PCM
Peak Capital Management

Veering Left

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Political handicappers and forecasters do not have any better track record than those forecasting the weather. While the latest election seemed anything but a “Blue Wave” with Republicans in the House picking up seats, the reality is that Democrats now control the White House, Senate, and House and have an agenda ready for their vision of America. The implications are likely to be widespread in terms economic and market impact.

The new President signed 17 new Executive Orders on his first day in the White House, more than the prior 3 Presidents combined. At a minimum, this gives us insight into the direction we should expect the Executive and Congressional branches of government to gravitate toward. Some of these actions have the potential to impact the markets in the short-term, while other priorities, such as tax increases, are likely to impact the economy and earnings gradually.

Here is a look at potentially the most meaningful shifts in policy:

Taxes: President Biden campaigned on reversing the Trump Administration’s corporate tax rate cut, and there is no reason to believe they will not follow through now that Democrats have 51 votes in the Senate. You could argue that cutting the corporate tax rate from 35% to 21% on January 1, 2018 was the largest driver of stock market gains over the following years. Since the tax cut was enacted, the S&P 500 has gained 34%, while the Nasdaq soared over 80%. Analysts from FactSet estimate that returning the rate to 35% will cut earnings on the S&P 500 by approximately 10% from $189/share to $170/share. A drop in earnings of that magnitude has not been priced into the markets today.

Trade: As Vice-President, Biden championed the Trans-Pacific Partnership (TPP) and has been a reliable proponent of free trade. I expect to see many of the punitive tariffs implemented by Trump removed, and trade relations with Asia and Europe are likely to improve. While you could argue that many of Trump’s policies were good for American workers, the economy should benefit from a more free-flowing trade and, at the same time, keep inflation in check.

Energy: Biden revoked the permit for the Keystone XL pipeline on his first day in Office, and the company sponsoring the pipeline announced 1,000 job losses the same day. It has been estimated by some that 11,000 jobs will be lost, but that may just be speculation. Biden also signed an order putting the U.S. back in the Paris Climate Accord that, according to NERA Economic Consulting, will cost 6.5 million jobs and $3T in reduced GDP by the year 2040. Regardless of how many jobs are lost or the economic impact, the reality is that we will see higher energy prices and that will negatively impact earnings and low-income wage earners who are most impacted by rising gas and electricity prices.

> **With Democrats in control of all branches of government, we should expect to see more stimulus, which should benefit the economy and markets in the short term.**

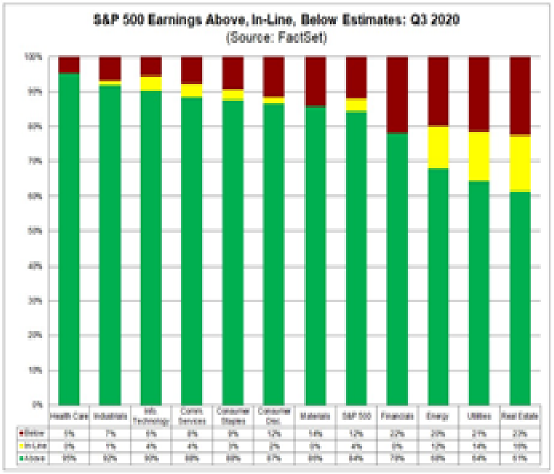
Immigration: Changes to immigration policy may have the most long-lasting impact on the economy as more of an “open border” approach is taken to immigration. Work on a border wall was immediately stopped, and steps to make DACA permanent are being taken. The cost burden on states for the increase in immigrants arriving will likely be borne by the Federal government, and history suggests areas with large new immigrant populations stifle wage growth for the middle class, resulting in lower per capita consumption.

With Democrats in control of Congress and the Executive Branch, we should expect to see more stimulus, which should benefit the economy and markets in the short term. Goldman Sachs Chief Economist Jan Hatzius is optimistic about GDP growth in 2021, expecting growth to accelerate to 6.6%, well ahead of the consensus among economist of 4.1% growth. He is expecting a mid-year consumption boom as the economy reopens following successful vaccine administration. He does point out risks associated with a vaccine-resistant strain of COVID that may require a new vaccine to be developed.

There is an interesting divergence occurring in the markets right now, with the sentiment on the NFIB survey plunging more than 5% in December while small cap stocks, measured by the Russell 2000, are moving higher. It is unusual to see higher appetite for risk while sentiment is falling, but it signals the markets may move higher in the short-term.

