A Brave New Financial World? – 1/3/2021

by Robert G. Kahl, CFA, CPA, MBA

2020 ended with nearly 20 million people receiving unemployment benefits. At the end of 2019, there were about 2 million people receiving unemployment benefits. The unemployment claims reflect the status of employees. Employers are not doing any better.

According to a poll conducted during November 21-24 among Alignable's small business owner/members, 48% of small businesses risk permanent closure. While 45% of restaurants risk permanent closure, some categories were higher. 50% of consumer retail, 60% of beauty salons, 61% of gym/fitness clubs, and 62% of travel/hospitality risk permanent closure. The loss of capital associated with many of these business closures is devastating for many families and a government check of $600 or $2,000 will not make up for it.

In a normal world, a high level of unemployment and a high level of imminent closure of many small businesses is not favorable for the stock market. However, 2020 was an unusual year. During the year, the S&P 500 Index increased by 16.6% and the NASDAQ Composite Index, which has a heavy weighting in technology, increased by 44.07%.

A Brave New Financial World? – 1/3/2021

by Robert G. Kahl, CFA, CPA, MBA

While many companies trade at valuations that are relatively high, some companies now trade at valuations that make no sense based on traditional measures of revenue, net income, or cash flow.

Tesla Inc. (TSLA) was among the largest cap stocks in the NASDAQ Composite Index that contributed to the Index's great performance. TSLA now has a market capitalization of $669 billion. The company has had annual operating losses since its creation, and now has reported two consecutive quarters of profitability. Apparently, that was enough to justify the dramatic rise in the price of the stock. TSLA now trades at a price/earnings ratio of 1417, based on the last twelve months of earnings. The price/revenue ratio is 25.2 and price/book value is 41.7.

Rob Arnott, et al at Research Affiliates wrote about the valuation of Tesla in their December commentary.

> The eightfold increase in Tesla's share price since its March low meets our two-part definition of a bubble: 1) implausible assumptions are needed to justify its valuation, and 2) buyer interest is based on a great narrative rather than being supported by a conventional valuation model.

They also provide a comparison to the nine largest car manufacturers in the world, some of which produce competing electrical vehicles.

