

# 2021 Market Perspective

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Advice to Wealth





# 2021 Market Perspective

It doesn't require mentioning that 2020 was a year marked by chaos. If ever we conveyed insights or wisdom in our Market Perspectives, divining any amidst last year's chaos is proving elusive. Our hope for the coming pages is only to provide a modicum of clarity to the state of the markets, not to make sense of it.

American societal conditions of 2020 were unique in the past century: political upheaval and division unlike any we've seen in modern memory, a global pandemic that killed more Americans than all wars since World War II, and a resultant economic shock causing unprecedented unemployment and economic depression.

The financial markets responded accordingly.

Briefly.

The S&P 500 fell 38% in the space of a month. But from its nadir on March 23, it took only four months—to August 4—to climb back to where it had started the year. It spent the next three months vacillating, and then it climbed an additional 15% over the last two months of the year. It's a story mimicked by subsets of the equity markets across the globe. The euphoria in stock markets, however, belied the underlying economic fundamentals. Bond yields fell somewhat consistently throughout the first three quarters of the year. The yield on a 10-year treasury note opened the year at 1.88% and closed the year at 0.93%, nearly exactly half of where it started, hardly an expectation of economic expansion from bond buyers.<sup>1</sup>

Markets untethered from fundamentals are demonstrative of speculation and panic. The goal of our Market Perspectives is to illuminate the underlying market fundamentals, provide a lens through which to view current market conditions, and explain the actions we are taking to guide portfolios. The goal of our investment management is to generate financial strategies that are resilient across economic regimes and market conditions, and, more importantly, to provide you with the highest probability of achieving your financial objectives.

As always, we appreciate your interest, and the trust and confidence you place in us.

Sincerely,

Bard Malovany, CFP®  
Principal  
Aspect Partners

<sup>1</sup>US Dept of the Treasury, <https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/TextView.aspx?data=realyieldYear&year=2020>



Attentive readers of our Market Perspectives will note we have been warning of expanding valuations in the financial markets for the past half-decade. Assets that began as expensive have been inflated by exuberance and, as we will argue, a speculative frenzy. While we are reluctant to take a firm stance that the equity markets have formed a bubble, we feel the evidence is strongly suggestive. What follows is data we find makes a compelling case.

What to do in the face of this data is less clear. While the existence of a bubble may presage its implosion, it is impossible to forecast when that might happen—and what the markets may do in the meantime. As the famous economist John Maynard Keynes purportedly wrote, “the markets can remain irrational longer than you can remain solvent.”

As a result, we choose to keep a “light hand on the tiller” in our portfolio positioning. We will describe the various ways we construct portfolios, the shifts we implemented last year, our current views of the market, and how we are positioning portfolios today to manage risk.

## The Global Market Portfolio

The cornerstone of modern finance science is the “Efficient Market Hypothesis” which posits that financial markets are inherently “efficient”: that current prices reflect the best information available and therefore assets trade at their “fair value.” More concisely, in theory it is impossible to consistently outguess the markets.<sup>2</sup>

There is a lively debate, of course (especially amongst those who charge fees to try to outperform the markets), but also considerable evidence to suggest that consistently beating the market is a low-probability outcome. As a result, while we don’t adhere to the philosophy entirely, it does heavily influence how we think about investments and how we design portfolios.

Our somewhat idiosyncratic approach to portfolio design incorporates three broad categories of investing: asset allocation strategies, tactical strategies, and opportunistic strategies. Opportunistic strategies are those that we generally use to supplement portfolios. They tend to be less focused on risk mitigation and instead focus on long-range return generation, although some of their approaches, while volatile, can be used to diversify risk in the rest of a portfolio. Our tactical strategies are heavily quantitative and are responsive to short-term economic and market data. They are a significant and growing portion of our client portfolios, but a topic for a different missive. Our asset allocation strategies are predicated on our market perspectives. These strategies use the Global Market Portfolio as their basis.

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<sup>2</sup> There a great Wikipedia page here: [https://en.wikipedia.org/wiki/Efficient-market\\_hypothesis](https://en.wikipedia.org/wiki/Efficient-market_hypothesis)



Simply put, the Global Market Portfolio is the representation of how the “average dollar” is invested across the globe. It is the most fundamental of index strategies. It combines the value of all publicly traded assets around the world: stocks, bonds, publicly traded real estate, etc., and it calculates the weight of each asset relative to the total.

In our case, we cull data using the MSCI investable market indexes, research from an article in the Financial Analyst Journal by Doeswijk, Lam, & Swinkels, and from data from Vanguard, Fidelity, Dimensional Fund Advisors, Morningstar, SSgA & the Center for Research and Securities Pricing to develop our Global Market Portfolio, trying to represent as accurately as possible the total equity and fixed income markets’ free-float adjusted market capitalization.