I am reminded of Newton’s First Law of Motion, which states that a body in motion will remain in motion until acted upon by an outside force. Markets are trending higher, and that trend will likely remain until an outside force, currently unknown, appears. Last year it was COVID, but we saw a V-shaped recovery. It is anyone’s guess what it will be in 2021.

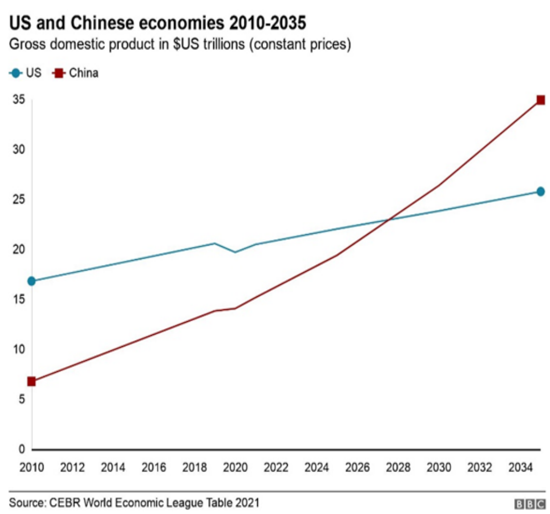
Earnings Soar



There are times when it is hard to tell whether good news is really good or bad news is really bad. Take earnings as we approach the midway point of 4th quarter reporting. The news has been strikingly positive, with the average company reporting earnings 22.4% above estimates, according to FactSet data. The 5-year average on upside earnings surprises is just 6.3%. If reporting season finished with gains intact, it would represent the 2nd best average earnings beats since they began tracking the data in 2008, with only the 2nd quarter of 2020 exceeding that at 23.1%. However, Q4 will also represent the 4th consecutive quarter, and 7 of the last 8 quarters, where earnings have fallen on a year-over-year basis and this quarter's -4.7% decline is the largest since 3Q 2009.

- Big banks dominate the early earnings season and they have not disappointed. In aggregate, banks that have reported beat estimates by 30%, while the rest of the market has beaten by an average of just 15%.
- According to S&P data, EPS for the S&P 500 in the 4th quarter of 2020 will be equal to the EPS back in March 2018, nearly three full years earlier, while stocks are 44% higher over that period.
- Revenues on a year-over-year basis are forecasted to be slightly higher, even as earnings are lower. Profit margins are tracking at 10.3%, which is in line with the average margins over the last 5 years.

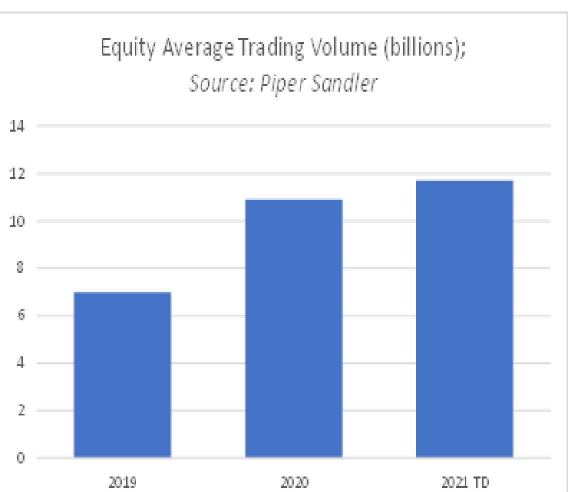
China — Friend or Foe



Beyond dealing with a global pandemic, one of the most pressing issues for President Biden is defining the path forward specific to China. Biden appears to be hitting the reset button on President Trump's China policy. The chart to the left shows U.S. and Chinese GDP, showing China at the current growth rate surpassing the U.S. in 2028. Biden is working toward a multilateral alliance of democracies that will create pressure on China to create a level playing field in areas that range from manufacturing to artificial intelligence to mining rare earth metals. China has responded by working aggressively to create trade pacts with Japan, South Korea, Australia, and across Europe. Short of reinvigorating the cold war, alliances acknowledge the challenges associated with a democratic economy working in harmony with an autocratic economy.

- According to CNBC, Chinese GDP grew by 2.3% in 2020 as a result of alliances with other countries across Asia and Europe.
- Janet Yellen has described China as "our most important strategic competitor" (Barrons).
- President Xi's message at the World Economic Forum was marked with confidence in China's ability to maintain it's pace in defining itself as the world's most powerful economy by positioning itself as a friend to globalization.

