Market Watch with RMH – The Light at the End of the Tunnel

Wow, what an interesting year! If one just looked at the markets, one would come to the conclusion we have had a good year, the same firms leading the charge at the end of last year are again leading the charge this year. **Well, in between we had a little excitement, or was it a lot? I will go with the latter**.

For 2021, my prediction is that we will be in for a normal year. First, one has to agree what is normal in today's world, and that is anything but easy.

Reflecting on the year just passed, I am very thankful to be living in this country, and I choose to see all of the benefits and successes we achieve. Imagine what we could accomplish if we were all pulling together.

This was the first Thanksgiving our children were not home, work obligations. I suggested to them as it was suggested to me, work all of the holidays or awkward days, as it sends a message to the higher ups. Both children are following this message. I was the creator of our quiet Thanksgiving.

The Light at the End of the Tunnel (It's Always Darkest Before The Dawn)

The next two charts give rise to my optimism. Corporate profits support the current level of equity prices. I have always found this important as it is very hard to have a meaningful correction in stock market prices, when all of the companies are making profits. Finally, if companies are profitable, they are hiring and not defaulting on their debt (another big concern).

Wednesday November 25th, the updated Corporate Profits and Gross Domestic Product (GDP) came out (see chart below), and this was a pleasant surprise for the markets. The data showed the United States (U.S.) was well on its way to a Corporate Profit recovery from the lows brought on by Covid-19, and now has recovered to previous highs.

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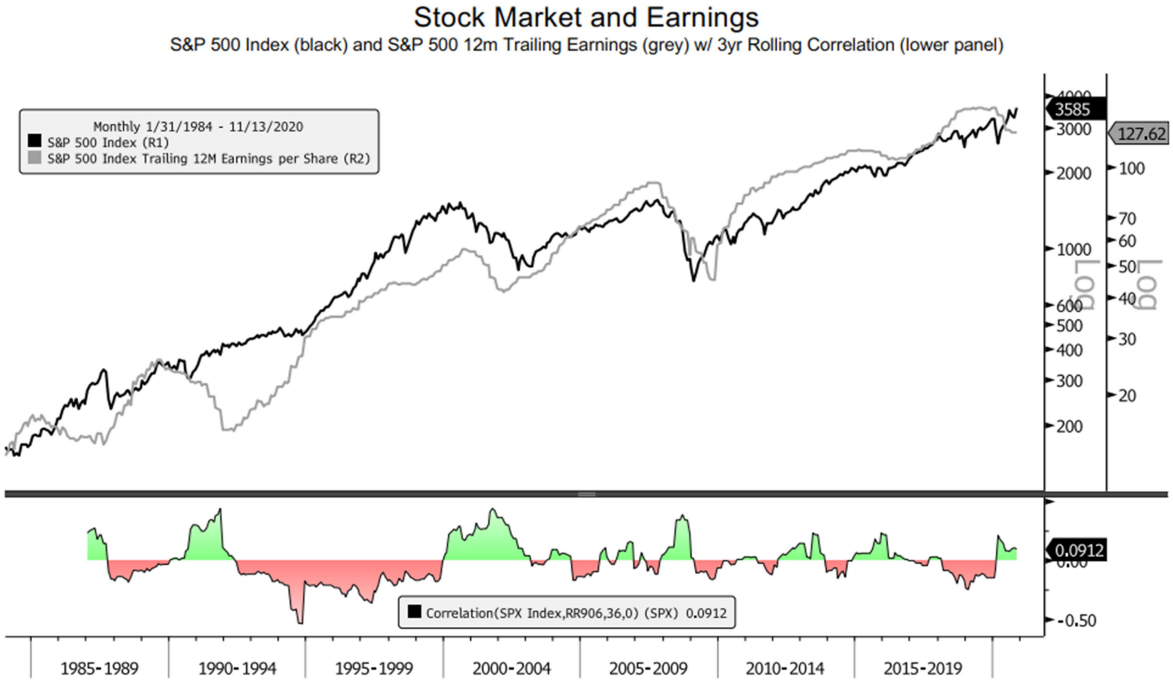
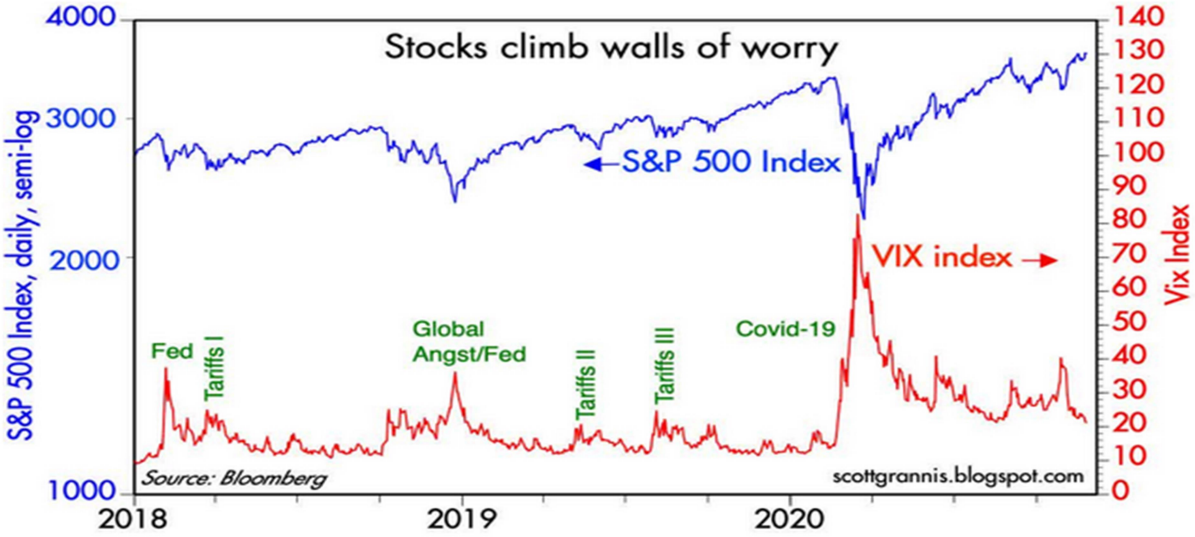
U.S. EQUITY MARKET REPORT-NOV 2020



