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Q&A: PETER W. TUZ
PRESIDENT & PORTFOLIO MANAGER

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Peter W. Tuz, President & Portfolio Manager

2021 Equity Market Focus

Economic Recovery & Outlook

Q: After the considerable move up in 2020, what do you think equity markets will focus on as we enter 2021?

We would all probably like to see the market for face-masks plummet in 2021! Overall, equity markets will focus on whether the economic recovery that began sometime in the summer continues into 2021 or falters, at least early in the new year. With two Covid vaccines now on the market and more to come, substantial numbers of people will be getting vaccinated soon. At some point in 2021, enough people will have gotten the vaccine so that life returns to more of what we were used to prior to 2020. Travel should increase, restaurant dining should increase, movie-going should increase. The difficult question to answer is how much of this is already factored into equity markets which are ending the year on or near a high note. Earnings estimates for the full S&P 500® index are now about $165 or so for 2021 according to S&P Capital IQ, one of our research sources. Given today's S&P 500® price of $3692, that gives the index a price/earnings ratio of 22x. By historic norms, this is pretty expensive, but given the lack of attractive alternative investment opportunities it is perhaps easily understood. Depending on what happens in the two run-off Georgia U.S. Senate elections in early January, markets may also focus on whether we will continue to have gridlock or not in Washington. Gridlock is generally viewed more positively than single-party control because of the lower odds for significant policy changes under split government.

Q: Can you discuss the impact of low interest rates on equity markets?

Low interest rates along with ample liquidity are probably the two biggest factors responsible for the strong stock market we enjoyed last year. Immediately after the Covid pandemic shut down our economy, monetary authorities around the world acted to inject liquidity into markets and to keep rates at extremely low levels. The idea behind this, is both to make it easier for borrowers to stay current on their debts and, maybe more importantly, to prompt investors to take more risk in search of potentially greater returns. So, money flowed into equity markets, high yield debt markets, residential real estate markets, private equity and venture capital. It has created some situations that seem absurd. We saw government debt in several countries move to where yields were less than 0%. Equity markets tend to be strongly influenced by institutional investors such as pension funds, endowments and the like. They generally have to pay out about 5% of their portfolio value every year. When interest rates were far higher than they are today, fixed income investments used to make up large parts of their portfolios. In today's world of ultra-low rates, "riskier" assets like stocks, private equity, real estate, etc. have grown in importance for them and that has helped keep markets high.

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Q: Will the "work from home" stocks that did so well in 2020 continue to do well in 2021 as we hope to enter a more normal working environment once Covid has come under control?

In some ways, the "work from home" stocks have probably changed the world forever. For many people and businesses, it has proven to be just as efficient to work remotely as it was to work in an office. Because many people had no commute, "working hours" actually increased for many people. Probably the industries most affected in the future will be real estate and travel. Many companies will conclude they just do not need as much office space for employees as they once did. So urban office real estate especially might suffer. The work-from-home movement has led to single family home sales in many suburban and exurban markets booming as people left cities for areas they deemed safer. We all know what internet shopping via Amazon and other e-retailers has done to retail real estate. Business travel, obviously, dropped substantially this year. Going forward, I don't think it ever returns to pre-Covid levels. While video conferencing like "Zoom" won't work for all meetings, it will work for many and the need to travel and stay in hotels will lag. That said, it wouldn't be surprising for some tech items like personal computers to see sales slack off some in 2021 since there were so many sold in 2020.

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Q: Which sectors of equity markets did well and badly in 2020 and do you believe different sectors will fare better or worse in 2021?

Through December 31st , the best-performing sectors in the S&P 500® index were information technology, consumer discretionary and telecommunications respectively. The worst-performing were energy, real estate and financials. No surprise about information technology – this is where most of the "work from home" companies like Apple, Microsoft, Nvidia and Salesforce lie. While the consumer discretionary sector contains a lot of travel/leisure/fashion names, it also contains Amazon, which rose more than 76% through December 31st . It also includes Home Depot and Lowe's as well as Tesla which was just added to the S&P 500® in late December. Telecom has a lot of stocks that people may not have heard of that did very well in 2020; it obviously was helped by millions more "telecommuters" throughout the year. It should come as no surprise to anyone that energy was the worst sector in 2020. Travel pretty much came to a halt and is still down considerably from 2019 levels. The demand for and price of gasoline dropped considerably. As noted earlier, office and retail real estate demand fell a lot in 2020 as people worked and shopped from home. Banks and other financial services firms faced a lot of challenges in 2020. For many firms in the sector, they faced a combination of low interest rates and a flat yield curve – two factors hurting their revenues. In addition, the weakening economy stoked fears of ever-growing amounts of bad loans, something that affected the stocks but really hasn't happened yet.

It's hard to tell which sectors will do best in 2021. Technology seems to be on a pretty consistent growth path. One of the important factors in all of investing is "reversion to the mean," which simply means stocks and sectors that underperform or overperform for some time frame do the opposite at some point in the future.

Q: Size and style seemed to matter a lot in 2020's equity markets with large-cap and growth-oriented indices doing well early in the year but smaller and to some extent value-oriented indices doing better in the fourth quarter. Do you think this will stay the same as we enter 2021?

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It was a tale of two seasons at least for stocks of various sizes in 2020. Large growth-oriented indices like the NASDAQ and Russell 1000® Growth Index did extremely well throughout the year rising about 44% and 39% respectively through December 31st. But when you look at fourth-quarter results, things like the Russell 2000® Value Index and the S&P 600® index were top performers. Again, this is the "reversion to the mean" affect demonstrating itself in the later part of the year. One thing that suggests large stocks will continue to do well is the tremendous impact of index funds on markets now – by definition when you add money to an index fund, you add proportionally more money to the largest, most valuable companies in the index than to the smallest ones.

Q: Can you put all this together in some sort of investment philosophy for 2021?

Markets have and will always have their vagaries. The S&P 500® index has tended to go up about 2/3 of the time going back to 1928 and this is fairly independent of whether the prior year was up or down. How much it goes up year-to-year seems to be fairly random. The long-term average since 1928, according to New York University, is 11.65%. It's more important for anyone in the markets to consider his or her individual situation and ask the question "if markets fell 25% this year, would it hurt my lifestyle or cause me to make major spending changes?" If the answer is "yes," even with today's low interest rates you shouldn't have all your money in equities. If you can say to yourself "I don't need this money for five years," then it's probably ok to have it all in stocks. It's really difficult to say whether small, large or mid-sized stocks will do best going forward, so having a mix of companies of different sizes is prudent. Given how volatile the world was in 2020, setting aside some percentage of your assets for things like gold-related equities, is probably also worth thinking about.