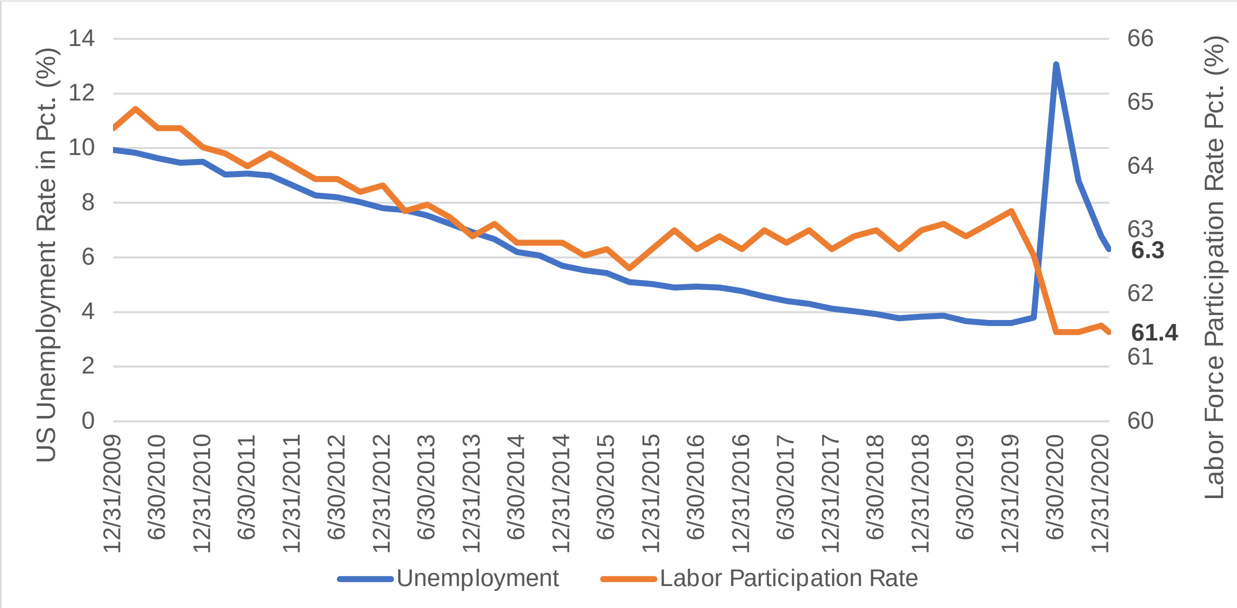
AndCo's Monthly Market Update

February 2021

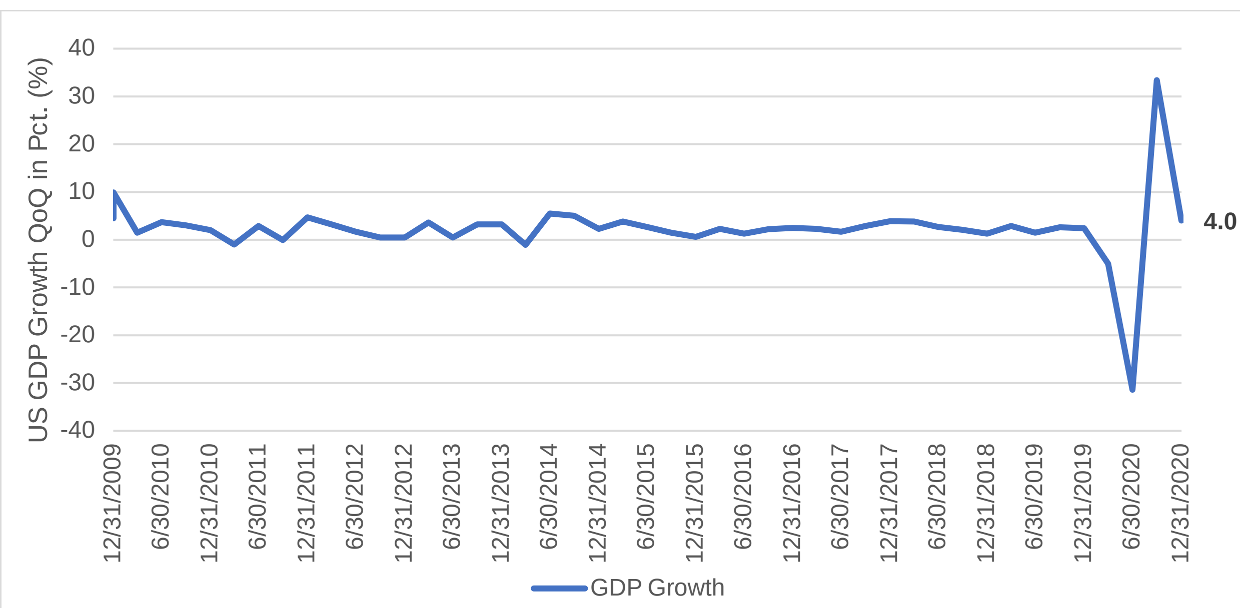
THE ECONOMY

It has been said that time has a way of healing all wounds. From an economic perspective, we can see this to be true as we move farther away from periods of volatility like the market dislocation we experienced during the first quarter last year. The labor market is a great example of the healing process. As seen in the chart below, during the period of economic expansion following the "Great Financial Crisis", the labor market, as measured by the unemployment rate, steadily improved with the unemployment rate falling to 3.8% in March 2020.[1] Some of that improvement can be attributed to the fact that the number of participants in the labor force fell over the same period. Beginning in 2015, the labor force stabilized and began showing signs of improvement. Following the shock associated with the COVID-19 pandemic, the US labor market also experienced a dramatic shock resulting in many individuals leaving the labor force. While the labor market has shown signs of healing with the unemployment rate falling to 6.3% in January, participation has yet to follow suite.[2] We contend that the combination of continuing monetary and fiscal stimulus, along with the passage of time, should result in participants re-entering the labor market as the economy continues to open. This should result in a continued decline in the US unemployment rate which most likely will create a cascading effect resulting in increased consumer spending, an uptick in the velocity of money in the economy, increased tax revenues at both the local and state levels, and higher asset prices.



