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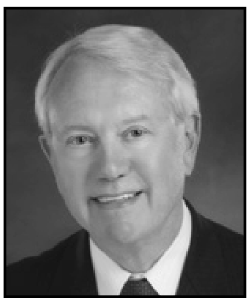
THE ECONOMY

# *2020:A year that was unlike any other; indeed*

**By Jim Flinchum**

The most common question of 2020 was how can the stock market do so well, while the economy does so poorly? The short answer is that the economy reflects the present, while the stock market reflects the future. A better answer is that the price of stocks reflects the supply and demand for stocks. Last year, the amount of cash available for the purchase of stocks increased greatly, bidding up the price of those stocks.



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First, huge deficit spending by the federal government injected $2.3 trillion of cash and steadied the overall economy initially. The Federal Reserve's asset purchase program steadied the financial markets and was virtually a promise by the Fed that they would not let the stock market crash. Of course, some of that cash seeped into the stock market, increasing demand for stocks.

Second, while Americans idled at home during the pandemic lockdown, they were spending less money and their savings increased, on which the banks paid them virtually nothing in interest. Often, the dividends paid by stocks are greater than the interest paid by banks. A favorite expression on Wall Street is TINA — there is no alternative to stocks. Additional froth probably resulted from stimulus payments to employed people, who used their payments to buy more "cult" stocks, such as millennials buying Tesla and bitcoin. Over 10 million new investment accounts were opened online last year.

Third, margin borrowing reached an all-time high of $722 billion in November. That was a lot of extra purchasing power added to the market. It involves borrowing against your existing portfolio. Debt is debt, and I would never recommend this.

You know there is huge demand for stocks, when the market ignored the attack on the Capitol and still reached a new record high.

**The Stock Market:** The increased cash caused the demand for stocks to increase, which drove up the price of stocks. In particular, the large-cap S&P was up 18.4%, substantially beating mid-caps at 13.66% and small-caps at 11.29%. That was reversed in the fourth quarter, with small-caps up 31.31%, beating mid-caps at 24.37% and large caps at 12.15%. This shift into small caps was accompanied by a shift from growth stocks to value stocks(think dividends). Growth stocks were up 33.47% for the full year, compared with value stocks at a mere 1.36%. For the fourth quarter, value beat growth 14.49% to 10.66%. Obviously, investors started finding more upside in smaller value companies.

Of course, numbers do not begin to describe the drama in 2020. The pandemic brought a sudden dramatic collapse in February and March, before rallying to record highs. One long-term cost of a high-profile collapse is that it scares investors out of the market and makes them painfully reluctant to get back into it.

Also, there was a rush of companies seeking to raise capital in the stock market last year, and it was a good year for initial public offerings. One worrisome trend are the simpler rules for taking a company public. An IPO requires a great deal of strategic and financial disclosure. It is also expensive and slow. A special purpose acquisition corporation is faster and cheaper, because it is a "blank check" or "blind pool" where you may or may not be certain what company or industry you're buying. The latest is direct listing by unlisted companies who want to raise capital on a public exchange. None of my clients will be investing this way.

**The Labor Market:** There are now two labor forces. One has a secure paycheck and can often work from home during the pandemic. The other is dependent on the whims of the economy or the politicians. An example would be the hospitality industry, which lost 498 thousand jobs in December alone.

After the huge pandemic-related layoffs in March and April, we have recovered 56% of those jobs, improving each month until December, when we lost

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140,000 jobs, much more than the 50,000 that economists expected to lose. The unemployment rate remained unchanged at 6.7%, but the average monthly earnings increased 0.8%, largely because so many low-paid workers in the hospitality industry lost their jobs, which raised the overall average.

There is room for optimism in the labor market, as the manufacturing sector has strengthened. The ISM manufacturing index greatly improved, almost reaching its record high in 2018. In addition, there is a huge amount of pent-up spending, suggesting better times for the retail industry, which has declined the last three months.

Interest Rates: Neither short-term rates nor long-term rates reflect the real supply and demand for credit any longer. Artificially low rates prop up the recovery, especially short-term rates. With our national debt quickly approaching $28 trillion, even a 1% increase is too costly for American taxpayers.

**Outlook:** During the initial stage of our post-pandemic recovery, there was considerable debate about the shape of our recovery, such as V-shaped or U-shaped or L-shaped. Currently many expect a K-shaped recovery, where one America benefits while the other America sinks. One cost of the pandemic is that the concentration of wealth is becoming worse. It is a bitter irony that some of the debt issued by the nation to finance the pandemic will pump up the stock market.

With the vaccine, with an accommodative Fed, and with the virtual certainty of additional stimulus, I am bullish on the economy in both the short-term and the medium-term. While the stock market already fully priced, I am not bearish on it. Corporate earnings are generally rising, and the economy should catch up to the stock market by year-end. Most of all, I am even more bullish on America. We survived a serious attack on our Capitol, and our democracy still stands, and it absolutely will be stronger than ever before!

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