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INVESTMENT MANAGEMENT, INC

Disciplined Value Investing

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Q1 2021 Commentary: As it rains money, it's all good for now…

We are still riding the wave more than a year into the pandemic paradigm. A year ago, in this letter we wrote "the turnaround from where we are now is not in question…it is inevitable and the only question is how long it will take. The government is seeing to it that we will muddle through in the meantime." In many respects those words are as relevant today as they were then. Financial markets have hopped from the initial CARES Act stimulus wave to the vaccination wave and now on to the latest wave of stimulus. During the quarter, the S&P 500 tacked on 6.2%. The Federal Reserve continued its zero-interest rate policy for short term rates. However, longer term rates rose significantly during the quarter responding to improved economic expectations. Rising rates on the long end of the yield curve drove bond prices down. The US aggregate bond index fell by 3.7% in the quarter. Bottom line, persistent good news has raised US economic expectations and been a boon for the stock market and our portfolios.

While we can thank rising expectations for the march higher by the stock market, it is a potential cause for concern. In the meantime, the adage "don't fight the fed" is a dominating paradigm in the stock market. The Fed continues to forcefully reiterate that it has no intention of letting up on its easy money policies. In addition, the economic recovery has been strong. Anticipation of the economy opening has led to strong consumer demand. Job creation in the first quarter was strong and unemployment has fallen substantially. Frankly, we were skeptical of a strong economic surge and expected a more modest but steady recovery. More than a decade ago, former fed chairman Ben Bernanke earned the moniker "helicopter Ben" when he speculated about directly dropping money into the economy to combat deflation. In 2020, the government effectively implemented the strategy. JP Morgan Chase CEO, Jamie Dimon, summed it up in his company's earnings release; "with all of the stimulus spending, potential infrastructure spending, continued Quantitative Easing, strong consumer and business balance sheets and euphoria around the potential end of the pandemic, we believe that the economy has the potential to have extremely robust, multi-year growth.

Given the state of the recovery, what can we expect from the stock market. Late last year, after the vaccination approvals we speculated on the earnings recovery in 2021 and 2022. If aggregate S&P 500 earnings could climb all the way back to pre-pandemic levels (as analysts were projecting) the S&P 500 would be trading around 22x estimated earnings. Low interest rates justify the current lofty earnings multiple. In anticipation of the economy emerging from covid-19 limitations and further government stimulus it was reasonable to expect better than 10% earnings growth for the S&P 500 for the following year. With these estimates AND steady interest rates, it was reasonable to project a 10% market return in 2021. So far, so good. In the ensuing four months, earnings projections have ratcheted higher. Consensus estimates for 2021 and 2022 have increased by almost 10%. These numbers provide for meaningfully higher price targets from today's level of the S&P 500, again with the caveat that interest rates hold at current levels.

With higher expectations comes a higher bar that needs to be cleared to justify current prices. The market valuation reflects a rosy scenario in the year ahead. Should the rosy scenario be called into question there may be a few bumps in market advance. Any market weakness would be viewed as a buying opportunity. We do not necessarily expect the stock market to be a smooth ride in the months ahead, but it should be a pretty good one.

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