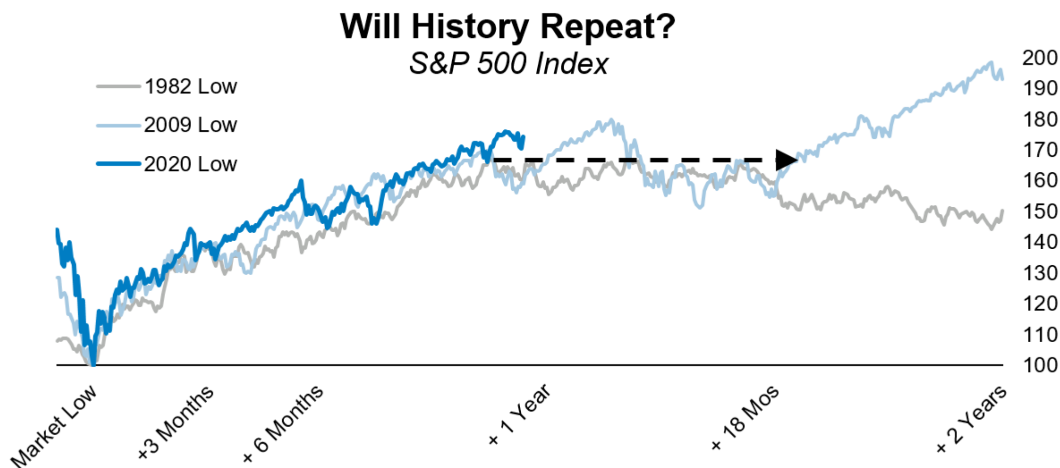
Like Déjà Vu All Over Again?

"The future ain't what it used to be."
- *Yogi Berra*

No, you are not experiencing déjà vu – the chart below led off our January market commentary as well. But given the striking similarities between the S&P 500 since the 2020 lows and its path following two other major market lows – 1982 and 2009 – we thought it would be worthwhile to update and revisit the illustration.

Despite the unprecedented circumstances that predicated last year's freefall, the S&P 500 has responded fairly normally in the almost year that has passed. That is, the first year off of a major market low is often strong, and fairly uninterrupted. In that sense, the market rally has been pretty much as expected.



Source: Yahoo! Finance, FFWM Research. S&P 500 Index values indexed to 100 as of 8/12/82, 3/9/09 and 3/23/20. Prices updated through 2/26/21.

This new Bull market (and yes, we think that this is the start of a new multi-year Bull) started as a result of improving market sentiment. Throughout the first few months of the pandemic, corporate fundamentals deteriorated rapidly for all but a few corners of the economy. Any investment that could benefit from the "working / staying at home" theme went bonkers, and those were the stocks that initially drove the market off of the bottom.

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Then, as economic data started the slow climb out of the bottom of the trough, investor sentiment improved further as it appeared that the economic situation wouldn't get much worse. This improved sentiment began to lift stocks in other areas of the market.

Now, the market appears to be at the point where fundamentals (and not just sentiment) are going to matter again. Not only will investors be able to broaden their search for earnings growth – as we've said in previous editions, growth should be easier to come by in 2021 – but they will be able to find this growth at fairly attractive valuations.

We believe that this bargain hunting will focus on more economically sensitive "value" stocks. This area of the market has lagged "growth" for years, and we feel like 2021 might be the time that this leadership finally flips.

Major equity market leadership changes can cause some choppy markets as the prior leaders refuse to give up the reins without a fight. This back and forth – something that we've seen to an extent over the past few months – can cause the broader market to be fairly volatile while still trending higher.

As you can see in the table at right, the stock market usually races higher in the first year following a major market low. Second-year gains rarely surpass those achieved in the first year (1987 being the only exception), but these returns are still strong relative to long-term averages. What is interesting is that each of these sophomore years experience a fairly hefty drawdown at some point. These pullbacks have, for the most part, been a result of changing market leadership where

EXPECT SOME BUMPS IN THE ROAD

S&P 500 Index, Since 1950

Major Low - S&P 500	First Year After Low	Second Year After Low	Maximum Drawdown Second Year
10/22/1957	31.0%	9.7%	-9.2%
6/26/1962	32.7%	17.4%	-6.5%
10/7/1966	32.9%	6.6%	-10.0%
5/26/1970	43.7%	11.1%	-11.0%
10/3/1974	38.0%	21.2%	-5.1%
8/12/1982	58.3%	2.0%	-14.7%
12/4/1987	21.4%	29.3%	-9.2%
10/11/1990	29.1%	5.6%	-6.8%
10/9/2002	33.7%	8.0%	-8.8%
3/9/2009	68.6%	15.7%	-17.1%
3/23/2020	+75% in 11 Months	???	???
Average	**42.2%**	**12.7%**	**-9.8%**

