Quarterly Economic and Market Comments
March 31, 2021

It has been just over a year since the coronavirus struck in earnest and we used the movie title, "The Good, the Bad, and the Ugly", to think about how things were likely to play out. In the case of financial markets, the Ugly had already given way to the Good when we wrote these comments a year ago and the good times extended into the first quarter of this year as the S&P 500 gained 5.8%, making it one of the top 25% of all first quarters over the past century. Combined with the final three quarters of 2020, the annual rise of almost 54% was the fourth largest on record. Partly, this is merely a reflection of the fact that the end of March 2020 marked the bottom of a short, vicious, Covid-driven 34% stock market drop. Indeed, not surprisingly, the only three bigger annual stock market gains took place in the 1930s. However, that equity prices are higher than a year ago is one thing; that they are, in many cases, at record highs, is something else again. After all, it's not like stock prices in early 2020 were cheap or underowned - just the opposite, in fact. It is estimated that Covid has cost the U.S. economy roughly the equivalent of a year's worth of GDP between lost output and healthcare costs. Whatever "fair value" on the S&P 500 was prior to Covid, therefore, presumably that number would be, if anything, lower today; yet, in fact, the index is 20% higher. What's going on?

Since world equity markets bottomed in 2009 during the global financial crisis, stock prices in general, and big U.S. technology stocks in particular, have been in a long upward trend. This is not to say there were no speed bumps along the way as the underlying economic recovery was the weakest on record. However, on the three occasions when a meaningful stock market correction looked like it might turn into something more serious, the world's central bankers came to the rescue with some new form of monetary easing. Measures that were supposed to be for emergency purposes in 2008-09 had become a permanent fact of life. Global short-term interest rates, that fell from roughly 4.5% before the global financial crisis to 1.5%, never made it back much above 2%. The balance sheets of global central banks, which rose by 2.5 trillion or 7% of GDP during the crisis - which seemed massive at the time - had risen to $16.5 trillion by December 2019. Then came Covid and the central bankers really went to town. Global short-term interest rates have fallen to 0.5% and are negative taking inflation into account. Meantime, central bank balance sheets are expected to total $28.5 trillion by the end of this year, up $12 trillion or 29% of GDP over two years. The balance sheet of the Federal Reserve Board is at its highest level ever by far relative to GDP, as is the case for the Bank of England which includes not only World War II, but also the South Sea Bubble Era of 1720. So, what was once referred to as the "Greenspan put" is now more than ever believed by investors; namely, that the monetary authorities cannot and will not let asset prices go down and stay down and that the appropriate strategy is to always "buy the dip".

Two related factors came into play in 2020. First, many governments decided to support people whose incomes were, in one way or another, affected by the Covid lockdowns. Given the desire to get the funds into people's hands quickly, much of the money was not well-targeted and went to people who didn't need it to pay the rent. Furthermore, the sums involved were not trivial. In the U.S., for example, fiscal stimulus, which, in 2008-09 was less than $2 trillion - much derided by conservatives as excessive at the time - has been around $6 trillion in 2020-21 with more big spending bills pending. Suddenly, many younger people, finding themselves with some extra money and, in many cases, unable to work, go to concerts, or travel, and discovering apps on their phones that allowed them trade securities easily and for free, decided to engage in stock market speculation.

For much of the past decade, equities, in particular U.S. growth stocks, were expensive relative to the historic norms, but, in the face of unprecedented monetary action, unattractive valuations were insufficient to deter investors and derail the uptrend. What was missing to suggest a possible end, as the famous investor, Jeremy Grantham, noted in January, was "really crazy investor behavior, especially on the part of individuals. For the first 10 years of this bull market, the longest in history, we lacked such wild speculation. But now we have it. In record amounts." As the head of the world's largest hedge fund, Ray Dalio, recently noted, "There's just so much money injected into the markets and the economy that the markets are like a casino with people playing with funny money." The Wall Street Journal summarized the past three months as follows: "Investors Embraced Big Risks in a Wild Quarter for Trading." So-called safe haven assets were treated with disdain in the first quarter. The gold price fell almost 10% and long-term U.S. Treasury bonds suffered their worst quarter in 40 years. The difference between the return on stocks and the return on bonds in the U.S. over the past four quarters is the widest on record. Indeed, while the first quarter was a good one for equities, it was not that great for the typical 40/60 portfolio such was the poor performance of the fixed-income sector. To quote a third investment icon, Howard Marks, "Fear of missing out (FOMO) has taken over from the fear of losing money. If people are risk-tolerant and afraid of being out of the market, they buy aggressively, in which case you can't find any bargains. That's where we are now. That's what the Fed engineered by putting rates at zero."