Retail Trading Volume

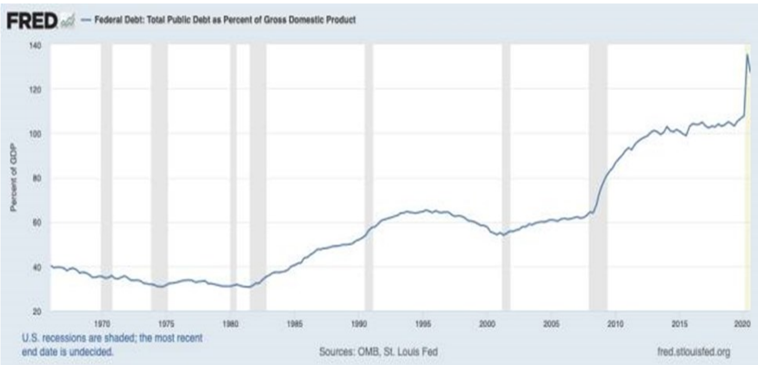


With most market indexes reaching new highs, it is no surprise that trading volumes for equities and options are hitting new highs as well. According to data from Piper Sandler, total equity volume (shares traded) was approximately 7 billion in 2019. This figure increased to roughly 10.9 billion in 2020 (55%) and has totaled 14.7 billion so far this year. According to the data, the increase is due mainly to retail participation in the markets. Volumes at retail brokerages have surged, as well as options trading in obscure, thinly traded stocks.

- The Piper report shows increased trading, particularly in long positions in short-dated call options and in low-cost stocks (so-called penny stocks). Both strategies are directionally bullish. This behavior might suggest that retail clients are chasing momentum for fear of losing out on the bull run in equities.
- The volume data could be interpreted as highly speculative, unsustainable behavior that has helped propel equity indexes to extreme valuations (the price-to-earnings multiple on the S&P is roughly 27). Perhaps retail money is coming into the last stages of a bull run in equities? Only time will tell, but there seems to be little regard for fundamentals.

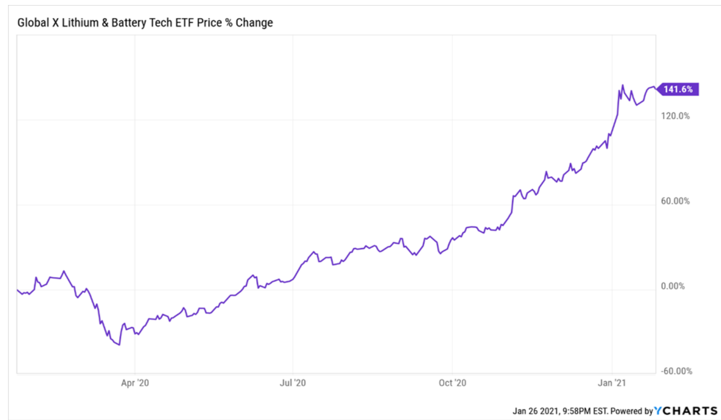
Macro View – The World According to Yellen

The Senate swore in Janet Yellen as Treasury Secretary. Analysts are studying her policy while serving at the Federal Reserve Bank to gauge how she will inform policy, regulation, taxes, the market, and the economy. Yellen was well known as being dovish on monetary policy, supporting low rates. Yellen also was regarded as moderately hawkish on fiscal policy, meaning she is less likely to support excessive government spending without offsetting the spending with counterbalancing action such as raising taxes. The chart below shows current debt to GDP at approximately 127% versus approximately 102% in 2017, a trend Yellen appears determined to reverse. Yellen has been vocal in support of globalization and immigration over populism. Yellen does seek to address China's infringing on U.S. intellectual property and limiting free market competition. This clearly creates a tension between supporting a global economy and a balanced trade policy with China.



