Wellington Shields

Quarterly Market Strategy Report

April 2021

ON THE ALERT FOR INFLATION

The first quarter of 2021 was a rewarding one for most investors. The Dow Jones Industrial Average rose nearly 8%, the S&P 500 gained about 6% and the Russell 2000 index advanced over 12%. However, the real winner in the first quarter of the year was the Dow Jones Transportation Average which soared a stunning 17%. This stellar performance in the transport sector was in anticipation of COVID-19 vaccinations becoming widely available, of the economy opening up, and of abundant government spending on infrastructure. But in general, the gain in the DJ Transportation Average was a continuation of a shift initiated earlier in the year from growth to economically sensitive stocks. Plus, the action of the first few trading days of April is encouraging and suggests equities could move higher in the second quarter.

The first few months of the year were also good to investment bankers as seen by the number of IPO deals priced, capital raised, and new filings. One hundred new deals were priced, versus the 25 a year earlier. Capital raised hit $39.2 billion versus $6.7 billion in a year earlier and 126 new deals were filed versus the 35 new deals filed in the first quarter of 2020. In fact, the only measure of IPO activity that showed any weakness was the IPO after-market, where prices underperformed the overall equity stock market. This detail could be a sign of fading demand and as such, should be watched carefully in coming months.

The first quarter was also memorable since it introduced investors to GameStop (GME -$77.97), a struggling video game retailer whose price rose 1500% in a matter of days. An investment forum on Reddit called WALLSTREETBETS, led a massive buying spree in GME to oppose hedge funds holding large short positions. It was somewhat of a David versus Goliath anti-establishment movement that demonstrated the changes and hazards social media can wreak on the stock market. GameStop's stock price soared from $18 at the end of 2020 to a peak of $347.51 on January 27 and is now trading below $200.

The quarter also revealed the existence of a new form of leverage called contracts-for-difference, or CFDs. These swaps were at the center of the collapse of Archegos Capital Management, a family office run like a hedge fund. Archegos borrowed capital from at least five different prime brokers to buy CFDs and held a concentrated portfolio of stocks with leverage estimated to be at least five-to-one. When underlying stock prices fell, Archegos was unable to make its margin calls and brokers sold Archegos' underlying collateral to avert massive losses. Even so, Credit Suisse expects to take a $4.7 billion hit. But during the chaos, stocks like ViacomCBS (VIAC.O - $43.89) fell 60% from a peak of $100 in early March. In short, the first quarter was a time of rising stock prices, but it was not without its pitfalls.

From an economic perspective the quarter ended on a high note. The March ISM manufacturing index jumped to 64.7, its highest level since the early 1980's. The ISM nonmanufacturing index surged to 63.7, exceeding its October 2018 record of 60.9. March payrolls grew by 916,000 in March while the job figures for January and February were revised higher. Unit vehicle sales rose to an annualized rate of 18.2 million, the highest since October 2017. These reports were signs that the economy was strengthening in 2021. But there have also been warnings that the recovery was not as uniform as it could be. According to the *Wall Street Journal*, annual SEC reports filed between July 1 and March 31, showed global employment rose by roughly 370,000 for the 286 S&P companies that filed annual reports. However, Amazon (AMZN - $3279.39) added 500,000 workers around the world, creating nearly as many jobs last year as 136 other companies in the index. This means that job gains in some companies were masking job losses in other companies. This is something to be concerned about. In addition, a Census Bureau study in late March reported that 18% of small businesses stated they would need financial assistance or additional capital in the next six months. These are some of the reasons critics warn that raising tax rates in 2021 would hurt entrepreneurs and US companies competing on a global basis. Supporters of the tax increases, including President Biden, say tax increases will not cool down the economy. We think this latter point is unlikely to prove true.

A number of recent surveys show consumer sentiment is rising but other data suggests there is a steady dependence upon government support. February's personal income report showed a 7% decline from January's level due primarily to the waning of government transfers. This drop should reverse dramatically in March, however, there are indications of stress in some households. The percentage of subprime borrowers with outstanding auto loans or leases more than 60 days past due hit 9% in the fourth quarter, the highest quarterly figure since 2005. Clearly, some households have navigated the coronavirus downturn and others have not. Car loans can reveal how riskier borrowers are faring. For subprime borrowers who do not have mortgages or college debt, car loans represent the biggest monthly debt payment. Keep in mind that many subprime borrowers work in restaurants, hotels, and bars hurt badly by Covid-19. Getting back to "normal" is therefore critically important for many small businesses, employees, and households.

We believe it is possible that several events are converging at the start of the second quarter that could be the catalyst for a 5% to 10% correction in coming months. The S&P 500 index has breached the psychological 4000 level which is a positive, but it will be important to see more upward follow through from this level. The SPX 4000 is the equivalent of 20 times 2022 consensus forecasts which now center around $200 a share. In other words, at the SPX 4000 level, stock prices are discounting all the good news expected in the oncoming 21 months. Interestingly, this price point is materializing just as first quarter earnings season begins. For the first time in four earnings seasons, expectations are high for earnings growth. This alone lends itself to the possibility of disappointment. But at this juncture, earnings must continue to beat the consensus forecasts if stocks are to continue to advance. Last but far from least, inflation could be a big threat in 2021. Inflation is pivotal to both monetary policy and to price earnings multiples. We believe there is risk that inflation benchmarks for March could show a CPI over 2% and a PPI greater than 4% and spook the market. If so, this could threaten the consensus view of monetary policy remaining stable through mid-2023. Low inflation and low interest rates have been the foundation of above average PE multiples in several years. If inflation becomes a concern, PE multiples will not expand, but could be at risk of contracting. With the election behind us, vaccines becoming more abundant, states opening up for business, and job growth getting a second wind, we are concerned that most of the good news is already priced in. All in all, we are a bit more cautious today than earlier in the year.