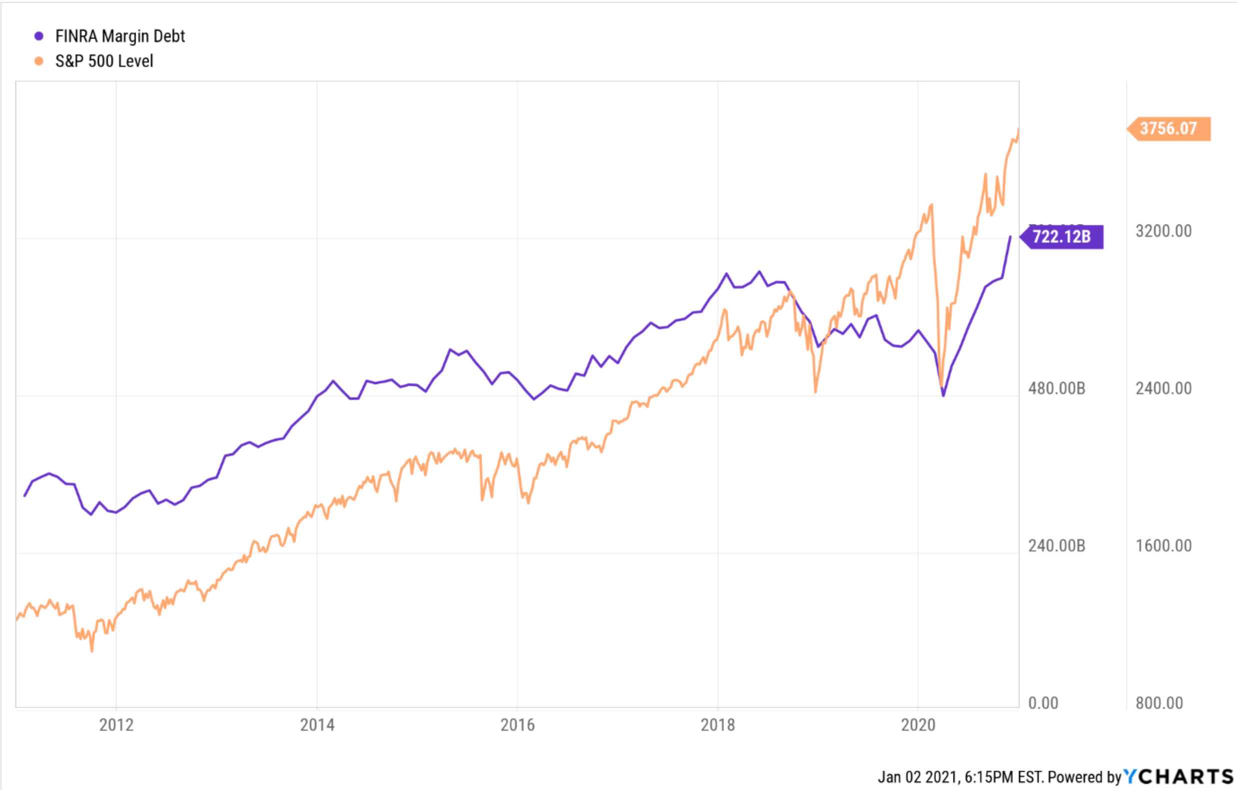
> And what could we buy using the *total* $608 billion (now $669 billion as of December 31) of Tesla's market-cap? How about the "Nifty Nine," the nine largest car manufacturers in the world—Toyota, Volkswagen, Renault-Nissan, General Motors, Hyundai-Kia, SAIC, Honda, Ford, and Fiat Chrysler? Yes, that's right, and we would still have $15 billion left over…

Tesla was not the only beneficiary of speculative exuberance. The ARK Innovation Fund held Tesla as its largest position, along with other companies that are involved in "disruptive innovation" which is the primary criteria for inclusion in the fund. Seven of its largest ten positions report net losses and are years away from profitability. However, in 2020, speculative interest was strong for "disruptive innovation" and the fund's net asset value increased 152.5% during the year.

Margin debt reported by FINRA has increased to a record high level $722 billion at the end of November, an increase of $143 billion since December 2019. As the chart below illustrates, margin debt and the S&P 500 Index usually move in the same direction. Margin debt is a source of volatility in both directions.

