Insights and Observations: Second Quarter 2021

Domestic stocks have performed extremely well over the past decade. In fact, U.S. stocks have been compounding at an annualized rate of 13.8% over the past ten calendar years … not to mention the 15% gain during the first six months of 2021.

With interest rates at such low levels, the prospects for bond investors appear to be modest at best. So, I suppose we shouldn't be shocked that investors are piling into equities. They are buying stocks because they believe "there is no alternative" … a phrase often abbreviated by the acronym TINA.

For those of us keeping score, U.S. stocks have returned about 7% annually over the past 21 years. For the first ten years of this period (2000-2009) returns were flat. Fittingly, this period is often times referred to as *The Lost Decade* for U.S. investors.

> There was a survey done in 2000. The average investor expected to make 15% per year for the next 10 years. Oops. They got it wrong, especially after inflation.
>
> John Mauldin, Mauldin Economics – 7/9/21

A recent survey by Natixis Investment Managers found that investors expect stocks to deliver 17% returns after inflation over the long run … more than twice the historical average going back to 1926.

Not long ago, it was thought that you could easily take 5% of your retirement savings each year (adjusted for inflation) … and that the money would last for 30 years. But with stock valuations at historically high levels, what are the implications for people currently contemplating retirement?

According to Crestmont Research, during times of high valuations, defined as the top 25% of investment quartiles, your money would only have lasted an average of 22 years. Put another way, there was only a 47% chance of the money lasting 30 years.

> **Your money only lasts 30 years 47% of the time. Not exactly good odds.**
>
> **John Mauldin, Mauldin Economics – 7/9/21**

Just how high are valuations now? Today's stock valuations are arguably considered second only to the highs reached during the 2000 technology craze … just before that bubble imploded.

A recent "Blackpaper" from Blackstone outlines what they refer to as the realities of investing today. Here are their observations:

- The number of days that U.S. equity prices moved 3% or more reached a peak of 95 in the 2000-2009 decade. In the previous 50 years all together there were only 81 episodes. From 2010-2020 there were a total of 60 times when markets moved 3% or more.
- From 2008-2020, the major investment asset classes have become more correlated. In other words, it is getting very difficult for investors to achieve true diversification.
- Fixed income investments, with annualized returns of 4.5% from 1982-2020, have been both a diversifier to stocks and a source of solid returns. But with interest rates currently close to zero, investors should lower their expectations. Remember, from 1953-1981, fixed income returned a measly 0.2% annually.

- In summary, low current yields, tepid economic growth, and relatively high equity valuations suggest anemic returns for equity markets ahead … with general expectations for annualized returns of 5% for stocks and just 3% for a moderate risk portfolio.

According to Federal Reserve data, Americans age 70 and above had a net worth of nearly $35 trillion as of March 31 … or 27% of all U.S. wealth. That amount represents 157% of U.S. gross domestic product … more than double the proportion just thirty years ago. And, more importantly, they are not waiting until they die to give it away.

> Now they have started parceling it out to their heirs and others, unleashing a torrent of economic activity including buying homes, starting businesses and giving to charity … The transfer will provide another display of the outsize economic power of baby boomers, who came of age during a wave of post-World War II prosperity and drove the economy through many stages of their lives.
>
> Eisen/Tergesen – WSJ 7/2/21

American households saw their wealth increase by over $13 trillion last year … the largest increase in the three decades of available data. In the previous economic downturn of 2008, U.S. households saw their wealth decline by $8 trillion.

Many Americans of all stripes paid off credit-card debt, saved more, and refinanced into cheaper mortgages. That challenged the conventions of previous economic downturns … In some ways, the singularity of the Covid-19 recession – and the recovery – shouldn't surprise. The scope of the pandemic was unprecedented in the modern era. So was the government's response.

McCaffrey/Shifflett – WSJ 6/27/21

The Federal Reserve Bank of Philadelphia estimates that American colleges and universities will lose $70-$115 billion in revenue over the next five years as a result of the pandemic. Schools are giving more scholarships to offset declining enrollment, while room-and-board revenues are dropping as students enroll but take courses online. If that's not enough, Google just launched certificate programs that it will treat as the equivalent of a four-year degree for hiring purposes.

