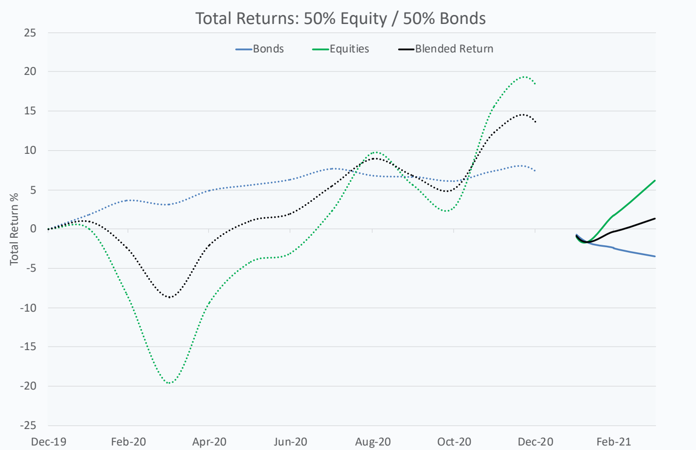
APRIL 1ST, 2021

RYE, NY
914.282.0941
WWW.BLUMBERGADVISORS.COM

WHERE WE STAND – Q1 2021

The S&P 500 Total Return Index was up 6.2% (including dividends) in Q1 2021. See the solid green line to the right in the chart below. The Aggregate Investment Grade Bond Index (including interest) was down 3.4% for the quarter (blue line). If your portfolio comprised 50% S&P 500 and 50% Bonds, your YTD return would be 1.3% (black line). Data for 2020 is shown, broken lines, to the left.

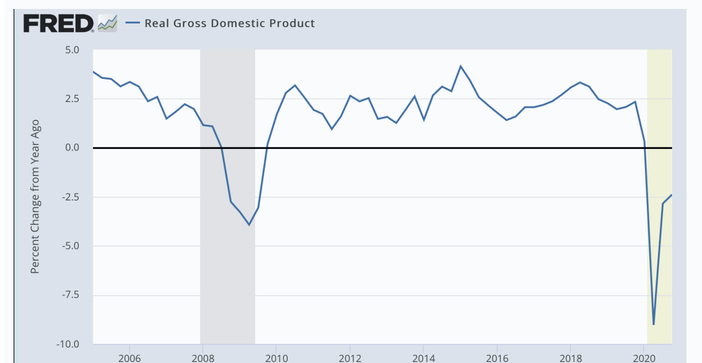


Overview

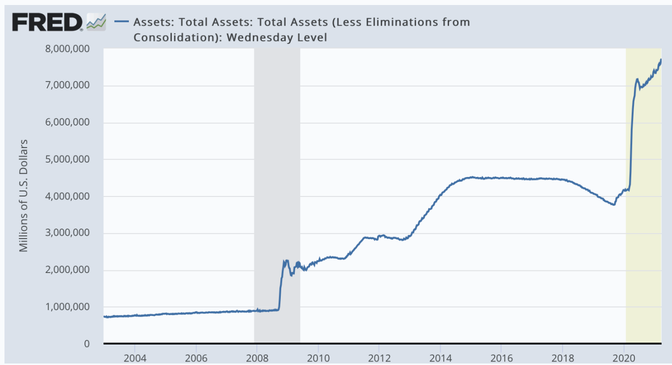
The S&P 500 index was up 5.8% in the 1st quarter, to new all-time highs. See the chart below. On the other hand,

the long-term US Treasury Bond ETF fell by 13.6% in the quarter as shown in the next chart.

As we all know, the US economy plunged into recession (yellow bar in the chart below) in 2020, at a pace that far exceeded even the previous recession (grey bar).

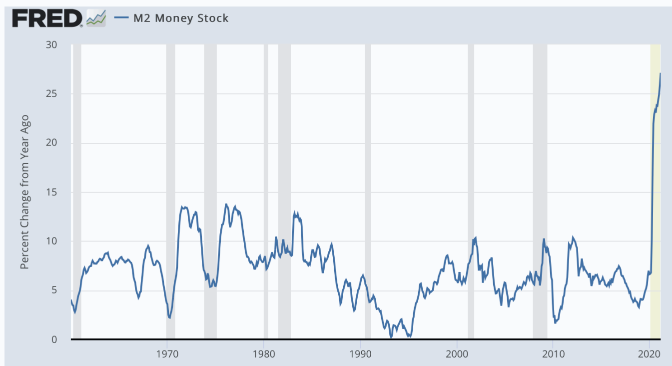


US monetary and fiscal policy stewards (the Federal Reserve and the US Government, respectively), have rushed to the aid of the economy in an unprecedented manner. As mentioned in previous reports, the Federal Reserve quickly lowered its policy rate to 0%. It continues to expand its balance sheet (i.e., buy debt issued by private and public sector borrowers at extremely attractive rates to ensure solvency and high levels of liquidity) to, again, unprecedented levels. See chart at top of next page. Additionally, the Fed policy committee continues to reassure market participants that this policy will continue well into 2024, until the Fed meets its dual