Source: © Merk Investments, Bloomberg

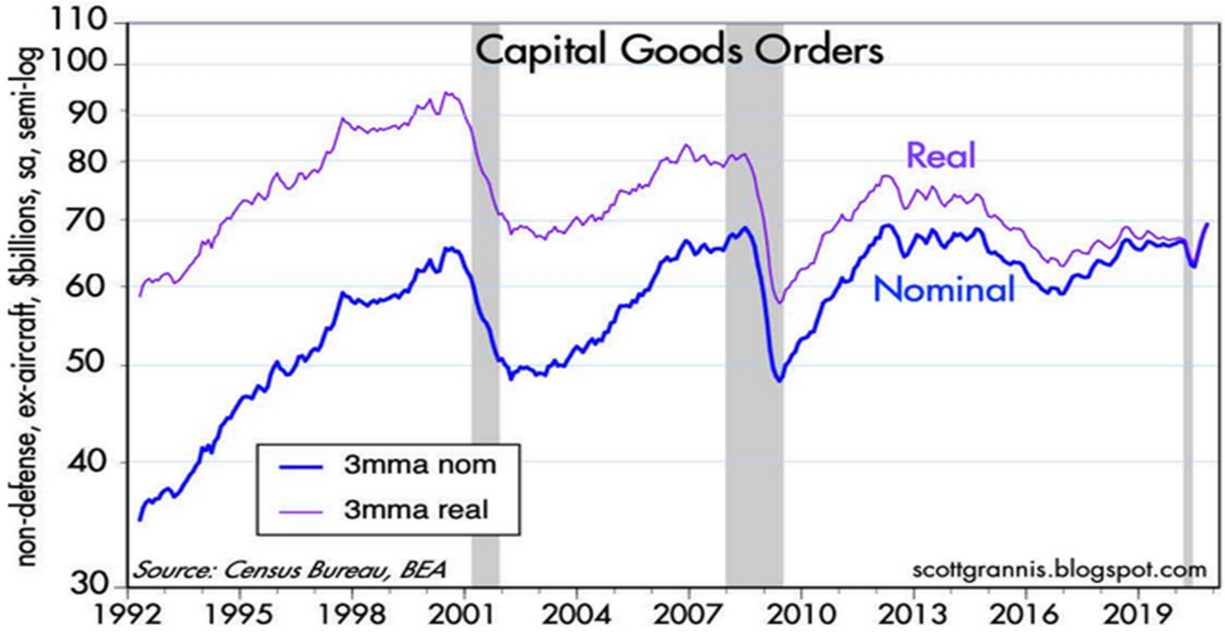
Analysis: Logically and empirically there's a relationship between stock prices and underlying earnings. Over the long term, earnings and the market rise together. But it's interesting to note that there's actually very little correlation between concurrent earnings results and the stock market. The market can be down with earnings up and vice versa. In 2018, the market was down with earnings up, and in 2019 the market was up with earnings down. Part of the explanation is likely that the market is forward looking and trying to price-in earnings ahead of the actual results. But it's hard to know how far out the market is looking and exactly what has already been priced-in. Of note, there was a massive earnings recession in the first half of the 1990s with no bear market.