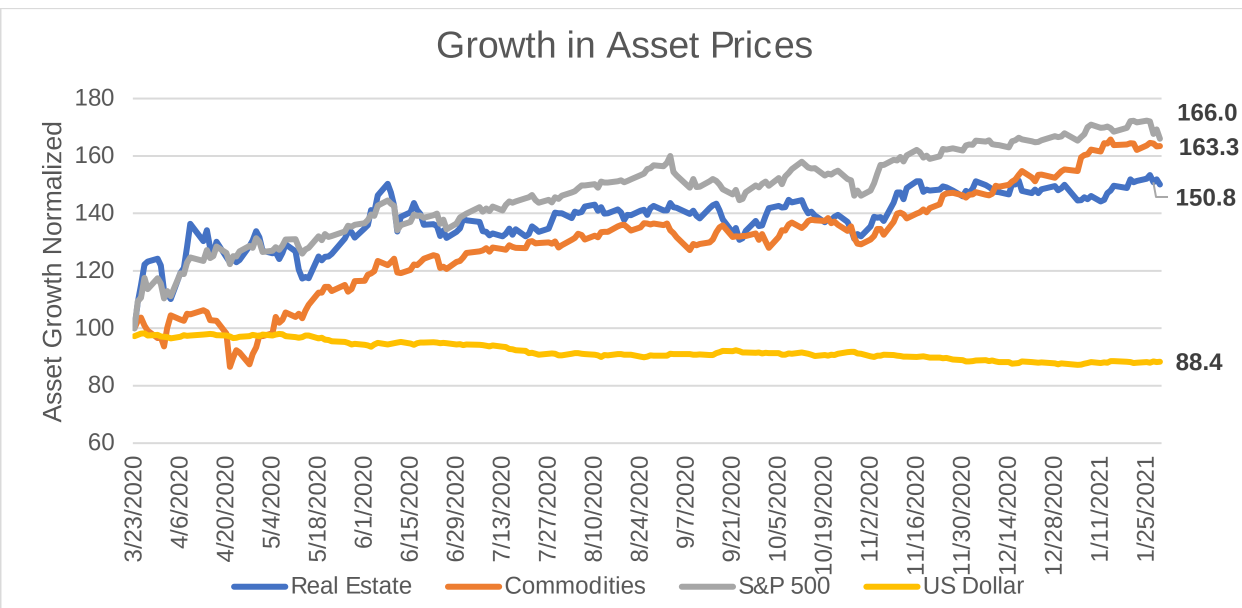
Source: Bloomberg as February 5, 2021

Similar to the labor market, the US economy bounced back nicely following the disastrous second quarter in 2020. While not as robust as initial estimates suggested, the initial survey of the 4th quarter's GDP growth rate came in at 4.0% showing the economy remains on a growth trajectory, albeit at a slightly slower pace.[3] Importantly, the Fed recently committed to keeping interest rates low in addition to purchasing US Treasury bonds to provide the market with liquidity. These actions, in combination with the additional pandemic-related fiscal stimulus from Congress, should result continued economic growth.



Source: Bloomberg as January 31, 2021

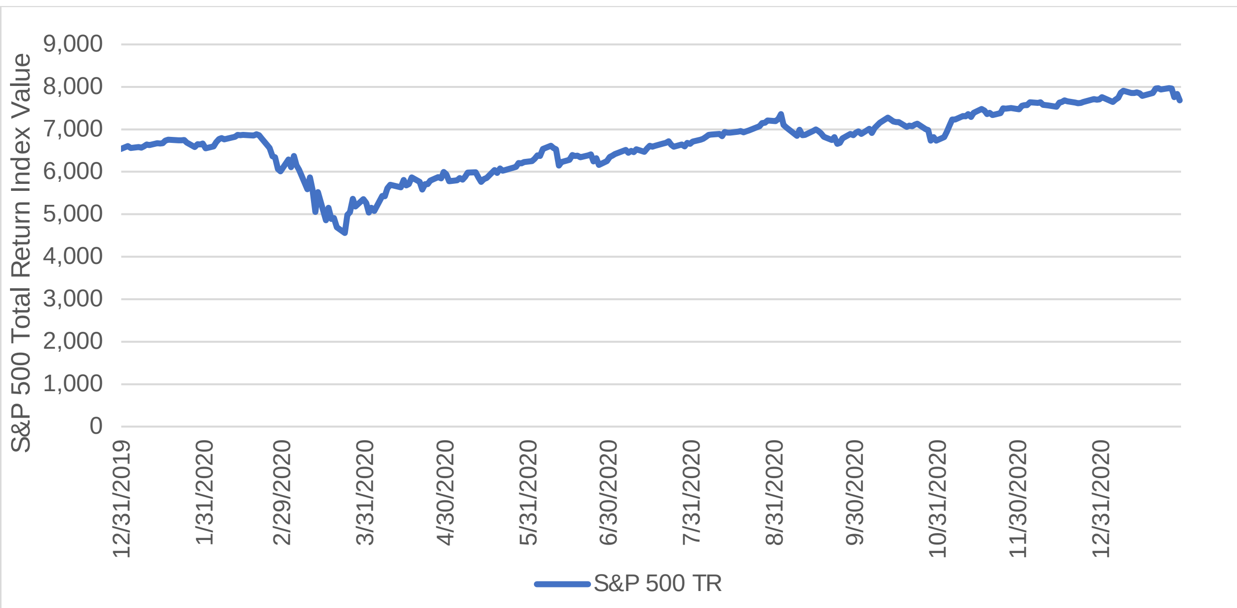
One area of the market that we have been keenly focused on is inflation. As we have discussed in previous updates, the magnitude of the combined fiscal and monetary stimulus injected into the global economy cannot be understated. The passage of the $2.3 trillion Coronavirus Aid, Relief and Economy Security Act (CARES) was estimated to be at around 11% of US GDP.[4] Subsequent relief packages resulted in additional stimulus of between 4% to 6% of US GDP.[5] Presently, the Biden administration is considering an additional $1.9 trillion in stimulus, or roughly 10% of GDP.[6] Why this matters is really two-fold. First, we can see the effects of the stimulus in asset prices such as real estate, commodities, and stocks. As seen in the chart below, from the market's low on March 23rd last year, all three asset classes rebounded significantly as investors looked to put capital to work. While not all the growth in asset values can be attributed directly to the stimulus, it is reasonable to suspect that investors looked to capitalize on the abundant liquidity to purchase assets that could shield them from increasing inflation. Secondly, given the relative size of the stimulus, the US dollar was expected to decline versus most major currencies. Since the market low last year, the US dollar has fallen nearly 12% as of January 31st.[7] Should the Congress pass additional stimulus, the dollar will most likely continue its relative decline which could act as a catalyst for investors to seek out other assets and currency to act as a hedge against future declines.