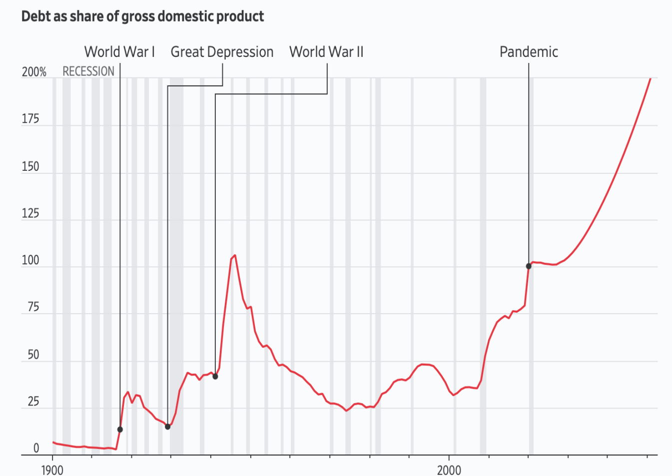


mandate of achieving full employment and inflation. In this instance, avoiding deflation.

As a result, the US money supply (a measure of liquidity in the system) has exploded by over 25% in the past year, far outweighing the response that the Fed has had to previous recessions (shown by grey bars in the next chart). Its true the velocity of money has declined, but still.



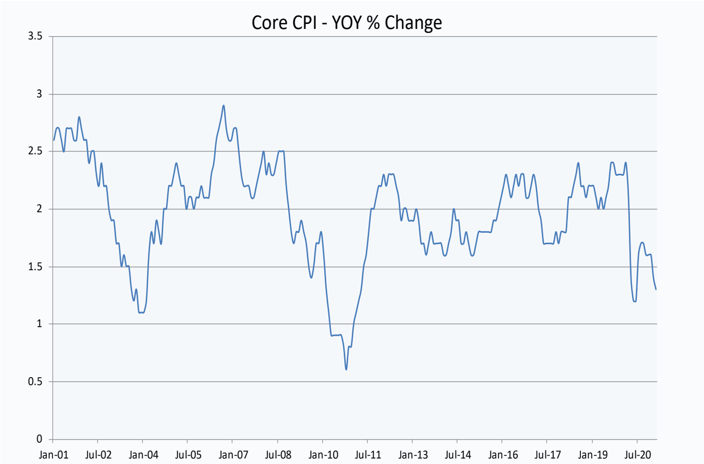
At the same time, the US Government has responded with, again, unprecedented deficit financed fiscal stimulus: free money to support US business and private citizens. And now with the Democrats controlling all three branches of the government, and with a narrow window to pass legislation through reconciliation bills, more is on the way. Needless to say, the deficit is exploding (see next chart), but being populist policies, only the bond



market (and not the electorate and the politicians that represent them) is starting to protest the efficacy of these policies. The non-partisan Congressional Budget Office points out that US budget deficit has now surpassed 100% of GDP and is set on an unsustainable path at the current rate as shown in the previous chart. As with individuals who borrow and spend too much relative to their income, so do excess government budget deficits ultimately weigh on an economy's ability to generate growth in the future.

Emboldening the proponents of this triage-like support to the Coronavirus-hobbled US economy is the fact that interest rates are very low and therefore the ability of individuals, corporations and governments to service this burgeoning debt is greater now than in the past when interest rates were higher.

Supporting their argument is the fact that inflation remains low and therefore the Fed does in fact have the luxury of keeping interest rates very low. The existential question is whether inflation will remain low in the coming year/s to support this, the current capital markets narrative. For now, largely, the bet is it will even though the charts on this page suggest there is a fair chance it won't: excess money creation is correlated to higher inflation.



Having addressed the macro backdrop, let's look at valuations.

There have been three distinct phases in equity markets since the beginning of 2020:

- The pandemic induced 36% collapse in the benchmark indices to level that were last seen in 2016, obviously due to the perceived threat to the global economy from the Coronovirus pandemic.
- The massive recovery in the indices, particularly technology stocks, owing to the aforementioned monetary and fiscal stimulus; a rally that was

reinforced by the quick roll-out of effective vaccination.

