniably turned out to be more deadly than influenza as shown in the images to the right. Based on the heat map shown above, one might conclude that the U.S. has far to go before the pandemic subsides. However, the actual level of resistance to the virus that causes COVID-19 (SARS-CoV-2) is influenced not just by the percentage of the population that has received at least one dose of COVID-related vaccine, it's also influenced by the percentage of the population that has already contracted the disease, including those who have contracted the disease without having been counted as a an official "case."





As shown in the image below, the CDC estimates that in addition to the 24 million officially documented COVID-19 cases in this country (the blue bars), an additional 83 million people who are not included in the official case tally (the gray bars) may also have already contracted the disease.

After including the 17+ million people who have already received at least one COVID-related shot, the total number of people within the U.S. who ostensibly have some level of resistance to the virus could be somewhere around 120 million. Figured against a U.S. population of 328 million people, 38% of the U.S. population may already be resistant to the various strains of COVID-19, as captured by the orange line, below.

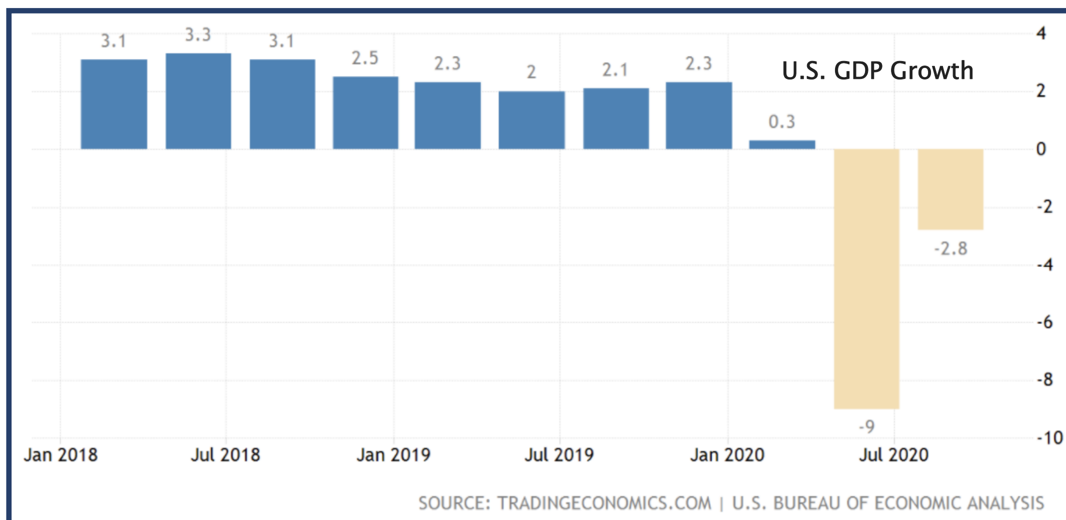


Herd immunity is the threshold percentage of the population that must be immune to a disease for the incident rate of that disease to remain stable or decline. For COVID-19, herd immunity estimates tend to vary from 70% - 90%. If more contagious strains of SARS-CoV-2 does, in fact, become the dominant strain in the U.S. as experts are now cautioning, the herd immunity threshold for COVID-19 might then rise to the upper end of that 70% - 90% range. Even then, we could conceivably be about 38/90ths of our way toward that end. And now that vaccines are starting to find their way into arms at around 1 million doses per day, we could be well over half-way through this ordeal in terms of total pandemic time. I believe this is, in part, driving investor optimism.

NEAR-TERM GROWTH EXPECTED TO BE SUBSTANTIAL

Returning to Conference Board economist, Dana Peterson, she anticipates global economic activity to rise 4.4% this year. In November, economic forecasting firm Capital Economics had been targeting year-over-year U.S. GDP growth of 4.5%, but as of mid-January it envisions growth of 6.5% for 2021 and a still robust 4.0% for 2022. When economists revise their GDP estimates, they often nudge them by a couple tenths of a percent either way, therefore a 2% increase is notable.

Similarly, a January 22 research note from Zacks Research alludes to various economists expecting GDP growth within the U.S. to reach 6% — 7% during the second half of the year. In GDP terms, those are large numbers, even if that growth will stem from a COVID-damaged economic base. The following image may help put these growth estimates in better historical perspective. Clearly, expectations for robust economic growth are in the air.



#2 CONTINUED FISCAL SUPPORT

Prior to his inauguration, then President-elect Biden unveiled a $1.9 trillion, fiscal stimulus plan, dubbed the American Rescue Plan, to provide support to people and businesses within the U.S. until COVID-19 vaccines are widely available. In short, it would authorize $1,400 in relief payments to eligible recipients, increase federal unemployment benefits to $400 per week while extending them through the end of September, phase-in increases to the minimum wage toward an eventual target of $15 per hour, extend moratoriums on evictions and foreclosures through the end of September, provide $350 billion in state and local government aid, provide $170 billion for schools, provide $50 billion toward COVID-19 testing, provide $30 billion toward a

national vaccine program, make the Child Tax Credit fully refundable (which means that the full credit can be claimed as a refund even if that amount exceeds the amount of tax paid into the system by the taxpayer) while increasing it to $3,000 per child ($3,600 if the child is under age 6). I wish I could have found a graph for all that.

