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Update on the Economy and Investment Markets

Welcome to the Stearns Financial *Poolside Chat.*

We are early in an important earnings season where we will see if the corporate earnings rebound is as strong as expected. So far so good, with average earnings growth over this time last year exceeding 30%. While Q1 looks to be good, most of our sources continue to expect even better earnings growth to be reported in July for Q2, settling back to more normal growth rates in 2022. Retail sales, unemployment and manufacturing data were all positive last week and surpassed expectations.

This increase in the "E" of the Price-to-Earnings ratio lowers concerns about valuations being rich. Based on current S&P 500 price levels, valuations are now projected to settle back to approximately 20 times earnings, **stretched but not a repeat of the bubble year 2000 where earnings growth couldn't compensate for sky high prices.** This is reflected in the blue dotted line in the chart below. https://www.schwab.com/resource-center/insights/content/pump-it-up-earnings-season-starts-off-strong

Source: Charles Schwab, Bloomberg, as of 4/16/2021. For illustrative purposes only.

Annual U.S. inflation readings have moved higher due to gasoline rising 9.1% in March. Half of March's inflation uptick is attributed to gasoline, the other half is largely due to "reflation" in the service industries: hotel stays, sporting event admission, car insurance and public transportation have all seen cost increases above historical averages. These prices are still below their pre-pandemic peaks. The year-over-year comparisons are expected to be higher in April's numbers (especially for energy), which could push headline inflation above 3% and core inflation above 2%. All signs still point to this being a temporary reflation effect.

Surveys of both large and small businesses and discussions we've had with leaders in public and private companies indicate that pricing pressures up and down their supply chains are a concern. The weight of the evidence still suggests that we are in a reflationary environment as demand slowly returns to normal, rather than in one of exploding inflation.

The strong inflows into value stocks, and outflows from growth (especially technology stocks) has continued. These crosswinds are not unusual coming out of a tough environment and considering the concerns many investors have about the new corporate tax increases in the tech sector. Still, we remain in the techno-industrial revolution, and many large technology stocks have recently recovered some of their losses despite daunting headwinds. This is due in part to expectations their 2022 earnings growth will exceed their earnings decline as a result of higher taxes.

SFG's Take: Our three pillars of recovery (i.e. COVID-19 vaccine progress, corporate earnings growth, and economic health recovery) are still moving in a positive direction in the U.S. These pillars are more uneven overseas, the primary reason that overseas high-quality companies are still generally selling at a discount to their U.S. counterparts.

Our fourth pillar of recovery, the wildcard scenarios (shifting market sentiment, interest rate/inflation trends, tax changes, unwillingness to vaccinate, COVID-19 variant growth, etc.), remains a concern and a reason to stay grounded. SFG remains positive on certain investment areas and cautious in others.

Key Points to Consider

- **Jobs, Jobs, Jobs** – the growth in nonfarm payrolls in March was very strong with 916,000 jobs added and an upward revision of nearly 90,000 in February. The downside is that we still have nearly 8.5 million jobs to regain to get back to pre-pandemic levels. The good news – nearly every sector added jobs in March and those industries tied closely to the economy's reopening (such as leisure and hospitality) made substantial gains.

  A future trend predictor is also positive – the Job Openings and Labor Turnover Survey (JOLTS) from the Bureau of Labor Statistics has sharply recovered, surpassing their pre-pandemic levels. Openings in February reached 7.37 million, just 171,000 below the record high in November 2018.

- **Cash, Cash, Cash** – Strategas reports that cash on the balance sheets of U.S. public companies in the S&P 500 is over $2 trillion, while cash in bank deposits has surged to a record $15.7 trillion (with a surplus $4 trillion that could find its way back into the economy as spending increases), even as money market balances remain above $4 trillion.

