Q4 2021: Can the Good Times Continue for Investors?

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It's already been an extraordinarily good year for investors. Stocks, including dividends, are up over 19%, twice the typical return for an entire year. Investors have been well rewarded for venturing out from money market funds, yielding just 0.07%, or CDs, as the five-year version returns just 0.44% annually.

Skeptics will counter that the market returns are so strong only because we've been coming out of a pandemic. Stocks plunged 35% in March of last year. However, we have set over 50 new all-time highs on the market averages this year alone, so markets have risen well beyond pre-pandemic levels.

What are the key drivers? Start with a roll out of largely effective vaccines. While there's much consternation as to why many Americans have not yet "gotten the jab," the fact is that most adults are now vaccinated; last year at this time no one was. This has allowed travel to restart, offices to reopen, the economy to re-energize.

Corporate earnings are the mother's milk of stock prices. You buy a stock for the cash and profits generated. Corporate America did not disappoint. Earnings in the second quarter were up nearly 90% from a year ago, achieving one of the biggest year over year increases on record. There were also a surprising number of "beats" on both the bottom and top line. Although those profits were compared with year ago tallies, from the pandemic shutdown, many companies accompanied their stellar results by raising their forecasts for the rest of the year.

Interest rates have stayed low. Rates surged in March, to nearly 1.75% on the ten-year Treasury, but have receded thereafter, and are now about 1.5%.

Fiscal stimulus and the hope for more also provides a tailwind. Over $5 trillion of aid was dispensed during the pandemic, including special supplemental payments to the jobless. Plans are afoot for even more spending to improve our infrastructure.

Outlook in a Nutshell

Does anyone on Wall Street truly rely on a quarterly forecast? If your investing horizon is a mere 90 days keep your money under the mattress or the virtual equivalent thereof.

However, we continue to be quite positive over the long haul. Investors with an appropriately long-time horizon should continue to tilt their portfolios to stocks and other risk assets. The low

rates on fixed income provide little competition and tremendous stimulus to the real economy. Policymakers in Washington continue dovish, recognizing that failing to keep the economy strong and markets healthy will put their jobs at risk. The pandemic, for all the uncertainty it causes, will provide less of a headwind as medical developments provide even more tools to keep us safe. Job creation is likely to continue strong with an ebbing pandemic. Corporations are laser focused on growing profits, and new technologies provide more ways to reduce costs and streamline operations.

Covid 19 and the Delta Variant

The number one variable driving the market is progress against the Covid pandemic. The outlook is good. For all the frustration with those who refuse to get vaccinated and the fear of what new variant could be coming down the pike, the fact is we are winning the war.

Better health outcomes start with better preparation. Over 60% of Americans have gotten at least one dose of the vaccines. These doses have shown a high degree of efficacy. Children as young as 12 are now eligible for vaccination, and we believe it will soon be made available to those as young as five. A third shot is now recommended for the most vulnerable and it appears that the two-dose regimen will soon become a three-dose regimen, improving protection. The "jab" will soon become a term of the past; vaccines are likely to be offered as pills before long. Drugs like Gilead's Veklury reduce the risk of hospitalization if Covid is contracted.

However, what about future variants? The risk of new pandemics or health issues has always been with mankind and is unlikely to disappear. We are better prepared now as we are familiar with the basic tools to stay safe, and more resources are being allocated to vaccine research.

Can investors still profit from improvements in the economy as the pandemic wanes? That seems highly likely; further "reopening" should allow countless businesses to prosper, including restaurants, sports and music venues, and travel companies.

Low Interest Rates

Interest rates at some of their lowest levels ever have driven the TINA trade, meaning interest rates are so low There Is No Alternative to buying stocks. Interest rates are below the inflation rate to a degree not seen since the 1970s. Helping keep rates low is the Federal Reserve; it has amassed a balance sheet of approximately $8 trillion in government and other securities as it has created money and liquidity to bolster the economy.

Those low interest rates provide a mighty tailwind for stocks. Real estate benefits, too, as mortgage rates stay low. Indeed, the value of any asset is improved, as the low interest rates create a higher present value for all future returns.

However, as the economy improves, inflation and loan demand may well push interest rates up. The Federal Reserve has already signaled that its monetary support will decrease, despite its unwillingness to provide a fixed timetable for that.

Higher interest rates won't be a positive, but improving economic conditions, one reason rates may rise, will be better for stocks than for bonds. If the economy, falters the Federal Reserve is highly likely to provide renewed support.

Fiscal Stimulus

The largest player in the economy is the US Government. It's getting ready to spend, and the amounts, when the dust settles, will be expressed in trillions, not just billions, resulting in revenues for consumers and corporations alike. That's another big tailwind.

Some of those heady expectations are already priced into stocks. Investors earlier this year rushed into infrastructure stocks, like makers of steel, concrete, and earth moving equipment, even though negotiations on the spending bill may well take many more months.

Government expenditures create revenues for the private sector. However, policymakers want to pay for those expenditures by raising taxes. Taxes are negative revenues and can create a drag on the economy.

The bullish take is that most Americans believe deficits don't matter, so taxes are unlikely to rise as much as government spending. Higher corporate taxes have the most direct negative impact on corporate profits, while hikes in the capital gains rates can be a disincentive to invest.

Investors must stay attuned to progress on the infrastructure bills in Washington, plus any accompanying tax hikes.

Valuations

The price you pay for a stock matters. Overpaying reduces returns. On all metrics the current market is richly priced relative to history, and by some metrics, like price to sales, it's the most expensive market ever.

Two key factors mitigate. First is the extremely low interest rates. In other words, the stock market may be less richly priced than bonds. That keeps a steady flow of money coming into stocks from bonds and bank accounts. That's why stock investors need to keep a close eye on any rise in interest rates.

Second is that not all stocks are richly priced. Relative to history, the extreme valuation is focused on the largest companies in the S&P 500. Because that index is market cap weighted, meaning the more valuable the company the greater the weighting, the top five companies account for about 25% of the entire index. Stripping out the largest companies from the index results in a more reasonable average valuation for those remaining.

Smaller, Dividend Paying, Cyclical, and Value Stocks May Offer Relatively Superior Opportunity

Investments in cyclical companies, like financials, industrials, materials, and energy names, may benefit more from an improving economy than the megacap tech names. Those megacaps are seen as powering ahead without regard to the pace of the economy. Indeed, some benefited from the pandemic shut down.

While all companies are priced at a premium to their long-term averages, smaller companies and so-called value names are less richly priced relative to their large cap growth counterparts. While

investors should always remain diversified, a tilt to value and smaller companies may provide an edge.

International Stocks

Stock overseas have lagged domestic stocks for a decade now, but that has not always been the case. There's no law of nature that domestic investments will always outperform international ones. Indeed, if that were the case so much money would be allocated to domestic investments that any outperformance would be lost due to the high prices.

One reason why international markets have lagged is their greater exposure to value and cyclical companies than is the case Stateside. In the same way that a tilt to smaller, value-oriented companies in this country may provide an advantage, a slight bias to overseas investments may do the same.

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