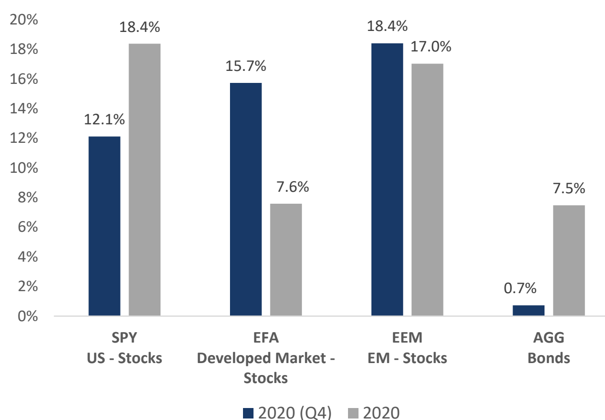
# 2021 Looking Past the Pandemic

*"2020 was a unique Leap Year. It had 29 days in February, 300 days in March, and five years in April"*– ***Unknown***




We spent many hours at the end of 2019 trying to figure out what could derail one of the greatest markets in history. Most investors' biggest concern going into 2020 was the upcoming election and what a potential change in Washington leadership would mean for the markets. Of course, no one predicted a global pandemic causing a global recession. Fortunately, it was the shortest recession and fastest market recovery in history. Unprecedented stimulus and Federal Reserve intervention brought much of the world out of despair and back to financial solvency, which saved many businesses and even lead some to thrive. The global economy is still in the process of digesting what a post-pandemic world will look like, but what became clear to investors in 2020, was that the global, coordinated fiscal and monetary support provided the reassurance investors needed to remain invested in the markets. The stock market ended 2020 up ~18%, easily erasing the 34% drop in March.

### Smooth Sailing

Although investor anxiety remains extremely high following the drama of the 2020 elections, we believe low rates, additional stimulus and likely no tax increases this year should create a very good environment for investors over the coming 18-24 months.

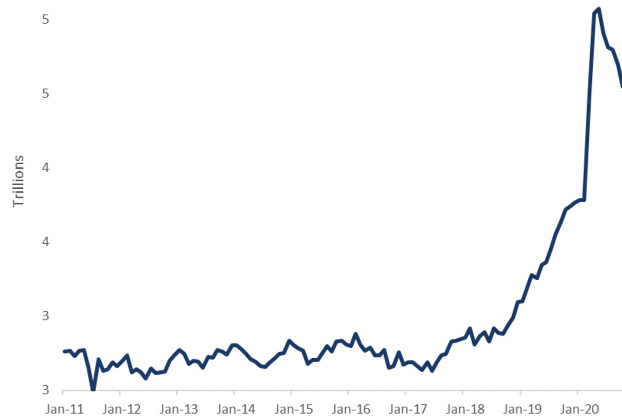
**Interest Rates** – Interest rates are the lowest in history. This benefits 3 types of borrowers. The first is the US government and its $27 trillion of debt. Low rates certainly help make those payments more manageable. The second beneficiary is corporations, who can once again refinance higher rate loans and free up capital to secure operations, grow via acquisitions and/or buy back stock. The final beneficiary is all of us and the historically low mortgage rates. We have seen clients receive 15-year mortgages at 1.75% which is truly unbelievable.

**Stimulus & Infrastructure** – Politics have dominated conversations over the past 90 days. However, we continue to say that the markets are not as concerned about politics as most people believe. It wants liquidity and now that liquidity is likely coming in the form of more stimulus and perhaps the biggest infrastructure bill in American History.

