YANKE FINANCIAL

5540 Centerview Dr, Ste 200 | Raleigh, NC 27606
919-306-5811 | Toll-Free: 800-513-2812 | Fax: 919-375-2303
patrick.yanke@yankefinancial.com
www.yankefinancial.com

YANKE FINANCIAL, LLC NEWSLETTER WINTER 2021

The only constant is change

Not a Repeat... But it Rhymes

Patrick H. Yanke, CFP ®
Branch Manager

January 29, 2021

Last year was a good year for investors… but it sure didn't feel like it most of the time. The S&P 500 rose 18.4%. Equity markets are now at or near all-time highs. As interest rates tumbled, bond values rose. The year ended well for those with the courage to hang on through the worst of it.

The temptation most of us face is to take market highs as a signal to reduce our equity exposure for the next downturn. I think that would be a mistake at this point. Most economists are forecasting robust GDP growth in the US this year as the recovery from the flash COVID recession continues. This is a good time for proactive money managers with a strong track record through varied market cycles. Don't assume what worked before will continue to work going forward and don't get hung up on politics. Elections influence economic policy and those policies could have an effect on growth. Focus on the fundamentals.

COVID-19 Update

Any discussion of the economic and investment outlook must start with an understanding of the human toll of the pandemic itself. The path of the pandemic impacts the level of economic activity, and fluctuations cause a lot of uncertainty. After surging and retreating in the spring and the summer, the pandemic has worsened in recent months and will likely continue to surge in the first quarter. However, the approval of several vaccines should allow for the inoculation of roughly 150 million people in the first half of 2021.

Also, the elevated rates of infection may allow for a path to some herd immunity. Recent news reports have suggested some lasting immunity to those who have been infected—possibly greater than vaccination. Reports of double infections may be due to inaccuracies in testing which allow for false positives. Keep in mind that as high as the official numbers are, it is estimated that the real rate of infections among those not being tested could be 10x the official amount. That's a lot of potential immunity. Vaccines and herd immunity suggest a chance that life largely returns to normal by the Fall of 2021.

Economic Growth

After suffering the most severe recession since WWII resulting in the worst quarterly GDP retreat on record in 2Q20, economic growth surged in the third quarter, notching the best quarterly GDP growth on record. However, despite this strong surge, economic activity has only partially recovered from the collapse and remains far below the trend suggested by economic growth at the end of the last decade. This reflects the dominance of the service sector and the inability of it to recover fully in a pandemic.

The renewed pandemic will put further pressure on these industries and this, combined with a delay in getting extra fiscal support to the U.S. economy, is leading to a deceleration in economic activity with growth likely slowing to a low single-digit pace in early 2021. Thereafter, however, growth should surge due to both pent-up demand and pent-up supply in those sectors that have been most impacted by the pandemic.

Unemployment

After reaching a 50-year low in February, 2020, of 3.5%, the unemployment rate spiked to 14.7% in April of 2020, as 22 million people lost their jobs. Although there has been a sharp recovery in jobs thus far, the second half of the labor market recovery is likely to be much more gradual, as the pace of job gains has already slowed. Much of the remaining employment decline from the pandemic is in sectors that will have a hard time reopening while the pandemic continues, including the leisure, hospitality, travel, retail and food services industries. In addition, state and local government cutbacks could weigh on payroll employment. However, once the vaccine is broadly deployed, service-sector jobs could have a healthy rebound.

Inflation

The onset of the recession, combined with a collapse in oil prices, triggered a decline in already low inflation. Although inflation normally troughs after the end of a recession, things may be a little different this time around, particularly given the potential for further fiscal stimulus, the continuing extra costs of operating during a pandemic and the likelihood of an economic surge following the distribution of vaccines. Consequently, expect inflation, using both CPI and personal deflator measures, to edge over 2% by the middle of 2021 and stay at close to this pace into 2022.

Equity Markets

The deep recession in the economy was mirrored in big declines in S&P500 operating earnings in early 2020, pushing profits into recession. Analysts are expecting profits to recover in 2021. However, past earnings recessions have typically lasted 2-3 years and, given the severity of the plunge in profits and the gradual economic recovery, it is likely that profits will not surpass their 2019 peak until 2022. However, in 2021, areas hardest hit by the pandemic, like energy, financials, and industrials, could experience solid earnings rebounds, while areas like technology and health care should continue to hold up well.

U.S. equities have recovered significantly from the March lows, and at record speed. However, as markets look through the virus and the downturn to the recovery, valuations are well above historical averages. Investors should recognize that earnings are likely to continue to grow quickly in the year ahead which should lead to some compression in these ratios. Moreover, a continuation of relatively low interest rates likely justifies some elevation of valuation measures above their historical averages. Still, rich valuations may constrain equity returns over the long-run. Consequently, investors may want to consider diversifying their equity exposure adding more to value stocks as well as reducing weightings to the very largest companies in the stock market.