## Asset Allocation Strategies

We take three separate but related approaches to asset allocation strategies. We use the term “asset allocation” to refer to the strategic decisions we make in determining how much of a portfolio is invested in stocks, bonds, and other investments.

Our “Indexed Strategies” simply mirror our interpretation of the Global Market Portfolio. For more aggressive clients, we increase the weighting to “risk assets”, meaning stocks and real estate, and we decrease the weighting to bonds. For more conservative ones, we increase the weighting to bonds and reduce risk assets.

Our “Traditional Strategies” include a small allotment to investments that we expect to have little to no relationship to stocks and bonds, thereby providing some additional diversification. And only because there is a nearly universal “home country bias,” we construct a portfolio that might feel more familiar to the average US investor by being slightly overweight domestic assets relative to the Global Market Portfolio.

Our “Strategic Allocations” start with a Global Market Portfolio to which we make two modifications. First, we employ our views of the financial markets to apply slight tactical over and under-weightings to asset classes. Second, we increase our weighting to “alternative investments”, meaning those things that we expect to help diversify the portfolio. That diversification may come from various sources. It may be the use of assets that tend to exhibit low correlations to stocks and bonds. It may be the use of managers that we believe can add value and diversification from their security selection. Or it may be using assets or managers that may generate a return stream from unconventional strategies.

As a result, our views of the markets have their primary bearing on our Strategic Allocations. Following is a compilation of data we find relevant and a description of how it influences our thinking.



## Skate to where the puck is going

Wayne Gretzky, the great hockey player, was quoted saying, “I skate to where the puck is going to be, not where it has been.” Our aim is to try to understand where the financial markets are going and invest accordingly rather than chasing yesterday’s enthusiasm. Predicting the markets’ short-term performance is a matter of chance, but understanding current valuations can provide some insights into what to expect over the next “full market cycle”—meaning the next seven to fifteen years.

As we have pointed out in prior Market Perspectives, there are no perfect valuation indicators. We consider numerous, but even taken in total, one can get a sense of probabilities but not certainties.

Bloomberg analyzes multiple earnings estimates and derives their Bloomberg Estimate Price to Earnings (P/E) ratio.

**Pricing Up**  
PE ratios around globe are above pre-pandemic levels



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<sup>3</sup> <https://www.bloomberg.com/news/articles/2021-02-12/a-year-on-from-the-covid-crash-here-s-where-the-market-stands>



The P/E ratio for the S&P 500, representative of US stocks is substantially higher than it was prior to the onset of the pandemic and higher than most other markets around the world.

More predictive of future stock market returns is the percentage of the average household's investment allocation to equities. That value is now higher than it has ever been. The higher that value, the lower the expected return of stocks over the ensuing decade.

### Equity Allocation of the US Household Sector

Sum of equities held directly or via mutual fund shares or via Defined Contribution plans as % of total financial assets. HH equity allocation is up until Q4 2020 and extrapolated since then based on market price changes till March 11, 2021.



Source: Flow of Funds, J.P. Morgan

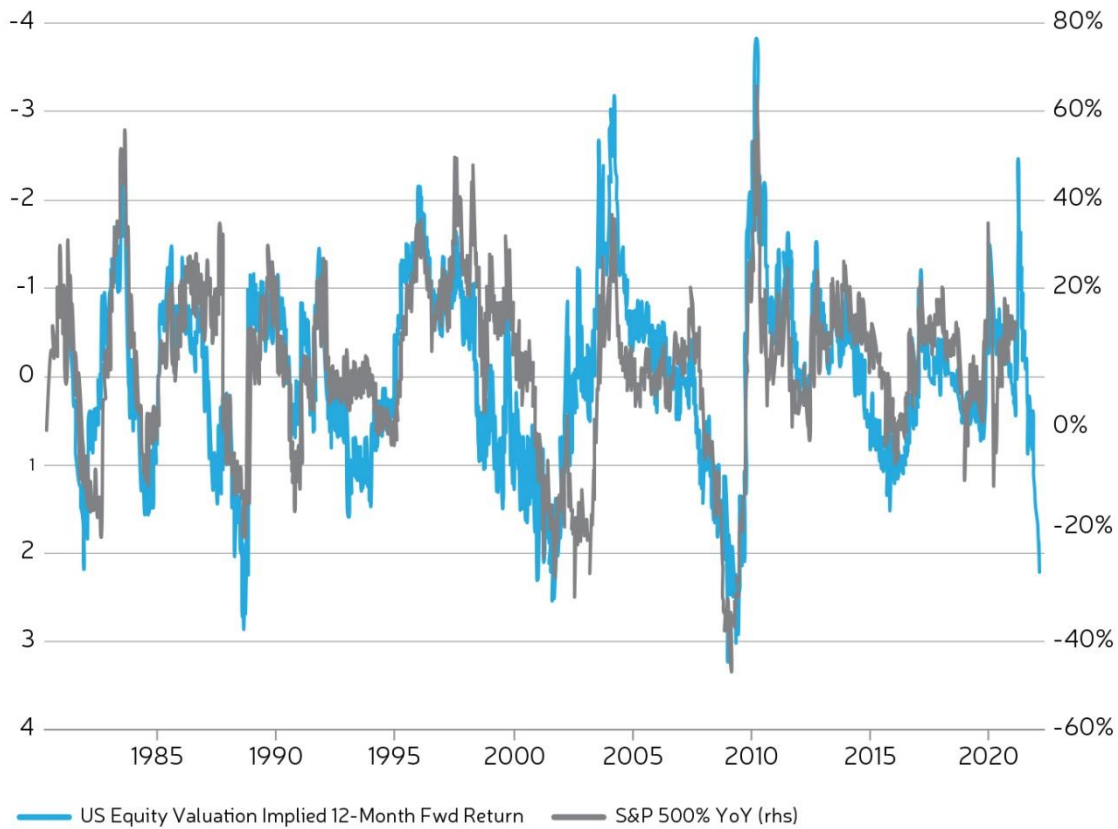
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<sup>4</sup> [https://twitter.com/Callum\\_Thomas/status/1370834588122148870?s=20](https://twitter.com/Callum_Thomas/status/1370834588122148870?s=20)