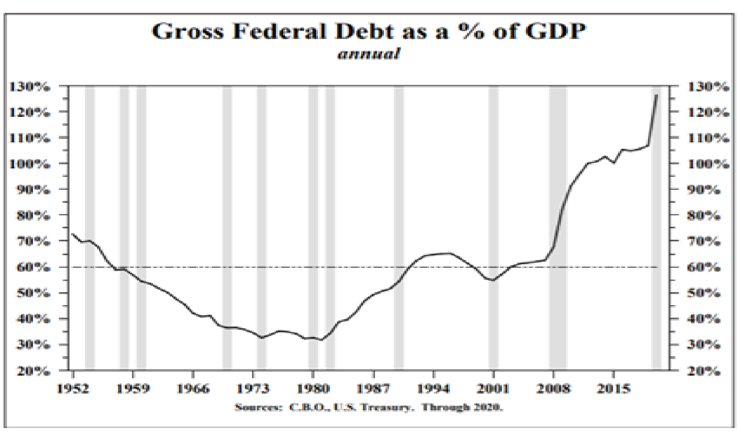
Taking Stock – Electric Vehicle Emissions

Electric vehicles (EV) found a new gear when Tesla was added to the S&P 500 index recently, and President Biden's outspoken climate change initiatives have also intensified the spotlight on EV. The question, or risk, is whether lithium and other rare earth metals used in battery power can keep up with demand. Barrons has noted that based on current EV demand, a 50x increase of lithium will be required. Half of global lithium supply comes from Livent, Albermarle, and SQM. Barrons goes on to state that the lithium mining industry will need approximately $7bb to provide the supply necessary to meet the EV demand. ARK Portfolio Manager, Cathie Wood, leveraged their firm's battery research, stating that EV sales will increase 20-fold in five to six years accounting for 40% of total global auto sales (Twitter @CathieDWood). The chart below is one-year performance for the lithium ETF, LIT, demonstrating the significant price appreciation.



Fixed Income - Up, Up, and Away

If there is one thing we have learned over the last couple of decades, it is that neither party can claim a moral high ground on the issue of government deficit spending. As late as 2000, the government debt as a percentage of GDP stood at 60%, a reasonable figure putting the U.S. among the lowest indebted countries in the developed world. That figure has skyrocketed to more than 130% of GDP as of the end of 2020, and is slated to rise in the fashion of a hockey stick. Even the conservative Austrian School of Economics understands the need for deficit spending when something like the Great Financial Crisis or COVID occurs, but the idea is that after the period of crisis, restraint is brought back and deficits grow slower than the rate of economic growth during the recovery period. However, here, that appears unlikely to occur.



Technical - Pulling for the Underdog

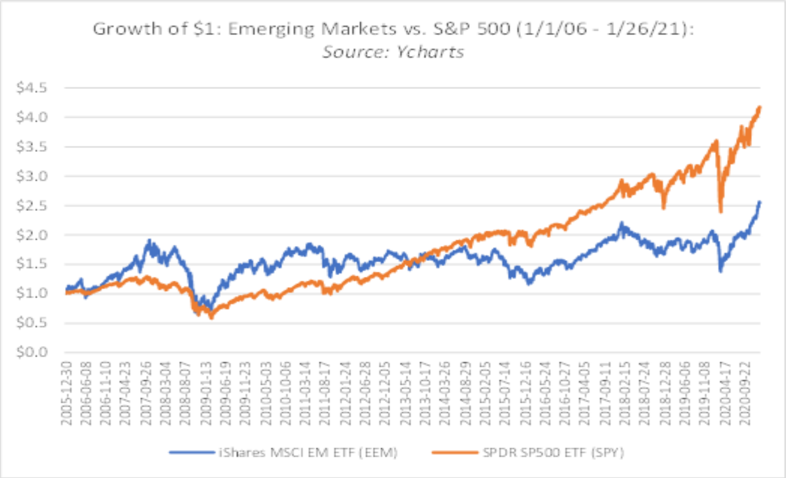
If the options markets were a sport, Puts would be considered the perennial favorite and Calls the perennial underdog. It is said that the "smart money" is in selling Puts because the majority of the options are out of the money at expiration. Something interesting is happening in the Put/Call ratio this week as demand for Calls has skyrocketed in relation to Puts. There was also a dramatic increase in Calls in the late 1990's, right before the tech bubble burst in 2000, but the latest surge in Call interest is unprecedented. At the forefront of this phenomenon is GameStop, one of the widest held short positions on Wall Street. This stock has 69.75 million shares trading and 68 million shares sold short, and the stock is up more than 600% since the end of October and over 300% YTD, putting a hurt on many traders.

Emerging Market Equities

Clint Pekrul, CFA

So far 2021 has been a good year for emerging market equities. Year-to-date the iShares MSCI Emerging Markets ETF is higher by roughly 8%, compared to a gain of approximately 3% for the SPDR S&P 500 ETF. As the chart below illustrates, ever since the financial crisis of 2008, emerging markets collectively have woefully lagged U.S. equities.

