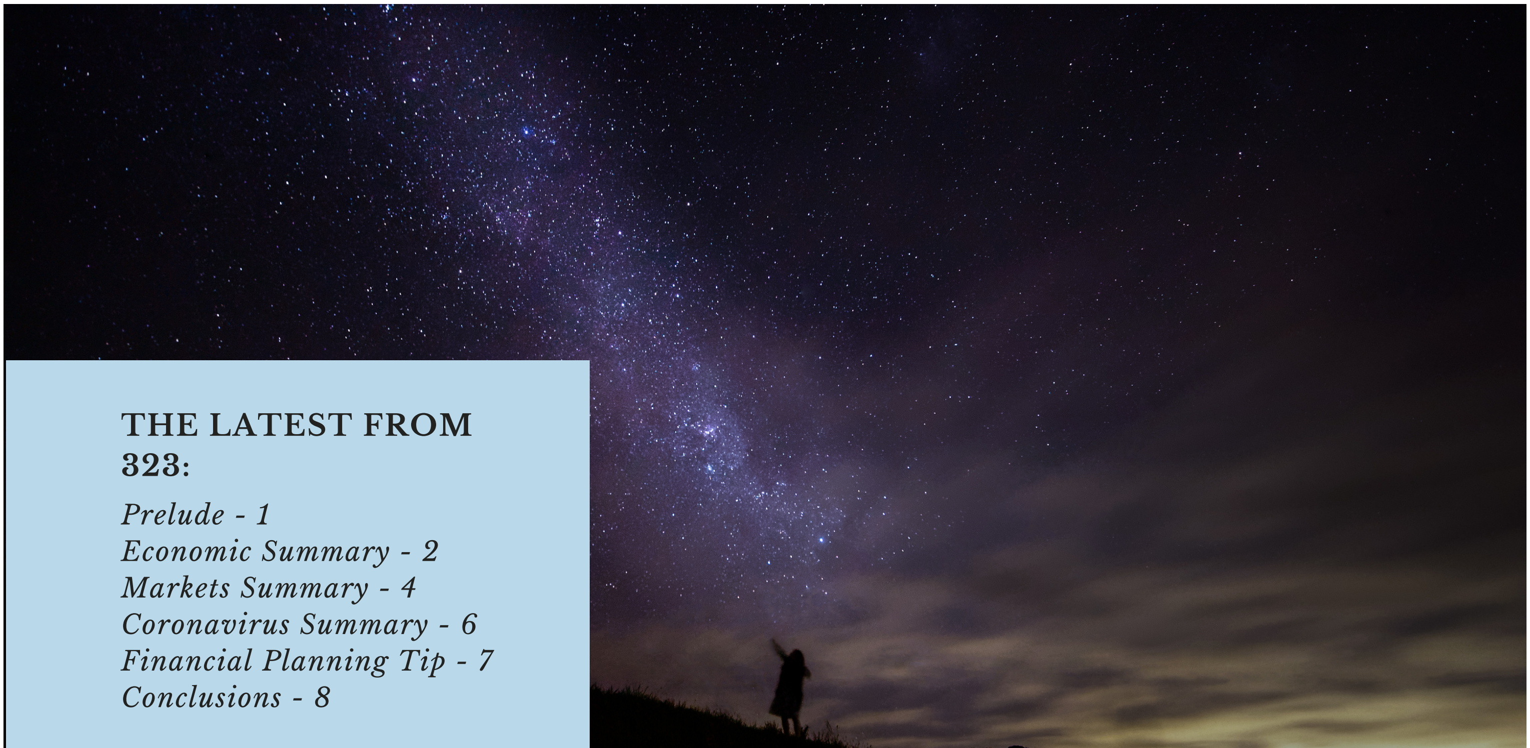
January 6, 2020

323 YEAR END UPDATE

The Newsletter of 323 Wealth Management LLC



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PRELUDE

Story by Greg Wilson, CFA, CFP, MBA

As 2020 was winding down, I gave serious thought to not writing this update. To be fair, I have encountered very few people who are genuinely interested in revisiting the events of 2020 and understandably so. So, if you prefer to skip this update and move forward to 2021, I will completely understand! For those who wish to read on, we will not dissect every important event of 2020. We could fill a book or two with that much material. We will only cover the topics most pertinent to investors and their financial plans. This should allow us to keep the update relatively short.