The craziness has become so pervasive as to somehow seem normal when it surely is not. Starting with conventional valuation metrics, the median P/E ratio of the Ned Davis database of institutional grade common stocks is over 45 or almost 50% higher than it was at the peak of the dot.com bubble and triple what it was thirty years ago. The ratio of price-to-sales of the S&P 500 has reached a record of three which is 25% above the prior record in March 2000 and triple the average that investors were willing to pay for $1 dollar of sales for most of the past 150 years. According to GoldmanSachs, the median stock in New York is in the 100th valuation percentile (i.e., never higher). Of course, as noted earlier, if extreme valuations could stop the bull market, it would have ended long ago. However, to quote Grantham again, "The one reality you can never change is that a higher-priced asset will produce a lower return than a lower-priced asset. You can't have your cake and eat it. The price we pay for having this market go higher and higher is a lower 10-year return from the peak. Yet, as the Wall Street Journal notes, "even as valuations stretch indicating lower future returns, investors continue to expect above-average results".

Overall valuation levels are just the tip of the iceberg. Take Paycom Software Inc., a company that provides cloud-based human resources and payroll support. Its main claim to fame is that its CEO is the highest paid in the United States. Exactly what he makes is a bit ambiguous, but the best guess is that it's about equal to the aggregate wages of 25,000 leisure and hospitality sector workers who lost their jobs last year. The company at its recent peak was trading at 187 times its 2020 net income. Surely it must be growing rapidly? Well, no, actually. Earnings have grown at a 5% rate over the past three years. However, at least it is profitable and growing. By way of contrast, there are 200 U.S. companies out of the biggest 1500 that have been unprofitable for three consecutive years, a number last seen at the early 2000 peak, but these companies today carry a market capitalization of almost $2.5 trillion, far in excess of the value of such companies in 2000. One factor that has led to eye-popping valuations for companies with minimal, if any, earnings is investors' willingness to pay up for the alleged future gains to be made by so-called disruptors relative to their more traditional rivals. For example, Airbnb has a market capitalization $40 billion greater than Marriott, Hyatt, and Hilton combined despite having a fraction of their revenue. Doordash, which has yet to make a full year profit, has a market capitalization greater than every restaurant chain but Starbucks and McDonalds and investors have valued Snowflake, a cloud favourite, as far larger than Hewlett Packard Enterprise despite having a fraction of the revenues. Then there's the poster boy for this phenomenon, Tesla, which recently had a market capitalization of $1.25 million per car sold annually compared to $9000 for General Motors.

Infatuation with technology is not new. What has been added to the mix since Covid struck has been the tsunami of inexperienced investors that have poured into the stock market with their government "stimmy" cheques. Joseph Kennedy famously said he knew it was time to sell his stocks in the late 1920s when the shoeshine boy wanted to talk about the market. Today, the shoeshine boys (and they are mainly boys) hang out on WallStreetBets' Reddit forum or TikTok. According to recent polls, two-thirds of 18–34-year-old Americans who received government stimulus cheques used some of the money to "play" the stock market. Two thirds of those investors had less than 12 months investing experience and 60% or them consider social media their most important source of information. Nor is it just an American phenomenon as younger Asians are getting into the market for the first time. In March, a bar called Stock Tickers, catering to patrons who want to trade stock tips and serving drinks called "Lehman Shock" and "Margin Call", opened in Tokyo. There are at least three aspects of this new retail investing army. First, it has added to the demand for stocks as retail buying in the first quarter often accounted for as much volume as mutual funds and hedge funds combined. Secondly, they are willing to take risks. On average, they trade options forty times a month and penny stock trading volume has exploded. It was retail investors on WallStreetBets who drove the shares of Gamestop, a troubled company with a questionable business model, from less than $4 a share to more than $480 a share in a matter of days. Lastly, they don't know what they are doing and they brag about it. The Wall Street Journal recently quoted a young man who noted in a TikTok video, "I don't know what I'm doing. I just know I'm making money." Over the next few weeks, the article notes, he racked up roughly 500,000 followers on TikTok. It should be obvious this cannot end well. The old Wall Street axiom states, "A man with money meets a man with experience. The man with experience leaves with the money, while the man with the money leaves with the experience."