Source: Bloomberg as January 31, 2021

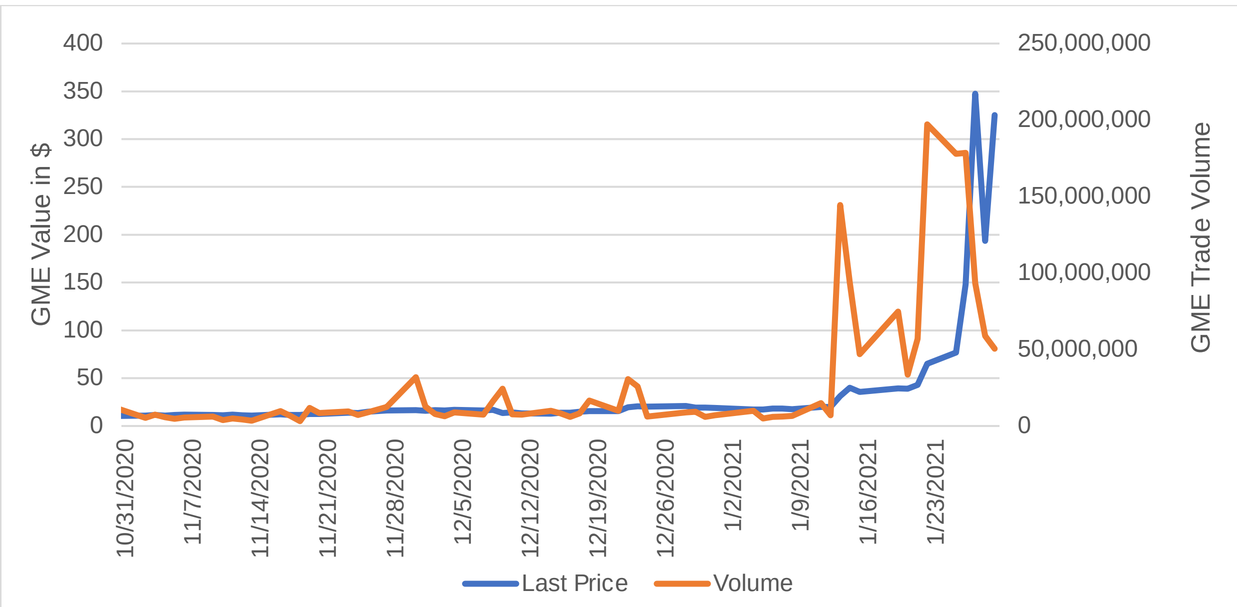
EQUITIES

Equity market returns were bifurcated during the month with domestic and international developed market stocks lagging US small caps and emerging markets. For the month, the S&P 500 Index returned -1.0% while the smaller Russell 2000 Index returned 5.0%.[8] Overseas, the MSCI EAFE ex-US Index returned 0.2% compared to 3.1% for the MSCI EM Index.[9] In looking at the fundamentals, according to Bloomberg, roughly 60% of the S&P 500's companies have reported their 4th quarter's earnings as of February 8th, and the index is on pace to exceed both revenue and earnings per share growth year-over-year.[10] Importantly, according to Bloomberg positive earnings guidance continues to outpace lowered investors' expectations for the 1st quarter 2021, which could act as a catalyst for higher corporate earnings, thereby mitigating some of the concern investors may have about stretched P/E ratios.



