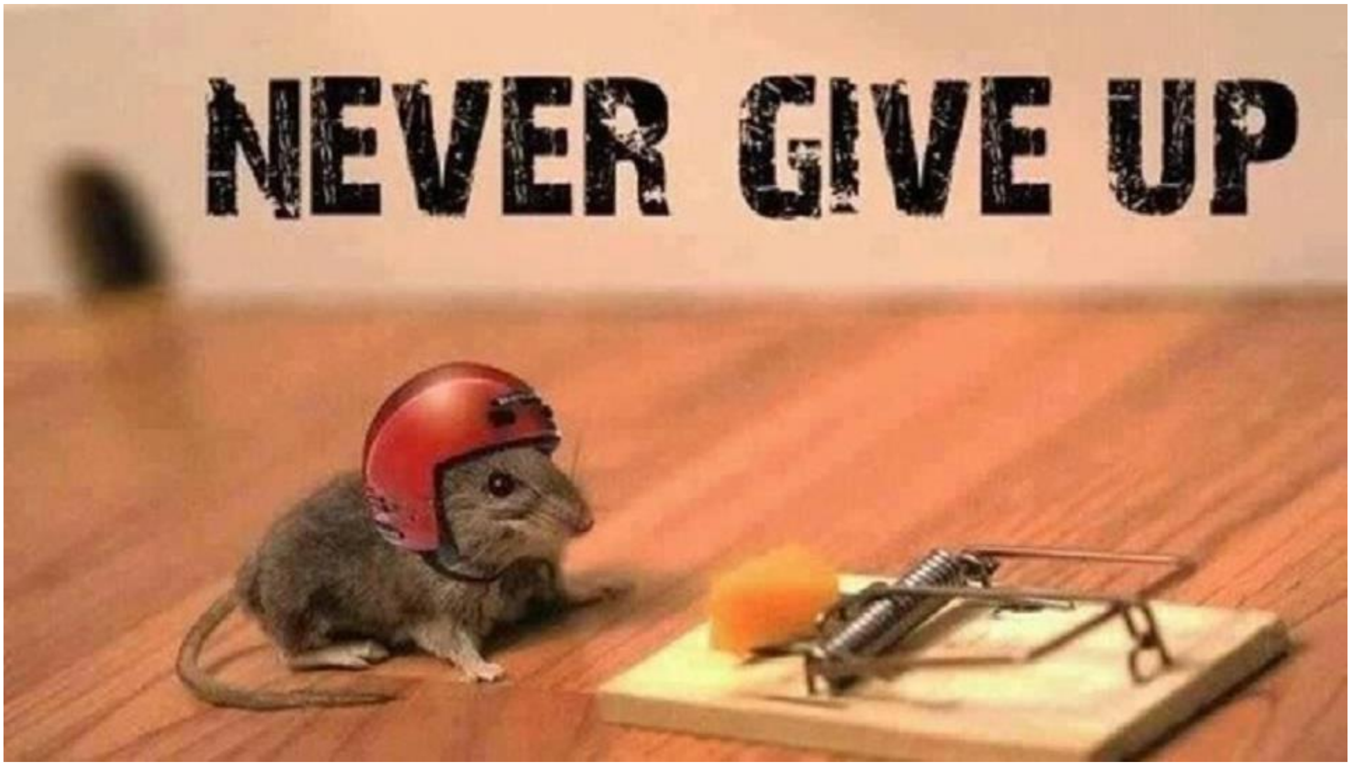
Coming into 2020, everyone on the Street had their tag phrases for 'seeing clearly', or having '20/20 vision' for the year. Irony of all ironies, none of it could have been further from the truth, as a pair of very fat tail events were headed our way in a year-long event that would forever change the landscape of the economy, global markets, and the fortunes (or lack thereof) of so many people.

Einstein on the Floor

Trader Peter Tuchman wears 2020 glasses to celebrate the New Year at the New York Stock Exchange in New York. REUTERS/Bryan R Smith

With that, we give you part one of Stillwater's four part *This Year in the Markets.* First up is the top down, next week the bottom up, and then a look at which strategies and funds worked and will continue to, and then we will wrap up next Friday with a diversions special, *Shit We Plan on Doing When this Ends,* as we sincerely hope that 2021 is the year when your little inner mouse thrives.



