MV CAPITAL MANAGEMENT

Weekly Market Flash

Our 2021 Investment Thesis

January 8, 2021

Happy New Year! As is our custom, we open the year by presenting our investment thesis for the twelve months ahead. This thesis will be central to the Annual Outlook we will be publishing within the coming two weeks. The year ahead promises to be full of twists and turns – though we hope that every week will not be quite as full of stomach-churning drama as was this first full week of the year. Let's get to work.

2021: Priced For Perfection

In 2020 assets of just about every shape and stripe had a banner year. Equities, fixed income, commodities of both the risk-hedging and risk-taking variety – all had their day in the sun while the world struggled with a rampant health pandemic. Now in 2021 the end is at least in sight for the Covid-19 pandemic to exit off the stage with the arrival and mass scaling of multiple vaccines. The conventional wisdom – and scarcely has there been in recent years a more unified consensus across the spectrum of economists, analysts, traders, bankers media pundits and assorted hangers-on than there is this year – is that just as everything investable flourished in the bad times, they will flourish ever more in the coming good times.

The case for continued growth in asset markets is strong. But markets are priced for perfection: for vaccines arriving on time, for virus mutations not running out of control, for enough of a fiscal and monetary bridge to get households and businesses over the pandemic's final chaotic months, and for a pre-2020 mentality of giddy consumerism to return and propel corporate sales and earnings back to health. Thus our thesis, while on balance positive, is not without caveats, risks and what-ifs. Here it is.

Low short-term interest rates and supportive monetary policy should continue to be a tailwind for risk assets as the global economy finally transitions from the pandemic to a resumption of consumer spending on the things we all missed for the last twelve-months plus (assuming mass scaling of vaccinations is achieved at least by sometime in late summer). The low rates plus upbeat prospects for corporate earnings should keep valuation concerns more or less in check, though there may be more upside room for less stretched corners of the market like value, small cap and non-US than for the growth darlings of the past five years. But intermediate and long-term interest rates have the potential to steepen (and are less influenced by central bank actions in the absence of an explicit change in standing policy). One potential near-term risk to market upside could be an unexpected surge in inflation. The entrenched groupthink of the bullish consensus itself could also be a risk if it leads to unwarranted overconfidence. Watch out for imprudent enthusiasm by those who fail to distinguish innovation from hype. Longer-term structural risks may or may not have a direct material impact in 2021, but they are nonetheless present (let 2020 be a warning for the tyranny of the unexpected).

- The Fed is committed to using its full complement of monetary tools to stimulate the economy back to full recovery. The central bank may get some previously unexpected help from fiscal policy following the surprise win by Democrats in the Senate runoffs in Georgia and thus – albeit barely – a unified government with the potential to bring up and pass critical relief and stimulus legislation.

Expansive monetary and fiscal policy could justify a continuation of the “buy the dip” approach that has worked for the past decade whenever markets hit a rough patch. **Key risks**: The Fed has less influence over intermediate and long-term rates. These are subject to a variety of influences from diminished demand for Treasuries from foreign investors to a rise in inflationary expectations as the economy grows. An unexpected inflationary surge is a particularly noteworthy risk because very few experts have expected it. The members of the Fed’s Open Market Committee on average believe that inflation won’t breach even the central bank’s target 2 percent level any time before the end of 2022. It would be hard for the Fed to withstand upward pressure on longer term rates in the face of a jump in expectations. A more pronounced steepening of the yield curve will, all else being equal, have a negative impact on equity valuations as well as on activity and behavior in the real economy.

- China is in a stronger position at the beginning of 2021 than it was a year ago. The world’s second-largest market has broadened and deepened its strategic impact on the global economy with trade deals in the Asia-Pacific region and the EU (both of which conspicuously exclude the US). It, along with other regional Asian economies, is farther along on the return to growth than the mature markets of North America and Europe. Demand for Chinese assets by foreign investors is high and growing. **Key risks**: Recent actions by Beijing to bring leaders of China’s burgeoning fintech industry to heel (in particular Jack Ma, the founder of Alibaba and Ant Group, its fintech subsidiary) offer a clear reminder that the Chinese Communist Party is very much in control and plays by a different set of rules, which can at different times work to the benefit or to the detriment of holders of Chinese assets.

