WELLINGTON SHIELDS & CO. LLC
Quarterly Market Strategy Report

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# Goodbye Annus Horribilis

*Many are calling 2020 annus horribilis* (a Latin phrase meaning "horrible year") due in large part to the spread of the deadly COVID-19 virus around the globe and its knock-on effects on the global economy. Yet despite the various challenges 2020 posed to the world, it was a good year for investors. The gains seen in the Dow Jones Industrial Average, S&P 500, Russell 2000, and NASDAQ Composite index were 7.3%, 16.3%, 18.4% and 43.6%, respectively. And as shown by these figures, the year provided excellent gains for many stocks and spectacular gains for others. Moreover, if historical precedents and Wall Street adages hold true to form, 2021 could add to these gains. For example, the Santa Claus Rally which includes the last five trading days of the year and the first two trading days of the new year, produced a small increase which is a favorable sign for the next twelve months. In addition, the market's performance in January has had a respectable history of predicting the outcome for the entire year. Many believe the first five trading days of January predicts the month and January's performance predicts the year. We believe January's action is important since the liquidity generally available to investors early in the year from tax-loss selling, annual work bonuses, IRA and pension funding is typically the best of all the twelve months; therefore, January should produce a positive result for equities. If not, it is a warning. So far, 2021 is off to an excellent start.

While 2020 was a historic period in many ways, it was also record breaking in terms how countries responded to the global pandemic. Most nations boosted their ailing economies with massive fiscal or monetary support, or both. In our view, liquidity was the primary driver of equity gains in 2020. According to the International Monetary Fund, as of September 2020, total worldwide fiscal stimulus amounted to $11.7 trillion, or 12% of global GDP. In the US, the $2.7 trillion authorized by the CARES Act was direct fiscal support to the US economy and the $3.2 trillion increase in the Federal Reserve's balance sheet provided monetary stimulus to the banking system. Combined, these policies equaled 23% of annualized US GDP. Moreover, Congress passed an additional $900 billion pandemic relief package in late December. Before lawmakers closed the books for 2020, they tacked on a $1.4 trillion catchall spending bill. All in all, the total stimulus authorized in the last twelve months is equal to 38.8% of nominal GDP. This extraordinary stimulus not only buoyed an artificially shutdown economy, but it also helped drive equity prices to record levels.

It was also fiscal stimulus that drove the personal saving rate to 34% in April. November's savings rate fell to 12.9%, yet this still remains more than twice the long-term average of 6.2%. A strong personal savings rate is an auspicious sign for the economy as well as for equity performance for the first quarter of 2021. In addition, with Democrats now in control of the White House, both chambers of Congress and with ex-Fed Chair Janet Yellen, a proponent of easy monetary policy, appointed as Secretary of the Treasury, most investors expect more fiscal and monetary stimulus in 2021. The Wall Street adage "Don't Fight the Fed" will be an important phrase to remember in 2021. For these reasons, one could expect more stock gains ahead.

Still, there is a dark side to liquidity. The main risk of excess liquidity in the system is the potential of a stock market bubble. We expect the phrase "stock market bubble" to be mentioned often in 2021, however, bubbles are not well understood by many investors. Bubbles can materialize in any form of investment. The first bubble in recorded history was the Tulip Mania during the Dutch Golden Age in 1637. Bubbles are complicated and have many components, but they are almost always underwritten by good economies and excess liquidity. They are also distinctive because they incorporate a belief that the cycle "is different this time" and prices can continue to rise even as they disconnect from fundamentals.

For all these reasons, including the lofty level of PE multiples at the end of 2020, we are optimistic yet cautious about 2021. It is important to remember that bubbles can persist longer than many expect. This was proven in late 1997 when equities disconnected from normal valuation benchmarks yet continued to rise until March 2000. To analyze a bubble and its growing risks, one must monitor both the level of equity ownership and the amount of leverage in the system. Bubbles typically end only after all potential investors have joined the bandwagon, households reach an over-ownership level in equities, and leverage, or margin debt, has reached its limits.

In the third quarter, equities were 25.4% of total household assets as compared to the 2000 peak of 26.4%. Equities were also 22.6% of financial assets versus the March 2000 peak of 24.2%. Given the recent gains in stock prices, it is likely that equity percentages increased in the fourth quarter and we will continue to monitor ownership levels for extremes. But ownership is apt to move higher. New investors are joining the investment world as a result of new digital venues and websites such as Robinhood.com, Stash.com, and Nerdwallet.com. From an historical perspective, many of the aspects of a bubble such as excess liquidity and new investors, seem to be moving into place. And we would also note that in early January there was a jump in bullish sentiment in the Association of American Individual Investors survey. The one-week reading of 54.0% bullishness was the most extreme since November 11, 2020 of 55.8%. Too much bullishness is not a good timing device, but this does suggest investors should remain alert in 2021.

Even so, the most troublesome characteristic of an equity bubble and the key signal that a bubble is reaching its exhaustion phase is tied to the use of leverage, or margin debt. An extreme is reached when increasing levels of leverage, or margin debt, fail to lift stock prices much higher. This is a serious warning for investors. We can monitor this by comparing the 2-month rate of change in margin debt to the 2-month rate of change in the Wilshire 5000 index. If the 2-month rate of change in margin exceeds two standard deviations (15.3%) and the Wilshire price index does not follow suit, the bubble may be in trouble. The most recent negative signals from this indicator were seen in December 1999, June 2003, and May 2007. In November, the 2-month rate of change in margin debt was 10.4% (below the 15.3% standard deviation warning level) and the 2-month rate of change in the Wilshire was similar at 9.7%. In short, there were no signs of excessive margin or exhaustion in recent data.

To sum up, while it is possible that 2021 could be planting the seeds for an equity bubble it is equally possible that 2021 could become a tricky roller coaster year for stocks. There are signs of rising inflation emanating from rising oil prices, wholesale prices and a weak dollar. More inflation could lead to higher interest rates which could trigger an equity market correction. The weakness seen in the job market at the end of the year could lead to disappointing economic data, hurt investor optimism, and stall stock prices. Given this backdrop, investors should take a multiyear view of equities and seek companies that one wants to own over the next decade. This should be both the path to profits and preservation of capital. Expect 2021 to be an interesting and volatile year.

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