As readers of this finely curated piece of financial journalism know, we are big fans of the late Anthony Bourdain. One of our favorite episodes of his acclaimed production for CNN, ‘Parts Unknown’, is when he took his brand of culinary gonzo journalism to Scotland.

‘Everything changes, yet everything stays the same’, is how he starts the program with an almost eerie look across a wind-blown lake to the Letterewe-Estate hunting lodge. We could think of no better theme for the times we are living in, and the traveling we have done across a most extreme Gaustian bell curve.

The Bells Are Ringing

Everything Changes

For the ‘everything changes’ side of the ledger, it’s tough to even begin to think of how the world is different now from where it was a year ago. Sadly, we’ve lost 2 million people worldwide to Covid-19 with 100 million infected, according to the Johns Hopkins coronavirus resource center. That said, the vaccine is here and rapidly making its way into the hands of those that need it. In the authors very own 10-person immediate family, three people, two recent octogenarians and one schoolteacher, will have it by the end of next week.

The Answer

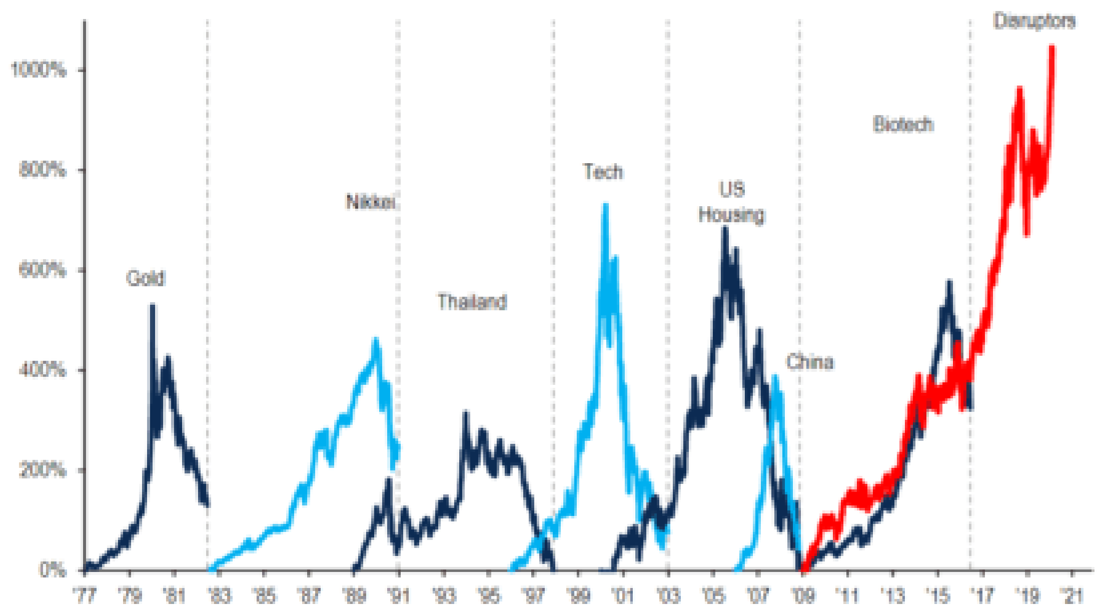
While the previous pandemic list of comparables is short, the Spanish Flu of 1918 is the one most often referred to as we grapple with the fallout. While Covid-19 has left its mark in terms of infection and death, it pales in comparison to the 50 million killed worldwide by the Spanish Flu.

‘Mask Up’ circa 1918

Putting aside the past, what has changed the most in a very short period of time is the shift out of the office and large cities, and into the home and other remote locations. There is a reason that any company with a 'cloud technology' or a 'stay at home' theme is afforded a premium valuation well above the rest of the market. Call it what you will, but we think we know a massive bubble when we see it, and we aren't alone. This chart from Merrill Lynch shows where 'disruptors' fit on that scale, which covers a whole slew of thematic companies that benefit from the massive shift we are seeing in the economy.

