January 4, 2021

"We struggle with the complexities and avoid the simplicities"
-Norman Vincent Peale

The long-term impact of 2020 will become more apparent over time. While there were some silver linings, we are confident few people would wish to relive it. Yet, as unsettling as it has been, it was quite a good year for the stock market. In this note we will provide some brief comments sharing our perspective as to why stocks did well, and we will also review some factors we are monitoring as we look ahead.

The global collapse in GDP was caused by countries voluntarily curtailing business activity to slow the spread of Covid-19 and not by economic flaws. Swift action by the government softened the financial hit. In March the Coronavirus Aid, Relief and Economic Security (CARES) Act provided $2.3 trillion in aid to citizens and businesses impacted by the crisis. The Fed injected liquidity into the financial system driving the yield on the 10-year US Treasury to an all-time low of 0.318% in March from its pre-pandemic yield of 1.8%. Enhanced unemployment benefits and government transfer payments helped keep many afloat. Personal disposable income rose by 10% between the first and second quarter of 2020, despite GDP falling 10% in the same period. Last week, another $900 billion was authorized by the government, giving additional aid to businesses and people still suffering under Covid-19 restrictions. With the rollout of the vaccine underway, it is likely that the latest aid package will bridge the gap to when life begins to return to normal later in 2021.

As we look forward into the new year, we want to highlight some observations. First, assuming the vaccine successfully reigns in the pandemic, we expect economic growth to become stronger as the year progresses. Much of the recovery is already discounted by the stock market so equity returns may be more modest. The second point we want to make is that the excellent double-digit returns generated by the stock market over the last ten years will be tougher to replicate in the coming decade. The stock market is currently trading around a P/E ratio of 23x, the high end of the range of the last decade and interest rates are near historic lows. The Federal Reserve has indicated it will tolerate higher inflation which should begin to push yields higher and rising rates historically serve as a headwind to market valuation. Therefore, unless earnings growth can outpace multiple contraction, it is prudent to anticipate lower returns.

Finally, government intervention to support citizens and the economy during Covid-19 came with a price. Before the pandemic, the US Federal budget was operating at a $1 trillion deficit. With the additional $4 trillion in pandemic related spending, combined with years of fiscal irresponsibility in Washington, the US Federal debt is now approximately $27 trillion, larger than the entire US GDP. We would not be surprised to see higher taxes and entitlement programs reformed, both of which could detract from economic growth potential.

Our character as a nation and as individuals was tested in 2020. As investors, our discipline of owning well managed companies generating free cash flow was affirmed. We remain committed to investing for the long term and we will continue to work on your behalf throughout the ever-changing business climate. Thank you for entrusting Ayrshire Capital with the management of your money. We look forward to speaking with you soon.

Sincerely,

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