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Main Points:

- The Biden administration is expected to govern in a moderate way due to a close division of government.
- Conditions are set for extraordinarily strong growth as the economy uncoils from compression caused by Covid-19 as well as unprecedented monetary conditions. We will call it the Biden Boom.
- Corporate earnings set to surge and are expected to reach record levels in ’21.
- Upward pressure on bond yields remains, and we think 1.5% yield on 10-year U.S. Treasury bond is in sight.
- The Euro rally is running out of steam.
- Our main concern is that Fed officials may get their wish: Higher Inflation; While not an issue now, we can envision higher inflation rates by 2023 which would harm stock valuations.

The Biden Boom is Coming

While the election gave Democrats control of Congress and the Presidency, the government remains closely divided and the moderates will control the direction of legislation. Perhaps the most surprising result of the election was not that Joe Biden will become president, but that the Republicans gained 10 seats in the House of Representatives, which is now divided 222/211 with Democrats in control. Furthermore, the Senate is divided 50/50 with the Democrats in control due to the Vice President’s tie breaking vote. However, all these politicians are already thinking ahead to the November 2022 elections. Such “mid-term elections” are rarely good for the incumbent party. This will prevent moderate members of the Democratic party from backing extreme ideas like adding Washington DC and Puerto Rico as states or passing depressing tax legislation. This state of affairs (moderation) is attractive from a markets perspective.

While the Federal government has been increasing its debt load, U.S. households have been stuck at home much of the time and saving money. This pent-up demand is like a coiled spring that is waiting for the Covid-19 vaccines to unleash. It is true that the unemployment rate jumped to 14.8% last April before falling to the recent level of 6.7%, but household income has held up well. Most of the jobs lost were low wage jobs in restaurants and retail shops, whereas high value jobs were mostly unaffected because people could work from home using computers, VOIP communications and other technology. Manufacturing facilities continued to operate as well. Furthermore, those workers who did lose jobs received expanded unemployment benefits that in most cases exceeded their regular wages. The Federal government also made direct cash “stimulus payments” to individuals earning less than $75,000 per year for individuals.

U.S. households have been reducing debt and saving income. As shown in the charts below, thanks to the combination of debt reduction and low interest rates, the amount spent to pay for debt service has fallen to about 9% of disposable personal income. Furthermore, the savings rate spiked to 33.7% last April when $2,000 per person “stimulus checks” were sent out. Ongoing Federal support has kept the savings rate high as families put much of the Federal largesse away in the bank while they sheltered in place. The savings rate has continued to average nearly 14% over the past few months, and another spike is coming with another round of government payments ($600 this time) having started on December 30th.

Chart 1

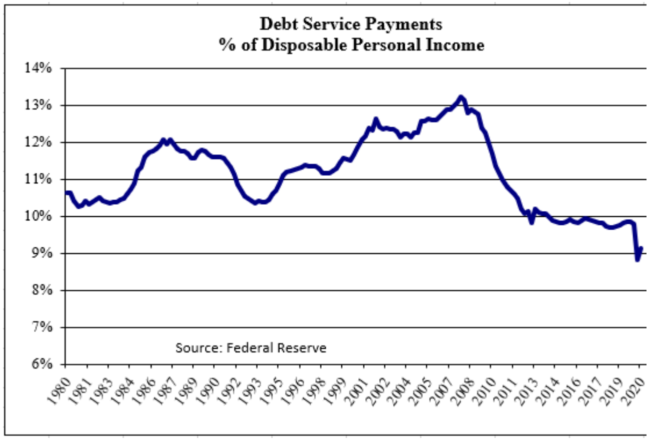
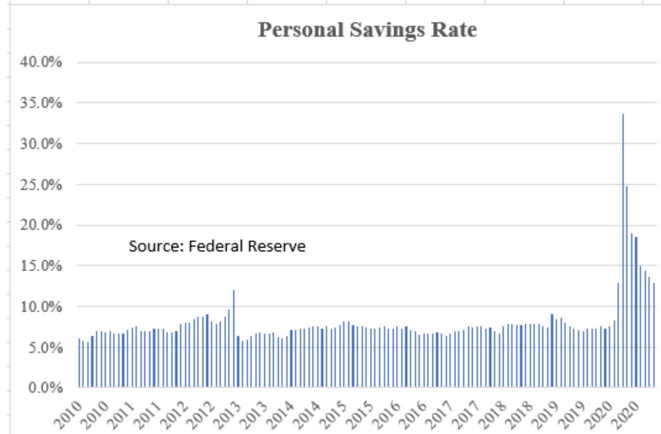