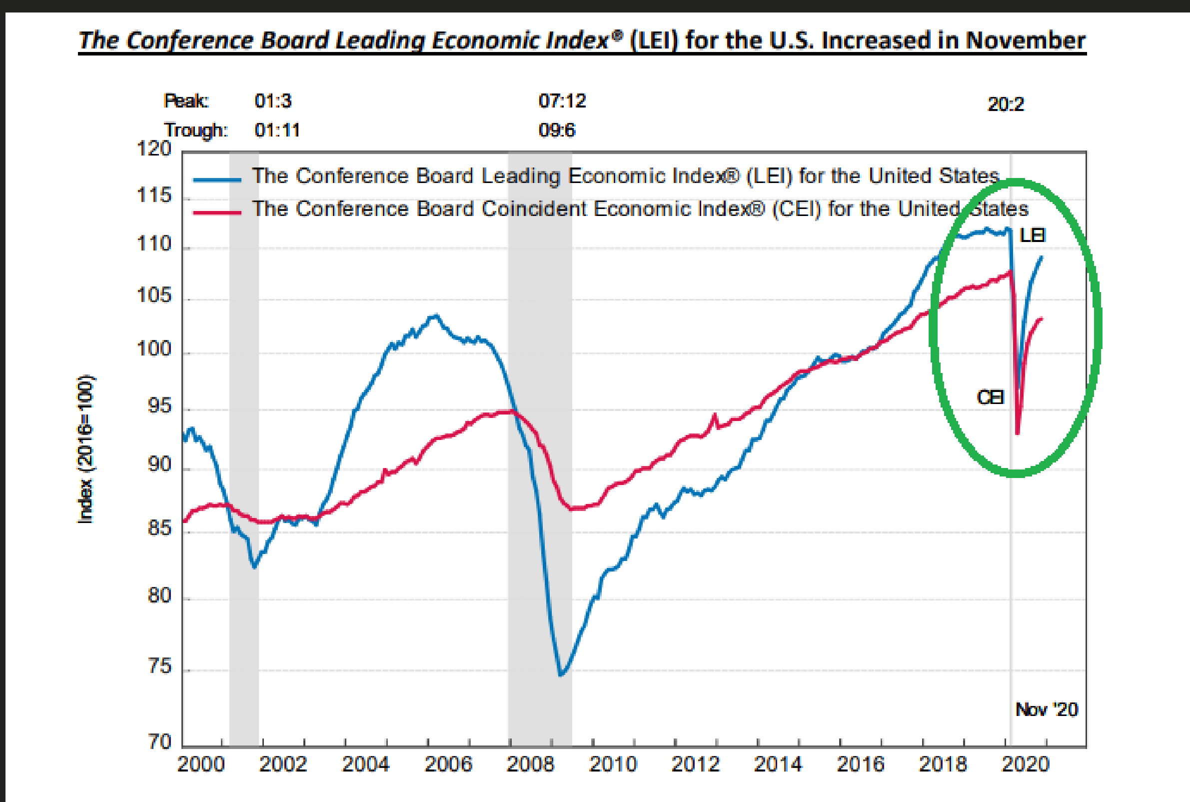
So, why do we need a recap at all? That's a good question. I think the answer is: "While imperfect, we should attempt to use history as a guide.". George Santayana is credited with saying, "Those who do not remember the past are condemned to repeat it.". Thus, I encourage our society to push forward, ever mindful of our past and the lessons learned. This should give us a greater chance of success in the future.

ECONOMICS SUMMARY

V-Shaped Recovery with a waning impact

Understanding the economy is one of the first steps to understanding investing.

The economy can be summarized in one chart, and more specifically, within the green oval below. While not yet fully recovered, this is a classic V-shaped recovery pattern.



Source: https://conference-board.org/data/bcicountry.cfm?cid=1

ECONOMICS SUMMARY (CONT.)

Understanding the economy is one of the first steps to understanding investing.

V-Shaped Recovery with a waning impact

Even in the early part of 2020, economic growth had begun to stall, but the pandemic and subsequent lockdowns essentially closed the economy for several weeks. Consumer spending fell dramatically as people lost their jobs at a rate not seen since the Great Depression. People were nervous and concerned. No one had a blueprint for what to do. No individual. No business. And, neither did the government.

You see the economy is like a machine or a factory. It takes in raw materials, labor, and technology and uses those to produce goods and services. Essentially, the factory was intentionally closed down, but no one knew for how long and what that meant. Economic output and growth are measured by Gross Domestic Product or GDP. ~70% of GDP is driven by consumer spending. So, when consumers dramatically reduced their spending in March and April, the impact to GDP was adversely felt and that sent shockwaves through the entire factory or system. The vacuum created by the drop in consumer spending needed to be filled and filled quickly.

