KLCM Advisors, Inc.

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Bell Ringing

A year ago, as we looked forward to 2020 and the beginning of a new decade, we wrote, "Conditions do not immediately change with the turning of a calendar; however, we are confident that the next decade will NOT be a rerun." The economic cycle had grown long in the tooth, and growth had plateaued around 2%. This was half of the previous economic cycles but looked good compared to the rest of the world. Combined with our relatively high-interest rates, this growth attracted capital from around the globe and strengthened the dollar, which enabled low inflation. It was a trifecta for central bankers as they had achieved stable growth, low inflation, and a strong currency.

For value investors, the environment was less rosy. With interest rates at all-time lows, prospective fixed income returns were paltry. In the equity markets, a bifurcation had occurred, companies that could continue growing revenues despite slow macroeconomic growth continued to attract capital regardless of valuation. Meanwhile, the stocks of mature businesses whose fortunes are tied more to macroeconomic growth languished as their valuations shrank. While we did not know what the catalyst for a changing environment would be, we believed many of these relationships had reached their zenith.

Covid-19 and the ensuing economic shutdown proved to be the change agent for the market environment. Treasury yields, which we thought had bottomed in the fall of 2019 at 1.50%, collapsed to 0.50%. The dollar, as measured by the DXY (we thought had peaked at approximately 99), quickly surged to 103 while inflation expectations plunged from 2% to less than 1%. All these moves happened between late February and the middle of March - taking each to even further extremes and providing the fuel for the final blowoff in relative valuations between growth and value stocks. As the pandemic spread worldwide and leverage was pulled out of the system, investors pondered how deep this recession would become.

To combat the virus, governments around the globe ordered their citizens to shelter in place. As a result, in the United States, our government took extraordinary measures to avoid causing direct financial pain to its citizens. These moves ranged from direct relief for individuals and small businesses to support of capital markets via open market purchases of government securities and facilities designed to support private credit markets. To date, direct fiscal relief to individuals and businesses has approached nearly $4 trillion - approximately 20% of GDP. Unlike the last crises, most of this support was provided directly to individuals. As a result, it will work itself back into the economy and support a significantly more rapid economic recovery.

While the lockdowns did cause significant damage to the economy, much of it is not permanent, and the inability to spend allowed many to fortify their personal balance sheets. The personal savings rate exceeded 30% in April and remains over 10%, exactly the opposite of what normally happens in a recession. At the same time, the pent-up demand for travel, leisure, and hospitality continues to grow by the day. The necessary condition to release this demand ultimately will be a defeat of COVID-19. Usually, there is no bell rung to signal a changing market environment or the end of a recession, but like so many other aspects of 2020, this recession is very unique. We believe the announcements of highly efficacious vaccines in November will prove to be as close to a bell as we will ever hear.

The combination of efficacious vaccines and previous fiscal relief has already started to lead to an improving economy. While GDP contracted at an unprecedented 33% in the second quarter, it rebounded an equally unprecedented 33% in the third quarter. Most economists believe we will surpass our prior peak GDP in the second half of 2021, driven by a return to normal from a self-induced economic coma. Consumers will lead this charge, and they have already started with retail sales having eclipsed the previous cycle's high-water mark, something that took nearly 60 months following the great financial crises.

Markets have started to take notice and begun to price in a very strong recovery. This recovery is perceived as a synchronized global phenomenon. As a result, we have seen the dollar weaken materially as alternative sources of growth exist. The DXY has fallen from 103 to 89, a nearly 14% decline in a matter of months. This puts upward pressure on yields where we have seen the ten-year treasury yield double off its bottom of 0.50%. The combination of a weaker dollar and prospects for significantly faster growth has manifested in higher expected inflation rates. Ten-year inflation expectations are now 2.25%, already surpassing where they stood at the beginning of 2020.

When a currency falls while interest rates rise, one should pay attention. It means the previous state was unnatural. We believe that is also a perfect depiction of equity markets today - **unnatural.** The winners of 2020 performed well; many ultimately exceeded earnings expectations. The top 15 contributors to the S&P 500's performance in 2020 beat estimates by about 5% over the last year. Many are good businesses. However, they now trade at an average of 39 times earnings and represent nearly 30% of the entire index. For the most part, the uniqueness of their growth will prove unsustainable. As the economy continues to reopen, growth will broaden out - making many value stocks look attractive. In fact, since the bell rang on November 9, value stocks have outperformed growth stocks by nearly 8%. Returns for small and cyclical stocks have been even more powerful, further signaling a new economic cycle is at hand.

The robust economic growth we expect to see in 2021 (4-5%) **before** considering additional fiscal stimulus or an infrastructure bill will push inflation expectations higher. This will force interest rates higher or the dollar lower or maybe both!! The combination of faster nominal growth and higher inflation expectations, which we see as a virtual certainty, should cause some of the air to come out of the valuation bubble surrounding large growth stocks. As Jeremy Grantham, co-founder of GMO, recently wrote, "Investors are relying on accommodative monetary conditions and zero real rates extrapolated indefinitely. In theory, this has a similar effect to assuming peak economic performance forever: it can be used to justify much lower yields on all assets and, therefore, correspondingly higher asset prices. But neither perfect economic conditions nor perfect financial conditions can last forever, and there's the rub."

Financial conditions are changing quickly. The investment implications are wide-ranging. Equity index returns will likely moderate, and interest rates are headed higher, meaning returns in fixed income will be limited at best. Despite those headwinds, we are optimistic that the very recovery driving inflation and rates higher will allow our companies to shine as their businesses are allowed to return to normal. We have already started to see a change in market leadership and are positioned to win as this new economic cycle unfolds.