Hughes Investment Advisory Service LLC

January 1, 2021

Dear Clients and Investors,

Happy New Year to you and your families. Like everyone, our family is happy to see 2020 in the rear-view mirror, but we are also grateful for so many of the little things that we didn't recognize before this pandemic. As investors we should all be happy with the positive finish to the year, something no one could have imagined in March during the worst of the rapid bear market decline which took place at the onset of the pandemic. Due to the pandemic, I am suspending my yearly roster of predictions for 2021 other than my view that the S&P 500 will likely see a single advance of 6-8%, suggesting low to moderate returns overall.

In 2020, we had a severe but quick bear market in stocks that started on Feb 19 and ended on March 23 and then stocks were back to new highs in early Sept – truly extraordinary market behavior. For 2020, the S&P 500 was up over 16%, the Dow Jones Industrial Avg was up 7.25% and the standout Nasdaq was up an astounding 43%.

Is there a disconnect between the economy and the markets? If you simply look at what the markets have done this year and what GDP (Gross Domestic Product) has done then yes, it's extraordinarily disconnected. In reality it's more reflective of the economy today. You can see this in the divergence between the big 5 stocks Apple, Amazon, Microsoft, Facebook and Google and the rest of the market. On Sept 2, these stocks as a group were up 65%, while the other 495 S&P 500 stocks were only up 3%. Because these 5 stocks represent 25% of the S&P 500 index, it lifted the overall index. However, the other 495 stocks were barely higher and 36% of the S&P 500 were still down at least 20% in bear market territory. I believe that this example sums up well the overall economy where we had a small subset of winners amidst a tremendous amount of pain.

Where are we now? I believe that we are in a K shaped recovery where we are seeing winners and losers across the economy, stock market, demographics, age, health, and income. Some of this will see mean reversion but much of what we are seeing seems to be permanent long-term secular trends in how we work, live, and invest. To summarize, the vaccine has pulled forward the economic recovery which is reflected in the record setting stock market but in the near term the virus continues to depress economic growth.

There are many areas to focus on but during times of unusual economic stress, as we are experiencing now due to Covid-19, I like to stick with the basics and that leads me back to corporate earnings, inflation, interest rates, and debt levels which are ultimately what drives future stock prices.

S&P 500 earnings were $163.00 in 2019. 12 months ago, my earnings estimate for 2020 was $180. Actual 2020 earnings will be around $140.00 for a drop of 14%. Estimates for 2021 earnings are currently $165 and $195.00 for 2022. This means, if accurate, that earnings will take 3 years to recover to a new record high due to the pandemic and related economic slowdown. GDP will take a similar time span to recover back to pre-Covid 19 levels. In the mean-time stock prices have fully recovered to new highs already despite all of the risks associated with today's economy which makes the market very expensive on a P/E basis.

While the economy hopefully recovers, the country's total debt levels have gone from $10 trillion in 2008 to $27 trillion today. This is the highest debt level to GDP ever, and stands at 136% versus the old record high of 118% in 1946 due to the costs of WW2.

I will be keeping a close eye on inflation. Why, when inflation has remained below the Fed's target of 2% for many years? Because the Fed and Treasury have caused a surge in the money supply of almost +25% year over year. What we have seen so far is massive inflation in asset prices, gold, bitcoin, stocks but not in the real economy. The money has remained in the financial system due to the economy being mostly shut down. This may be sowing the seeds of real inflation if we see a future surge in economic recovery as the economy comes back online with the vaccine rollout throughout 2021. Combine that with a potential surge in post pandemic demand that could easily outstrip the disrupted supply lines, growing government deficits and the Fed's new policy framework that encourages an increase in inflation and it's quite possible that inflation arrives sooner rather than later.

Higher inflation would cause interest rates to rise and a 10-year T-Note at 1.5% and a 30-year Bond at 2.5% would not be surprising under this scenario. Higher rates would favor value over growth and create sub sector winners and losers. This would be a completely different investing environment than we have had the last 11 years since the Great Recession.

So, what do we do from an investment standpoint? Bottom-up stock picking and stock selection will be critical. Continue to differentiate between the winners and losers in the late and post-pandemic economy. Where do I find winning industries and companies today? Industrial/Defense, technology especially financial and medical tech, and pharma.
The utility and consumer staples sectors stand out as income producers in a low-rate environment but would be susceptible to higher rates as outlined above.

At this time, I continue to favor large-cap, dividend paying, US based multi-national companies with strong balance sheets. We love businesses with irreplaceable brand names, high barriers to entry, wide margins, grow their dividends, and have modest debt. Risk/reward continues to favor equities over fixed income. A few select REIT's and specialized bond and income funds continue to look good as income producers. I will continue upgrading and adjusting portfolios accordingly and look for special situations as conditions on the ground change. Please do not hesitate to give me a call to discuss the above analysis.

Sincerely,

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