Pictet, the global wealth management firm, generates a model of implied returns over the next 12-month based on various valuation metrics. Their model suggests a return of -29.2% over the next twelve months. While we find predictions of specific values somewhat misleading, the implication of direction and degree is noteworthy.

### US Equity Valuation Implied 12-Month Forward Return vs. S&P 500% Change YoY



Source: Datastream, Pictet Asset Management

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<sup>5</sup> <https://twitter.com/BittelJulien/status/1362731770173657095/photo/1>

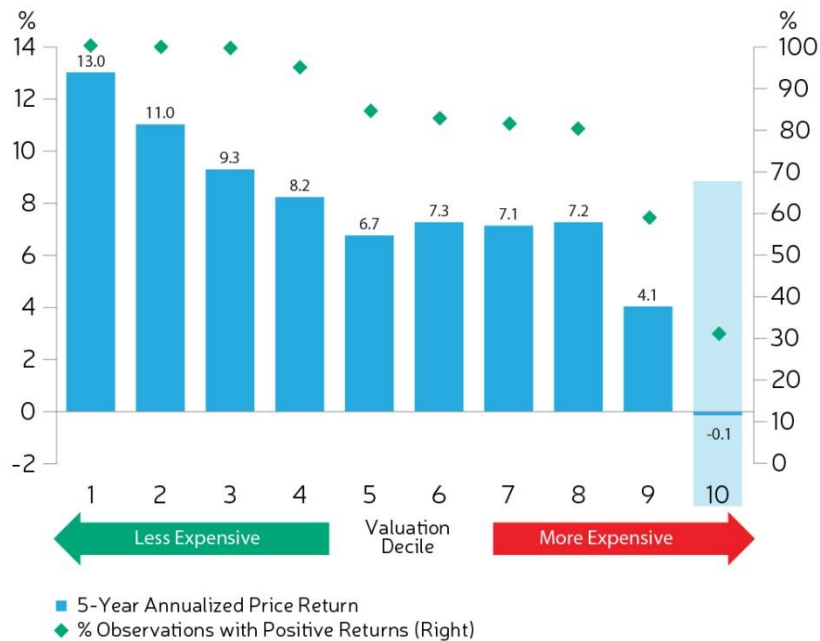




Goldman Sachs published the following chart, which indicate that when the market is at its most expensive, returns over the subsequent five years tend to be at their worst.

### US Equity Price Returns from Each Valuation Decile

Subsequent returns from high valuation levels have been muted historically.



Data as of December 31, 2020.

Note: Based on five valuation metrics for the S&P 500, beginning in September 1945: Price/Trend Earnings, Price/Peak Earnings, Price/Trailing 12m Earnings, Shiller Cyclically Adjusted Price/Earnings Ratio (CAPE) and Price/10-Year Average Earnings. These metrics are ranked from least expensive to most expensive and divided into 10 valuation buckets ("deciles"). The subsequent realized, annualized 5-year price return is then calculated for each observation and average within each decile.

Source: Investment Strategy Group, Bloomberg, Datastream, Robert Shiller.

Past performance is not indicative of future results.

<sup>6</sup> Goldman Sachs 2021 Market Outlook



Indeed, the investment research firm Morningstar has compiled predicted returns of various asset classes from some of the largest asset managers in the world.