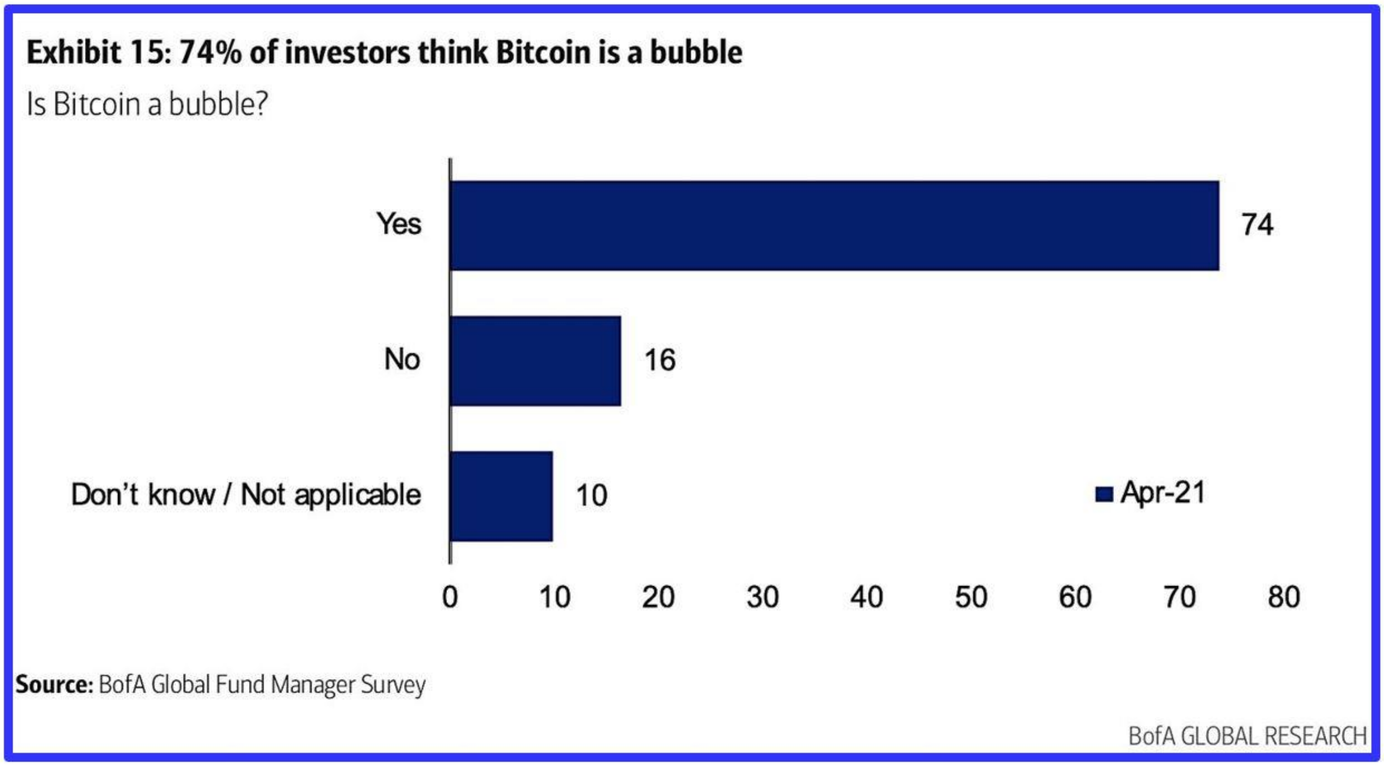
  They expect that corporate cash will be whittled back a bit to buy back stock, pay down debt and invest in future growth.

Frequently Asked Questions

Q: Are bitcoin's upward moves sustainable or a bubble? What about Coinbase that recently went public?

A: Fascination over bitcoin remains among young investors, and more seasoned investors have jumped on the cryptocurrency bandwagon. For some, their FOMO

(fear of missing out) got the best of them. This recent survey suggests bitcoin is more of a bubble:



While we can't say if bitcoin, or the new crypto company Coinbase, are going 20% higher or lower next, we can predict high volatility.

The sell-off in bitcoin, Ethereum, and Dogecoin last week has been ferocious. By CNBC's tally, crypto currencies have plunged **$260 billion** from Thursday to Friday, more than the entire market cap of Exxon Mobil! https://www.cnbc.com/2021/04/23/bitcoin-btc-price-plunges-as-260-billion-wiped-off-cryptocurrencies.html

Crypto assets were rattled last weekend as the post-Coinbase mania turned on itself. Bitcoin has now plunged below $50,000. The fall came just days after it hit a record of $64,870. Volatility also buffeted other cryptocurrencies including Ether, Binance Coin, XRP and Cardano.