The degree to which any of these proposals might be codified into law remains an open issue, but I suspect the Conference Board would regard these proposals as meeting the need for substantive fiscal support. I think investors are drawing some cheer from this, too, even if some of it might not become law.

#3 CONTINUED MONETARY SUPPORT

In a previous letter, I provided details of the many actions our Federal Reserve was taking to provide liquidity to the monetary system within the U.S. and abroad. By all accounts, the Fed is as committed now as it was then to getting the U.S. through this pandemic. According to a January 25th article from Reuters, "Fed policy remains firmly in rescue mode, with interest rates pinned near zero and no change expected for perhaps three years to come. The economy remains about 10 million jobs short of where it was last February." Again, the Fed has its foot firmly on the gas and it likely to keep it there even to the extent inflation exceeds its preferred, 2%-per-year target.

Because the Fed is independent, continued monetary support from the Fed is essentially assured, unlike fiscal support that can flow only if or when Congress functions.

#4 GOVERNMENT POLICY TO CONTROL OUTBREAKS

Earmarking funds for specific purposes doesn't necessarily mean that those purposes will be accomplished, but the $1.9 trillion package proposed by the new administration would funnel $50 billion toward COVID-testing and another $30 billion toward a national vaccine program that aims to vaccinate 50 million people (100 million shots) during President Biden's first 100 days in office. Efforts are also being made to increase the acceptance and use of masks. The effectiveness of these plans remains an open question, but I suspect investors are drawing optimism from these plans, as well.

My sense is that despite the slew of deaths that are still likely to occur before the COVID curve truly does flatten, better days are within sight. At some point, then, the liquidity and fiscal stimulus that's now sloshing around in the system will make an impressive

appearance as consumers sate their pent-up demand for the goods, services and experiences they've foregone for so long.

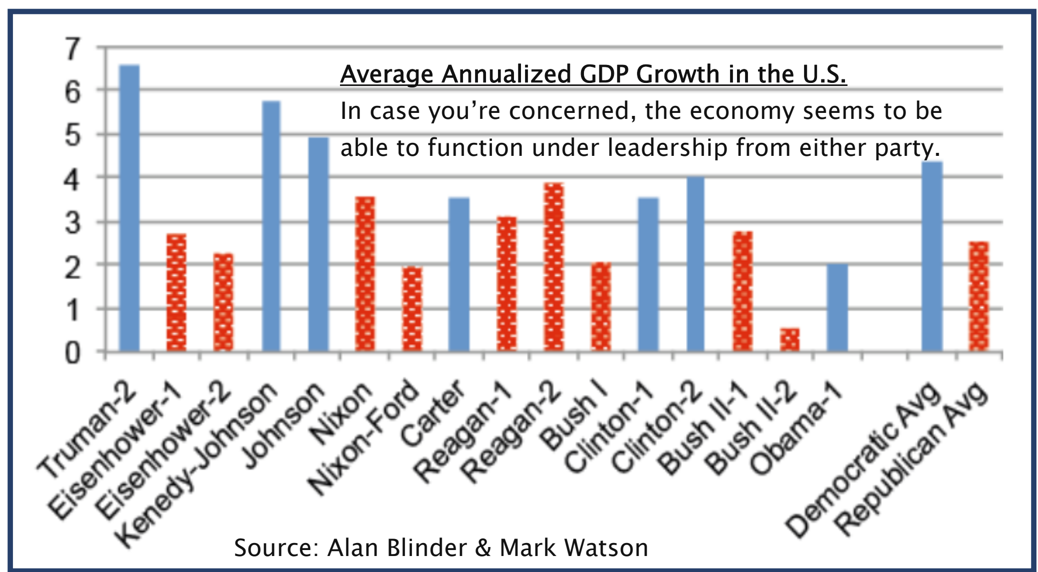
ELECTION IMPACT A MIXED BAG (AS USUAL)

With the elections behind us, there is some likelihood of higher income tax rates. After the corporate tax rate was slashed from 35% to 21% under President Trump, President Biden has proposed reversing half of that cut. His proposal would ameliorate the budget deficit problem, but it would also act as a headwind to corporate earnings and equity valuations since the share of income available to shareholders is the share that remains *after* considering income taxes.

President Biden has also proposed increasing the tax burden on those who earn over $400,000 per year. If that were to occur a few folks I know would be unhappy, at least until they notice that those higher tax rates increased the value of their tax-free bonds as more investors seek refuge by owning an asset class they already hold.

On the fiscal side, the pandemic-related stimulus has already increased U.S. indebtedness relative to its productive output to a level not experienced since the conclusion of WWII. At some point, the U.S. will have to address the issue of persistent deficits, but there probably won't be much appetite to do so during the pandemic.