### Expert Forecasts for Long-Term Asset-Class Returns

Firm	Date	U.S. Equities	Developed- Markets Equities	Emerging- Markets Equities	U.S. Bonds
BlackRock	Sep 2020	5%	7% <sup>a</sup>	6.40%	0.80%
JP Morgan	Dec 2020	4.10%	5%-6%	7.20%	2.5% <sup>c</sup>
Morningstar Inv. Mgmt.	Dec 2020	-0.10%	4.80%	4.50%	1%
Research Affiliates	Dec 2020	2% <sup>d</sup>	6.30%	7.90%	1.10%
Vanguard	Dec 2020	3.7%-5.7%	7%-9% <sup>e</sup>	7-9%	0.75%-1.75%

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There are some consistencies: all five expect below-average returns from US equities – some substantially. All expect higher returns from developed and emerging international markets than from US equities. And all expect weak performance from US Bonds. We don't claim any unique insights; we find the logic behind the prediction persuasive.

As a result, in our strategic allocations, we continue to overweight developed international and emerging market equities vis-à-vis US assets.

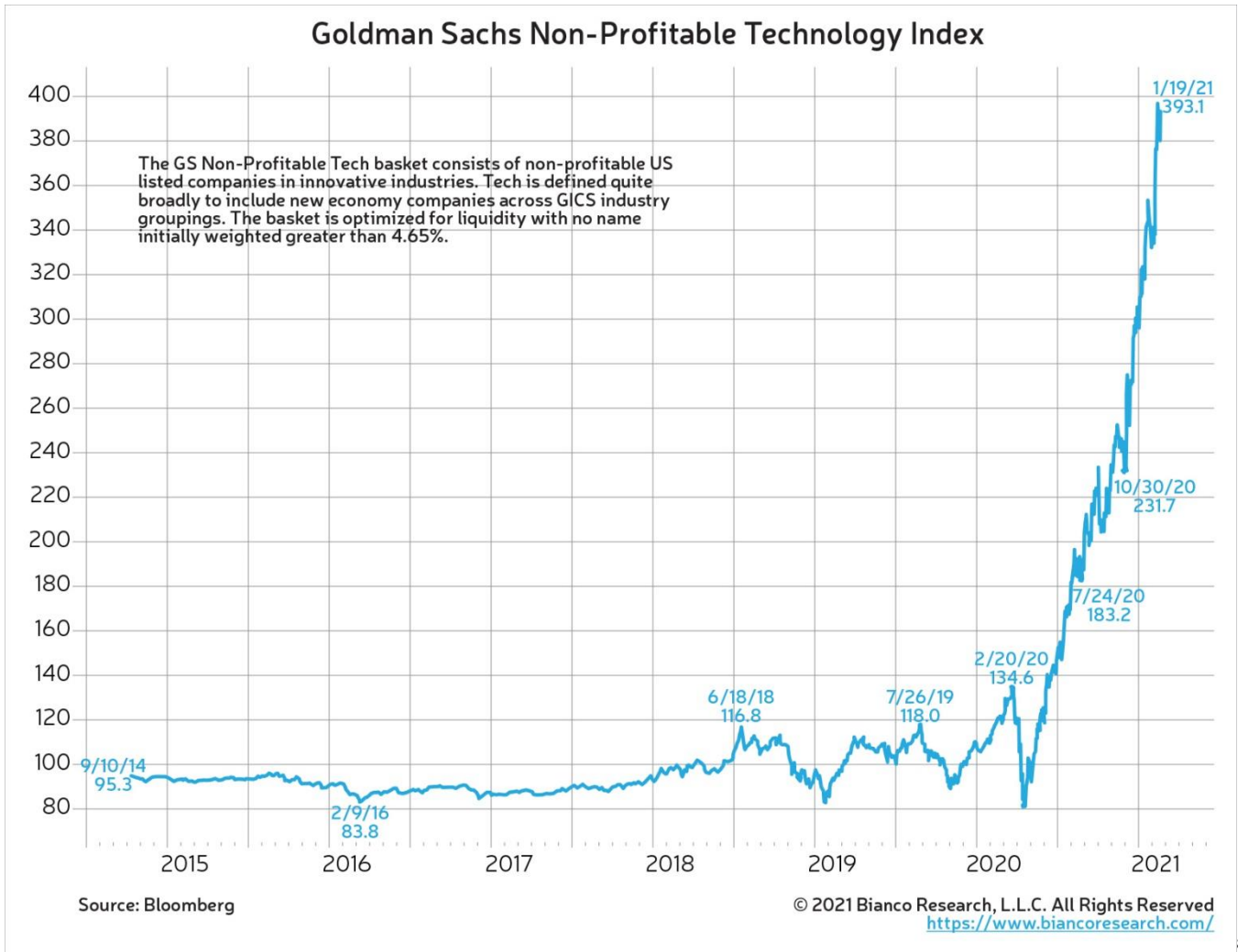
This has, however, been our stance for a number of years now, as valuations of US assets have been 'stretched' for quite some time.