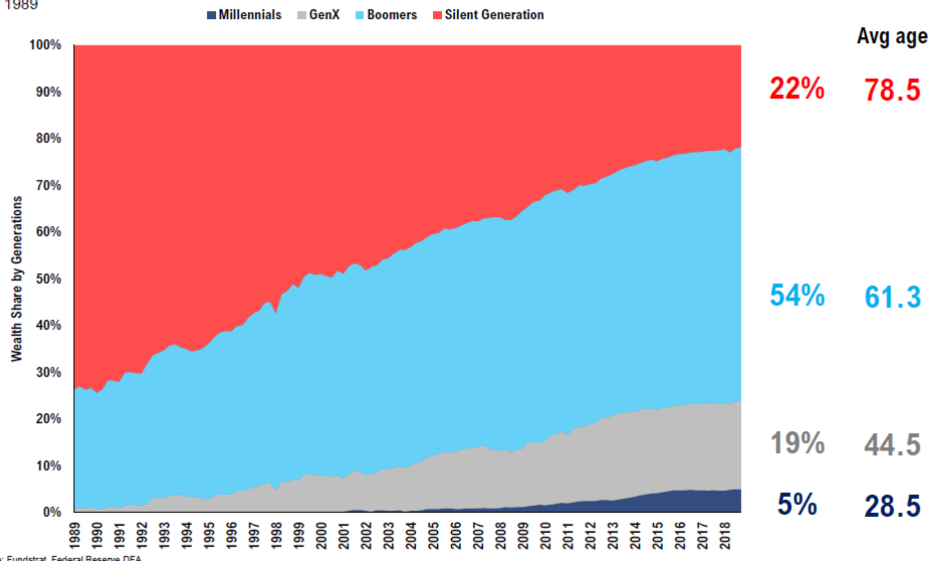
**Taxes** – The market does care about taxes. The Federal Tax Cuts of 2017 slashed the tax rate for corporations from 35% to 21%. If this were to be repealed, it would have an immediate impact on corporate earnings. Biden's plan calls for this rate to be increased to 28%. We are not all that concerned about this for

a couple of reasons. First, public companies have armies of accountants and lawyers who are paid to minimize tax exposure. Second, even with a Democratic Senate and House, it is going to be difficult to raise taxes while we are still in the middle of this pandemic. Looking forward to 2022, we will be in a mid-term election year, and higher taxes might not be looked upon favorably for those candidates looking to be reelected.

**Fear & Anxiety** – Perhaps there is no better indicator of short-term tops and bottoms than investor sentiment, which is a counterintuitive philosophy and one Warren Buffet and other investors have made famous. *Buy when others are fearful and sell when there is extreme greed.* Although there are pockets of froth and speculation in some assets such as Bitcoin and Tesla that feel a bit extended, most of our conversations with clients still exhibit a wall of worry and this is confirmed with a massive amount of cash still on the sidelines (nearly $5 trillion in money markets).




**Demographics** – Demographics are playing a major role in today's markets. Although the baby boomer's control the majority the of country's investable assets, Generation X and the Millennials, who are approaching their peak working years, are playing ever increasing roles in market movements. Many Baby Boomers have reduced their allocations to stocks and may never increase them again. This is more than offset by the millions of millennials entering the investing world for the first time. In addition, a study by Coldwell Banker indicates that the wealth transfer to millennials will be $68 trillion over the next 20 years.



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### Choppy Waters

Although we are optimistic, we know that stocks do not move in straight lines. Many analysts are predicting a pull back in the first half of the year, but a very strong year end. Here are some of items that could derail the current trend in the short term:

**The Senate** – Technically the Democrats have the advantage in the Senate, but in order to pass most bills in the Senate, a vote of 60 senators is required, which will be very difficult with the makeup of this Senate. However, there is a loophole called the reconciliation process (created in 1974). Reconciliation allows for fiscal matters to be dealt with within the context of reconciling a House and Senate budget together. Essentially, certain committees give specific instructions to meet various goals (ie; The US Budget). When bills are originated through the reconciliation process, they only require a simple majority to pass. Many modern bills have passed in this manner, including The 2017 Tax Cuts and Jobs Act, Obamacare and The Bush Tax Cuts. The process is highly manipulated and abused, but surely an easier path forward than getting 60 votes.

**Interest Rates** – While the Fed has indicated it will keep rates low for the next couple of years, the 10-year Treasury rate fluctuates based on the overall economy. 2021 started with the 10-year Treasury at 0.93% before rising to 1.15% in just a week. If the vaccine is successful and the economy opens up, the 10-year may rise more than most people are currently projecting and provide a headwind to those low mortgage rates mentioned earlier. Many pundits argue that the market is overvalued, and it is, which we discuss below in detail. Valuation models incorporate the “risk free rate”, which has historically been around 3% and is now around 1%. Experts argue stock prices should be slightly overvalued because the safe alternative pays little to nothing.

