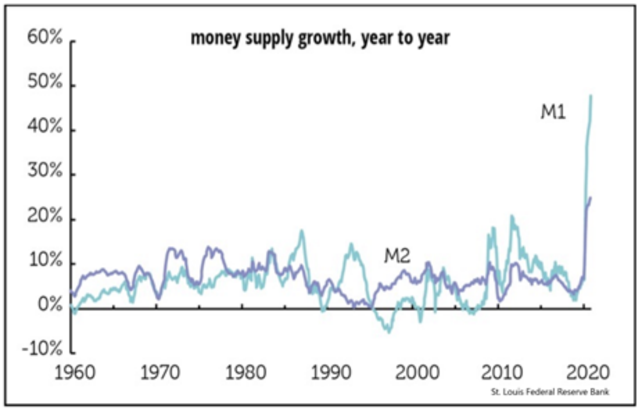
BLOG POST
Into the Unknown
01/05/2021

The phrase, "Happy New Year," is likely to be repeated more often than at the start of any other year of our lifetimes. Everyone will be glad to yell "adios" to 2020, but how confident can we be about what 2021 holds? We entered last year in pretty routine fashion before news of a virus originating in Wuhan, China sent the world into the largest pandemic since the Spanish Flu of 1918. The markets have traded in unprecedented fashion, losing over 30% in the shortest time in history, followed by the fastest stock market recovery in history.

Time will tell if the coming year has its own surprises in store, but there are some unknowns or risks that investors should be watching as trading in 2021 unfolds. Markets appear to be priced for a goldilocks scenario, where the economy opens up the first half of 2021 and corporate earnings surge. If there is one thing we have learned, it is whatever consensus suggests will take place, is far from guaranteed.

Risk #1 – Hiccup with vaccine rollout. It is astonishing that the market has traded at new highs when much of the global economy has been shuttered. The impact COVID-19 has had on the publicly traded companies has varied greatly. Big and emerging technology companies have seen windfall profits as companies scrambled to figure out 'work from home' scenarios, while travel and leisure companies and large retailers have filed bankruptcy at staggering rates. The ultimate impact of the virus, however, is going to be on small businesses, and that has been mostly ignored by the markets.

It has been estimated that more than 30% of small businesses closed over COVID concerns will never reopen. That represents a huge swath of jobs held by the most vulnerable, those with the lowest level of savings. There are still many unknowns about the vaccine adding to risks in the coming year. Side effects and allergic reactions are causing many to not be eligible or not desire the vaccine. The first approved vaccine needs be kept at minus 70 degrees Celsius, making logistics like transportation complicated. The best and brightest are working to solve this crisis, but the potential all does not go as planned is high and poses a significant risk to the impact of the first vaccine. Of course, the second approved vaccine requires storage at standard refrigeration temperatures, and other candidates may be viable at room temperatures, so the vaccination issue will not necessarily turn on the cold storage logistics alone.



Risk #2 – Balance of power in the Senate. Who controls the U.S. Senate will be determined following the January 5, 2021 runoff elections for 2 Senate seats in Georgia. If Democrats were to prevail in both races, they would control the House, Senate and White House, a potential panacea for Progressives who want to dramatically change the political landscape.

Many of the promises made by candidate Biden could pose highly substantial headwinds for investors and the markets in general. According to some, U.S. corporate competitiveness surged following the drop in corporate tax rates from 35% to 21%. Because many corporate profits are distributed as taxable dividends to stockholders, it often resulted in a 60% net combined tax rate on profits. Lower taxes allowed U.S. companies to better compete and the surge in profits drove markets higher. Higher taxes on small businesses will significantly quell job growth at a time when as many as 20 million people find themselves unemployed.

Risk #3 – Fed blinks, impacting liquidity. Of all the reasons for the stock market's resiliency, excess liquidity provided by the Fed sits at the top of the list. Buyers of risk assets have benefitted from historically low rates in two ways: (1) low rates make borrowing for corporations very inexpensive, and (2) with little yield available from bonds, investors are almost forced into risk assets, driving prices higher. The chart in the middle showing the risk in the M1 and M2 money supply demonstrates how historic the Fed's response to COVID-19 has been.

The M1 money supply grew year-over-year by 48%, while the broader M2 grew at 25%. Personal savings has also skyrocketed, climbing YoY 302% in Q2 and 142% in Q3, representing more than $1.3T of new savings in just 6 months, according to the Bureau of Economic Analysis. Because of historically low velocity of money, there has not yet been any inflation associated with the surge in money supply, but if that starts to appear and the Fed tapers liquidity, I would expect a rush for the exits by investors.

Goldilocks scenarios rarely play out in real life and 2021 may prove that to be true. The markets appear priced for perfection and we live in anything but a perfect market environment. Don't be surprised if we see oxygen masks falling from the ceiling as the ride for investors gets bumpy in 2021.