Eagle Strategies LLC

The Eagle Edge

Quarterly

MARKET & ECONOMIC OUTLOOK

DECEMBER | 2020

On the Radar Screen

1. **The Georgia runoff elections on January 5th will determine party control of the Senate.** While it is likely to take several days before both races are called the winning party will have significant influence over policy for the next two years.
2. **Biden's "honeymoon"—the first 100 days in office—**establishes the policy direction based on his agenda and key personnel. We expect to see a focus on green energy and an equitable economic recovery.
3. **Employment growth was faltering as we moved through the fourth quarter** due to a surge in cases and renewed economic restrictions. This may persist as we work through the winter months.
4. **Household confidence/comfort surveys also declined into year end,** again likely attributable to renewed pandemic-related restrictions. An extension of that trend into January despite would suggest to us that even more fiscal stimulus is needed.
5. **Consumer confidence matters because it influences retail sales,** which also have been faltering. A further pullback in the early part of 2021 has the potential to induce a stock market correction.

Insights from Multi-Asset Solutions' Portfolio Managers

"When all the experts and forecasts agree—something else is going to happen."

– Bob Farrell, Merrill Lynch

To infinity and beyond! As events in the economy and capital markets unfold, a shared narrative that attempts to explain what may follow often emerges within the financial community. Such has certainly been the case in the closing months of 2020 as the rollout of COVID vaccinations seemed to refocus the collective wisdom on the better days that likely lie beyond a dark winter.

Throughout the spring months of 2020, pandemic-induced restrictions impaired output and corporate profitability. In the third quarter, the resilience of the US economy was on full display as activity levels staged a historic rebound. As the virus reaccelerated in the final months of the year (and threatens to intensify further in the weeks ahead) economic activity gauges have again faltered, but market participants and commentators seem near universal in looking beyond this transitory dip. Vaccinations bring an end of the pandemic restrictions into sight. Pent-up demand, accumulated savings, and ongoing fiscal support portends a massive boom on the horizon providing a gale-force tailwind to corporate earnings—a roughly 20% increase for the 500 largest publicly traded U.S. companies. It is rare to find a piece of financial commentary that suggests anything else.

The logic is compelling. We've seen already the voracity with which demand can recover as restrictions are removed. With the fear of illness eradicated, why shouldn't that force be even stronger once immunity has been established? Fiscal largesse provided through the CARES Act in March and the, less elegantly named, Consolidated Appropriations Act, 2021 in December has helped many businesses bridge the temporary

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slack in activity while also padding household budgets, leaving some consumers prepared to splurge once it is safe to fully reengage. In this light, expectations for solid growth of Gross domestic product (GDP) and a pop in corporate profits seem entirely reasonable and we are comfortable joining the consensus.

But at the same time, it's difficult not to be at least a little wary of the powerful rally in stocks that has accompanied this line of thought. The final two months of 2020 saw the strongest return for that period in recorded history. That wouldn't be alarming, given the developments around the pandemic, were it not coming on the heels of a historic rally earlier in the year. Pricing is now in rarefied air.

"If you participate in that enthusiasm, they you'll also participate in the correction." – Howard Marks, Oaktree Capital. Aggregate earnings on the S&P 500—an stock index representing the 500 largest publicly traded companies—in 2019 came in close to $165. As we entered 2020, unaware of the coming pandemic, earnings were anticipated to reach $190. In the event, they will likely clock in close to $135—a huge miss. The big boom in activity still ahead in 2021 is likely only to restore earnings to their 2019 level, yet prices have already climbed double digits since then. Big gains on lower earnings translates into much richer valuations, a potential vulnerability. One argument to be made is that lower interest rates justify higher valuations. If we could bank on permanently lower rates, that might be true, but we are reluctant to embrace that idea ourselves. Markets are dynamic and adaptable – rates that went down can also go back up. Additionally, we have the examples of Japan and Europe that saw near zero rates well before the US, yet also experienced declining price multiples. Regardless, anytime we hear an argument being made that we are in a new regime and permanently higher valuations are upon us, we get anxious.

Campaign in poetry, govern in prose. Another theory we've heard made in favor of higher valuations relates to policy. Here too, we are cautious. The argument runs that a Biden presidency, backed by a progressive Veep and in cahoots with a dovish Fed, will engage in aggressive, deficit-funded stimulus programs including infrastructure, healthcare and education. While such programs were absolutely elements of Biden's campaign platform, his ability (and even desire?) to implement them is likely to be much constrained by a narrowly divided Congress, regardless the outcome of the Georgia runoff elections. And to the extent that new spending is introduced that is not offset by higher taxes, the rising deficit may eventually engender faster inflation and higher yields, sabotaging the case for higher valuations built on a foundation of ever-lower rates.

Taking all this into consideration, it is difficult to be so enthusiastic about equities as to tilt our portfolios in their favor. But at the same time, we do acknowledge that the market has significant momentum and optimism about the post-COVID world continues to build. As such, we maintain a roughly neutral posture. The story is similar with credit. Spreads are surprisingly narrow given the amount of leverage that has been deployed and the stress that many businesses continue to suffer, yet they continue to tighten. That's not a force we are inclined to fight.

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One of the few assets about which we are genuinely constructive is gold. In a world of endless public deficits and hyperactive central banks, inflationary impulses and waning confidence in fiat currencies seem sure to follow eventually. Gold, and by proxy gold miners, should fare well in such an environment.

There is no assurance that the investment objectives will be met.

Past performance is no guarantee of future results, which will vary. All investments are subject to market risk and will fluctuate in value.

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Stocks and bonds can decline due to adverse issuer, market, regulatory, or economic developments. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner, or that negative perception of the issuer's ability to make such payments may cause the price of that bond to decline. A bond's prices are inversely affected by interest rates. The price will go up when interest rates fall and go down as interest rates rise.