History Rhymes

Chart 2: History of asset bubbles past 40-years



Cases in point, the Amazon of pet supplies delivered to your home, Chewy, is currently worth \$45 billion on \$7 billion in sales. Peloton is valued at about the same, with only \$3.5 billion expected revenues this year. And finally, Carvana, the online car retailer, goes for \$50 billion, on \$5 billion in revenues, with an expected loss of \$2.00 per share in 2020. That's a total of \$15 billion in revenue worth \$150 billion in market capitalization, and something in the realm of \$2.00 to \$3.00 dollars in earnings. Nice work, if you can get it.

Used Cars.com

In the beginning, even really smart people like Tom Siebel thought that technology would take a hit as global purchasing took a hit. Nothing, and we mean absolutely nothing, could have been farther from the truth. While manias and bubbles come and go, what changes is where the themes emerge, and who makes the life changing amount of money and gets to start flying private. As anyone visiting the new NetJets pop-up tucked between the Safeway and the Shell station in the Sharon Heights strip mall can attest to, these are the days of milk and honey on Sand Hill road in Palo Alto.

Tech's Holy Mecca

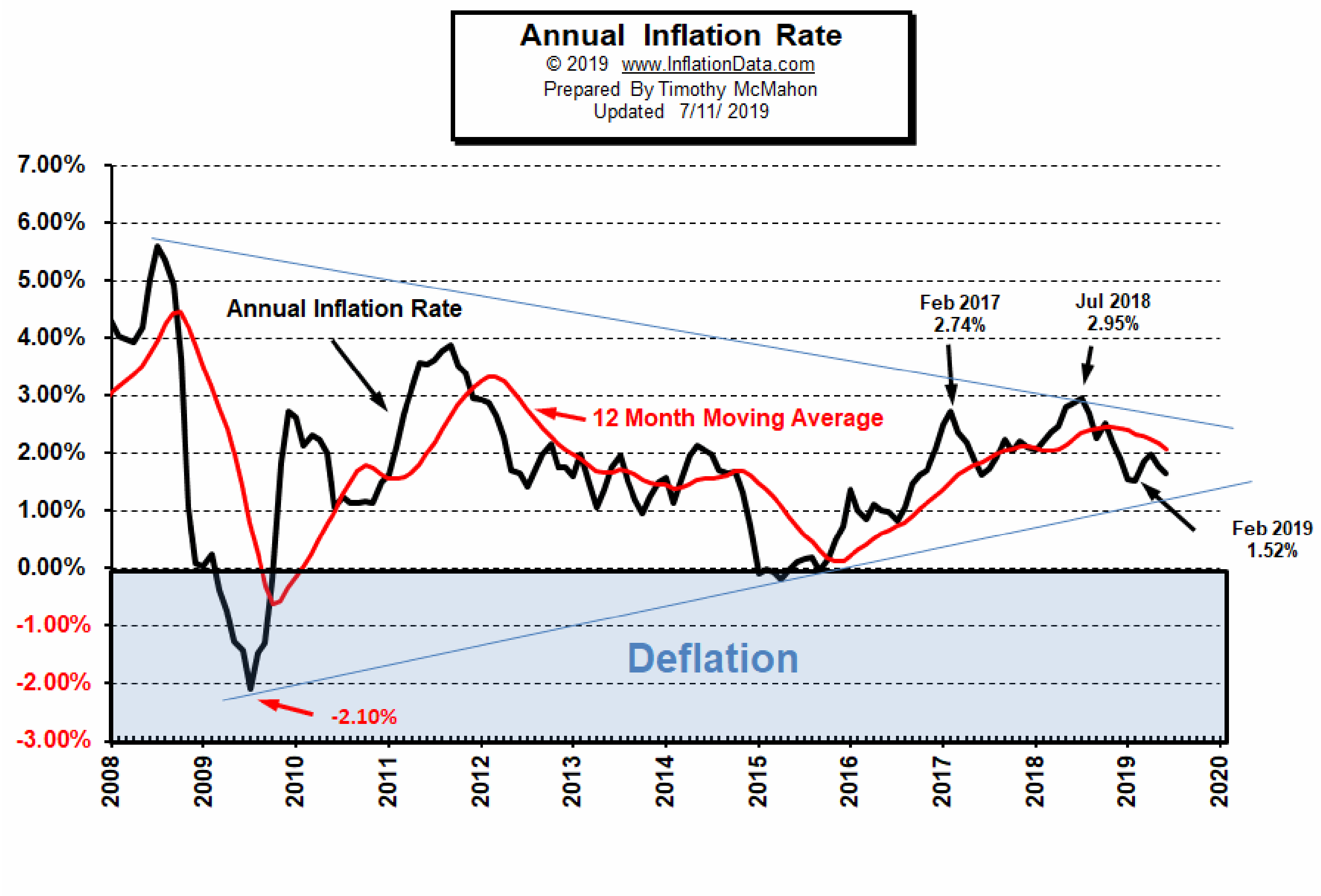
Everything Stays the Same

First thing we can say about everything staying the same, regarding the 'tortoise wins the race' kind of management we employ on our main body of work, is that it sucks when markets enter the mania and bubble phase. The longs are too stable and pedestrian to keep up, and we leak out basis points trying to get ahead of the inevitable bursting of said bubble. Same thing happened in 2000, and it was a demoralizing period as the party was on, and we had to stand on the outside looking in.

Same, Same!

The other part of staying the same, is the Federal Reserve's willingness to step in and backstop losses, although this time to an extreme we could not begin to have imagined. The idea that Mr. Jerry Powell and his people would be stepping in and buying junk bond ETFs is now a reality, and we simply don't know how you get out of the moral hazard defense business without major breakage to the system. We mean, on a Thursday well into the future, is there going to be a press conference where whomever is then Fed chair comes out and says we are getting out of the monetary drug dealing business? As long as inflation stays below 2%, it's dime bags for everyone.