What came next was a coordinated effort by governments and central banks around the globe. In short, they injected capital into the financial system and sent money to individuals and families to allow them to get by and to encourage a restart of spending. While imperfect, it worked better than most economists expected. Early in the pandemic, I remember economists predicting a 4-5 year recovery. Perhaps a full recovery is more than a year away. But one thing is for sure, we are not in the doldrums anymore.

MARKET SUMMARY

What pandemic?

Understanding the markets can help us build a better plan for our financial futures AND sleep easier at night.

In February 2020, the S&P 500 Index hit an intraday all-time high. However, that would be short-lived as a global pandemic was about to unfold at a speed never before seen. In March, the WHO declared a global pandemic and a national emergency was declared in the U.S. On March 23, the S&P 500 Index slid to 2192 which meant it was down 32% year-to-date. The extreme volatility, as measured by the VIX, echoed what we saw in the depths of the financial crisis in the Fall of 2008. The difference this time was that we saw multiple circuit breakers get triggered for the stock market which means the market would be forced to shut down for short periods. This is designed to reduce panic selling. To add to the market confusion, we also had limit up days where the market was closed for a period of time because it rose above a circuit breaker. Even in the depths of the financial crisis, we never hit a single circuit breaker. For investors, this was an exceptionally trying time.

What followed was the aforementioned government and central bank policy response meant to ease the financial burdens of lockdowns and keep the financial and economic systems from collapsing. Again, it worked. The S&P 500 Index rallied from the March lows and went on to close the year, not only in positive territory, but up over 18%. Some analysts say the market disconnected from the economy and launched ahead. Other analysts say that the market is simply reflecting the fundamentals including lower interest rates. I think it's a combination of both. When we talk about valuations, we are referencing the Price to Earnings ratio (P/E ratio) which takes the price of a stock and divides it by it's earnings. Those earnings are either from the last 12 months or the expected earnings for the next 12 months (NTM). For this discussion, we are referencing the P/E NTM. With this measure sitting at 22.3 as of 12/31/2020 with a historical average of 16.2 over the last 24 years, the market appears overvalued or expensive, at least on the surface. However, that ignores a host of primary variables like interest rates, tax conditions, regulatory conditions, trade policies, etc. Simply put, it's far too simple of a framework to use for major investment decisions. You have to dig further, especially during a pandemic.

MARKET SUMMARY (CONT.)

What pandemic?

Understanding the markets can help us build a better plan for our financial futures AND sleep easier at night.

I will absolutely agree that valuations look stretched. There are three ways for valuations to get closer to historical averages. 1) Prices can come down. 2) Earnings can go up. 3) Or, a combination of #1 and #2, which is the most typical scenario. But, you also have to realize that not every stock is extremely overvalued. For the S&P 500 Index, the 10 largest companies (not including Tesla)* had a P/E NTM of 33.3 as of 12/31/2020 while the other 495* companies had a P/E NTM of 19.7. (Source: JPM Guide to the Markets) Remember, the historical average is around 16. That is a dramatic difference. In defense of those top 10 companies, they grew their earnings by an average of 31.5% and their cash flow by an average of 34% in 2020. With that kind of fundamental growth, during a pandemic, it's not surprising that investors were pushing those share prices higher and higher.

What does all this mean? It means the market is fragmented and confusing. More so than we have seen during past crises. Some areas of it should be a concern for investors. While other areas are rolling along as if the pandemic never happened. As an investor, you should know "what you own" and "why you own it".