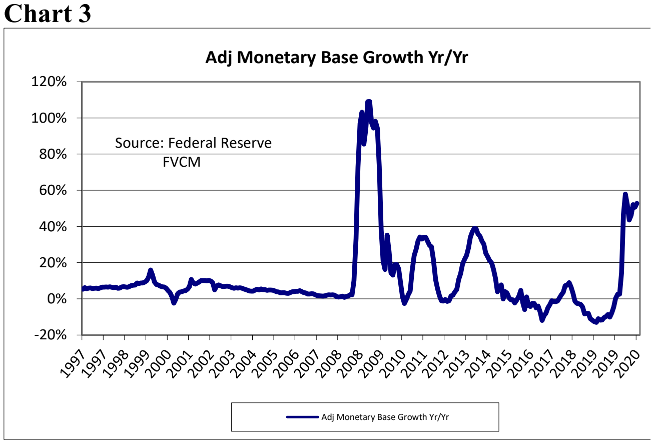
Chart 2



The improvement in household finances was enabled by the Federal Reserve's QE program, which created Helicopter Money. The Fed has been buying about $120 billion in securities per month: $80 billion of U.S. Treasuries and $40 billion of mortgage-backed securities. Like past periods of so-called quantitative easing (QE), the monetary base, which consists mostly of bank reserves at the Fed, has shot sharply higher (see Chart 3). But there is a significant difference this time around. During the QE operations following the 2008 financial crisis, the Fed was primarily buying U.S. treasuries from the banks, which received a Fed deposit (reserves) as payment for the U.S. Treasuries. In effect, the Fed was merely swapping U.S. Treasuries for interest paying reserves that the banks held. These operations had little effect on "money" deposits that the public held with banks. However, this time around, the U.S. Treasury, not the banks, is effectively selling securities to the Fed and then sending checks to individuals in the form of "stimulus." This has caused a sharp expansion in bank deposits held by the public. The M2 money supply was up about 25%, year over year, as of the end of November (see Chart 4). For all intents and purposes, the U.S. government is effectively providing what Milton Friedman famously referred to as "helicopter money."

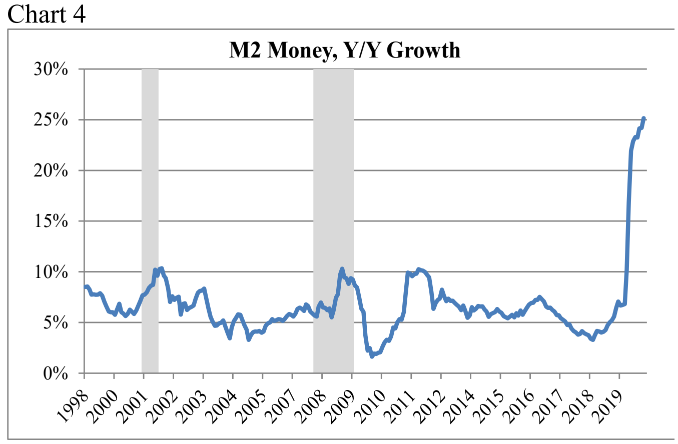
From an economic and capital markets perspective, the current conditions are about ideal. Make no mistake, there are few things more corrosive and destructive to the economy than inflation. But one characteristic of inflation is that it is hard to stop once it takes hold, and equally hard to start after long periods of relative stability. Inflation is a lagging phenomenon that follows two to three years of nominal spending. So, for now, inflation will stay low, spending can accelerate, happy times can come, and we will not see potential damage for at least a couple years. Furthermore, if the public decides to hoard cash rather than spend it, we may never get a material increase in inflation at all. The critical factor to watch in the quarters ahead is nominal spending.