Bulls say:

- **Corporations are increasingly adding bitcoin to their list of ways customers can buy products or services.** More than two dozen now have bitcoin on their balance sheets. They include Tesla, Square and PayPal. Mastercard and Visa are working on a similar plan to allow customers to use crypto to buy things. (Note a true digital currency future would put these two companies out of business – not very likely.) https://markets.businessinsider.com/news/stocks/five-companies-now-embracing-bitcoin-1030282422
- **Financial institutions are increasingly embracing bitcoin.** The nation's oldest bank, Bank of New York Mellon, announced in February they will soon give customers the same access and protection for cryptocurrencies they give other assets. (No, FDIC insurance is not part of the protection.)

- **Lawmakers are being lobbied by a powerful group** including Fidelity, Square and Coinbase Global, part of a new Crypto Council for Innovation that launched this month.
- **Bitcoin exchanges are getting more secure** after several major hacks and thefts. Citigroup says the crypto system is becoming increasingly professionalized.
- **Bitcoin is becoming accepted by major investment institutions. It is now being used as a diversifier in currency funds** at giants like BlackRock and Morgan Stanley. (Small amounts so far – these entities are dipping their toes in the water.)
- **Bitcoin itself has limited supply and growing demand**.

Bears say:

- **Major countries will pull the rug out of demand** as they attempt to thwart illicit use of crypto currencies by numerous underworld operatives, as well as support their own standard currency. China has already banned bitcoin and other cryptocurrencies in favor of their own new digital yuan.
- **The diversification value of bitcoin will diminish** as it becomes more mainstream. It is doubtful it will become the new gold of the world. (JP Morgan)
- **The damage to the environment is staggering**. (Note renewables like hydroelectric, wind and solar energy make up an estimated 73% of energy used in mining, according to Coinbase, but China is responsible for 65% of the mining and is using a wider mix of energy sources.)
- **The momentum will stall at some point.** 84% of major public corporations never intend to own bitcoin. ***Gartner survey, March 2021***
- **The IRS considers crypto an asset, not a currency**, creating tax challenges using it as a medium of exchange.
- **Bitcoin is volatile**, acting more like a thinly traded small-cap stock than a larger, more liquid stock. 95% of all the bitcoin that has been produced is controlled by 2.4% of the accounts. ***WSJ, 4/20/2021***
- **Law abiding people and corporations who have signed social responsibility pledges are supporting nefarious criminals and terrorists by buying and owning bitcoin.**

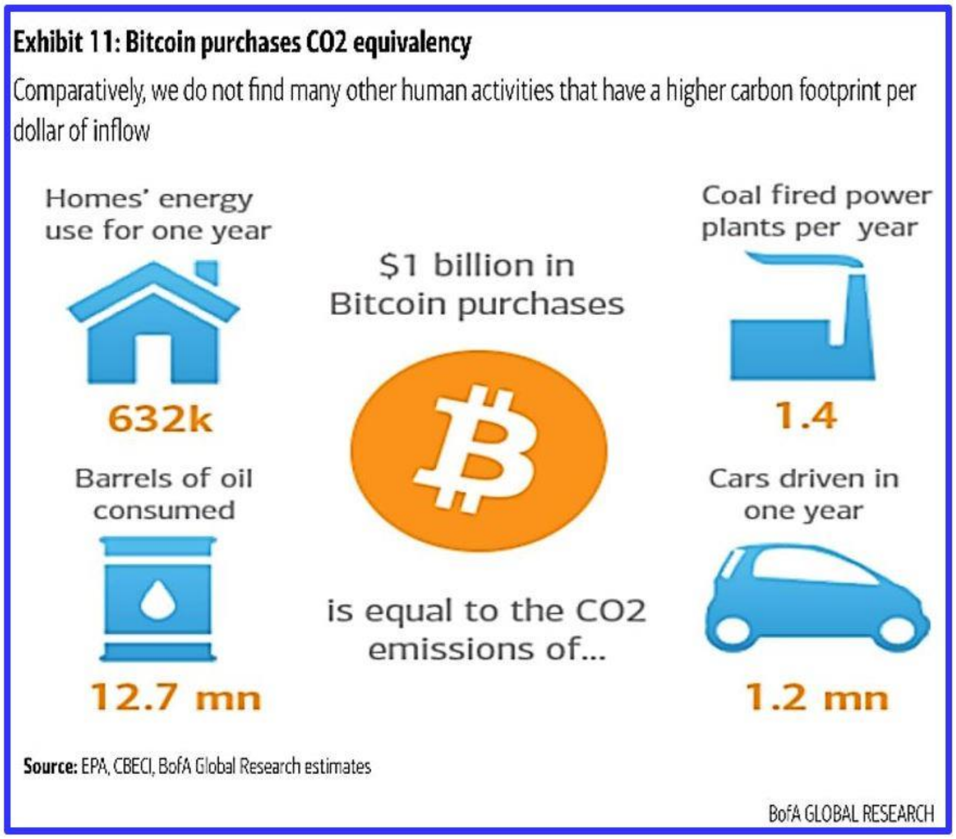
The major risks remain regulatory – the U.S. government and other governments have been considering ways to limit bad actors from having access to cryptocurrencies. **A recent report suggested the U.S. Treasury may crack down on money laundering using digital assets.** Other factors contributing to recent volatility are Coinbase insiders dumping equity, excess leverage, a report of an outage hitting Xinjiang Bitcoin miners, and just sheer exuberance.