A Brave New Financial World? – 1/3/2021

by Robert G. Kahl, CFA, CPA, MBA

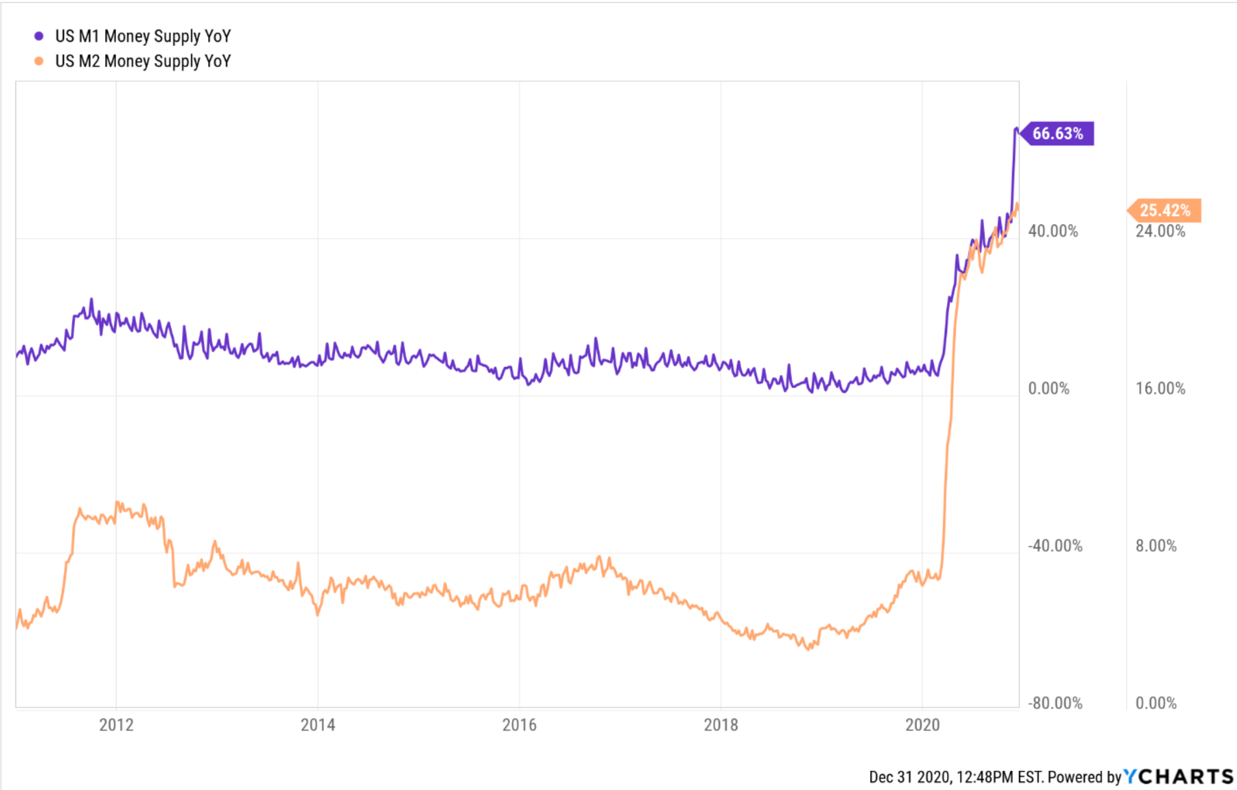


The Federal Reserve's monetary policy has been very accommodative. M1 money supply consists of currency and checkable deposits and it increased by 66.6% during 2020. M2 money supply consists of M1 plus other liquid assets such as savings deposits, small time deposits and retail money market mutual funds. M2 increased by 25.4% during 2020. The graph below shows a year over year comparison starting in 2011.

Rather than get the money supply growth under control, the Fed instead has decided to redefine the monetary aggregates and release information less frequently. On December 17, the Fed announced that it will redefine M1 and M2 money supply measures by shifting savings deposits to M1, which will lower the calculated growth rate. The adjustment will be made retroactive back to May 2020. The Fed will also begin to release data monthly rather than weekly.