Another indicator I look at, has to do with the old saying, **"Stocks climb a wall of worry"** as evidenced below in the chart.



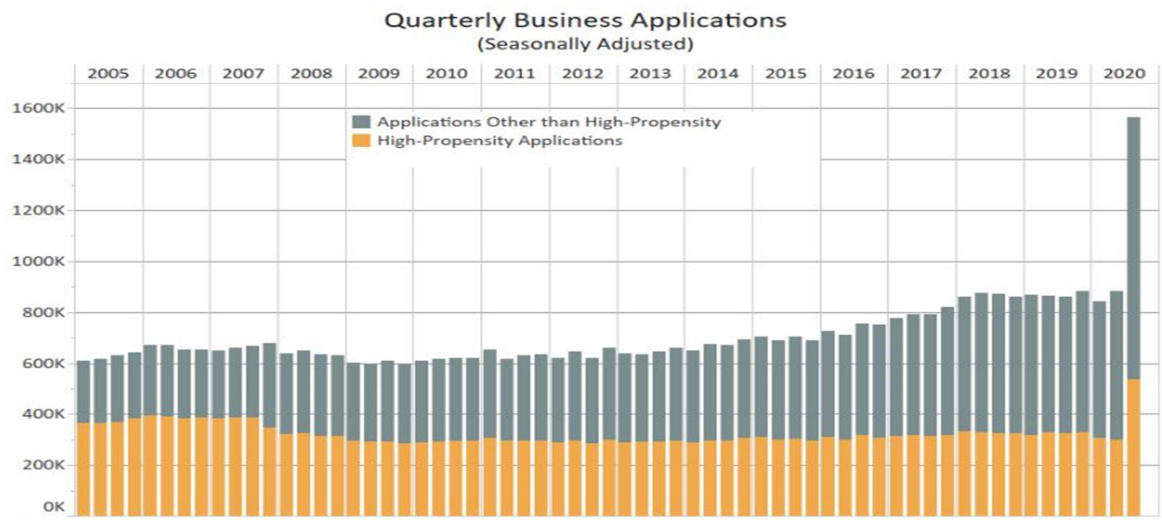
The Chart above looks at the VIX index (sometimes called the fear index) and as it rises, markets sell off as they did in February and March. The reverse works as well, the VIX index goes down and markets rise. Finally, there was a lot of worry with the presidential election, that is now in the rear view mirror. While there are negative headlines with covid-19, I believe people are looking past this, as they see at least three vaccines coming out shortly (**well over 50 covid-19 vaccines are in trials worldwide**), and anyone who wants to get tested can. Forewarned is Forearmed. We have learned a lot since the spring! **THE FIRST VACCINE WILL BE DELIVERED TODAY.**

The **Capital Goods Orders** chart going up was a real surprise for me, as it shows companies and people are sitting on a lot of cash (**see chart on cash further on in the article**), and are willing to spend this cash on goods with at least a three year timespan. To me, this indicator is an important predictor of future economic growth strength.