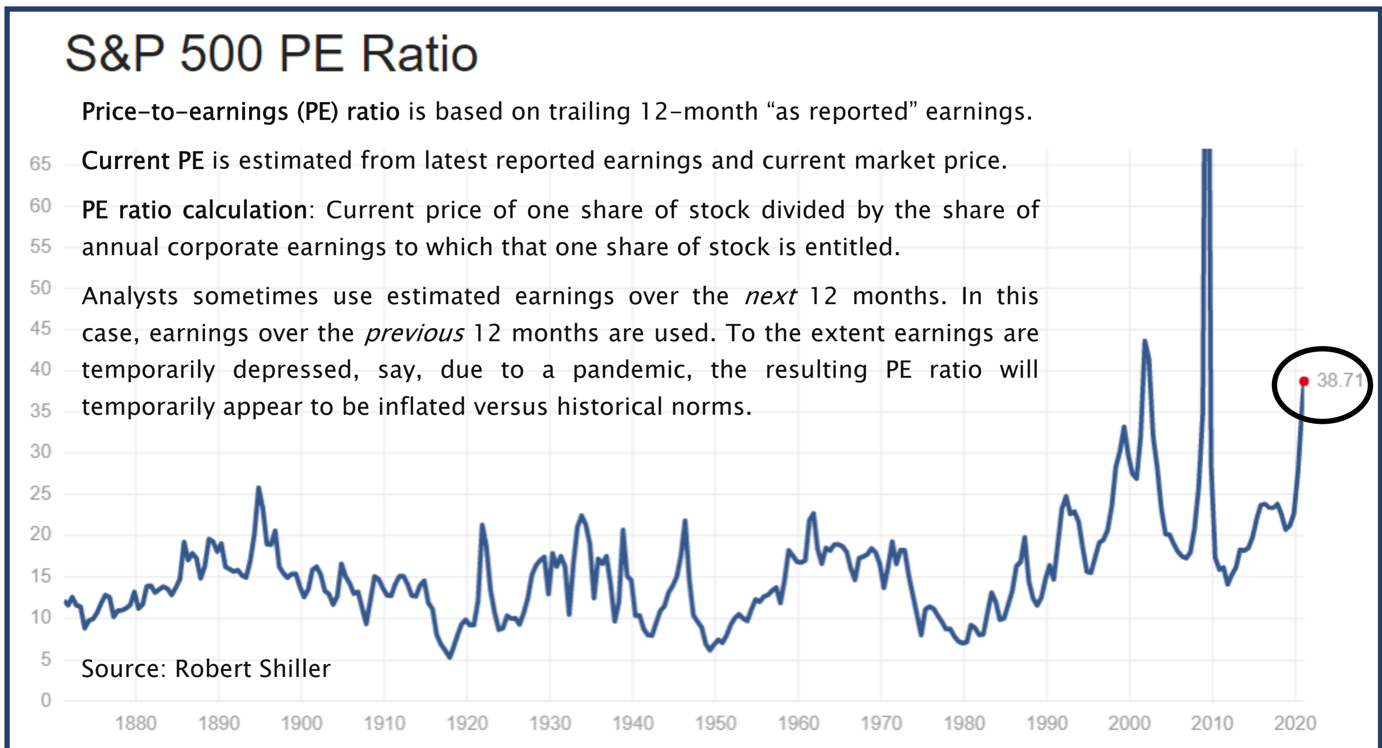
I assume there may be some restoration of the features of the Affordable Care Act and, possibly, some expansion of coverage. I also think there may be some bipartisan effort to keep drug prices in check. If so, that could create a headwind for pharmaceutical companies, but hospitals, health care providers and medical technology firms could benefit. As usual, having a new sheriff will result in some areas of the economy getting stiff-armed while others receive a lift.



Source: Alan Blinder & Mark Watson

OPTIMISM REIGNS, BUT ARE EQUITIES OVERVALUED?

They appear to be, but maybe not by as much as this next image suggests.



As discussed in the caption above, equity valuations may appear to be loftier than they actually are. Additionally, low interest rates tend to push equity values higher. As yield-starved investors notice that equities offer dividend yields that are routinely 3 — 6 times as high as they are for certificate of deposit, FDIC junkies slowly but surely venture into the stock market, pushing equity values higher in the process.

Although the PE image that appears above is based on trailing 12-month earnings, investors care far more about prospective earnings. If earnings were to miraculously double over the next 12 months, the PE ratio would decline to about 17 which would be right back in line with historical norms. However, consensus, per-share earnings estimates for the S&P 500 are only about 23% higher than actual per-share earnings were during 2020. If that estimate holds, the S&P 500's PE ratio would then fall to about 31, which would still be quite high in historical terms. Even so, market-timing has a dismal long-term record, so I hope you'll allow me to adhere to the asset allocation targets and ranges that are already in place for your portfolio. If we hadn't done that during 2019 and 2020, we would have missed the double-digit equity returns that were unexpectedly on offer. — Glenn Wessel