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Investment Outlook

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A Real Market Rally or Another Bubble?

That's what some are asking as we marvel at the stock market's advance in the fourth quarter. This month's follow through to a memorable and historic November rally has brought record-shattering results for all of the major indexes. Looking back through the data yields some comparisons to 1999 in terms of market valuation and investor enthusiasm. The close of the 90's is remembered as *the* stock market bubble of the modern era, joining the real estate bubble of 2008 as historic examples of groupthink driving manic investors to pile into markets that "can only appreciate and will never go down". As we know, both of those asset bubbles "popped" with severe consequences for investors and the economy. How does 2020 compare?

A Year in Review

Assessing 2020 is tricky. Generally speaking, most would describe this year as one to forget due to the pandemic. How one views the year *personally* depends on things like your demographic, health, and socio-economic circumstances. On that basis, most would describe the year as "OK", "awful", or "life-changing", and not in a good way. That depends on where you reside on Main Street and whether you have a connection to Wall Street. For many investors, 2020 looks like a success but feels like something else.

For those working in Tech, Healthcare, Industrials, and other sectors more adaptive to COVID restrictions, 2020 has been challenging but falls under the "OK" heading. They've been able to endure through the pandemic period (along with their 401k plans) and their prospects will likely recover along with the economy. For those employed in the service sectors (Hospitality, Leisure), and others dependent on people gathering in public, it's been a grim 2020 due to state-mandated lockdowns. While many view themselves as *temporarily* out of work, the sad reality for some is that their job loss could become permanent in the smaller, slower economy that will emerge in the next few years. For them, life on Main Street will forever be altered. In retrospect, 2020 will seem like a tale of two very different economies for many, depending on where they live and what they do to earn an income.

This divergence in outcome has implications for *when* we'll see a full recovery of the broader economy, the kind where *most* people will benefit. We have no doubt that will happen. On the plus side, distribution of a high-efficacy vaccine is imminent so the economy should reap some benefits from that in 2021. Currently, employment and GDP growth have reclaimed roughly half of what's been lost this year. Reclaiming *optimal* levels of both will require continued monetary stimulus along with stable and consistent fiscal policy. We have no doubt the Fed will hold its course. We're looking to Q1 of next year for clarity as to whether current fiscal policy might be disrupted at the worst possible time. If that occurs, timeliness of a full recovery becomes uncertain and investors will respond accordingly.

The K-Shaped Recovery

The recovery in 2020 has been best described by Schwab investment strategist Liz Ann Sonders as one shaped like a "K". The *ascending* portion of the economy represents components that are adaptive to the pandemic and on an upward trajectory due to an assist from fiscal policy and stimulus from the Fed. The sectors hobbled by the policy response to the pandemic form the *descending* part of the K. That divergence within the economy has been reflected in the stock market for the better part of this year. With the distribution of a vaccine at hand and a better 2021 in sight, investors have begun to reallocate capital from issues that have *led* the market to those that have *lagged* it.

Obviously, the stock market will reflect the timeliness and amplitude of the recovery ahead. Investors are an optimistic lot and, as such, are generally reluctant to sell winners when they have cash available to buy the next round of winners. That might account for December's market performance to-date where the NASDAQ rose for 11 consecutive days and set new record highs for six of those. Meanwhile, capital also flooded into traditional early cycle favorites that were relatively cheap. The result was multiple record highs for *all* the major indexes in early December. Whether that continues is anybody's guess but it does have some asking if this is the beginning of another 1999-like stock market bubble.

Of course it could be, but we currently view it only as a period of *unwinding index inequality* through a natural tendency for investor capital to migrate to more opportunistic value propositions. 1999 was very different in that investors threw capital at non-existent or, at best, specious value propositions in lemming-like fashion. That mania could have ended only one way. In Tears. The fact that we have a K-shaped stock market reflecting a similar economy demonstrates a level of investor rationality that currently belies any hint of a '99-like market bubble.

It's natural to be enticed to buy into a bull market deep into a rally of historic proportions as many did in the late '90s. Many successful investors have learned the hard lesson that buying stocks is a counterintuitive process. If you're excited about deploying capital at lofty prices, It's likely you'll be challenged in the future by lower prices. It's at that point that fundamentals matter. So, while there's little doubt that *some* stocks are overshooting their metrics, the majority of the market is currently valued with fundamentals and economic data in mind. Much like seeing the occasional correction as a pause that refreshes, adding breadth to this advance at the expense of a few highly or over-priced issues is a healthy sign rather than the beginning of a stock market bubble.

Update on our list of Risks to Recovery and Economic Expansion

COVID-19: Vaccine offered in UK. US still awaiting approval from FDA. Reduced to **Moderate**

The Fed: Holding course with persistent lower rates and asset purchases. No inflation in sight. Remains **Benign**

Trade War: Election behind us. The reset button in play for 2021. A retreat from America First? Remains **Moderate**

Global Economy: Hard Brexit absent an EU capitulation on demand for regulatory and legal compliance. UK demands its sovereignty. Remains **Moderate**

The Election: Over. Awaiting conclusion to Senate contests. Fiscal policy hinges on outcome. Holding at **Significant**

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