The Bright Report

A periodical brought to you by Bright Wealth Management

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1st Quarter 2021

2021 Outlook

Last year proved to be a year of many risks. Despite those risks, US stocks posted strong gains with the S&P 500 returning over 16%. 2020 was, in many ways, a reminder to investors to push emotion aside as much as possible. In March of last year it was easy to extrapolate a dire future, worry deeply about what was next, and sell (rather than buy) into the crisis. In that moment, investors with the long view were rewarded.

As we move into 2021, it seems reasonable to assess the risks, as well as the opportunities, for investors in the coming year. Here is our take on what may lie ahead.

Many Risks Have Lifted

Many risks to investors have lifted in the new year. While COVID is still an ongoing concern, the vaccine rollout has given market participants a light at the end of the tunnel. Headlines (positive and negative) still have the potential to move prices, but we do expect that influence to wane as the year progresses.

The UK and EU reached a trade deal at the last minute. This concludes the four-year odyssey that saw markets (especially currency markets) seesaw around every headline. The final implications of the deal will, of course, only be known as time moves forward. However, the uncertainty of the deal has lifted—and it is uncertainty that markets do not like.

The US election is behind us. As we discussed in the last issue, presidential elections tend to add volatility to markets without really adding return (at least until November and December when markets tend to move higher). The now-known outcome can give investors more confidence in their actions.

We also cannot underestimate the uncertainty investors faced in the wake of the COVID lockdowns. From March to June of last year, much of the data reported by companies had become so “outdated” as to be useless. Many large institutions were left to simply guess at the effect the lockdowns might have on businesses and the economy as a whole. With several quarters of reporting now behind us and the economy on the mend (though not fully healed), investors can better gauge the trajectory of the economy.

Follow the Fed

In addition to lighter risks, the Federal Reserve continues to print about $120 billion per month. Much of this cash finds its way into financial markets and serves to push prices upward. Additionally, though not an explicit commitment, the Fed has reacted to market volatility over the past year. As stocks have sold off, the Fed has stepped in to increase the money supply or re-affirm their effort to maintain the smooth functioning of markets.

Though not as obvious, the recent series of stimulus packages can also be considered actions of the Federal Reserve. When congress authorizes spending in excess of income tax receipts, that spending is financed by issuing debt through the US Treasury Department. Over the past year, the Federal Reserve has been the top buyer of that debt—effectively financing government expenditure with newly-created money. Again, that money often finds its way into financial markets and the coffers of banks and corporations.

The Fed’s actions also tend to create a “bad news is good news” dynamic. Economic news becomes interpreted through the lens of its effect on Federal Reserve activity. Bad news yields more future dollars (higher prices), whereas good news yields fewer future dollars (lower prices).

There is an old saying on Wall Street: “don’t fight the Fed.” We tend to agree. With further stimulus on the horizon and the Fed continuing to print dollars, we believe prices in the coming year have an upward bias.

Many Risks Remain

There are always risks, of course. As investors we cannot avoid them!

First, with market returns dependent on continued actions by policymakers and the Federal Reserve, there is the obvious risk that they do not do what markets expect.

In that vein, investors are watching inflation very, very closely. Inflation is a real constraint on the ability of the Federal Reserve to continue printing money. If inflation ticks up in a meaningful way, market participants are likely to lower their expectations for future cash. In general, that would push prices down.

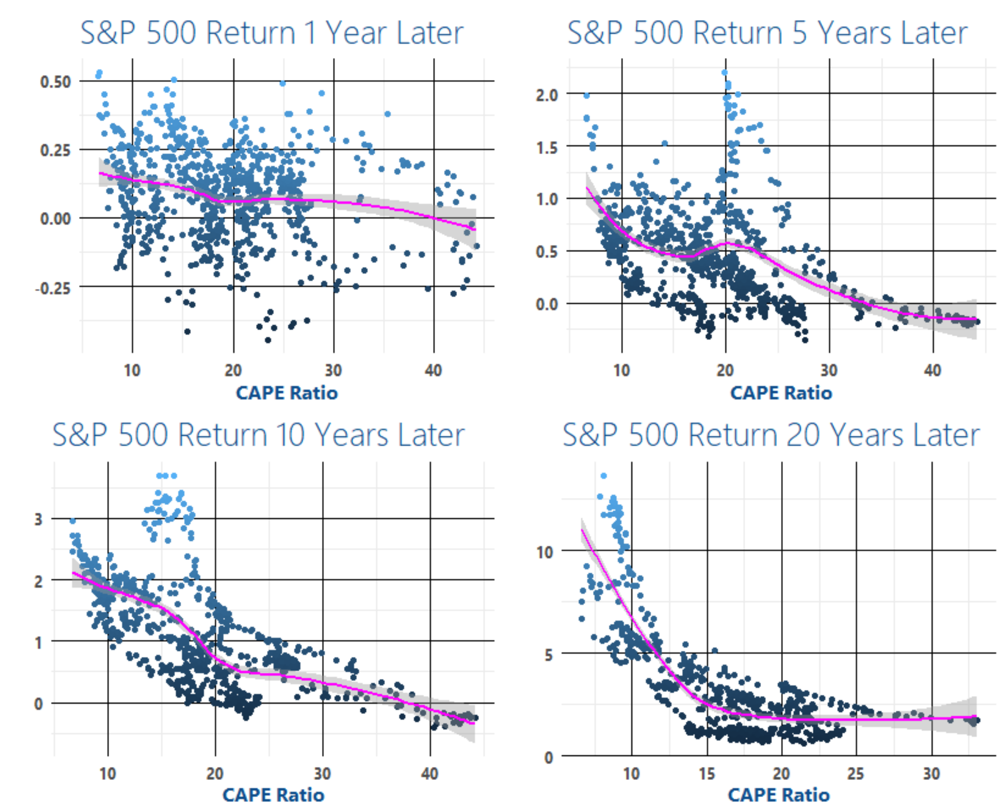
While the probability of further stimulus was increased with the outcome of the Georgia runoff elections, lawmakers have yet to even begin debating such a bill. Should negotiations stall, or lawmakers become distracted, markets are likely to reprice lower.

It is also worth nothing that stock valuations are very high. Current valuations can be justified by near-zero interest rates, but history has shown that long-term returns for investors are less than average (though still positive) when valuations are at current levels.

Finally, though there is light at the end of the tunnel, COVID has not yet been kicked! Hiccups in the vaccine rollout, the extra-virulent strain discovered in Colorado and the UK, and the risk of further lockdowns are all risks investors must bear at the moment.

In the end, this market is still rife with opportunities. Flexibility and caution are warranted, but we do believe investors will be rewarded for the right kind of risk-taking in 2021.

As always, your goals, time horizon, along with your ability and willingness to take risk will govern exactly how you operate in the coming year. We would be delighted to walk through that with you.



A common measure of stock market valuation is the cyclically-adjusted price to earnings ratio (or CAPE ratio for short). The CAPE ratio uses 10-year, inflation-adjusted earnings relative to current price to help smooth the effects of the business cycle.

As you can see, over 1-year periods, the CAPE ratio does not predict stock returns very well. Meaning we cannot use it effectively as a timing mechanism. Over longer periods, however, the ratio tends to do a decent job at predicting returns.

With a current CAPE ratio of 33, the S&P 500 is more expensive than 98% of its history. It also indicates that 5 and 10-year returns are likely to be considerably lower than they have been in the past.

History teaches us that valuations can remain stretched for a long time. It is not contradictory, therefore, to be positive about prices in over the coming year while concerned about valuations over the longer term.