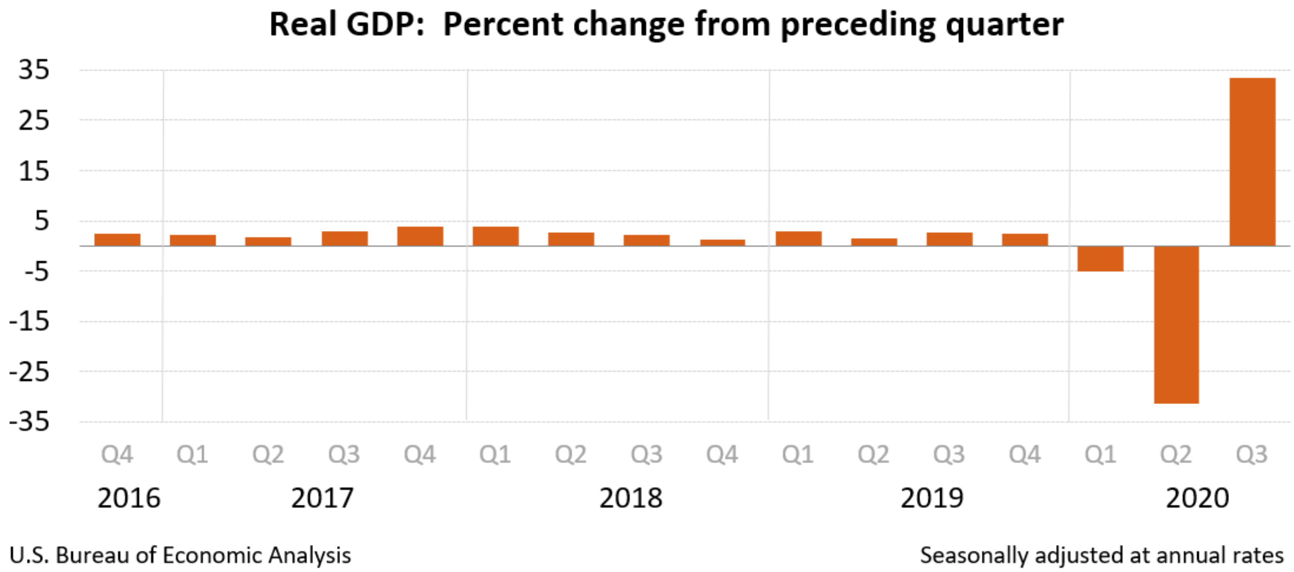
The Line in the Sand



Economy

Since the lows of April, the equity market has been saying that the dent Covid-19 put into GDP in the first and second quarters of 2020 was a massive anomaly, and that a more normalized rate of 3% to 5% is what we should expect into 2021. That said, this chart of real GDP will never look the same. Good luck in the future trying to see the difference between 2% growth and 5% growth. Regardless, this was one hell of a ride. Is down 35% and up 35% in gross domestic product growth over a two-quarter period even a lot? Ummmm, yes.

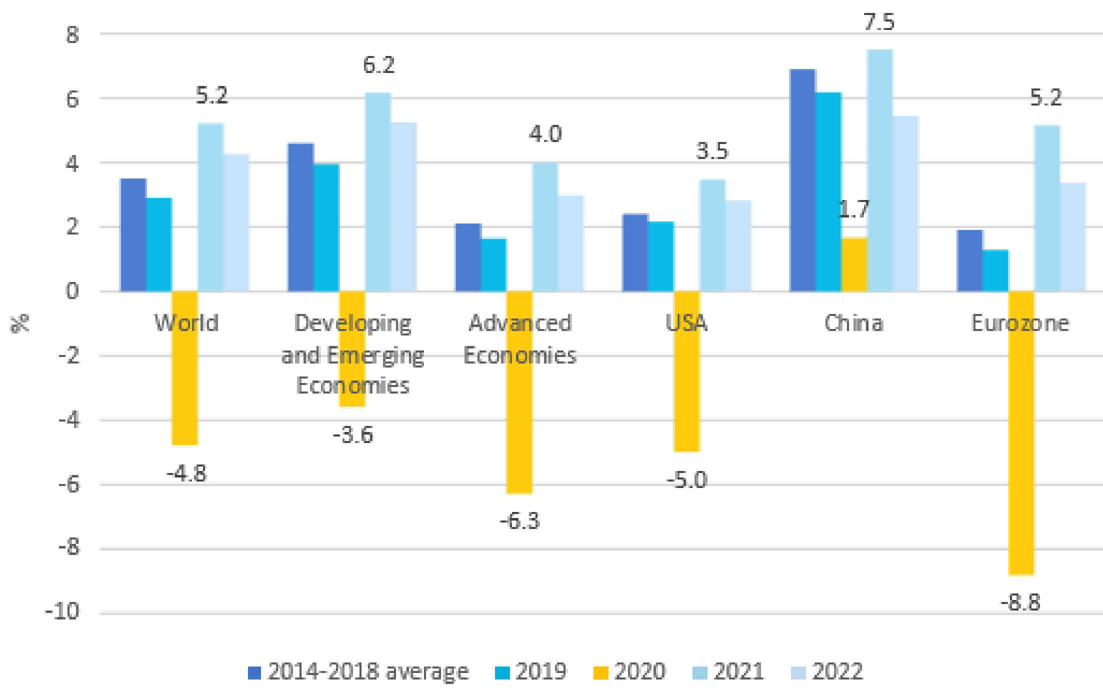
Real GDP Volatility



So, what does 2021 look like? As one can imagine, estimates are all over the place. According to Morgan Stanley, consensus clocks in around 3.8%, though their 2021 estimate of 5.9% is well above the rest of the Street. Across the board though, growth moderates to 2.5% to 3.0% in the out year. If you have the time, the piece they put together titled, *2021 Global Economic Outlook: The Next Phase of the V*., goes deep with their ultimate call being lean long emerging markets, as that's where Covid is on the wane and growth looks to be the highest. This chart looks about right in terms of recovery and then things getting back to normal.