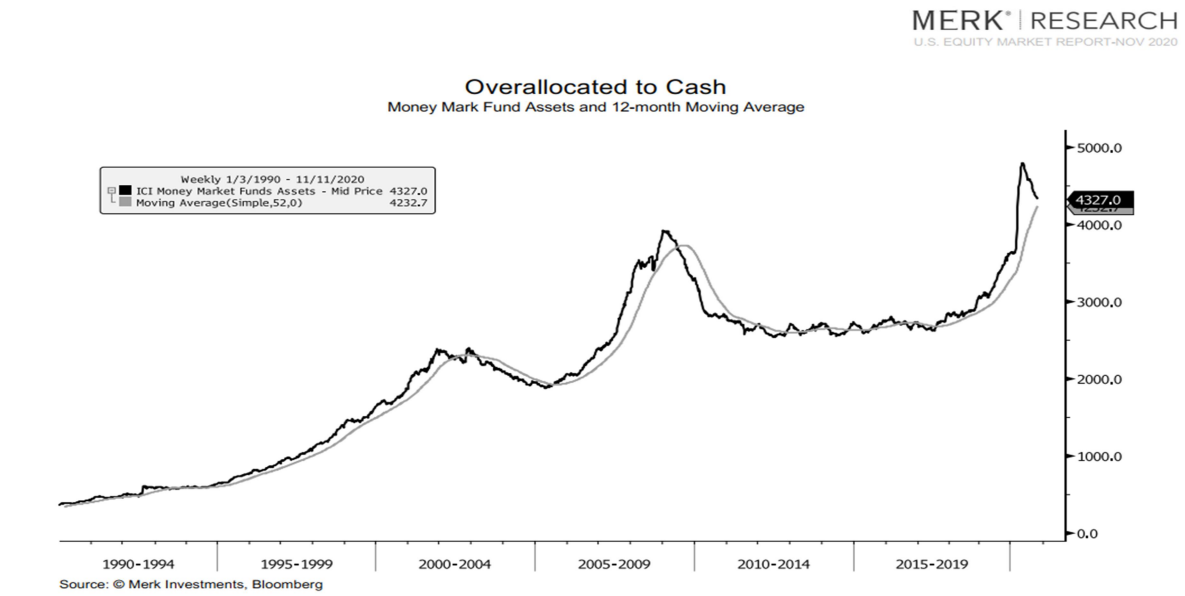
We will know we are close to the end of the tunnel when we start to see a continued recovery in the Labor market, as this is the last piece missing for a full recovery. Initial jobless claims have ceased to be having meaningful declines, and are now moving sideways. The recovery has been stunning, Unemployment (Ue) has fallen sharply, housing is performing well, and manufacturing has bounced back. The critical question to be asked, and will be answered in the months ahead, what effect will the second wave of covid-19 due to the economy?

The next chart is a favorite of mine, and I know I am biased. In March of 2003, I started the precursor to RMH Investment Management; we have survived and prospered since. Hard work and love of the job are just two requirements to be successful. The high level of new business applications bodes well for the future as they are the largest job creators, and this could be a tremendous tailwind to the economy for years.