**Market Bubbles -** Are always a surprise and always expected. They develop in plain sight and ignoring them requires greater restraint as they inflate. Investors are always shocked when they eventually burst. Stock market valuations are currently at the highest level since the dot-com bubble, with the S&P 500 trading at 19.5x 2022 earnings estimate of $196. However, it will take a lot more to reach the extreme valuation experienced in the dot-com bubble in 2000. In that year, the S&P 500 reached a P/E ratio of around 23.5x. Applying the current earnings estimate for 2022 of $196, the S&P would need to rise to 4,497 (~19% upside from the closing price of 3,768 on Jan 15th).

There are (valid) arguments that the entire market is not in a bubble. There are also (very valid) arguments that it is difficult for stocks to fall materially while bond yields remain historically low, and that there are strong forces preventing yields from rising any time soon.

One worrying trend is the significant increase in options and short-term trading on platforms such as Robinhood, especially among younger investors. Many of these investors are new to the markets and may irrationally expect the 2020 stock market performance as “proof“ that money can be made in the markets just as easily as the last 9-10 months.



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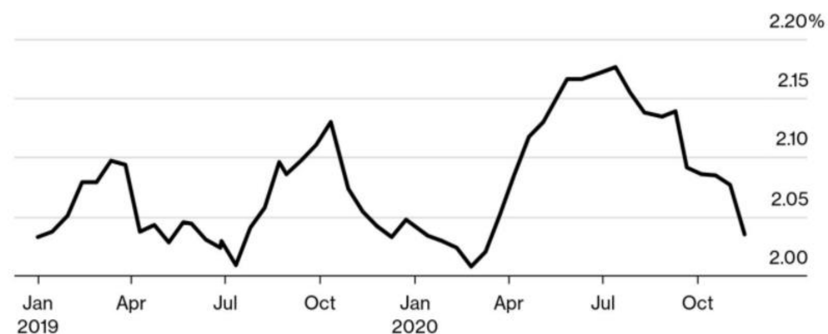
Obviously, it is impossible to know for sure what will cause the next market bubble, and the timing, but there are a few potential areas that we are watching closely:

### Is Bitcoin a (bursting) bubble-again?

The spectacular rise in the price of Bitcoin in 2020 has ignited nothing short of a mania on Main Street and Wall Street alike. The recent price action and investor behavior may fit the classic definition of a speculative bubble (follow-the-herd mentality) and an extremely crowded trade with many retail investors fearing they are missing out on an opportunity. Bitcoin inherently has a finite supply and was originally designed as a means of cash payment. Bitcoin was not created as an asset class and does not have a productive use case for most developed economies.

To be a viable form of money, Bitcoin needs to be a medium of exchange, store of value, and unit of account. Importantly, as Bitcoin has matured over the last few years, the volatility has not subsided materially, which is how a store of value currency is supposed to function. In our opinion, Bitcoin's price has been driven by nothing fundamental, but rather extreme ownership concentration (hoarding) and sentiment/speculation. Additionally, many investors argue that Bitcoin is an inflation hedge like gold. The challenge with this theory is that there has been no major inflation in the 12 years of Bitcoin's existence.




Furthermore, a few large holders continue to own most Bitcoins. About 2% of the anonymous ownership accounts that can be tracked on the cryptocurrency's blockchain control 95% of the digital asset, according to Flipside Crypto. A large holder can have an outsized impact on the still highly illiquid market. One trade can often move Bitcoin's price significantly, which continues to leave small investors susceptible to wild price swings.

According to a trade-policy professor at Cornell, Eswar Prasad, "It could equally well go to zero tomorrow if 10% of investors sold". Other types of investments depend on a similar faith, but traditional stocks and bonds are based on legitimate mathematical models to determine their fundamental value.