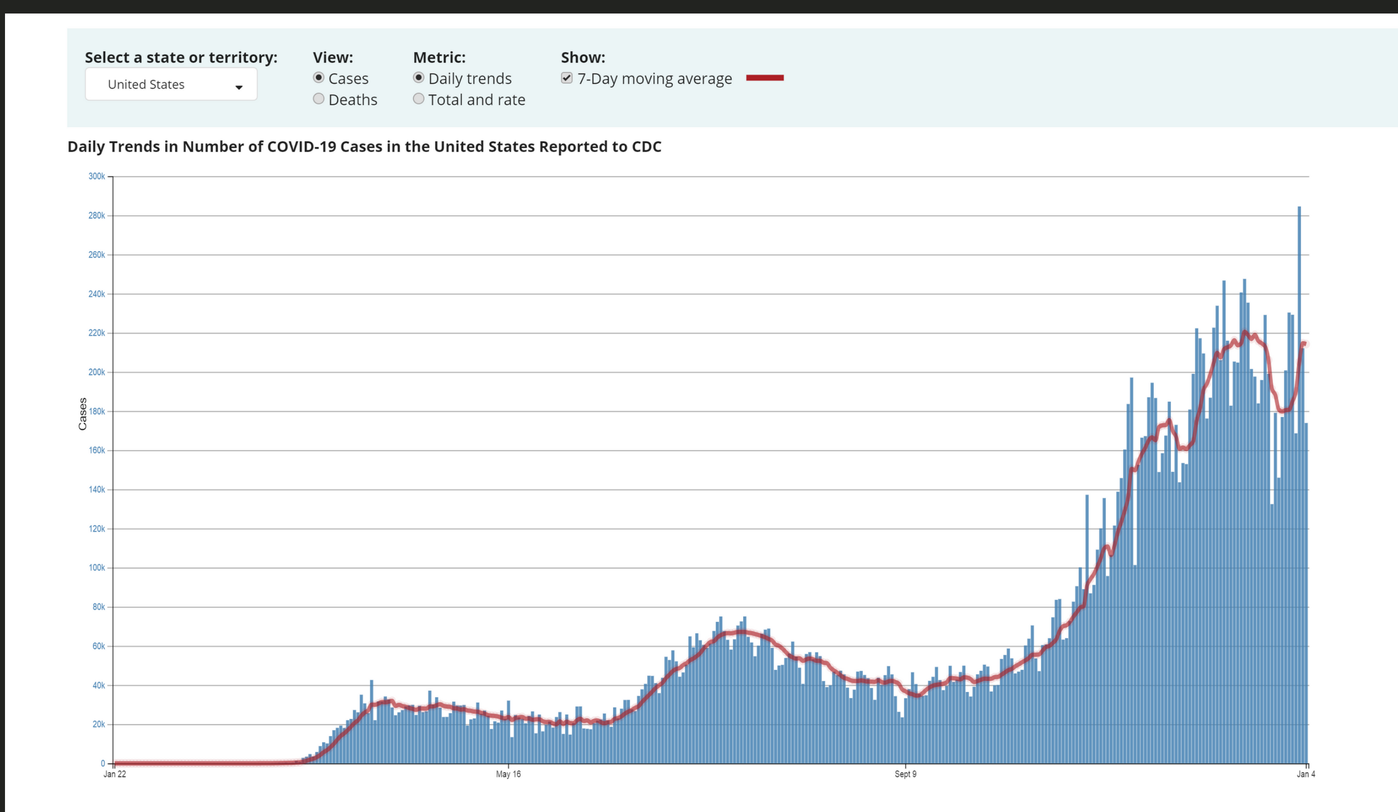
Looking ahead, if the pandemic starts to ease, then economic conditions should continue to improve. Couple that with the expectation that monetary policy (low interest rates) continues to be accommodative and you get a reasonably optimistic market scenario. Of course, that forecast is fraught with risk. There could be additional variants of the virus. There could be more difficulties with vaccine distribution. Or worse, there could be issues with vaccines and their affects. One thing I have stressed to our clients throughout this period is this. Historically speaking, pandemics have always ended. I see no reason to expect a different outcome this time. Hopefully, we are not faced with too many more challenges along the way. If/When those challenges arise, we have a plan for our clients. If you are not a client, do you have a plan?

*Tesla was added to the S&P 500 Index on 12/21/2020. As of 1/5/2020, the company has a P/E NTM of ~180. Adding this one data point would distort the numbers dramatically and tell an inaccurate story.
*There are 505 companies in the S&P 500 Index.

CORONAVIRUS UPDATE

I wish there was more optimistic information to present, but this is where we are in the U.S. With vaccine distribution occurring, let's hope this third wave dissipates soon. Until then, please be safe.

Keeping up to date on the pandemic will hopefully help you plan your finances as well as your life.



Source: https://covid.cdc.gov/covid-data-tracker/#trends_dailytrendscases

FINANCIAL PLANNING UPDATE

Have you ever heard of bunching expenses?

Financial planning is an ongoing process that evolves with your life's changing circumstances.

Here is a quick primer on bunching expenses for tax saving purposes.

https://abm.emaplan.com/ABM/MediaServe/MediaLink?token=51feacb245fa41efac27800e861c868e

CONCLUSION

What's next?

Moving forward, investors should be more focused on fundamentals. Earnings should start to matter more and policy response should matter less. The Federal Reserve has been very clear that they expect to hold interest rates at their lower bound for another couple of years. That could always change, but it would almost certainly be because economic and market conditions have improved tremendously.

If you have questions and/or concerns, please give us a call. We are here to help. If this update has been forwarded to you and you would like to be included on future emails, please subscribe at our website at www.323wm.com.

Thank you very much for your time.

DISCLOSURES