KNOX & DOWNING ADVISORS

A Member of Advisory Services Network, LLC

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Just over a year ago, as the Covid crisis burst upon us, we wrote that while we shared the same fears and doubts as everyone else, we believed the markets and the economy would weather the storm. This optimism was not due to any special prescience on our part but only long experience with market declines and financial panics. We believed the underlying strength of the economy would allow us to eventually emerge from the financial devastation caused by the pandemic.

While the course of the stock market during this worldwide crisis may seem a small matter, it is our role to comment on the financial aspects of the pandemic. The devastating loss of life worldwide and the ongoing threat of the virus weighs heavily on all of us. We are also mindful that the recovery in the economy and markets has left many behind. Hopefully, the rapid pace of vaccinations and the gradual re-opening of the businesses hardest hit by the crisis will revive the economy for all.

We have chronicled the recovery in the economy and stock markets throughout the pandemic in our newsletters and other communications but the rebound from the market lows in March 2020 still seems amazing. According to Ned Davis Research*, the Dow Jones Industrial Average (DJIA) rose 74.4% over the twelve months since the market lows of March 23, 2020.

Measuring on a twelve-month span dating from March 31, 2020 (not the low point of the market) to March 31,2021, the Standard & Poor's 500 (S&P 500) rose 56.4 %. Over the same period the NASDAQ Index rose almost 80%. Foreign Emerging and Developed Markets also recovered with the MSCI Emerging Markets Index and the MSCI Developed Markets Index up 55.1% and 45.2% respectively since March 31, 2020. While the battle against the virus is at different stages throughout the world, most of the major economies seem well on the way to recovery.

Admittedly, much of the recovery in major stock markets occurred last year and these spectacular returns are measured from a crisis induced bottom. The surge of the virus in the early part of 2021 may have tempered investor enthusiasm in many areas. The U.S. stock market, or certainly some major components of the S&P 500, may have gotten a little ahead of itself by year end 2020 as well.

While the S&P 500 rose 18.3% last year, much of the advance was due to only 5 stocks: Apple, Amazon, Alphabet, Microsoft, and Facebook. These stocks rose 65% over 2020 while the rest of the stocks in the index advanced 10%. There was also a distinct, and persistent, advantage for growth stocks over value stocks. The Russell 1000 Growth Exchange Traded Fund (ETF) gained 38.2% in 2020 versus a rise of only 2.7% for the Russell 1000 Value ETF.

Things have changed somewhat in 2021 as while the S&P 500 is up 6.2% year to date through March 31, the largest stock (by capitalization) in the index, Apple, is down 7.9%. By contrast, a more traditional value stock, J.P. Morgan, is up 20.6% so far this year. The Russell 1000 Growth ETF is up only 1.0% so far in 2021 while the Russell Value 1000 is up over 10.0%. This may not mark a permanent shift in the relative performance of growth stocks versus value stocks, but it is encouraging to have a broader group of stocks advancing. We still like both Apple and J.P. Morgan for long term investors as we continue to favor a combination of growth and value stocks.

The advance in value stocks in 2021 has been led by the energy sector and the financial sector. The energy stocks had become excessively undervalued last year and with oil prices rebounding and the economy heating up the recovery in the group should continue. The financial services sector benefitted from the rapid rise in interest rates as the yield on the 10-year U.S. Treasury note advance from under 1.0% at year end to roughly 1.7% today. Higher interest rates can improve bank earnings as the profit margins on loans increases.

What may be good for bank earnings may be worrying investors though, as the rapid rise in interest rates in 2021 seemed to spook investors in many high flying (and high priced) stocks. One possible hurdle for stocks as the economy continues to recover is higher interest rates as the result of inflationary pressures. Most analysts think the Federal Reserve will be able to keep interest rates low while stoking the economic recovery but there are worries that inflation and subsequently, interest rates, will move higher than expected. Higher interest rates could impact company earnings, stock price earnings ratios and consumer spending if things move too far too fast.

Other potential inflationary factors could be the massive government spending on Covid relief and the new comprehensive infrastructure recovery plan. While these spending plans would certainly boost the economy the combination of this stimulus with the ongoing recovery in the economy could lead to higher interest rates and subsequent pressure on stock prices. Most market observers do expect higher interest rates, but they believe they will rise gradually without disrupting the recovery.

That we are worried about the rapid pace of the economic recovery and the potential for higher interest rates is a measure of how far we have come since the fearful days of March 2021. The cost of the pandemic in lives and lost jobs has been devastating but the resilience of people, the accomplishments of science and the ingenuity of the new economy have been equally remarkable. It will be a relief to worry about the more mundane matters of stock prices and interest rates once again.

We wish you and your families all the best as we emerge from this crisis.

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*Ned Davis Research March 31, 2021

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