Bitcoin has in its past had a history of wild price swings. In 2017, the price of Bitcoin increased quickly from $5,000 and reached a high of over $19,000 before crashing below $3,500 (a drop of ~80%) a year later. In 2019, Bitcoin rose to $10,000 by June, only to see the price ball back to $7,000 by the end of the year.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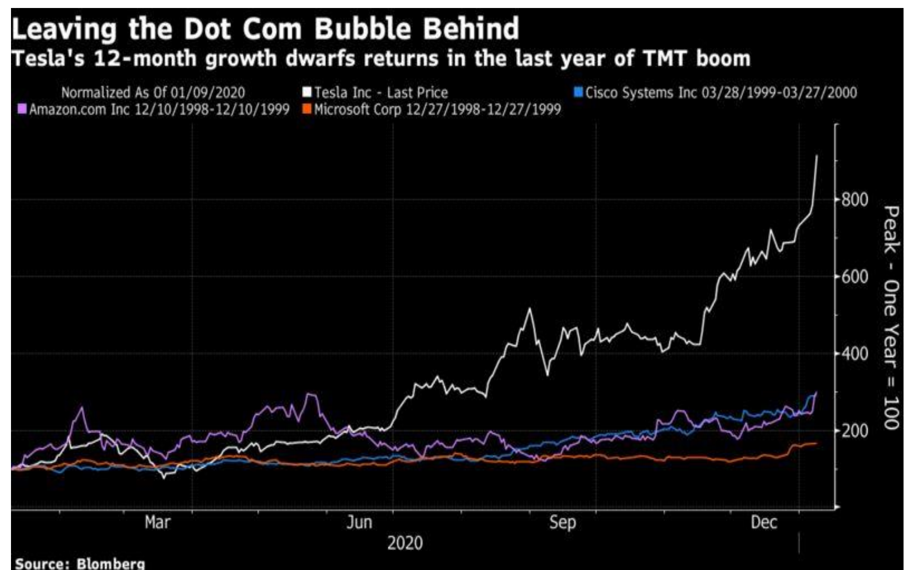
To be fair, the current run-up has included some big-name investors and institutions showing support for Bitcoin's investment value. Those include legendary investor Paul Tudor Jones, as well as a major insurance company Mass Mutual, which purchased $100M of Bitcoin in December. Whether some of the larger institutions are using Bitcoin as a pure speculative investment, a hedge against inflation or a decline in other financial assets, such as stock and bonds, is unclear. However, what is important is that retail investors are at the whim of large players in the market than can quickly change course.




## SPAC "blank check companies"

A SPAC (Special Purpose Acquisition Company) is a shell company that a "sponsors" investor organizes and takes public in an initial public offering (IPO). The "sponsors" of the SPAC get up to 20% of the equity at a modest price mostly as compensation for sourcing the investments. The SPAC manager has two years to find a private company with which to merge and then bring public through an IPO. SPACs are touted as cheaper way to go public than a traditional Wall Street IPO. SPACs have been around for decades but in recent years they have gone mainstream, attracting big-name sponsors and raising record capital (SPACs have raised more money in 2020 than over the last decade combined!). Some notable companies that went public via a SPAC in 2020 include: Richmond based CarLotz, Richard Branson's Virgin Galactic, and the hydrogen-powered truck startup company, Nikola.

The sponsors and the SPAC IPO investors generally earn a high return, while shareholders who remain invested through the eventual merger have not fared as well. The combination of the essentially free equity and the IPO investors' free warrants and rights dilute returns for shareholders. Renaissance Capital found that between 2015 and September 2020, less than a third of all SPAC IPOs had positive returns. At some point, SPAC shareholders will better understand how the SPAC structure stacks the deck against them and when that happens, the SPAC bubble might burst.

## Tesla (TSLA) – the poster child for irrational exuberance?



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While Tesla is no doubt an incredibly innovative company, the stock may be showing signs of being a bit frothy and out of line with current fundamentals, at least in the short-term. A stock bubble occurs when sentiment or other market forces bid up the price of a stock such that it becomes detached from its economic prospects/free cash flow generating capability. Tesla's rise to $500 per share ($2500 pre-split) is the result of individuals buying without regard to price to underlying fundamental value. This is apparent when you consider the market capitalization of TSLA is over $750B (the 5th largest stock in the U.S.), over $500B larger than the next biggest auto competitor Toyota, which is a globally recognized brand with a long history and massive infrastructure.

There are (valid) arguments that the entire market is not in a bubble, but when looking at individual stocks being overvalued based on current fundamentals, TSLA screens near the top of the list given the tremendous run it has had in the last 12 months (+800%). Comparing TSLA's performance to tech companies in 2000, no major tech company during the tech bubble increased its market value by as much as Tesla has in the last 12 months!

Importantly, we are becoming concerned the current valuation adds risk near-term. We are big believers in electric vehicles, and Tesla leads the nascent market, but it still has a long way to go, with plenty of well entrenched players. Bottom line, we see tremendous value in what Tesla is creating long-term, and fully expect the company to continue to grow at a very fast pace, but the stock performance recently may have accelerated too fast for even for such an innovative company like Tesla.

## Conclusion

We hope everyone is healthy and we are looking forward to a great 2021 as the world gets back to normal. As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance.

Sincerely,

Canal Capital Management

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