After moving more-or-less sideways for the better part of a decade, emerging markets have broken to the upside ever since the pandemic began in March 2020. Indeed, emerging markets have outpaced most developed market indexes.



To be sure, China drives much of the returns for the asset class, as it represents roughly 40% of the total market capitalization. The table below illustrates the top five emerging market economies, their percentage of the MSCI Emerging Market Index, and their respective performance for 2020:

Country	Weight	2020 Performance
China	40%	42%
South Korea	14%	39%
Taiwan	13%	32%
India	9%	15%
Brazil	4%	-20%

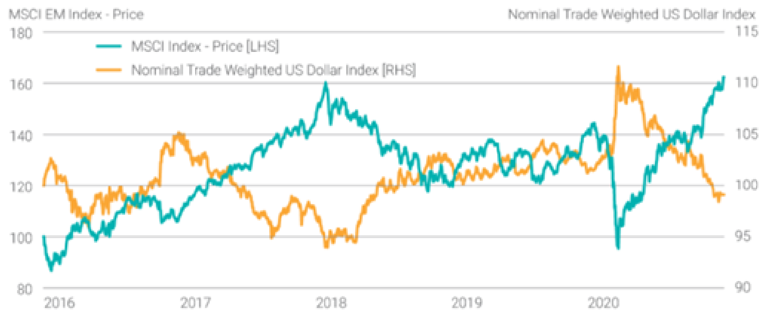
Source: MSCI, Ycharts

As the table above illustrates, returns for emerging markets were driven by strong performance, predominately from Asian economies. Latin American economies, such as Brazil, were harder hit by the coronavirus and materially underperformed the broader benchmark.

Given the recent run up in emerging markets, what could propel the asset class higher in 20201 and beyond? In the long-term, the likely catalyst is demographics. Developed markets such as the U.S. and Europe have aging populations, which could suggest lower productivity and GDP growth over the next decade compared to emerging market economies.

In their most recent capital markets report, JP Morgan projected GDP growth across emerging markets to be 3.9% in 2021, compared to 1.6% across developed markets (JP Morgan Long Term Capital Market Assumptions, 25th Edition). The report suggests both China and India will drive GDP growth, and that emerging markets productivity and human capital will gradually converge to developed market levels. This convergence is the narrative behind higher GDP growth.

In the shorter-term, currency valuations will have an impact on emerging market returns. The chart below illustrates the movements in the MSCI Emerging Markets Index against the USD Index:



Source: Lazard Outlook on Emerging Markets, 2021

Historically, there has been a strong negative correlation between movements in the USD and emerging market performance. As we have seen since the market lows in 2020, a weakening dollar has coincided with a rally in emerging market equities. With talks of further trillion-dollar COVID-19 relief, the USD could continue to weaken, which in turn could be a tailwind for emerging market equities.

Lastly, increased demand for commodities could help push emerging equities higher. According to Lazard Asset Management, a push for an infrastructure bill from the Biden administration should increase demand for materials and industrial products from emerging market countries (Lazard Outlook on Emerging Markets, 2021). Indeed, the S&P GSCI Commodity Index has moved higher by roughly 6% so far this year. However, investors should be reminded that promised infrastructure initiatives from four years ago never materialized.

Overall, there are some promising signs for emerging markets going forward. The long-term theme for investing in the asset class is driven by demographics – developed market populations are aging, while emerging markets, in terms of productivity and human capital – are catching up. This could lead to higher GDP growth for emerging economies over the next decade, but past that period, certain emerging markets may contend with their own demographic challenges. For example, China will need to grapple with the demographic consequences of its one-child policy.

In the short run, a weakening USD and increased demand for certain commodities from the U.S. could be a tailwind for emerging markets. Likewise, the continued distribution of the COVID-19 vaccine in countries outside of Asia should help lift the broader asset class.

Q: Do you expect the vaccine to allow the economy to return to pre-Covid levels by the 2nd half of the year?

I should start by stating that while I am not an epidemiologist, I did stay at a Holiday Inn Express last night. There are plenty of reasons to be hopeful with the Moderna and Pfizer vaccine as overall they seem to be effective in the limited studies that have been done. It is truly remarkable how quickly companies were able to get a vaccine through human trials and on the market, an unprecedented feat in history.

It has been documented that a strain of COVID-19 in South Africa is demonstrating resistance to current therapeutics and concern that the vaccine may not be effective against that strain. Viruses do mutate, so the risk that another vaccine will have to be developed exists and would definitely alter most forecasts for the economy in the 2nd half of 2021.