A Brave New Financial World? – 1/3/2021

by Robert G. Kahl, CFA, CPA, MBA



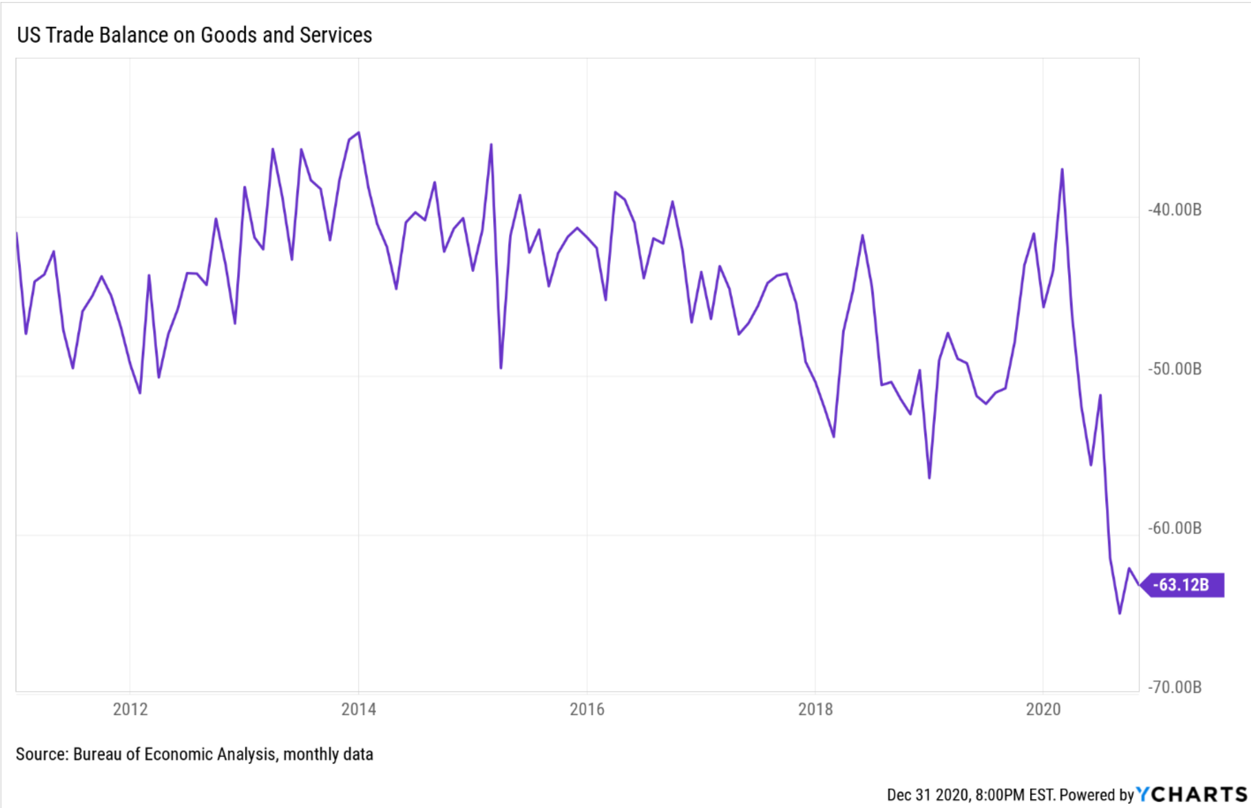
The US trade balance for goods and services has deteriorated further during 2020 and reached a near-record monthly deficit of $63.1 billion for October. The trade balance deficit has not been this large since 2008. The corona virus has reduced trade in services such as education and travel, in which the US has had persistent surpluses.

The US now has a combination of a high level of federal debt, ongoing large federal budget deficits, low interest rates that offer little incentive for domestic or foreign investors, and large trade deficits. It appears that Congress and the Fed are ringing the bell to end the US privilege of providing the world's reserve currency.

During 2020, the US dollar declined by 4.4% for the year. Nothing alarming – yet. Both gold and silver have received more investor interest during the year. According to Steve St. Angelo, a precious metals analyst, US Mint Silver Eagle sales for 2020 have more than doubled from 2019 and US Mint Gold Eagle sales have increased more than 5-fold.