Wall Street, of course, is salivating at the prospect of a whole new group of people waiting to be separated from their money. In January, the number of U.S. initial public offerings (IPOs) and secondary offerings skyrocketed to a level 50% higher than the record set during the dot.com era. Ten of the top twelve largest IPOs were losing money and the U.K. just saw its largest ever IPO in the form of Arrival, an electric bus manufacturer, that has yet to generate any revenues. More than 70% of the IPOs so far in 2021 have come in the form of Special Purpose Acquisition Companies. Since these "blank cheque" companies raise money and then go looking for a company in which to invest, they typically need to be associated with a well-known name or a trendy mission statement or both. So it is that A-Rod, the former Yankee, is the CEO of the SPAC, Slam Corp., that will buy an unknown entity in the "sports, media, entertainment, wellness, or consumer technology industries". Blackballed NFL quarterback Colin Kaepernick is a co-sponsor of Mission Advancement Corp. that is looking for a "consumer company advancing social inclusion". Shaquille O'Neal and Serena Williams are among the many others on board the SPAC train. Furthermore, these companies are structured so that, even if they manage to work out, it's the insiders who get the big payday.

In the event money losing IPOs and SPACs are not someone's cup of tea, there are cryptocurrencies and their progeny, NFTs. The total market value of cryptocurrencies rose from $250 billion in the third quarter of 2020 to more than one trillion dollars in the first quarter of 2021 as they have gone increasingly mainstream. Bitcoin, like the shares of the firm promoting it, Microstrategy, took off in a parabolic rise from just over $10,000 in late 2020 to $60,000 recently. This kind of action is similar to that experienced by Gamestop, Tesla, and numerous other recent objects of speculation including, for example, the Canadian ride-sharing startup, Facedrive, which, at its recent peak, had a market capitalization greater than SNC or CI Financial or Maple Leaf Foods. However, at least Gamestop, Tesla, Facedrive, and similar companies have a business and a plan, however fragile or tenuous, yet it is not at all clear what is the point of Bitcoin. What is clear is that it will not replace the dollar and other so-called fiat currencies as a medium of exchange even though the recent cover of Newsweek says, “The Smart Money” is betting on bitcoin and the cover of Time asks “Is Fiat Dead?” This leaves the main selling point of bitcoin that “only” 21 million coins will exist when the final coins are minted in 2040. Yet, when it comes to scarcity, how is this better than a Mickey Mantle rookie card, a vintage T-bird, or a whole host of things that can be touched, viewed, or otherwise enjoyed in a way bitcoin cannot, not to mention that, in the first quarter, scarcely an hour went by when bitcoin did not fluctuate 2% or more and bitcoin mining electricity usage exceeds that of Sweden.

