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In this week's recap: A streak of optimism on fiscal stimulus and vaccines boosts the markets; Yellen tells Congress to "act big."

Weekly Economic Update

Presented by Edward Papier, CIMA® CFF, January 25, 2021

THE WEEK ON WALL STREET

Anticipation of a new fiscal stimulus and improved vaccine distribution powered stocks to fresh record highs last week with technology stocks leading the way.

The Dow Jones Industrial Average gained 0.59%, while the Standard & Poor's 500 picked up 1.94%. The Nasdaq Composite index led, gaining 4.19% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, rose by 1.15%.[1,2,3]

STOCKS SCALE NEW HEIGHTS

In a holiday-shortened week, stocks rallied as investors welcomed testimony from incoming Treasury Secretary Janet Yellen to the Senate Finance Committee that suggested lawmakers needed to "act big" on fiscal stimulus, raising hopes for a new round of federal spending.

An orderly presidential transition and the anticipation of a more effective vaccine distribution plan contributed to stocks touching multiple new highs last week. Investor enthusiasm was further supported by a strong start to the fourth-quarter earnings season.

Mega-cap technology companies resumed their market leadership ahead of a full calendar of big tech earnings reports this week. Market momentum stalled a bit into the close on concerns that any stimulus spending bill might come in lower than expected.

EARNINGS BEATING EXPECTATIONS

One of the concerns of market watchers has been the valuations of stocks. Stocks are currently trading at about 23 times 2021 earnings, above the historical range of 15 to 17 times forward earnings.[4]

Today's valuations may be explained by expectations of a strong economic rebound and a concomitant rise in corporate profits. So far, this earnings season appears to vindicate the optimism;

With 41 of S&P 500 companies reporting through last Thursday, 91% of them have exceeded estimates by an average of 18.5%.[5]

Investors are expected to continue to watch company earnings in the weeks ahead to see whether these consensus-beating results continue.

THE WEEK AHEAD: KEY ECONOMIC DATA

Tuesday: Consumer Confidence.

Wednesday: Durable Goods Orders. FOMC (Federal Open Market Committee) Announcement.

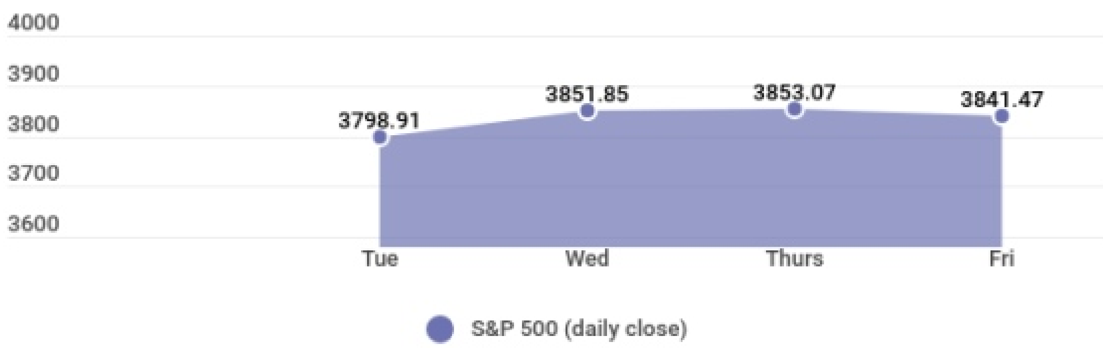
Thursday: Gross Domestic Product (GDP). Jobless Claims. New Home Sales.

QUOTE OF THE WEEK

"Most of the luxuries and many of the so-called comforts of life are not only not indispensable, but positive hindrances to the elevation of mankind"

HENRY DAVID THOREAU

Market Index	Close	Week	Y-T-D
DJIA	30,996.98	+0.59%	+1.28%
NASDAQ	13,543.06	+4.19%	+5.08%
MSCI-EAFE	2,209.99	+1.15%	+2.91%
S&P 500	3,841.47	+1.94%	+2.27%



	Treasury	Close	Week	Y-T-D
	10-Year Note	1.09%	-0.01%	+0.16%

Sources: The Wall Street Journal, January 22, 2021; Treasury.gov, January 22, 2021
Weekly performance for the Dow Jones Industrial Average, Standard & Poor's 500 Index, and NASDAQ Composite Index is measured from the close of trading on Friday, January 15, to Friday, January 22, close. Weekly performance for the MSCI-EAFE is measured from Friday, January 15, open to the Thursday, January 21, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

According to Seth Klarman, the Fed's policies and programs "have directly contributed to exceptionally benign market conditions where nearly everything is bid up while downside volatility is truncated...The market's usual role in price discovery has effectively been suspended."

First it was Citi, then Goldman. Now, it's Bank of America's turn to warn that the market's excess euphoria is about to cause some pain. In a note from BofA's Savita Subramanian, the equity strategist, echoed the warning from Citi and Goldman, and said that "sentiment and valuations are becoming euphoric. Our sentiment indicator is now closest to the "Sell" signal since the Great Financial Crisis." And yet, despite the bank's "more cautious view", BofA refuses to tell its clients to sell - after all this market refuses to ever go down.

Some more details: according to Subramanian, after the 16% gain in 2020, a year that sent tens of millions to the unemployed rolls, stocks now trade at 22.5x earnings, largely in line with the August peak level (22.7x), which is despite a ~40bps jump in the 10-year yield.

So big is the overvaluation that according to BofA's 20 valuation metrics, the market is now overvalued according to 18 out of 20 of the metrics. The punchline: with sentiment getting more euphoric by the day, according to Citi it is now off the chart.

So, does that mean it's time to sell? Maybe not, because every time in the past 12 years that banks called for a selloff, central banks stepped in and ripped everything higher, and perhaps this time won't be any different.

The difficulty is that, for as long as the market is being distorted in the way that it is, what would normally be irrational investing becomes rational. The signs of an investment bubble are all there, from the rise of SPACs (blank-check companies) to the surge in participation of retail investors (the latter doubtless helped by the combination of being stuck at home and the sheer ease of investment in the internet age) to electric vehicle mania, etc. But quite what, other than an abrupt change of direction from the Fed, will change that is not easy to say. As Jared Woodard said about timing markets based on bearish market signals: "Bearish market signals are famously harder to trade than bullish ones: a market trough is an event while a market top is a process".

Regarding the related topic of inflation, as Jeremy Siegel observed, the money created by the Fed is not going only into excess reserves of the banking system, it is going directly into the bank accounts of individuals and firms through the US Paycheck Protection Program, stimulus cheques, and grants to state and local governments.

"I certainly do not expect hyperinflation, or even high single-digit inflation. But I do believe that inflation will run well above the Fed's 2 per cent target and will do so for several years . . .It is inevitable that bond rates will rise and rise far more than now envisioned by the Fed and most forecasters". That, as Siegel observes, is "not good for bondholders."

It is also not tremendous news for taxpayers either. For rising interest rates on what is now an enormous pile of debt could be very expensive indeed and that brings us back to Seth Klarman, who observed the Fed's drastic measures have helped to boost economic activity and rescue ailing businesses, "But they have also kindled two dangerous ideas: that fiscal deficits don't matter, and that no matter how much debt is outstanding, we can effortlessly, safely, and reliably pile on more." [6,7]

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CITATIONS:

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