What seems new to us is the level of speculation that seems rife in the markets. Speculation is hard to quantify, but there is a variety of data that supports it.

<sup>7</sup> <https://www.morningstar.com/articles/1018261/experts-forecast-stock-and-bond-returns-2021-edition>



One metric that stands out is the number and value of technologies companies that are trading at extreme prices yet do not function at a profit. The following chart, posted by Bianco Research, is the Goldman Sachs Non-Profitable Technology Index. The chart speaks for itself.



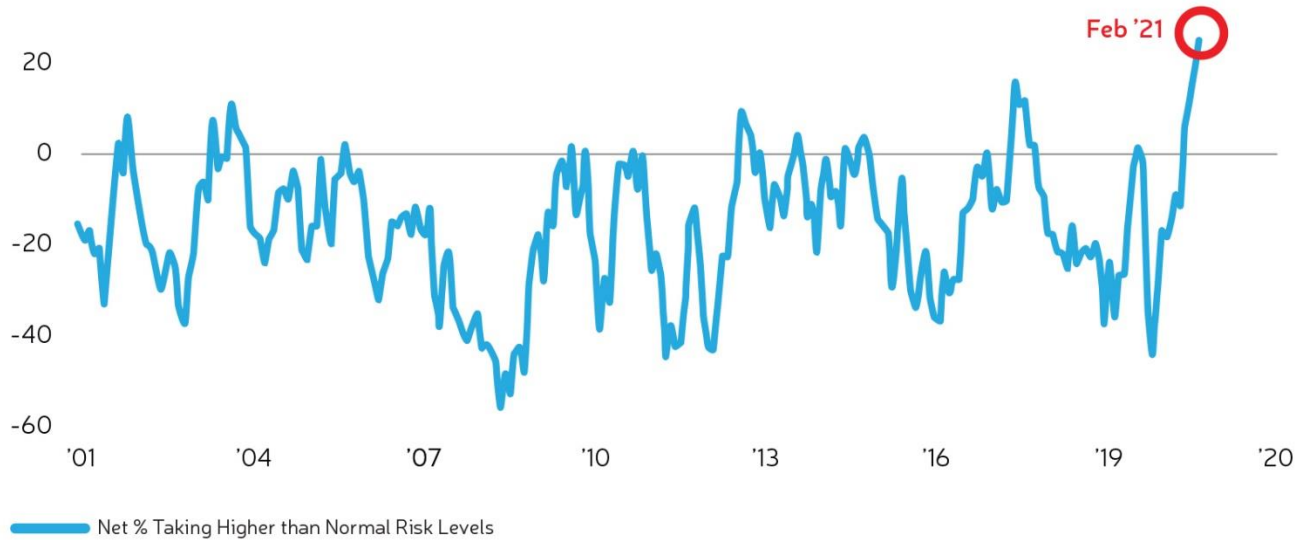
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<sup>8</sup> <https://www.ft.com/content/9a19f41e-1fb6-451f-b0eb-02decf331592>



The amount of risk that investors are currently willing to take is also unusually high – the highest it’s been in two decades.