- And in more recent months, the outperformance of, non-technology, value stocks: getting their boost from the likelihood of a strong economic rebound and their relative immunity to the aforementioned rise in long term interest rates.

The red line in the chart below shows, how entering 2020, earnings expectations for 2021 for the S&P 500 were for $195 per share and how that expectation dropped to $160 per share at the height of the pandemic panic. And how they have recovered to the now-$172 per share. The blue line shows how the S&P 500 entered the year at around 3,200, fell to around 2,600 (although the intra-week reading low was around 2,200) and the subsequent recovery I mentioned above.

Dividing the blue line by the red line we arrive at the price earnings ratio (PE) for the S&P 500 shown in the next chart.

Entering 2020, investors were prepared to pay almost 17x 2021 earnings for a basket of S&P500 stocks, what would be considered somewhat fair in a 'normal' environment. That dropped to an attractive ~14x by March 2020. Today, they are paying around 23x earnings. An inverted PE ratio gives you an earnings yield, a measure that may be more intuitive to the reader. 17x PE ratio = 5.9% earnings yield. 14x = 7.1%. 23x = 4.4%.

The PE ratio (or the valuation investors give to equity prices) has 3 independent influencers: the earnings forecasts, the level of interest rates and investor confidence. PE ratios will be high (aka stocks will be expensive) when earnings are expected to grow substantially, interest rates are expected to stay low or go lower, and investor confidence is high. You can glean from the two previous charts where we stood in January 2020, March 2020 and where we stand now. At the moment earnings are expected to rise; interest rates are expected to remain very low (except for that naggy long bond which equity investors are choosing to ignore) and investor confidence is extremely high.

A note on investor confidence. The surfeit of global liquidity has created an investor exuberance (or fear-of-missing-out) that is reminiscent of times that are looked back upon with the shake of a head . Gamestop short squeezes by Reddit traders; gen-Z and millennial Robinhood traders speculating with 'stimmie' proceeds; record issuance of Spacs; very low short interest; extreme leverage by family offices with subsequent margin call blow-ups; unregulated bitcoin and the ilk going 'mainstream'. And easier to understand: the number of companies with price to sales (not price to earnings) in excess of 17 has exploded. Well known, high market cap names: Tesla (20x sales), Nvidia (18), Shopify (46), Airbnb (34), Zoom (35), Snap (31), Snowflake (101) and others. At best the forward returns of such valuations are usually seriously challenged. And possibly what happens to a well-known name like Viacom CBS, losing $48bn in market capitalization over a weekend when the music stops (see family office margin call blow-up above) should be treated as instructive.

Where We Stand

We continue to strategize our portfolios recognizing that we are late in the investment cycle, even though the unexpected and massive corporate tax cuts of 2017; the incredible stimulus the Federal Reserve continues to provide (some argue with reckless abandon); and the utterly profligate and populist US fiscal policy, continue to extend the cycle.

Currently, our equity exposure is lighter than it will be in the future, when the investment cycle provides us with the opportunity, as it did from 2011 through 2017. However, we have benefited in two ways that has resulted in us keeping up with our benchmarks in Q1 2021, whilst having a much lower risk profile.
One, we have found opportunities in our value universe of equities and benefited therefrom, and two, we have extremely low exposure to long duration bonds and therefore have avoided the deterioration in bond values.

As a result, all our portfolios, continue to accrete to new all-time highs, albeit in a slow and steady manner, which we currently deem appropriate.

These are extremely pivotal times from an investment standpoint and the forward path is uncertain.
On the one hand, there is the potential for the new administration to execute its policies regarding distribution of wealth, education, emigration, race issues, infrastructure, environment and health care, effectively. And in so doing lay the groundwork for a vibrant, productive and faster-growth US economy. And at the same time inflation remains subdued allowing the Fed to continue on the current path.
On the other, political intransigence, the drag from extremely high budget deficits, the possibility of higher inflation (which cause the Fed to become less accommodative) create a malaise that challenges future growth prospects.

Based on valuations discussed above, the bet by market participants is solidly on the former outcome without regard for the latter.

We have an open mind as to which outcome will prevail and want to avoid introducing a prejudice into any outcome that will jeopardize your investment funds, both in terms of preserving capital and in optimizing risk adjusted returns.

Therefore, our approach will continue to be one where our decision-making process is driven by finding opportunities that show an unlevered expected equity return on, say, a two-year horizon in excess of 8% p.a. (These decisions are not cast in stone). Uncertain times should reward investors with higher forward return on investment.

Those opportunities are few and far between at the very moment (unless you incorporate the greater fool theory) into your analysis), but these are volatile times and I suspect we will have more of these opportunities in the near future.