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*advice; judgment; resolution; wisdom

Let the Good Times Roll

As measured by the S&P 500 index, the US equity market ended 2020 at record levels and with strong full year returns that should have been almost impossible under the circumstances. But as we discussed in our July issue of *Consilium*, the overwhelming and never-before-attempted fiscal and financial rescue efforts by Congress and the Federal Reserve were likely to be sufficient to stabilize the economy and buy time until a vaccine arrived. The announcement of two successful vaccines in November provided confirmation that optimism in the face of gloom had been justified, that the time to focus on poor current conditions had passed, and what mattered was how good things might be in the period just ahead.

Although the reasons were different in 2020, this is in fact the stock market's typical behavior around recessions: at some point it becomes clear that things will improve, and dwelling on current bad news is a money-losing proposition. Stocks truly do "climb a wall of worry".

The optimistic argument for the virus and the economy is obvious, easy to make, and very likely to be correct -- which is why nearly everyone is making it, and why the market has moved so quickly to discount it. Barring developments unrelated to Covid-19, it is nearly certain that the economy will be in better shape a year from now. But how much better? Dramatically, or somewhat less so? One of the main risks facing equity investors is that the economy and corporate profits recover strongly, but not as strongly as necessary to justify current elevated prices. Valuations on stocks have only been higher on extremely rare occasion, and future returns have almost certainly been "pulled forward" into 2020. Our elevated starting point is the biggest immediate challenge as investors.

In the very short term, the pace of vaccinations will be a key variable. Even if the vaccines work as well as advertised, distribution to those most in need remains a major logistical hurdle. It also seems inevitable that there will be concern and disproportionate publicity about side effects, which may slow the take-up rate. Any meaningful obstacle to a successful rollout of the vaccination program could delay the onset of the economic recovery we expect and tamp down stock market enthusiasm for a time.

But a strong economic recovery awaits us, regardless of timing. This is not the most pressing question -- that question is, what can we expect from the markets after the pandemic is in the rear-view mirror? With so much uncertainty removed (not to mention the election and global trade conflicts) what's left to surprise and reward us for our patience? Do today's elevated valuations merely leave room for disappointment?

One reasonable scenario for the economy is that demand rises faster than costs – in explosive, pent-up fashion, perhaps – leading to an unusually large expansion of corporate profit margins. This phenomenon is not uncommon in the very early stages of an economic recovery. It's one of the reasons that it's also normal for the stock market to "overshoot" consensus expectations at the beginning of a new cycle.

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This effect could be especially pronounced in the upturn we expect. Companies across a range of industries have aggressively cut costs in response to last spring's collapse in demand, including headcount reductions, migrating back-office processes to the cloud, cutting back on physical real estate, reducing travel expenses, and embracing lower-cost "digital-first" business models. High valuations are always a good reason to be a bit cautious, but the possibility of a boom in corporate profits keeps us erring on the side of bullishness for now. There is a good chance that companies will "grow into" their elevated valuations and that prices will seem more reasonable in a year or two.

More generally, it is also very important to put today's high valuations into proper context: *we have rarely seen an array of economic and market tailwinds such as those we enjoy entering 2021.* A partial list of positives includes

- Federal Reserve policy that is set to remain accommodative for years to come, providing an interest rate backdrop that will not impede stock market returns for an equally long period of time.
- Additional fiscal stimulus and support, likely including a large boost to infrastructure spending.
- Household savings at record levels that can enable an eventual return to normal consumer behavior, possibly including a celebratory burst of spending on discretionary items forgone for a year (especially travel/ leisure/ entertainment).
- Eventual rollbacks in tariffs and a weaker dollar that should combine to boost US multinationals' earnings and global growth.
- Record corporate cash balances that can fund a resumption of dividend growth and share repurchase activity.
- Pensions, endowments, and individuals that continue to shift asset allocations to stocks, as fixed income alternatives fail to meet income and return expectations.

While focused on the possibilities in the period ahead, we are not oblivious to the longer-term, multi-year challenges facing investors. Interest rates and inflation may stay low, but not this low. Valuations on equities may remain high, but not this high. Owning stocks in lieu of bonds to generate spendable returns demands patience and a willingness to tolerate portfolio drawdowns, which may be deeper and/or more frequent. And eventually, tailwinds fade, and unforeseen headwinds emerge.

But in the meantime, rarely has America been more deserving of an opportunity to say: "*Laissez les bons temps rouler!*"

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Following an extraordinarily difficult year in all respects, with significant disruption to work arrangements, personal and professional relationships, and daily routines – in addition to obvious concerns about health – we are grateful to be exiting 2020 with optimism, and for the loyalty and patience of our clients. From all of us at Mid-Continent Capital, we hope that the new year brings you and your families health, happiness, and prosperity.

Sources: CNBC, Bloomberg, Goldman Sachs Investment Research