Absent another outbreak not mitigated by the vaccine, I agree with Jan Hatzius of Goldman that we could experience a consumption boom later this year as there is a lot of built-up demand to get out and travel and consume entertainment. Just as there have been winners and losers among companies, the same is true for employees. FRB data shows approximately 60% of jobs paying $100,000 or more can be done remotely, while only 10% of jobs paying $40,000 or less can be done remotely. This suggests a lot of cash is available for spending when economies open up.

First off, I think as a country we could be doing a better job of distributing the vaccine. Consider that there is no federally mandated procedure for rolling out the vaccine, which means it is up to the states to administer the coronavirus treatment. This lack of coordination has led to delays. The previous Trump administration had set a goal to vaccinate 20 million people by the beginning of the year, but based on CDC data, roughly only 3 million people had received the vaccine. Perhaps there will be better coordination at the federal level under the Biden administration. The president has promised 100 million vaccinations in his first 100 days in office, but this could prove to be a monumental undertaking. Meanwhile, delays and a lack of coordination at the state level mean that infections are likely to continue to grow. My hope is that by late spring a good portion of the population will have had the opportunity to get vaccinated. If so, then I think the back half of 2021 could begin to resemble a more “normal” economy. We are not going to go back to the way things were (the economy will certainly look different) but we can get unemployment under control and move on from the pandemic.

Q: Is it too late to be buying “green energy” stocks?

For many investors, it probably feels too late to be buying any quality stock as prices have soared even in the face of unprecedented uncertainty. Consider earnings (which almost no green energy stocks have), S&P is forecasting 2021 aggregate earnings to be at the same level as what was earned in 2018 even though the markets are 44% higher today. For markets to be that much higher on the same dollar amount of earnings is astonishing.

Buying any of the battery companies today seems more akin to gambling than investing, as it is very hard to know which breakthrough technology will ultimately prevail. My guess is that for every “winner” there will be many losers who never achieve a viable market share.

It is undeniable that the current Administration is going to focus on sustainability and renewable energy sources moving towards a carbon-free footprint in the future. An interesting way to take advantage of this easily identifiable trend is with companies who have been around for a very long time and have the ability to transition from traditional energy to renewable energy. Companies like London-based Atlantica Sustainable Infrastructure or NextEra Energy are examples of established companies with real earnings who have the resources to be leaders in delivering renewable energy, yet trade at reasonable multiples. I suggest avoiding the hype with these stocks and find companies you are confident will be around decades from now.

If you look at the S&P Global Clean Energy Index – which represents a basket of 30 stocks that are involved in clean energy businesses – it has soared roughly 300% off the market lows in March 2020. The current price-to-earnings multiple is about 50 (compared to roughly 27 for the broader S&P 500) and the price-to-book value is roughly 5.5 (compared to about 4 for the S&P 500). By any historical measure, clean energy stocks as a group look incredibly expensive. One of the top holdings in the index – PLUG Power – is up just over 100% year-to-date, but has no earnings. Meanwhile, the volatility of clean energy stocks is likely well above the risk tolerance of the average investor. I believe that ESG themed investing is real and sustainable. There is no question that we are moving away from fossil fuel and that the opportunities in clean energy going forward are abundant. But as with any investment, you must question current valuations. In other words, what are you paying today for a potential return in the future? A multiple of 50 times earnings seems like a high hurdle. From a portfolio standpoint, you might want to tread lightly and maintain only a modest allocation.

Model Weights

All weights as of February 1, 2021

Income	
Mortgage Backed Bond	56.34%
Investment Grade Credit	17.76%
High Yield Bonds	7.19%
Preferred Stock	11.13%
US Dividend Equities	4.64%
US REITs	2.92%

Balanced Income	
US Dividend Equities	13.96%
International Dividend Equities	15.24%
US REITs	9.59%
High Yield Bonds	27.26%
Long Term Treasuries	33.95%

US Growth	
Low Volatility Factor	15.92%
High Quality Factor	13.85%
Small Cap Factor	12.05%
Value Factor	16.59%
Momentum Factor	11.84%
Long Term Treasuries	29.75%

Global Growth	
Low Volatility Factor	8.31%
High Quality Factor	6.52%
Small Cap Factor	5.63%
Value Factor	7.90%
Momentum Factor	5.72%
Developed Market Equity	18.54%
Emerging Market Equity	17.73%
Long Term Treasuries	29.65%

Weights are approximations only and are subject to change.

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