### All-time high in investors taking “higher-than-normal” risk Net % Taking Higher than Normal Risk Levels



Source: BofA Global Fund Manager Survey

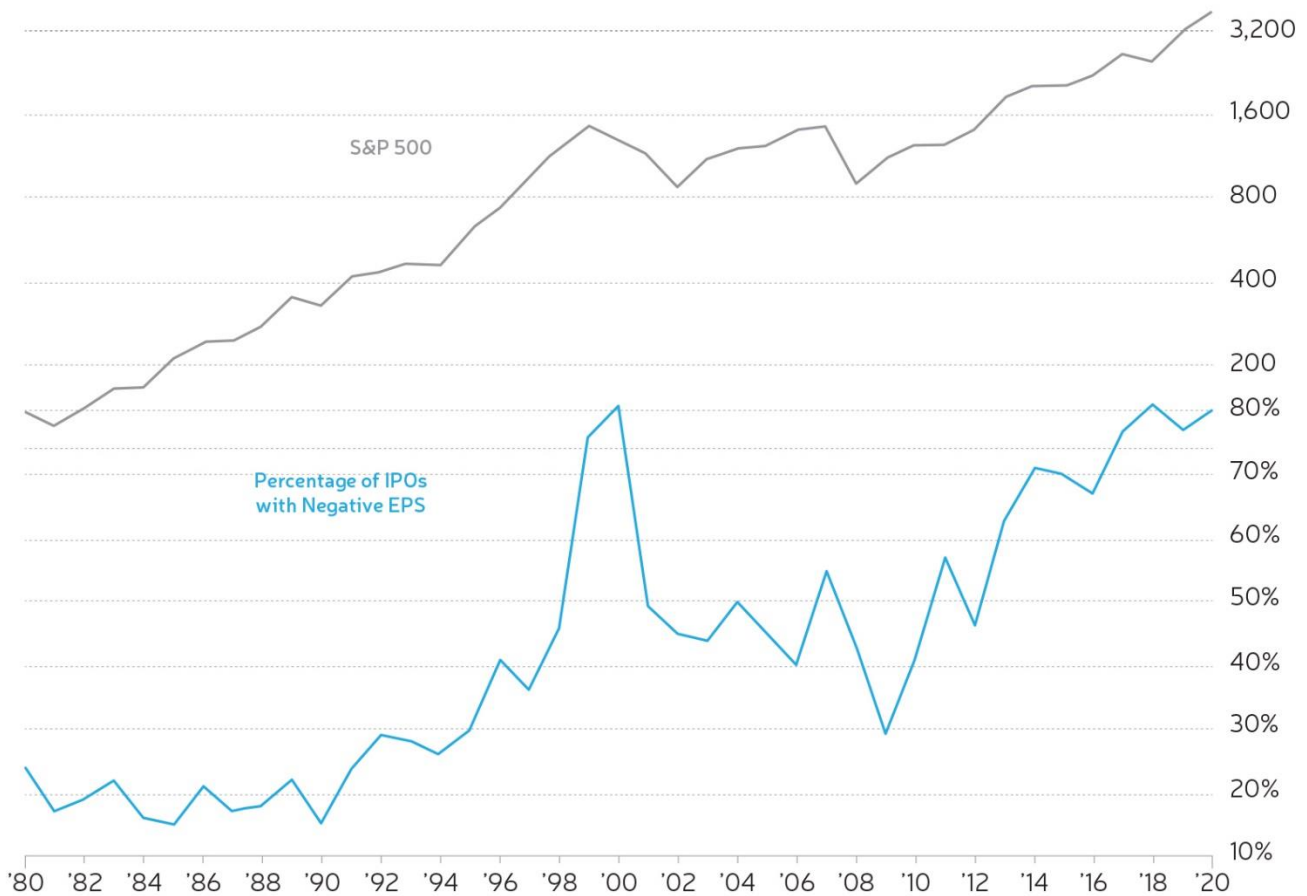
BofA GLOBAL RESEARCH 9

<sup>9</sup> <https://www.sentimentrader.com/blog/volume-pops-as-volatility-drops/>



You see it, too, in initial public offerings (IPOs). The number of companies that are listing their shares for public trading yet function at a loss is exceptional, rivaling 2000.

### It's hard to find a new issue with profits



Source: Jay Ritter

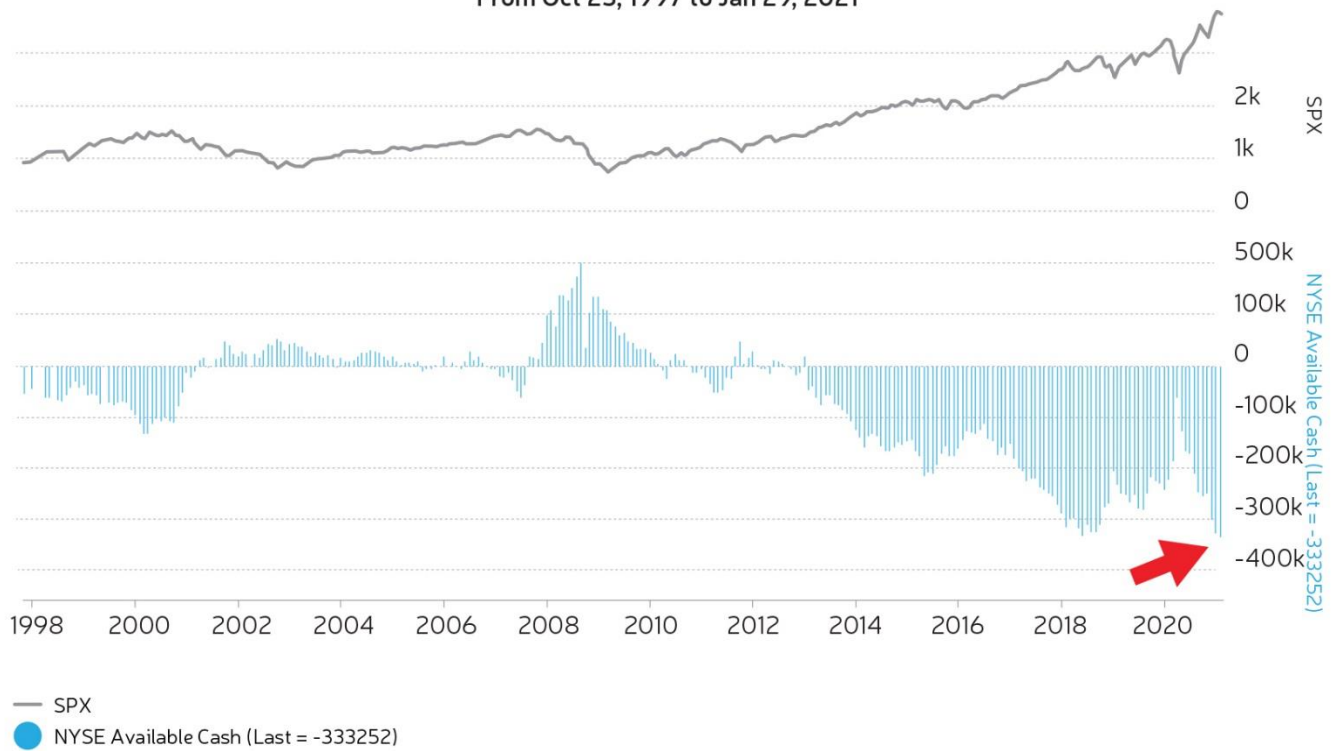
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The amount of “dry powder” or cash that investors hold waiting to make investments is also an indication of risk tolerance. The less cash investors hold, the more enthusiastic they are about taking risk.