Some of these governments are also designing their own digital currency which could take a percentage of the demand off the table. Here are just a few of the headlines that got our attention:

- **Turkey bans crypto payments for goods and services –** Turkey has barred the use of cryptocurrencies to purchase goods and services in an effort to protect consumers against volatility and illegal activity, threatening a boom in the country’s fast-growing digital money markets. ***Financial Times, 4/16/21***

- **India will propose a law banning cryptocurrencies**, fining anyone trading in the country or even holding such digital assets, a senior government official told Reuters in a potential blow to millions of investors piling into the red-hot asset class. ***Reuters, 3/14/21***
- "To the extent it is used **I fear it's often for illicit finance**. It's an extremely inefficient way of conducting transactions, and the amount of energy that's consumed in processing those transactions is staggering." **U.S. Treasury Secretary Janet Yellen**, ***CNBC, 2/23/21***

How big is the environmental damage from cryptocurrencies? Bank of America global research calculates the carbon footprint of Bitcoin mining to be pretty staggering. As mentioned above, renewables need to be more widely used if crypto becomes a more mainstream medium of exchange. Every $1 billion in BTC purchases is equivalent to the following:



SFG's Take: Bitcoin and other cryptocurrencies are speculative assets. We're not a fan of using crypto as a substitute for gold. Its diversification benefits have yet to be tested in more normal (non-pandemic) conditions.

For those who simply want to look cool to their kids and grandkids, we have the same advice as any hyper-aggressive area – don't invest so much that you'll lose sleep if it doesn't work out.

Summary

SFG's three pillars of recovery remain in positive trend territory, with COVID-19 news being more mixed. Wildcard risks in our fourth pillar remain elevated. SFG is balancing numerous opportunities and threats in our portfolios, customized to our clients' unique circumstances.

In **growth** portfolios, we are leaning into a variety of short- and intermediate-term asset classes and trends that we believe have favorable forward-looking risk/reward relationships.

In more conservative **growth and income** portfolios, we are taking more steps to be defensive, while still striving for positive real returns over inflation.

Our COVID-19 endgame investing approach can be summed up by six themes:

- Diversification with a balance of offensive and defensive measures, depending on the desired risk tolerance of our clients,
- Underweighting, or avoiding areas of higher future concern,
- A focus on higher-quality investment themes,
- Identifying and implementing buying opportunities that may be appropriate for more growth-oriented portfolios,
- A more defensive stance using different portfolio tools for more conservative growth and income portfolios, and,
- Utilizing select alternatives to traditional bonds and stocks.

~ Dax, Dennis, Glenn, Jason, John and PJ
(the SFG Investment Committee)

REMINDER THAT COVID-19 OFFICE HOURS ARE STILL IN EFFECT

Please keep in mind that we continue to maintain limited in-person service hours at our offices in Chapel Hill and Greensboro, NC until we can all return to the office safely.
If you have a need to meet with us in person or to pick up or drop off documents, we are glad to accommodate you. We also have a number of traditional and virtual tools to facilitate document transfers. Please contact us in advance if an in-person meeting is needed.

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