Chart 3



Source: Federal Reserve

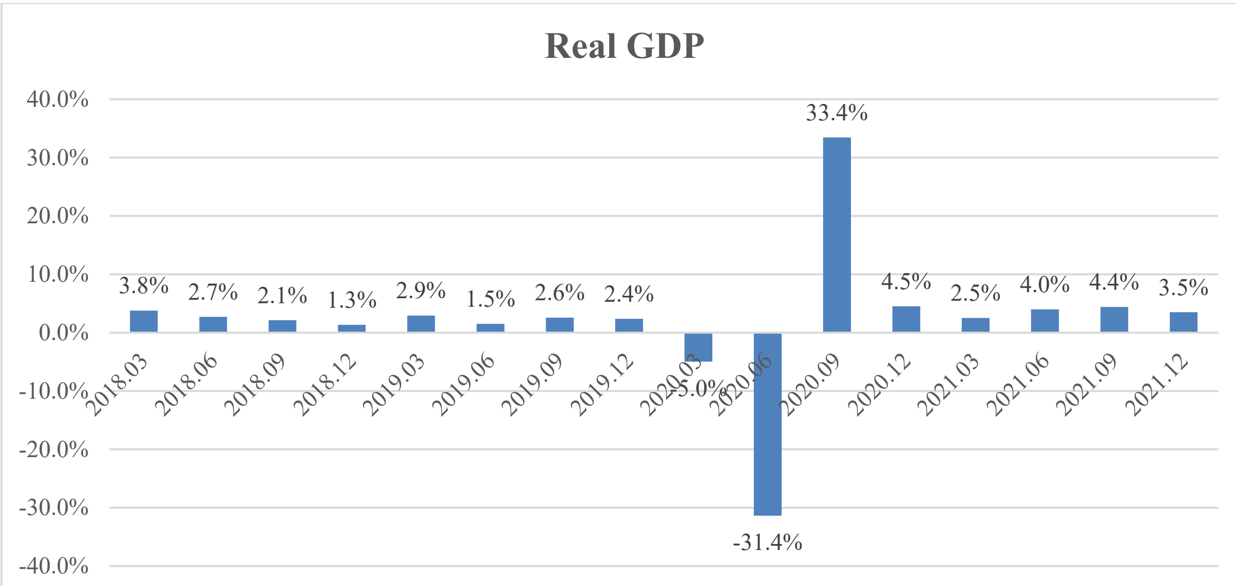
Chart 4



Source: Federal Reserve

After the extreme volatility of the second and third quarter due to Covid, the consensus is that real GDP growth will settle into about a 4% rate in 2021 (see Chart 5 below). However, we think these estimates are too low. It is difficult for economists to model extreme events such as the decline in spending due to Covid and the subsequent rebound. It has been our observation that with extreme events, the models underestimate both the lows and the highs. This is merely a guess based on years of observation, but we suspect that real GDP growth will significantly exceed the estimates for 2021 in the chart below. As we have already noted, there is substantial buying power and pent-up demand just waiting for release once the vaccine makes general business activities safe.

Chart 5



Source: Factset

Much has been made of the fact that stock prices are at record highs while a pandemic rages, as if the status of the two points were contradictory. But, the markets are always forward looking and record earnings are on the horizon. We have included more than 30 years of revenue and earnings data for the S&P 500 below in Table 1. Over the years there have been periods of decline, but it doesn't take a rocket scientist to notice that the long-term trend is consistently up. Buying stocks and reducing cash as we did throughout the pandemic was based on the knowledge that bad times never last. It is important to take advantage of the bad times while you can. When people are fearful, it is good to know that there will always be another sunrise. For all of 2020, we estimate that sales for the S&P 500 will be down 4% and operating earnings will be down 22% from 2019 levels. The conservative GAAP earnings are forecast to have declined 32% in 2020. Good analysts have long known that the best time to buy cyclical stocks, like heavy manufacturers, is during a recession when earnings evaporate and, accordingly, P/E ratios are very high. The same principle is true for the market as a whole. With the economy expected to grow sharply in the quarters ahead, as already discussed, strong growth in corporate sales and earnings are in the works.