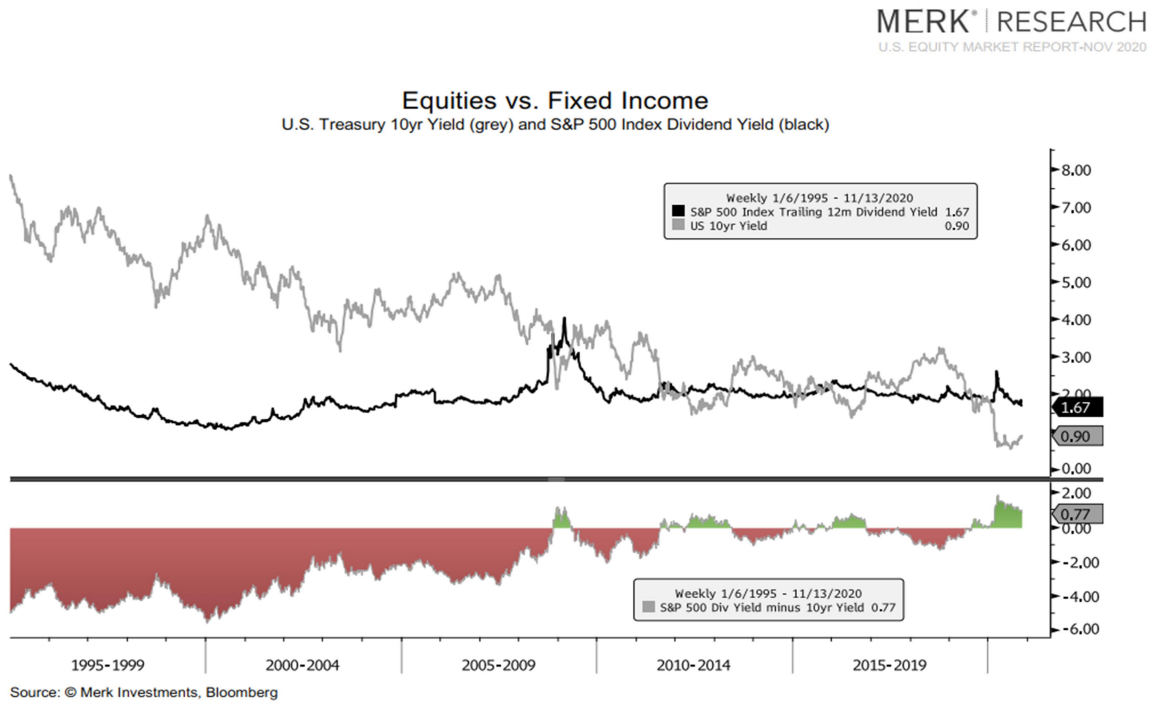
Too Much Cash

A concept which is neither new nor old, and is as current today as in the past, **is follow the money (cash).** The chart below shows we as a nation (not to mention the World) clearly have too much cash earning almost nothing. Corporations, endowments, foundations, 401-k plans, to individual retirement assets, there is too much cash sitting on the sidelines earning almost nothing. It was very understandable with all of the news this past spring from the pandemic, the uncertainty of the U.S. election, and the uncertainty of the Brexit decision to leave the EU. **Cash was raised for safety**. Individuals went from a before covid-19 savings rate of roughly 7%, to a high of 30% when the stimulus checks were coming in, to now around a 16% savings rate.



Analysis: The continuing decline in total money market fund assets suggests that market participants feel overallocated to cash. This continues to be one of the most important charts right now. If portfolios need to re-allocate to long-term target weights that could keep pushing stock prices up for a while.

In addition with the very low interest rates (cash and U.S. Treasuries are earning very little interest) this is forcing investors to move funds from fixed income to equities as you can see **from the chart below.** Currently equities have a three times higher yield than the 10 year U.S. Treasury bond, resulting in an inflow to equities. It is uncharacteristic that equities are in a better position to pay income (see the bottom panel of the chart and note the green colour). Not only are fixed income investments in a position of paying very little interest income for the foreseeable future, **they are facing a capital loss if sold before maturity.** For example if one was to buy a 10 year U.S. Treasury at 1%, and the yield curve rose 200 basis points or 2%, the price of this bond guaranteed by the U.S. Government would go down by 60 %, hence one would hold this bond to maturity where it would be redeemed at 100 or par.



Analysis: The trailing 12-month dividend yield on the S&P 500 is about 3x higher than the US 10yr Treasury bond yield. Even with some expected dividend cuts over the near term, stocks offer better cash flow to investors than Treasury bonds.