Speaking of the Time magazine cover, the image on the cover is, in fact, a non-fungible token (NFT) which sold recently for $133,000. Perhaps nothing symbolizes the investment craziness of the first quarter of 2021 than the fact that $2 billion of NFTs changed hands. An NFT is a unique identification code that is affixed to an asset using the blockchain technology underlying bitcoin to distinguish it from all other assets. Almost anything can be made into an NFT. Jack Dorsey, the Twitter CEO, has auctioned off an NFT of his first tweet for almost $3 million. There are NFTs of sneaker collections, virtual homes, Lebron James slam dunks, grumpy cats - you name it. Most bizarrely, on March 10th, a “digital collage” of post-apocalyptic images called Everyday by an artist who goes by the name Beeple sold for $69 million. This was the third largest price for a work by a living artist ever and more than has ever been paid for works of artists such as Paul Gaugin or Salvador Dali. Here’s the catch. This virtual picture, like the Time magazine cover, can be replicated endlessly and seen on the internet for free by anyone. The only thing the owner has is the right to resell the claim of ownership.

The recent blow-up of Greensill Capital and Archegos Capital Management left Credit Suisse and other banks with perhaps $6 billion of losses and showcased two additional potential vulnerabilities of a risk-seeking, easy credit environment - excessive leverage and overuse or misuse of derivatives. Margin debt (i.e., money borrowed to buy securities) reached another record high in February and is an extreme almost three standard deviations above its mean. Despite the ocean of stimmy cheques being deposited in brokerage accounts, the excess of margin debt relative to cash balances is also at a record level. Likewise, margin debt as a percent of real disposable personal income is roughly double where it was at the dot.com top and is at a record level at least since 1929. Margin debt ultimately did in Archegos along with the use of the arcane derivatives known as total return swaps whose main purpose seems to be to hide leverage and the true owner of the assets. This they apparently did successfully to the regret of all concerned.

So, when does the good for financial markets become too good or, in effect, bad? In December of 1996, Alan Greenspan, then Chairman of the Federal Reserve Board, famously asked the question, “How do we know when irrational exuberance has unduly escalated asset values, which then became subject to unexpected and prolonged contractions?” The phrase became the title of a book by Robert Shiller that fortuitously for him came out around the top of the dot.com bubble. Greenspan’s musings took place roughly three years before the top. Granted things appear more frenzied today than in 1996 with the benefit of hindsight, but it nonetheless shows the difficulty of timing the end of a bull market that has entered a manic stage. This is especially the case today as Greenspan’s put appears to be firmly in place and the central bankers repeat endlessly that they have no intention of tightening monetary policy because of runaway asset prices. Furthermore, from a fundamental point of view, if the next move for the markets is from good to bad, from the point of view of the coronavirus and the economy, the next move is from ugly to good, a move that is obviously underway albeit haltingly and unevenly around the world. “U.S. job openings rose to a two-year high in February while hiring picked up," Reuters reported recently. U.S. auto sales rose 13% on a monthly basis in March to their highest level since 2015, a well-known survey of U.S. retailers is at its highest level in a decade, and the economic index of the New York Federal Reserve has risen to a new all-time high. The markets should be bombarded with positive headlines like this in the weeks and even months ahead, partly because the economy was at its lockdown worst a year ago, partly because people will increasingly be getting vaccinated and life will increasingly get back to normal, whatever normal will end up looking like in six months to 12 months, and partly because the government has poured, and plans to continue to pour, epic amounts of money into the economy. As the well-known economist, Larry Summers, recently wrote, "The Obama stimulus was about half as large as the output shortfall (in 2008-09), whereas the proposed Biden stimulus is three times the output shortfall." What is uncertain is how much of the inevitable forthcoming good news on the coronavirus and the economy is already discounted at today's elevated market levels. Furthermore, it's possible the economic news could deteriorate from good to bad sooner than expected. As Summers goes on in his op/ed piece, "There is a chance that macroeconomic stimulus on a scale closer to WW II levels than to normal recession levels will set off inflation pressures of a kind we haven't seen in a generation with consequences for the value of the dollar and financial stability." These are no doubt legitimate concerns, but the good news of a world economy getting back on its feet seems likely to dominate the headlines in the short run. Similarly, when it comes to the markets, Jason Zweig writing in the Wall Street Journal, notes, "One of these days, perhaps sooner rather than later, stocks will stop going up and the importance of understanding what you own will reassert itself." For the time being, though, he quotes the British poet Thomas Gray, "Where ignorance is bliss, 'tis folly to be wise."