In addition to the strong rebound in economic growth, corporate sales and earnings will get a big boost from the recent decline in the U.S. dollar's foreign exchange value. Our regression model indicates that the 6% decline in the trade weighted value of the dollar over the past year alone will add about 2.5% to sales growth and even more to earnings. We think that the weakness in the dollar is nearing an end, but even if it only trades flat from here, the weaker f/x will have a lingering positive impact as 2021 progresses. We expect 2021 revenues for the S&P 500 to rise 10%, while operating earnings and GAAP earnings rise 34% and 45%, respectively.

Table 1

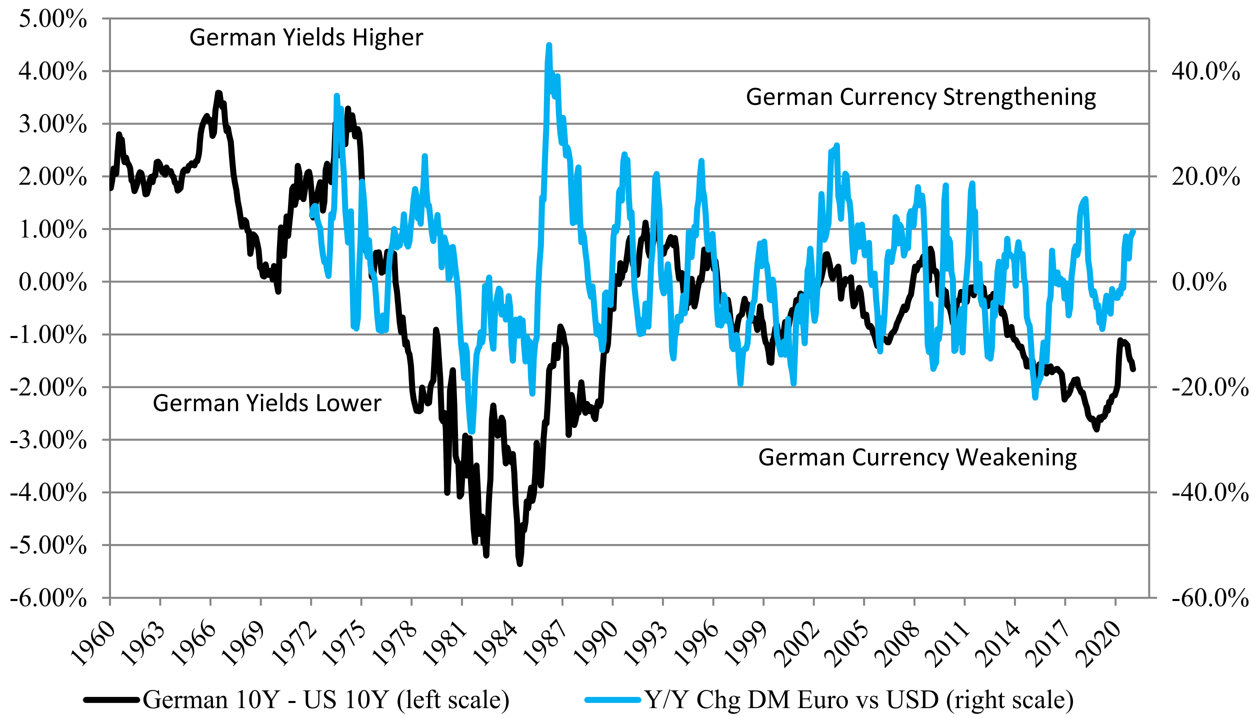
	S&P 500					
	Revenue	Operating Earnings	Special Items	GAAP Earnings	Oper Margin	Net Margin
1988	408.19	24.12	0.37	23.75	5.9%	5.8%
1989	461.15	24.32	1.45	22.87	5.3%	5.0%
1990	509.08	22.65	1.31	21.34	4.4%	4.2%
1991	512.57	19.30	3.33	15.97	3.8%	3.1%
1992	523.64	20.87	1.78	19.09	4.0%	3.6%
1993	527.22	26.90	5.01	21.89	5.1%	4.2%
1994	552.06	31.75	1.15	30.60	5.8%	5.5%
1995	598.41	37.70	3.74	33.96	6.3%	5.7%
1996	614.43	40.63	1.90	38.73	6.6%	6.3%
1997	640.40	44.01	4.29	39.72	6.9%	6.2%
1998	634.51	44.27	6.56	37.71	7.0%	5.9%
1999	663.21	51.68	3.51	48.17	7.8%	7.3%
2000	745.70	56.13	6.13	50.00	7.5%	6.7%
2001	736.88	38.85	14.16	24.69	5.3%	3.4%
2002	674.59	46.04	18.45	27.59	6.8%	4.1%
2003	710.81	54.69	5.95	48.74	7.7%	6.9%
2004	788.17	67.68	9.13	58.55	8.6%	7.4%
2005	874.32	76.45	6.52	69.93	8.7%	8.0%
2006	952.51	87.72	6.21	81.51	9.2%	8.6%
2007	1,025.08	82.54	16.36	66.18	8.1%	6.5%
2008	1,042.46	49.51	34.63	14.88	4.7%	1.4%
2009	908.40	56.86	5.89	50.97	6.3%	5.6%
2010	962.71	83.77	6.42	77.35	8.7%	8.0%
2011	1,052.83	96.44	9.49	86.95	9.2%	8.3%
2012	1,092.37	96.82	10.31	86.51	8.9%	7.9%
2013	1,116.81	107.30	7.10	100.20	9.6%	9.0%
2014	1,163.32	113.01	10.70	102.31	9.7%	8.8%
2015	1,127.13	100.45	13.92	86.53	8.9%	7.7%
2016	1,150.68	106.26	11.71	94.55	9.2%	8.2%
2017	1,231.57	124.51	14.63	109.88	10.1%	8.9%
2018	1,343.01	151.60	19.21	132.39	11.3%	9.9%
2019	1,415.01	157.12	17.65	139.47	11.1%	9.9%
2020(e)	1,357.14	123.08	27.79	95.29	9.1%	7.0%
2021(e)	1,494.10	164.80	26.52	138.28	11.0%	9.3%