Residential colleges won't disappear entirely – many young people relish the experience. Big state universities as well as name brands with global snob appeal and huge endowments will survive the additional pressure piled on by the pandemic. But hundreds of smaller institutions facing precarious finances – yes, maybe even your alma mater – might not if tuition and enrollment pressure outlast the pandemic … They are giving it the old college try, but Covid-19 has forced higher education to face economic reality.

Spencer Jakab – WSJ 6/25/21

The World Bank expects the global economy to grow by 5.6% this year, making this the fastest recovery of the five post-World War II recessions. Most developed economies are expected to fully recover by 2022, but two-thirds of developing nations could continue to struggle because of unequal access to Covid-19 vaccines.

> **While there are welcome signs of global recovery, the pandemic continues to inflict poverty and inequality on people in developing countries around the world.**
>
> **David Malpass, World Bank Group – WSJ 6/8/21**

The global economy shrank by 3.5% in 2020, and 2022 should see further growth of 4.3% … although the level of output is expected to remain 2% below pre-pandemic levels.

The World Bank increased its forecast for U.S. growth to 6.8% this year, but reduced growth forecasts for low-income countries. China is expected to see economic growth of 8.5% in 2021, while the euro zone should grow at a 4.2% rate.

Money is pouring into companies based on environmental, social, and governance (ESG) criteria. However, there are significant inconsistencies in the way companies are rated by the three primary providers of ESG data. Depending on the time period and provider, top-ranked ESG stocks either outperform or lag behind the market.

> **Scores can create confusion because a company is rated highly by one agency and given a very low grade by another.**
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> **Monica Billio, Ca’ Foscari University of Venice – WSJ 6/11/21**

Back in 1994, the budget deficit was $203 billion and the national debt was $3.4 trillion, or about 48% of U.S. GDP. The Congressional Budget Office now projects that the budget deficit will reach $1.9 trillion in 10 years, and the national debt will reach 202% of GDP within 30 years.

National debt figures do not include the projected $65 trillion in unfunded liabilities for Social Security and Medicare.

> Beyond the numbers, the biggest difference between then and now is that in 1994 both parties worried about deficits and debt. Today, neither Democrats nor Republicans seem to care.
>
> Bob Kerrey(D)/John Danforth(R), former U.S. senators – WSJ 6/20/21

The Chinese Communist Party, which includes 95 million members that rule over 1.4 billion people, celebrated its 100th anniversary on July 1.

> The biggest risks for China's ruling Communists are internal: a rapidly aging population while tens of millions remain poor, a huge debt overhang, political control that blocks more economic reform, and public expectations for continued prosperity.
>
> The Editorial Board – WSJ 6/30/21

China released a once-in-a decade census this quarter. The census showed a shrinking working class, along with a ballooning elderly population.

> It's going to be a decline that sees no end.
>
> Wang Feng, University of California – WSJ 5/13/21

A few weeks later, Beijing announced it would allow all married couples to have up to three children. At that time, Beijing also pledged to provide support for education and child rearing. All this comes more than five years after China ended its "one child policy".

> Stagnating population growth, even for crowded China, translates into fewer younger people to generate economic power as rising numbers of elderly represent a net drain on finances. It is the reverse of the demographic profile that underpinned China's economic miracle, essentially a surge in productivity driven by an endless supply of cheap labor.
>
> Areddy/Qi – WSJ 5/13/21

Consider some demographic observations pertaining to China:

- Fewer Chinese marry every year. In 2019, marriage registrations were 6.6 per 1,000 people, compared to 9.6 in 2014.
- Divorces are on the rise, with 70% initiated by women.

- There were 12 million births in 2020, a drop of 18% from the previous year, and the fourth straight year of declines.

- China's fertility rate dropped to 1.3 vs. 1.64 in the U.S.
- 18.7% of the population is now at or above the age of 60 … a significant rise from 13.3% in 2010.
- China's population is expected to peak in 2027 at 1.417 billion.
- Unlike the U.S., China does not rely on immigration to help replenish the workforce.

> China's demographic situation has in a short time moved to the forefront of Beijing's economic concerns. The aging population is expected to be a major drain on the country's savings. And just when China is turning to consumption as a growth driver, older people worried about pension payouts – and with just one child to help them in their old age – are likely to become reluctant to spend.
>
> Liyan Qi – WSJ 5/11/21

Inflation, asset values, budget deficits, demographics, ESG, GDP, developments in China … there's always plenty of issues to discuss.

Here's hoping for a little less rain and a little more sunshine!

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