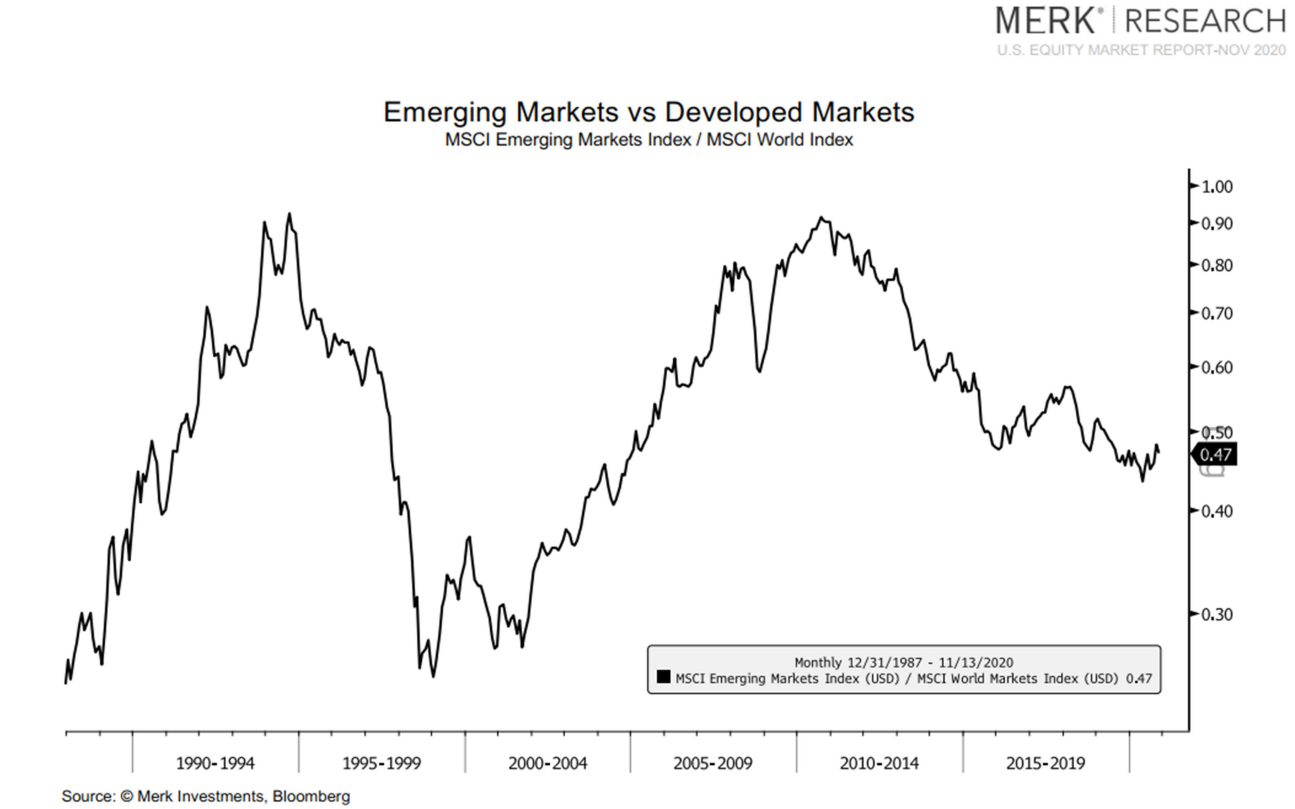
Emerging Markets for 2021

The following is from Nick Reece, CFA Senior Analyst & Portfolio Manager, Merk Investments, LLC, and it caught my attention as the Emerging Markets (EM) is more than just energy and commodities as evidenced from a number of conferences I have attended in Asia.

Analysis: The EM index has become much more like the S&P 500 over the past decade. More secular growth oriented (technology and consumer discretionary), and less value trappy (financials, energy, and materials). The biggest weights are now consumer discretionary and tech (secular growers) with far less in Financials and Materials (value trap sectors). And a big shift in country weight towards China, Taiwan, and India. EM has dramatically underperformed the S&P 500 over the past 10 years, but the dollar cycle has likely turned into a tailwind for EM (imo) and the sector weights in EM have dramatically improved.

The EM has better demographics (younger) and higher GDP growth rates than the developed world. One of the key variables in EM markets performance is the strength of the U.S. dollar, and now that covid-19 is being better understood, with vaccines coming out shortly, we might see a period of underperformance

for the U.S. dollar. To me the chart below is telling of a 10 year underperformance of the Emerging Markets, and the potential start of a turnaround? As always, we will be watching!



Analysis: Emerging markets have underperformed developed markets over the past decade, and might outperform for a period of time going forward. The dollar is a key variable here. As I wrote last year "In my view the dollar is likely to strengthen in a U.S. or global downturn, so I might be looking to get long EM coming out of the next U.S./global recession." We saw dollar strength in the Covid crisis and now might be in that environment where EM will start to outperform.

What steps are we taking at RMH?

- We are looking at the portfolios and rebalancing where necessary.
- We are taking advantage of tax loss selling to lower future capital gains.
- We are looking at what insiders are doing with some of the stocks we have purchased.
- We are talking with portfolio managers on a one to one basis and participating in conference calls.

If there are ever any topics you wish for us to explore, please let us know. ***We are here to help and guide you through these times.***

We thank you all for taking the time and reading "Market Watch." It is meant as an educational piece on the always evolving markets. It is something we plan on providing every month, and your feedback is very important to us.

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On a personal note, RMH is now in the position to bring on new clients so please be sure to share this informational letter with whomever you wish. RMH's focus is on the customizable investment needs of individuals, families, and foundations. We enjoy working with our clients to better understand their goals, values, and passions for what is important in their lives. In expanding our client base, we look forward to working with people who share these same desires

Richard Mundinger, CFA

Sources:

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