January 2021

Q4 2020 Commentary: Time to walk the walk…

Ignoring the noise and remaining focused on the narrow set of circumstances that we believe are driving stock market prices has served us well. If we need to be reminded that politics rarely have a meaningful impact on the stock market, we need look no further than January 6th and the storming of the capitol. That day's events did not register on the stock market. Unless it meaningfully impacts the economy, politics are of little interest in crafting an investment portfolio. The stock market rally continues to be fueled by optimism for an economic recovery from the Covid-19 induced recession. Vaccine approvals in the quarter spurred the S&P 500 rally further and 2020 was finished off with a 14% gain in the quarter. Bonds maturing within two years have seen little change in yield and are hovering just above zero percent. Longer term bond yields drifted higher, and the aggregate bond index returned 0.67% in the final three months of the year. At the market lows in March the S&P 500 was briefly down 33%, but the subsequent rally drove the index to a 17.9% for all of 2020. The bond market was also higher for the year as the economic upheaval early in the year drove interest rates down and drove returns 7.5% higher.

Where can we go from here? Last April, we proposed that closing the economy meant we could virtually ignore the numbers in 2020. As soon as Congress passed the Cares Act and the Federal Reserve pledged to peg short- term interest rates at zero, investors were willing to overlook 2020 and focus on 2021. The economic stimulus and government benefits instilled certainty that the US economy would make it through the year. Little else matters in 2021 but the prospects for recovery, which are ultimately tied to the prospects for a vaccine. Financial markets have been, and continue to be, supported by positive news flow. The stock market has moved on consistently positive news that further government stimulus is coming, that vaccine development was progressing toward approval and following approval that vaccinations can be rolled out on a massive scale. In this environment, valuation has not much mattered and stock market valuation has drifted to higher and higher levels.

Pockets of the stock market are now trading in irrational ways and it is disconcerting. Every day there are stocks that trade explosively higher and lower with no real news. These stocks are pinballing all over the place, untethered to any relation to valuation. The cause has been attributed to numerous reasons including FOMO (fear of missing out) in which investors pile into whatever stock is going up, or TINA (there is no alternative) in which stocks are viewed as the only asset class in which good returns can be had. There is speculation that new stock market traders are treating the stock market like a video game, or that quantitative traders and their computer algorithms are amplifying gyrations. Whatever the reasons, we will be giving these stocks a wide berth. We are comfortable holding a portfolio of attractively valued companies and know we can sidestep these situations that are confined to well defined areas of the market.

To reiterate, stock market excess is not yet pervasive. We find ourselves in peculiar circumstances. We proudly hang our hat on relying on company fundamentals to guide our investments and search relentlessly for investments that are at historically low valuations. We are very price sensitive, and it serves us well over time. Currently valuation does not seem to matter, but ultimately it will and high-quality companies with fair valuations will do well. There are plenty of stocks that this rally has left behind and they will do well in the coming economic environment. It is these kinds of companies that fill our portfolio.