Source: Bloomberg as January 31, 2021

One of the most interesting stories during the month was the price action seen in Gamestop (NYSE: GME). Prior to the runup seen in the company's stock, GME had languished in a relatively narrow trading range under constant pressure from a number of hedge funds including Melvin Capital, among others. The stock's daily trade volume began to increase following the company's announcement that holiday sales were strong led by e-commerce sales. Importantly, a group of retail traders began sharing ideas about the company on the website Reddit in the forum/chatroom "WallStreetBets".[11] According to the forum, the intent was to drive the stock "to the moon" by forcing those hedge funds who were short the stock to cover by purchasing in the open market. As seen in the chart below, the stock experienced near-parabolic daily gains as news of the pain being inflicted on the hedge funds spread. According to Bloomberg, Melvin Capital lost approximately 53% of its NAV in January and had to receive a capital infusion of roughly $2.75 billion from Citadel and Point72 Capital Management.[12] Another interesting sub-story related to GME is what took place with some of the largest on-line brokers during the mania. Specifically, the trading app Robinhood, one of the main trading portals for members of the Reddit forum, stopped users from purchasing additional shares of GME while continuing to allow seller, resulting in a reversal of the stock's gains.[13] Since the end of the month, GME stock has fallen considerably and is now trading below $60.[14] A number of prominent politicians are actively looking to hold hearings to better understand what transpired. While we do not know for sure, it is likely that some of the liquidity that governments have been providing ended up fueling the runup in GME.