A Brave New Financial World? – 1/3/2021

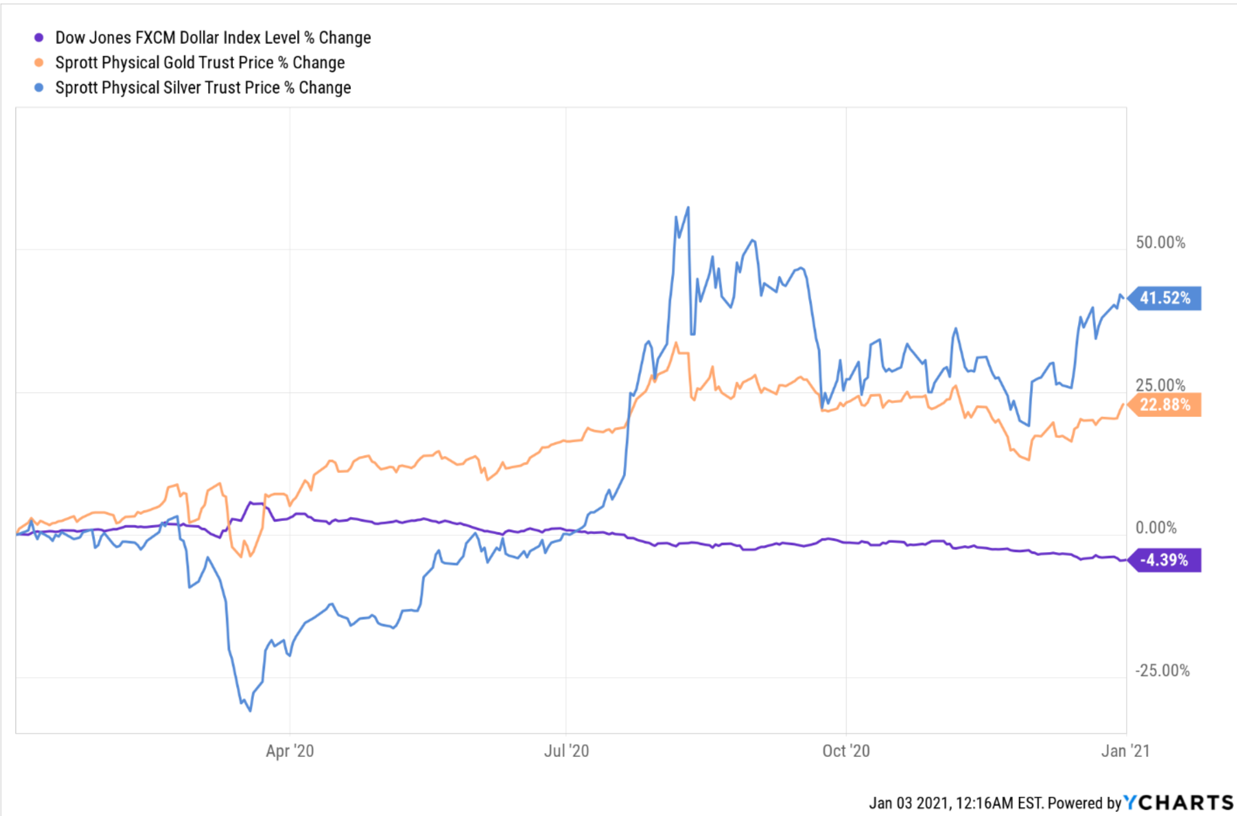
by Robert G. Kahl, CFA, CPA, MBA



Danielle DiMartino Booth, author and economic consultant, worked at the Federal Reserve Bank of Dallas and has an insider's knowledge of the Fed. She worked closely with Dallas Fed President Richard Fisher. During an interview with Eric King, she commented on central bank policy.

> I call it "Monetary Madness." And you're right, it is global. So you have to look to gold. And I look at it on a more pragmatic level than simply the idea of fiat money destruction. I look at it as central bankers are stoking financial instability with all of this money printing that is only going to the top tier of earners….
>
> What I am saying is the transmission mechanism into the financial markets making them so overvalued, that is where I see the validity and the value of holding gold. Because gold has proven itself time and again, whether it's in inflationary or deflationary times by the way, that when there is financial instability, when correlations line

up for most asset classes, gold is going to go the other way and provide the perfect hedge for your portfolio.



As we enter the new year, most stocks are at relatively high valuation levels regardless of which metric you use for a valuation comparison. Stock market valuation levels have already priced in a robust economic recovery before there is data to support it. Interest rates are too low given the rapid increase in money supply and federal fiscal stimulus on a grand scale. In 2021, I believe we will continue to see more investor interest in precious metals as an alternative form of liquidity that can maintain its value.

If you have any questions or comments, please contact me.

Robert G. Kahl
CFA, CPA, MBA