- The European Union and the United Kingdom start the year afresh following the conclusion of their terms of divorce at the very last hour in December. The EU would seem to have the better end of the deal, including a new lease on life for its financial services industry as volumes flow out of the City of London to regional bourses. Separately, a deal with China gives a new leg up to the EU’s export-dependent manufacturing businesses (not to mention another strategic coup for China as noted above). The euro is poised for more upside against the dollar. **Key risks**: None of the Eurozone’s structural weaknesses that brought the single-currency region to the brink of disaster in 2011-12 have been reformed; the issues have simply been kicked down the road time and again. The region’s tremulous financial system is never more than a systemic bank failure away from coming unraveled. Political ruptures between the autocratic drift of eastern Europe and the rule-of-law ethos of Brussels took deeper root in 2020 and continue to threaten the region’s stated goal of ever-closer union.

- US corporate earnings are expected to rise by a bit more than 22 percent in 2021, after falling by some 13 percent in 2020 (based on the current outlook for as-yet unreported Q4 numbers). This anticipated upturn is heavily weighted to earnings in sectors like industrials and consumer discretionary, which are expected to boom at mid-double digit rates in a post-vaccine world of Disney World holidays, packed sports stadiums and surging global sales of industrial goods. That would be good news for investors concerned about starting off another leg of the bull market with valuations as high as they already are. **Key risks**: Analysts are perennially upbeat about future earnings and regularly overshoot reality. Meanwhile stocks are priced about as closely to perfection as imaginable. Any number of setbacks – from vaccine hiccups to consumer demand that doesn’t materialize to another out-of-the-blue factor that renders all predictions useless in the manner of the pandemic in 2020 – will challenge the market’s hitherto blasé attitude towards valuation levels. Last year the earnings bar was low; this year it is high.

- In 2020 governments raised record amounts of debt to cushion the blow of the pandemic to businesses and households. Meanwhile, businesses took advantage of low interest rates to flood the

market with corporate bonds of both the investment grade and speculative (junk) variety. More debt is on the way in 2021. The Fed will offset some of the new volume with its monthly bond-buying program; however, a larger portion than usual of Treasury debt planned for this year will fall into longer-dated maturities that are outside the Fed's QE sweet spot. Demand from foreign investors has fallen in recent years; in 2021 foreign central banks will also have an expanded opportunity to add euro-denominated sovereign debt to their foreign exchange reserves via the EU's new €750 billion bond issuance program. **Key risks**: Interest rates represent the price of money. Lower demand for dollar-denominated debt obligations will put upward pressure on interest rates, while the supply of new issues by the Treasury Department and state & local municipalities continues at record-setting pace. This in turn could have a domino effect both on valuations of a broader range of assets and on business conditions in the real economy.

- A year of both innovation and hype lies ahead, and one of the big challenges for investors will be separating the two. For an illustrative case in point look no further than Tesla. The newest addition to the S&P 500 boasts a market cap either side of $700 billion on any given day, which is more than the combined value of the nine largest car manufacturers by sales – including GM, Ford, Fiat-Chrysler, Toyota, Daimler, Volkswagen and Peugeot. Pretty impressive for a company that sells less than one percent of all automotive vehicles sold worldwide in 2020. Tesla is not alone. 2020 was a year when investors grabbed onto seemingly anything associated with one of the major innovations percolating up from the labs over the past decade – from clean energy to blockchain technology and next-generation artificial intelligence. **Key risks**: Recall that in 1999 any company that slapped a "dot.com" next to its name seemed able to increase its value by magnitudes of many overnight. A few durable winners for the ages came out of that frenzy. The underlying promise of the revolutionary technology represented by the Internet was not off the mark. But for every Amazon there were hundreds of Pets.com – sock puppets tossed onto the flotsam of history' speculative frenzies. Buyer beware.

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