Source: S&P Global, FVCM

Since the election in November, the yield on the 10-year U.S. Treasury bond has moved up rather sharply from about 0.80% to 1.10%. At the same time the rally in foreign currencies has stalled out. The common theme published in U.S. business papers is that the rise in yields reflects the increased likelihood of even more “stimulus” from a Biden administration. While that is certainly possible, the markets are also reflecting the simple removal of uncertainty as well as the relief that there is unlikely to be any extreme legislation coming from the new administration. All eyes are now focused on the “Biden Boom” that is on the near horizon. This leads us to believe that 10-year yields can get back to at least the 1.5% level last seen in February 2020, if not higher. As recently as 2018 the 10-year yield was at 3.0%. It is not a crazy idea.

Nothing occurs in a vacuum, and we expect the European economy to rebound but, for now, it looks like a rise in European yields are lagging the rise in the U.S. This will put downward pressure on the Euro. As we have pointed out in the past, foreign exchange rates are more affected by massive global capital flows rather than merchandise trade, which is much smaller. As shown in Chart 6, the black line has turned downward, indicating that the spread between the 10-year U.S. Treasury yield and the 10-year Bund is widening. The higher relative yields are a signal that capital may flow more towards the U.S. In contrast, the year-to-year change in the Euro (the blue line) is still upward. This suggests to us that the recent strengthening in the Euro may start to fade. From a technical perspective, the Euro is also hitting some major downward trend lines that date back more than ten years.

Chart 6



Source: Federal Reserve, FVCM

The current policies with Helicopter Money and massive government spending, or Modern Monetary Theory (MMT) as some may wish to call it, is an unprecedented experiment and a major risk factor. As a long-time monetarist, such a large increase in the money supply is immediately disturbing. However, as a result of the fractional reserve banking system, as well as other private markets, there has been a secular increase in global debt over the past 70 years. Debt has become a dead weight on ongoing spending. There are some interesting arguments that money, which is a debt of the sovereign issuing it, has become scarce relative to "interest bearing" general debt. Without saying so, the monetary authorities appear to have decided that they need to aggressively provide liquidity to prevent a downward spiral in spending due to debt. If the theories are wrong, and people merely start to spend money like profligate politicians (pardon the redundancy), then we may get unwanted inflation within a few years. This is the risk, albeit a longer-term issue, that most concerns us. Conversely, if the proponents of the current policies are correct, they will have avoided a deflationary contraction.