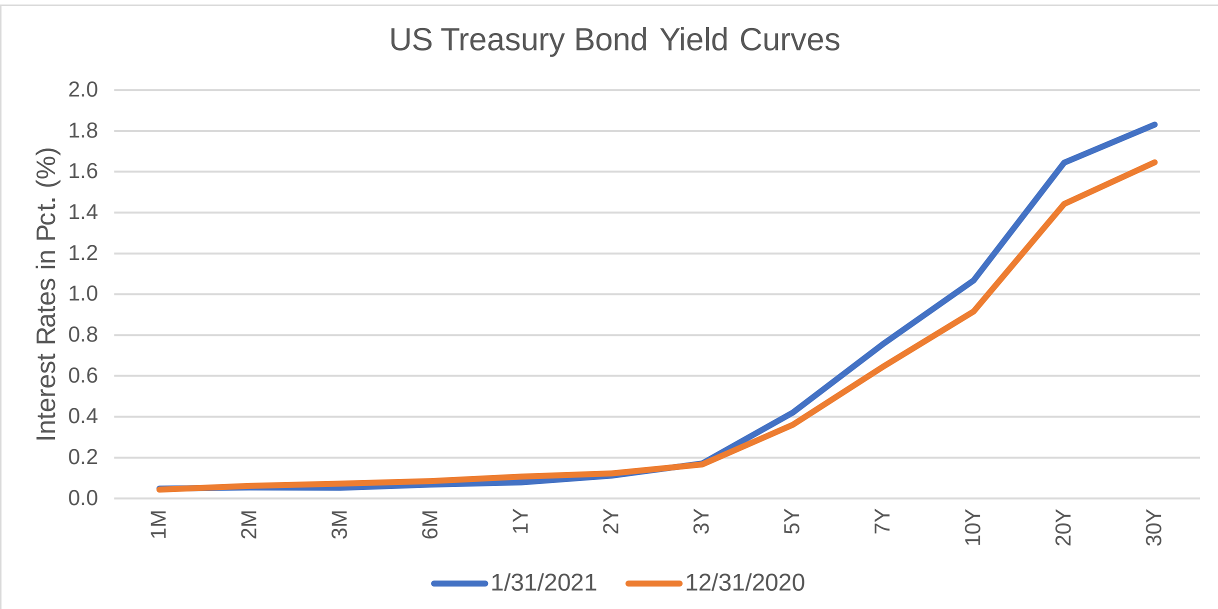


Source: Bloomberg as January 31, 2021

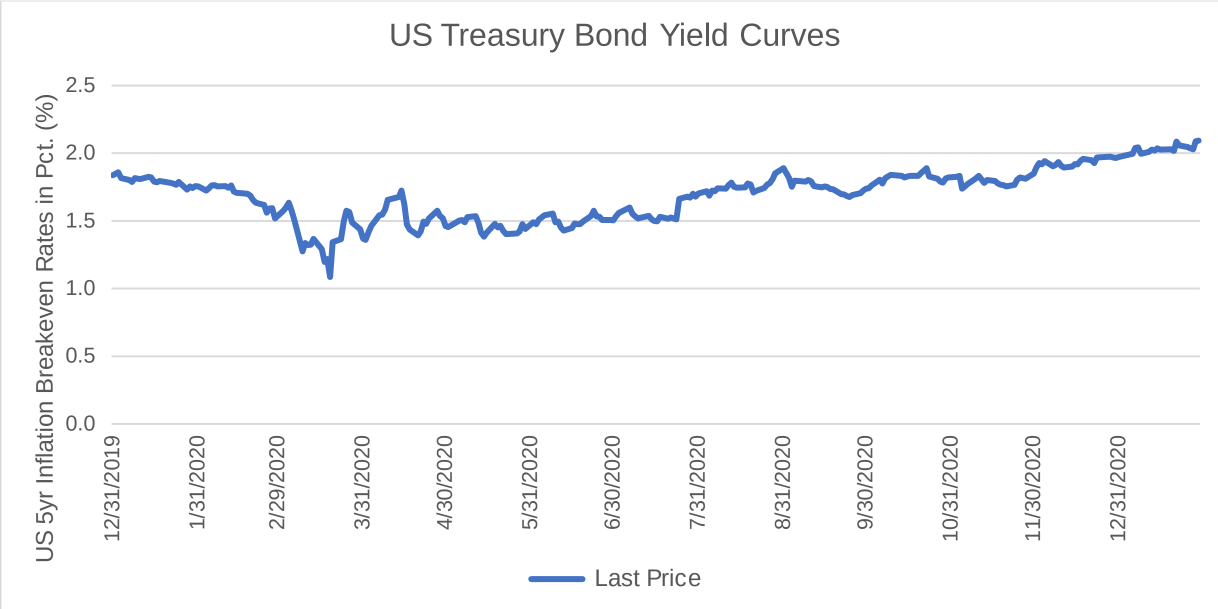
FIXED INCOME

Fixed income market returns were modestly lower in January with the exception being lower quality high yield corporate bonds. For the month, the Bloomberg Barclays US Aggregate Bond Index returned -0.2% compared with 0.3% for the high yield benchmark.[15] US Treasury bonds continued their recent weakness resulting in slightly higher yields across the curve. As seen in the chart below, the benchmark 10-year US Treasury Bond yield increased to 1.1%, up from 0.9%

in December.[16] The likely catalysts for higher yields is the combination of additional issuance tied to the expected stimulus, in addition to investors' expectations regarding future inflation. As discussed in previous updates, following the market dislocation in March last year, inflation expectations plummeted as the economy shuttered due to the pandemic. However, as a result of the globally coordinated monetary stimulus, inflation expectations began to recover. In looking at the chart below, the 5-year forward breakeven inflation rate was roughly 2.1% as of January, exceeding the Fed's target of 2.0%.[17] While it is likely that the market has already considered the impact of additional fiscal stimulus, we will be watching closely for signs that the economy begins to run hotter than expected which could force the Fed into raising interest rates sooner than expected.



Source: Bloomberg as January 31, 2021



Source: Bloomberg as January 31, 2021

APPENDIX

1. Bloomberg, April 2020
2. Bloomberg, February 2021
3. Bloomberg, January 2021
4. https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19#U
5. https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19#U
6. https://www.barrons.com/articles/1-9-trillion-is-too-much-stimulus-51612645043
7. Bloomberg, January 2021
8. Morningstar, January 2021
9. Morningstar, January 2021
10. https://blinks.bloomberg.com/news/stories/QO7TB4T0AFB6
11. https://www.reddit.com/
12. https://www.bloomberg.com/opinion/articles/2021-02-01/gamestop-gme-short-squeeze-inflicts-lasting-pain-on-hedge-funds
13. https://www.theguardian.com/business/2021/jan/28/gamestop-shares-robinhood-app-ban-blackberry-amc-nokia-reddit
14. Bloomberg, February 2021
15. Morningstar, January 2021
16. Bloomberg, January 2021
17. Bloomberg, January 2021

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