Economic Update 01/2021

John Maynard Keyes is known as the developer of Keynesian Economics, which theorizes that fiscal policy is the solution to save the economy and financial markets when threatened by unemployment and recession. No one is more important to quote about key economic events based on what happened in 2020. So here it goes: “**It is better to be approximately right than precisely wrong.” – John Maynard Keynes**

While I know that effective monetary policy undertaken by the Federal Reserve is also a very valuable tool, the United States employed aggressive fiscal policy in 2020, as anticipated, and fortunately it seemed to work as theorized. I believe the above quote is appropriate for all times and particularly relevant for my 2021 Crystal Ball Outlook. His words highlight that economic and financial market forecasting, while grounded in research, is more art than science. To that point, my goal is to evaluate the fundamental, valuation and technical data to get the general direction of the trend correct, not to nail down the exact financial targets. If I simply get the trend right (as well as the associated key factors I choose to monitor to determine if that projected trendline remains intact), that success in the market follows suit.

Last year, using this method, I forecasted a 75% probability of positive outcome with an upside target on the S&P 500 of 3500, and a 25% chance of a mediocre -to worse- case outcomes and a downside target of 2600. The S&P closed at 3756 representing an 18% rate of return in 2020. The S&P also hit it’s low in March at 2237. Despite a global pandemic and a very venomous election, the markets ended up following the trends very closely. This should not be a surprise. History tells us that the markets are positive 75% of the time and negative 25% of the time. Even in negative times, the market is even less likely to see significantly negative returns.

As time goes on it is inevitable that I will eventually turn negative on the markets, but these situations should be relatively rare. Such negative expectations will be accompanied by highly probable sustained negative accent in the data and in anticipated policy decisions (mistakes). This was not the fact set in 2020. Unprecedentedly powerful fiscal stimulus delivered in Keynesian fashion remedied a temporary soft patch, and the economic and earnings trend improved throughout the second half of the year.

The response to COVID and the stable economic earnings data are what encouraged me to say “hold your ground’ throughout 2020. Many in the industry were taking price targets down and suggesting that selling positions was the better course of action.

The big surprise was the strength of the recovery. I expected the 3500 level in the S&P, but I thought it might take till mid-way through 2021. I still see further upside in 2021, but it is a bit more measured, because gains were so strong in late 2020. In other words, we see some of the benefits of vaccine deployment and a more sustained and comprehensive reopening as already being realized. 2021 should be profitable in our eyes for stock investors but not dazzling in nature.

So here goes the Crystal Ball…I project a 75% probability of positive results in U.S. stock market returns and a 25% chance of moderately disappointing to negative results. The base case

calls for an end of year S&P of 3900. When coupled with a 2% dividend yield this would result in a 906% rate of return to investors. I project a 55% probability of this result. I place a 20% probability of a more optimistic outcome of 4150. This scenario would result in a 13% rate of return in the S&P for investors. Moving from the base case to the more optimistic case would be based on distribution of the vaccine going well and the full U.S. economy recovers, including the service sector.
Both the base case and Optimistic case are based on following the following key assumptions:

- Vaccine deployment and efficacy is safe and effective
- Real GDP growth of 4%
- The Fed remains boldly accommodative and additional stimulus is deployed as needed.
- The S&P 500 achieves consensus earnings expectations of $196
- The 10-year Treasury yield drifts up in moderate fashion and trades in the range of 1% to 2.5%

The disappointing case simply envisions vaccine deployment and reopening that is slower than the bulls expect, resulting in slightly lower earnings of $190. The result would be a -2% rate of return for investors.
A worst-case scenario of 3000 in the S&P would result in 20% price decline resulting in a -18% return for investors. The measures to watch for in this outcome are poor vaccine deployment and efficacy along with surging inflation and interest rates.

The wall of worry items for 2021 fall into three categories:

1. What investors worry about
    - Vaccine execution risk and mutated strains of the virus
    - Fiscal policy bobbles
    - Political leadership transition issues
    - Regulatory risk, FTC & DOJ investigations
2. What I worry about
    - Economic Growth
    - Employment
    - Earnings
    - Interest Rates
    - Credit Spreads
3. Wild Cards
    - Geo-political risk; Russia, China, Iran
    - Inflation

So, in summary, I maintain a positive “hold your ground” view for 2021 and look for solid returns for U.S. Stock.

Lastly, based on this report I believe we need to rebalance our Vanguard portfolio. Over the course of last year, we went from 80/20 stocks vs. bonds to 90/10. I recommend that we sell down our S&P exposure and buy back up the bonds. In addition, I want to slightly tilt the stock by equal weighting Large cap stock and value stock. Last year we were over-weight large cap and underweight value. I have attached a separate report that details my recommendation.