Source: Strategas, FFWM Research

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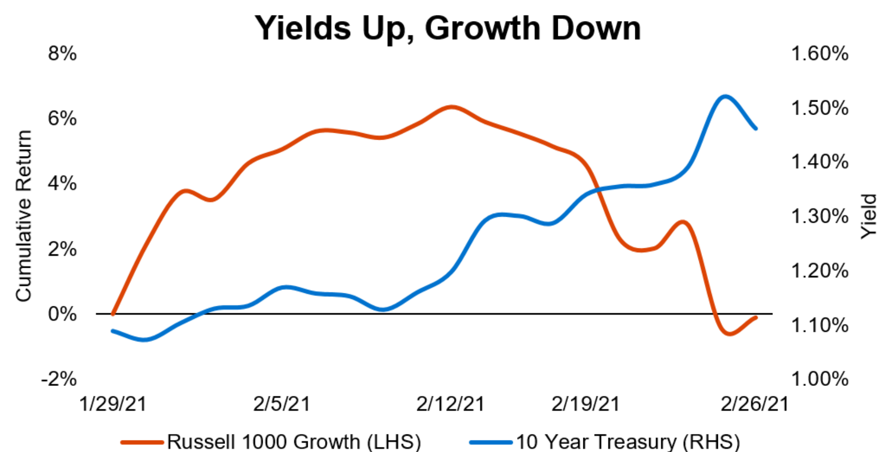
those areas that led the initial recovery hand the baton to those areas that will ultimately lead the market higher.

This leadership change doesn't just magically occur – there is always a catalyst for the change. In our view, the news of effective vaccines in November of last year was the first spark to catalyze the shift. The second spark is the prospect of rising interest rates.

You can see it in the market behavior of the last few weeks of February. Beginning in the middle of the month, interest rates (represented by the 10-year US Treasury bond) rose quickly from just over 1% to over 1.5%. In that same brief time, the Russell 1000 Growth index lost approximately 8% of its value.



Higher longer-term interest rates shouldn't come as too big of a surprise. While the Federal Reserve has reiterated the view that it's "not even thinking about thinking about raising short-term interest rates" the longer end of the interest rate spectrum is vulnerable to inflationary pressures and rapid economic growth.

Inflationary pressures could result from the massive amounts of liquidity that have been injected into the financial system since the start of the pandemic. Economic growth should spike when consumers feel like they are safe to eat out, travel and shop from somewhere other than the couch.

The combination of plenty of liquidity and the release of pent-up economic demand should send prices higher, and this increase in inflation should flow through to longer-term interest rates.

But why would higher interest rates negatively impact "growth" stocks? A lot of it has to do with how investors determine what an appropriate earnings multiple would be for

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these companies. One common method is for these investors to project what future earnings will look like, and then discount those future earnings back to the present. While projecting future earnings is obviously a huge part of success in this endeavor, the level of interest rates plays a huge part as well.

When determining the appropriate “discount rate” for those earnings that are expected in the distant future, investors will take the prevailing rates of the day and apply a risk premium. This becomes the denominator in the discounting calculation. As with any division problem, if the numerator stays the same and the denominator increases, the resulting answer will become smaller.

That’s what is beginning to happen now. With long-term rates as low as they have been, the “discount rate” has been extremely low which has the effect of keeping those future earnings relatively unaffected by the discounting process. As rates rise, simple math says that the present-day value of those future earnings declines. For companies whose current values are heavily predicated on the current value of future earnings, this can have a huge impact on price-earnings multiples. As rates rise and valuation multiples for “growth” stocks compress, “value” stocks should assert leadership in the market. In this way, the “Yogi-ism” of “the future ain’t what it used to be” applies to growth stocks.

Regarding our client portfolios, we recently trimmed our overweight allocations to riskier areas of the market in order to manage total portfolio volatility. While we believe the time has come to prepare for this change in market leadership by adding more exposure to cyclical areas of the market, we realize that the equity market could experience some volatility following such a strong run over the past year. In sum, client portfolios maintain their cyclical orientation.

Within equities, we’ve recently increased our clients’ exposure to larger, more developed international markets. We’ve also made moves to increase exposure to smaller companies in the US and have added targeted exposure to more cyclical areas of the US large cap space. In the fixed income area, we remain focused on more credit-sensitive securities (with less exposure to the more cyclical areas of the market) with shorter maturities as a hedge against potentially rising interest rates. Within the alternative

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market segments, we recently increased our exposure to "real assets" (think commodities and real estate) as a hedge against the potential for higher inflation. We have maintained our exposure to the diversified alternative sector as a hedge against potential market volatility.

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