WELLS TRECASO

FINANCIAL GROUP

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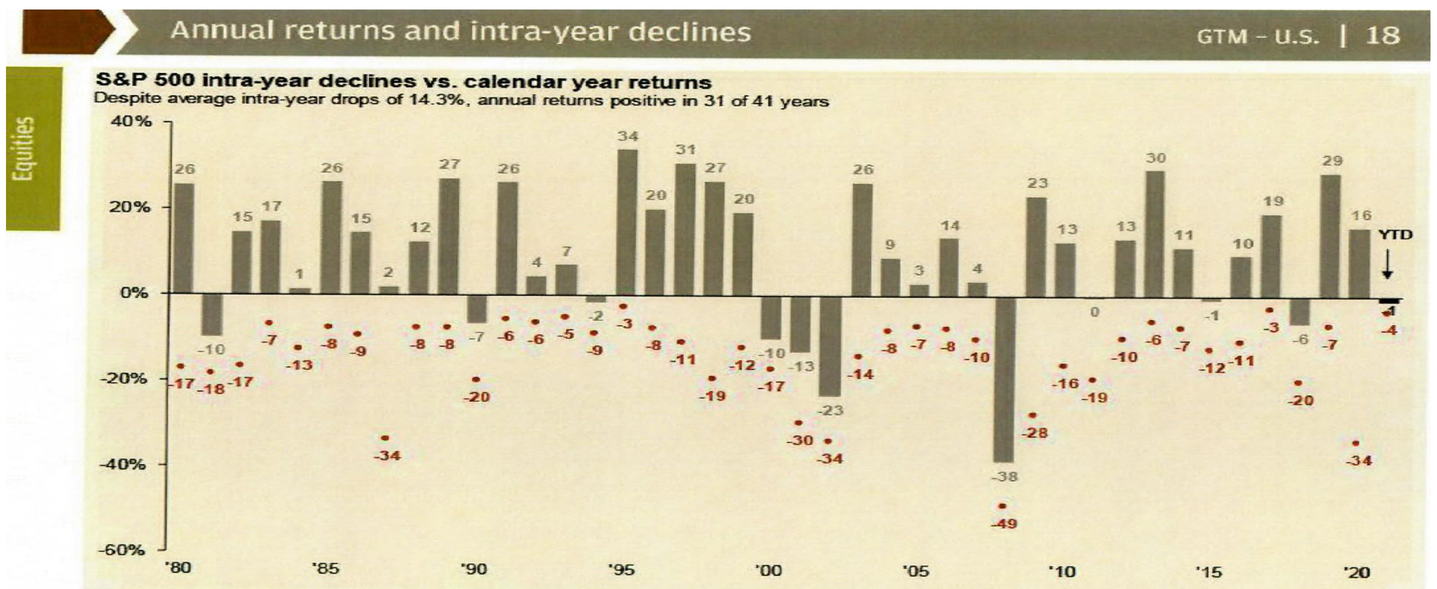
Portfolio Talk

Market Update 02/26/2021

Volatility seems to be front and center this week. Interest rates have scared the markets with the 10-year US Treasury breaking above 1.5% for the first time since the start of the pandemic. We've written about the relationship between interest rates and earnings multiples before, now we're seeing it live and in living color! But is it justified? We do not believe it is and here's why. The 10-year rate is bouncing around 1.48% today. Historically this is relatively low given the average yield since 1962 is 6.011%. Now comes the interesting part, if you subscribe to the model of 1 divided by 6.011 (the average historical 10-year Treasury yield), that would equal 16.664 (the historical equally valued market multiple). Here's the interesting part, the average market multiple since 1962 is approximately 16.8x, spot on! So, today 1 divided by 1.48 would give us a 67.57x multiple to be of equal value to the 10-year treasury. We're trading roughly at 22x 2021's estimated earnings for the S&P 500 today and while we do not believe we should trade at 67x earnings, mainly because the trend is for higher rates, we do believe 22x earnings in a growing economy may give us some protection against a "Black Swan" event (major unforeseen pullback). What we do believe is that we are probably experiencing the classic market correction we tend to suffer through on an annual basis. The chart below illustrates that annually we have an average pullback of 14.3% but end the year up 9% on average.



While corrections are never easy to endure, they can be healthy for the markets to wash out excesses such as speculators (GameStop) and bring investors focus back to the fundamentals. We believe this is just that, a reset!

Economic news

- Monday:
  - Leading Economic Indicators for Jan., 0.5% vs. 0.4% expected and 0.4% previously…good.
- Tuesday:
  - Case-Shiller home price index (year over year) for Dec., 10.4% vs. 9.5% previously…excellent.
  - FHFA home price index (year over year) for Dec., 11.4% vs. 11.0% previously.
  - Consumer Confidence Index for Feb., 91.3 vs 91.0 expected and 88.9 previously…very good.
- Wednesday:
  - New Home Sales (Seasonally adjusted) for Jan., 923,000 vs. 850,000 expected and 885,000 previously…excellent.
- Thursday:
  - Initial jobless claims (states, SA) for Feb. 20th, 730,000 vs. 845,000 expected and 841,000 previously…complicated
  - Continuing jobless claims (state, SA) for Feb. 13th, 4.42 million vs. 4.52 million previously… holding.
  - Gross Domestic Product revision (seasonally adjusted) Q4, 4.1% vs. 4.2% expected and 4.0% previously…still good.
  - Durable Goods Orders for Jan., 3.4% vs 1.0% expected and 1.2% previously…excellent.
  - Core Capital Goods Orders for Jan., 0.5% vs. 0.5% previously…holding.
  - Pending home sales index for Jan., -2.8% vs. -0.5% expected and -0.3% previously…weather related.
- Friday:
  - Personal Income for Jan., 10.0% vs. 9.5% expected and 0.6% previously…confusing!
  - Consumer Spending for Jan., 2.4% vs. 2.5% expected and -0.4% previously…holding.
  - Core inflation for Jan., 0.3% vs. 0.2% expected and 0.3%...holding.
  - Chicago PMI for Feb. 59.5 vs. 61.0 expected and 63.8 previously…slipping.
  - University of Michigan Consumer Sentiment Index (final)) for Feb., 76.8 vs. 76.8 expected and 76.2 previously…holding.

A couple of news releases kind of stand out: First, the core inflation rate reported still keeps us in the range the Federal Reserve has indicated is desired to kick start the economy. So, if this is the case, inflation within the guardrails the Feds have setup, why do we have bond yields surging? We believe rates are getting ahead of themselves and bonds will probably settle soon. Secondly, unemployment still looks like it's headed in a downward trend. The fact is that many are falling off the state supported unemployment benefit and are enrolling in the extended Federal programs. The unemployment rate, according to Chairman Powell, is closer to 10%. However, personal income surged up 10% annually! Kind of a contradiction, right? It is the tale of two cities; those who are struggling are still struggling, and those who are not are still doing well! It is something to watch closely over the coming weeks and months.

Earnings were quite good for a couple of companies in the portfolio this week, Lowes and Home Depot. Both saw their same store sales comps surge 24% and 21% respectively. Both had better than expected revenue and earnings. Both also did not give guidance for earnings in 2021 due to their inability to forecast against comparable that benefited from the pandemic. Will they be able to duplicate their results when the do it yourselfers are able to go outdoors again? That's a good question and one we're researching to see if profit taking is the correct call.

We should hear about Johnson and Johnson's vaccine approval within the next 24-72 hours. That's good news!

Hard to believe, but Monday is the 1st of March! Time flies even during these COVID days! Stay Safe and we are another week closer to HERD IMMUNITY!!!!!

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