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Continued from the front:

Both U.S. and international stocks sold off at the height of the COVID crisis, but the valuation gap between U.S. and international stocks that persisted throughout the recent expansion still persists today. However, this dynamic could shift in the next expansion.

The long-term growth prospects of EM economies still look better than for the US. Valuations remain cheaper overseas and the dollar has been retreating which amplifies the return on international equities. Europe, which has been long unloved, may have a catalyst for turnaround with more promising efforts towards fiscal integration. Given the extraordinary disruption to the U.S. and global economies in 2020, it is remarkable how resilient financial markets have seemed to be.

However, investors should recognize that the blessing of strong performance brings with it the challenge of higher valuations. The next few months should answer many questions with regard to our collective success in ending the pandemic as well as the pace and shape of the U.S. and global recoveries from the social-distancing recession. Given all the uncertainties surrounding these and other questions investors would be wise to maintain a somewhat defensive and diversified stance after one of the most difficult and unusual years in modern history.

Those relying on unmanaged indices enjoyed a decade of outperformance relative to the average money manager. The top 10 holdings in the S&P 500 have grown to be almost 30% of the market capitalization of the index. This could mean active managers may have greater influence on returns going forward.

The Fed and Interest Rates

In the first half of 2020, the Federal Reserve took very strong action to support the economy including cutting the federal funds rate to a range of 0-0.25%, opening or expanding a very wide range of facilities designed to support different parts of the bond market and adding dramatically to its balance sheet. In addition, in August, the Fed adopted an "Average Inflation Targeting" strategy, by which they will aim to achieve inflation of above 2% for some time to make up for years of undershooting this target. In order to achieve this they have pledged to hold the federal funds rate at its current 0-0.25% target range until inflation is at 2% and on track to moderately exceed 2% for some time.

Although the Fed pledged to maintain its current asset purchases until "substantial further progress" has been made to achieving its inflation and employment goals, it is important to note that this timetable suggests that the Fed will reduce its bond purchases well in advance of any increase in short-term interest rates. This, in turn, suggests a steepening of the yield curve as the economy continues to recover in 2021.

With the Federal funds rate at 0-0.25%, nominal Treasury yields have fallen to near-historic lows and real yields are negative. In this low rate environment, investors will continue to hunt for yield. Although spreads had widened in riskier fixed income, they have come in meaningfully, making risk-return dynamics less attractive. However, despite unattractive yields, high quality fixed income will continue to play an important role in providing investors with downside positioning and diversification.

Riskier fixed income tends to offer more yield, but also has a strong correlation to the S&P 500. Therefore, if equities market fall, these sectors will not provide much protection. In contrast, higher-quality fixed-income asset classes offering lower yields have diversification benefits when equity markets come under pressure. In other words, using fixed-income as a hedge against equity volatility comes at the cost of low yields.

Federal Government Finances

The heart of the economic damage is with consumers and businesses, so the U.S. government delivered a multi-trillion dollar fiscal package to mitigate permanent economic damage at the onset of the pandemic. Pending further fiscal support and possibly infrastructure spending, the budget deficit could further increase in 2021, but will likely still be below 2020 levels. However, the national debt as a share of GDP will continue to grow to the highest levels since WWII. While I don't believe this will result in a fiscal crisis in the next couple of years, a failure to rein in deficits and debt monetization once the economy accelerates in the wake of a vaccine could lead to significant problems. This suggests that eventually, the government will have to make some tough choices on tax hikes and spending cuts. Tax deferral strategies may help.

Do Something

Investors should still remain vigilant with their portfolios and review their holdings. I believe this environment is where the best managers will have an edge over "passive" managers that seek to match index performance. Sit down with your financial advisor and ensure your investments are prepared for the future and consistent with your objectives.

Plan for the future. Has there been a birth or a death in the family? Marriage or divorce? Graduation or retirement? Each of these will have an impact on existing financial plans. Keep your documents relevant to your particular situation by reviewing them frequently. Bear in mind, stale documents (not recently reviewed) may be challenged when activated.

Summary

My outlook favors equities over bonds—just don't expect higher than average gains this year. This is an environment for strong investment managers and careful stock selection. Overseas holdings may benefit long-term investors with greater growth potential. Income-oriented investments may struggle in a low interest rate environment. Bonds may have value as a diversifier for managing portfolio risk. However, chasing higher yields may reduce much of the benefit of diversification.

Equities are my recommendation for a 10-year outlook. With bond yields at historic lows, bond investors may realize low income and a risk of capital losses. Greater income will require higher interest rates which may drive down bond valuations. This isn't a recipe for long-term wealth-creation.

What to do now? **Take the long view with your investment assets** and dust off financial plans. When was the last time you reviewed your plans? Your estate plan should be reviewed at least bi-annually and updated with every change of life. Most importantly, make sure you have carefully delegated who will execute your documents for you. To review existing documents, develop new plans, or do end-of-year planning, talk to an advisor soon.

Source: General economic statistics are from JP Morgan "Guide to the Markets" 1Q2021.