<sup>10</sup> <https://twitter.com/sentimentrader/status/1360234694424551429/photo/1>



### NYSE Available Cash From Oct 23, 1997 to Jan 29, 2021



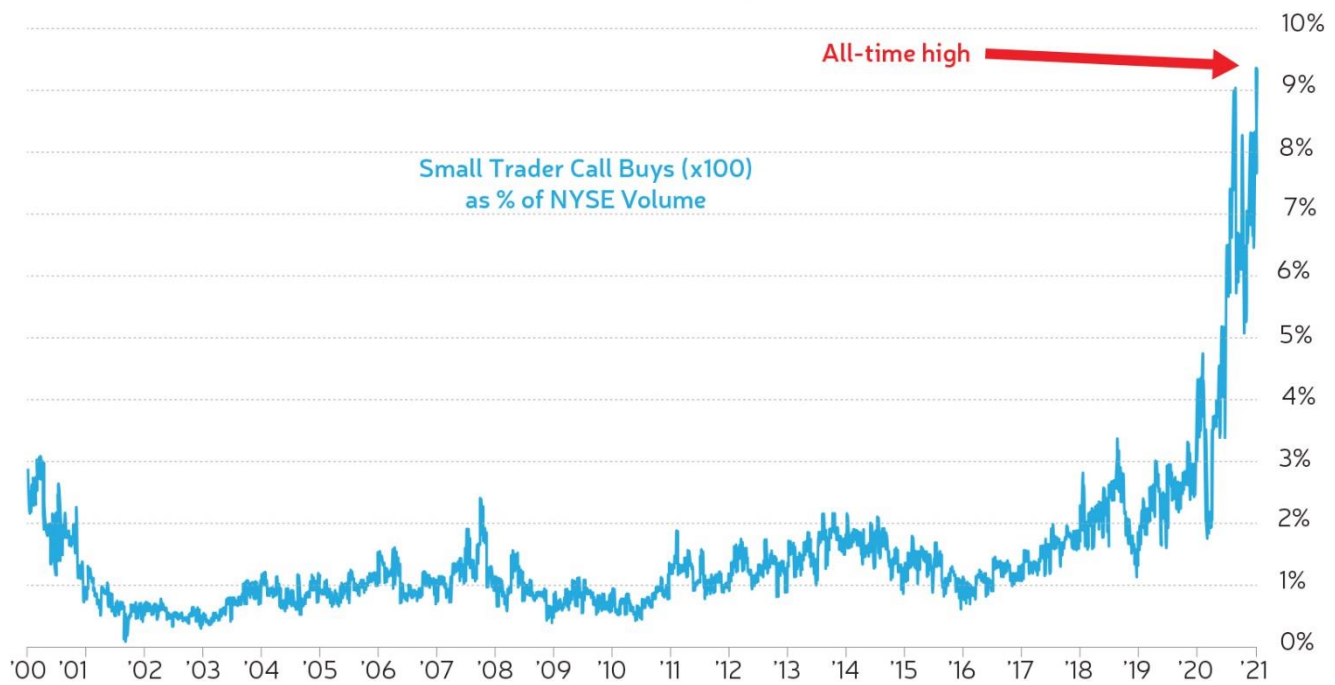
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<https://twitter.com/sentimentrader/status/1362785119757611015/photo/1>



The volume of call options owned by “small traders” is also at an all-time high:

### Yet Another Record in Speculation



Source: Bloomberg

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<sup>12</sup> <https://twitter.com/sentimentrader/status/1350457253250396161/photo/1>

