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Bradley F. Richardson

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What happened in 2020?

I occasionally receive communications from clients kindly suggesting that I consider making a significant change to the client's investment portfolio based either on some forthcoming event or how they perceive the status of the stock market. My advice is always the same, which is to suggest that their financial future would be brighter if they did not make any rash changes to their investments.

This long-term approach served us especially well in 2020. While there were many events to react to, the stock market's eventual path was anything but obvious. Who could have predicted that despite a pandemic induced economic crisis, the stock market would have double digit gains for the second year in a row?

As the year began, a fully valued stock market continued to rise in January and February despite the potential economic impact of the looming COVID-19 pandemic. In March, investors suddenly focused on the potential impact of the virus and the stock market proceeded to fall precipitously. Then, once it became clear the U. S. government was going to respond forcefully, the stock market quickly recovered.

The second half of the year had more such twists and turns (according to data cited by Liz Ann Sonders of Charles Schwab & Co., the S&P 500 index saw more than 40 daily swings of 2% or more in 2020, which is the most since the financial crisis of 2008-09) as worries grew about the continued economic impact of the pandemic while virus case rates soared in the United States. There were also concerns surrounding America's national elections. This pessimism dissipated during the fall with the announcement of early positive results from two vaccine trials.

In summary, the stock market began the year with elevated valuations, went up 5%, dropped by nearly 34%, and then rebounded by 70%. So, despite falling earnings, the stock market gained 18.4% in 2020.

These results were not preordained. Two events were crucial to the stock market's success. First, the massive government intervention in late March and second, the successful vaccine trials in the fall. Without both of these catalysts, the stock market's performance could have been quite different.

Why was the stock market so strong?

The stock market, as represented by the S&P 500 index, ended the year up 18.4% -- hitting a new all-time high on the last day of the year. This occurred despite continued challenging news about the

Bradyco Financial
16 Sargent Street, Cambridge, MA 02140-2514
TEL (617) 945-1991 ■ Brad@BradycoFinancial.com
www.BradycoFinancial.com

pandemic and its impact on our nation's economy. Many businesses and individuals continue to experience significant economic pain. But, despite record bankruptcies, very high unemployment rates, a horrific death toll from COVID and falling earnings, the stock market's momentum has continued to be strong.

The single most important factor for the strong stock market has been the cost of money (e.g. interest rates) since the Federal Reserve Bank lowered interest rates to nearly zero in March. This resulted in a search for alternatives to cash, which has benefited stocks. Further, the near promise that the Fed would not increase interest rates for the foreseeable future provided a strong tailwind.

Second, the stock market's performance has been boosted by accelerated technological gains. Microsoft CEO Satya Nadella observed last spring that he had seen two years' worth of digital transformation occur during the past two months. This trend continues and it promises to improve margins for many businesses both in the technology industry and those industries that can take advantage of these innovations.

Third, the pandemic has favored large, successful companies found in the S&P 500 index while smaller businesses have struggled to survive.

Finally, there has been an explosion in investing by individual investors. Estimates by JMP Securities, cited by the Wallstreet Journal, are that over 10 million new brokerage accounts were opened in 2020. This trend has fueled a rise in momentum stocks, whose valuations are driven by inexperienced speculators who mindlessly buy whatever they hear on social media channels is popular without any regard to the economic prospects of the company involved. This trend has continued into 2021.

What's Next?

By many traditional measures, the stock market is overvalued. According to the WSJ, the S&P 500 index traded in early January at 22 times analysts' expected earnings, which is its most expensive level since the dot.com bubble. One Wallstreet sage, Jeremy Grantham of Boston's GMO, who predicted the stock market crashes of 2000 and 2008, believes we are in a "major bubble."

While dismissing such concerns out of hand is unwise, there are two aspects we need to keep in mind. First, we must remember that the cost of money is extremely low by historical standards. For example, during the tech bubble, the Fed Funds rate was around 5%. Today, it is practically zero. Second, even when the cost of money was 5%, it took years for the dot.com bubble to burst. Jeremy Grantham admits that the timing on when such bubbles will burst is never clear.

In short, trying to time the stock market is not recommended. Rather, our strategy of being patient and taking advantage whenever opportunities present themselves is more likely to help our wallets.

Thank you for your confidence.

Brad