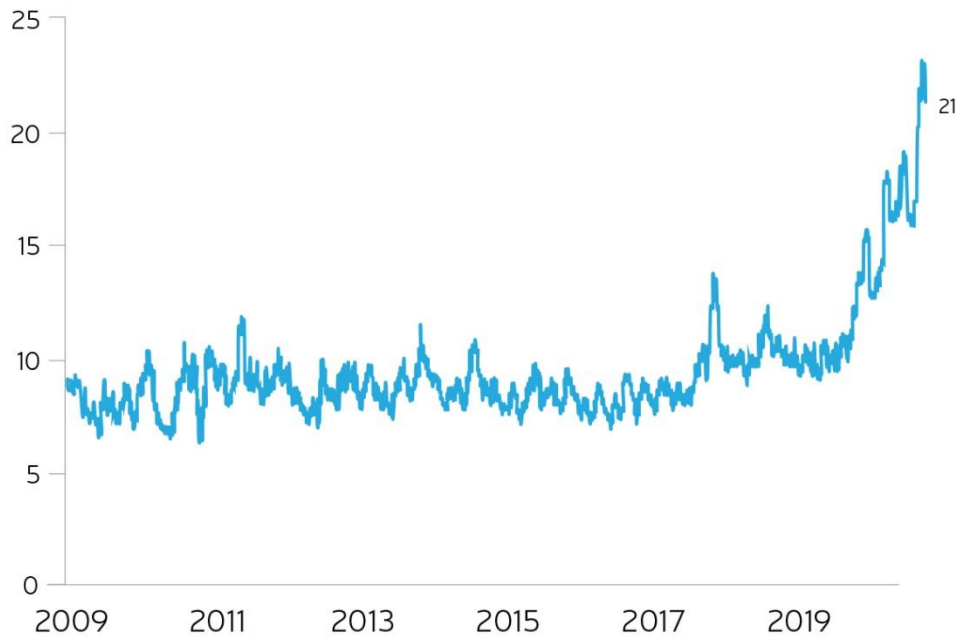


As is the overall volume of call options traded:

### Monthly Trading Volume in US Call Options

Call option trading volume more than doubled last year compared with its relatively stable historical average.

Monthly Average Volume (Millions of Contracts)



Data through December 31, 2020.

Note: The data represents the monthly average of total equity and index call option volume traded per day in the US market.

Source: Investment Strategy Group, Bloomberg.

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All of these suggest significant risk-taking in the financial markets, and most of them imply risk-taking without a fundamental analysis of those risks nor a solid investment thesis. Coupled with valuations that have gotten only more expensive, it has drawn naïve money into the markets. Enthusiasm begets enthusiasm, but ultimately reality is hard to escape. We prefer the flight of Daedalus to that of Icarus.

<sup>13</sup> Goldman Sachs 2021 Market Outlook





It is not our intention to suggest that we run for the hills, only to think carefully about how we mitigate risk in managing portfolios.

We are doing that in a number of ways. In our Strategic Portfolios:

- As mentioned above, we have been overweighting developed international and emerging market equities. Our hope is that, over time, this will generate improved returns compared to being overweight US equities.
- In our domestic equity portfolios, we have provided a slight weight to stocks that are both inexpensive and high-quality with the hope that if the equity markets fall in general, stocks that trade at lower multiples to cash flow and have strong balance sheets are likely to hold up better.
- In our fixed income portfolios, we have extended the duration of our holdings by specifically including some longer-term treasury bonds. This poses a risk if interest rates climb, which we think is likely in the longer term, as bond prices move inverse to their yields. In general, the prices of treasury bonds often appreciate in times of equity market stress as there is often a “flight to quality,” and in the near-term we like the balance to stocks that treasury bonds provide.
- We have also included investments in inflation-sensitive bonds. As the government prints more money and the economy recovers from the COVID crisis, the likelihood of inflation seems higher.
- In addition, we have added some exposure to natural resources as part of our allocation to alternative investments, with the hopes that if inflation does increase, it may be driven by a rise in natural resources prices—or will drive natural resources prices. Natural resources and inflation have historically had a high correlation.

For many clients, we have also moved money to one or multiple of our risk-based, tactical strategies, which are designed to be more responsive to market movements.

Warren Buffett is credited with admonishing, “Be greedy when others are fearful and fearful when others are greedy.” Psychologically, that is difficult to do. It is our role to try to help clients do so. As we noted in last year’s Market Perspective, “Our aim in portfolio construction is taking risk judiciously – where we expect the highest likelihood of adding value,” and to be cognizant of where risk is less likely to be rewarded.

Our intention is to develop portfolio strategies that uniquely fit the needs of each individual client. To do so requires understanding the financial markets as thoroughly as possible, understanding you, your objectives for yourself and your family, and helping identify your capacity for risk-taking. From there, we design a comprehensive plan that weaves those elements together.

We welcome your questions, comments, and concerns, and the opportunity to discuss your investments with you.



*Disclosure:*

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