Big Bounce Then Normalization

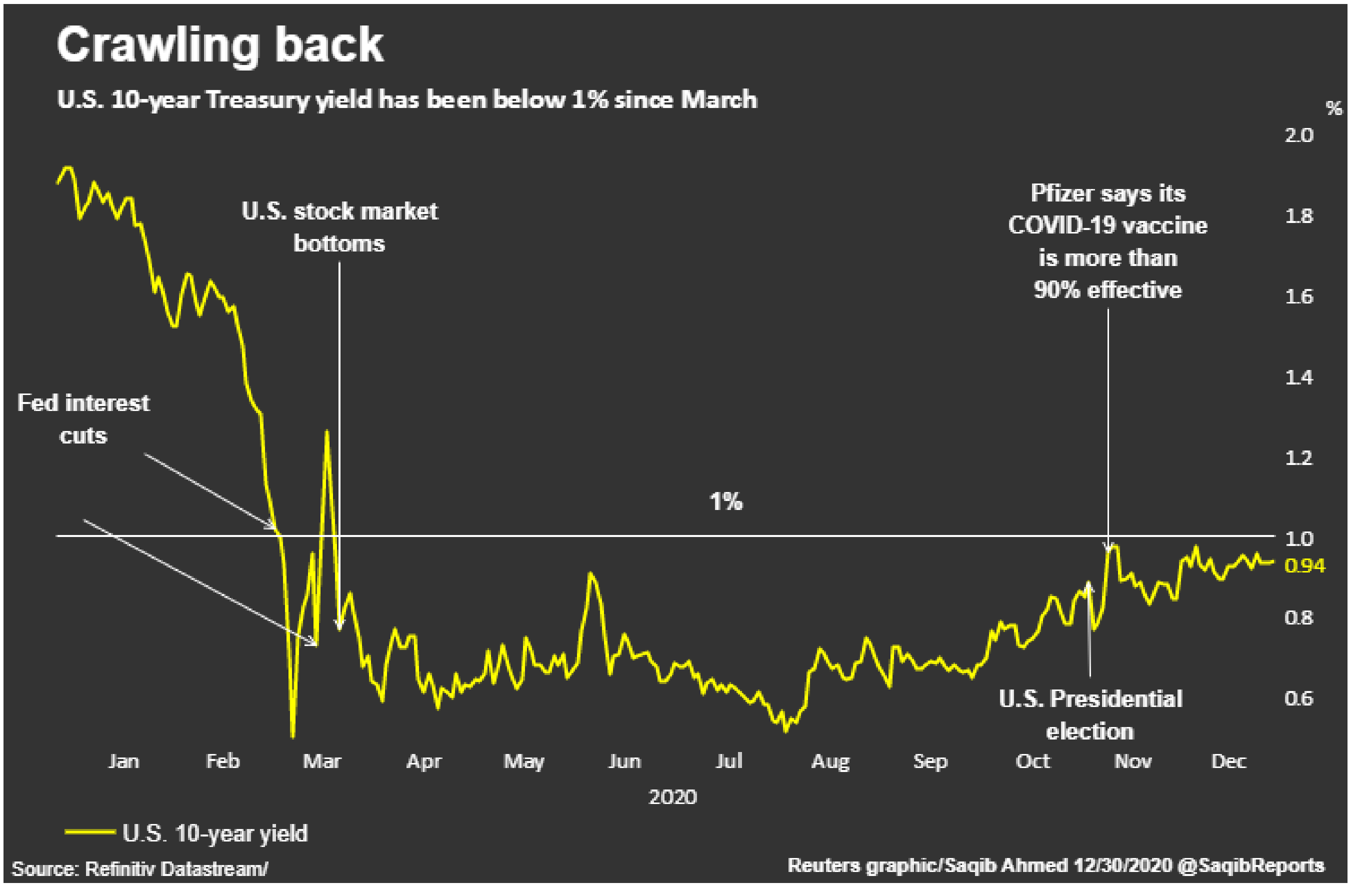
Global Real GDP Growth Baseline Forecast: 2014-2022



Interest Rates

In our reasonable view of the equity markets, certain sizeable sectors, namely technology and anything that benefits for a post-Covid economy, is in a bubble. But as Mohammed El-Erian pointed out recently, some think it's a rational one based largely on the fact that central banks have backstopped losses and driven rates to near zero to stoke investor spirits and force money into speculative places to make any sort of return. But with God as our witness, if interest rates rise materially, and the equity market keeps on its blistering path higher, we are getting out of the business, because nothing, literally nothing, will make sense anymore.

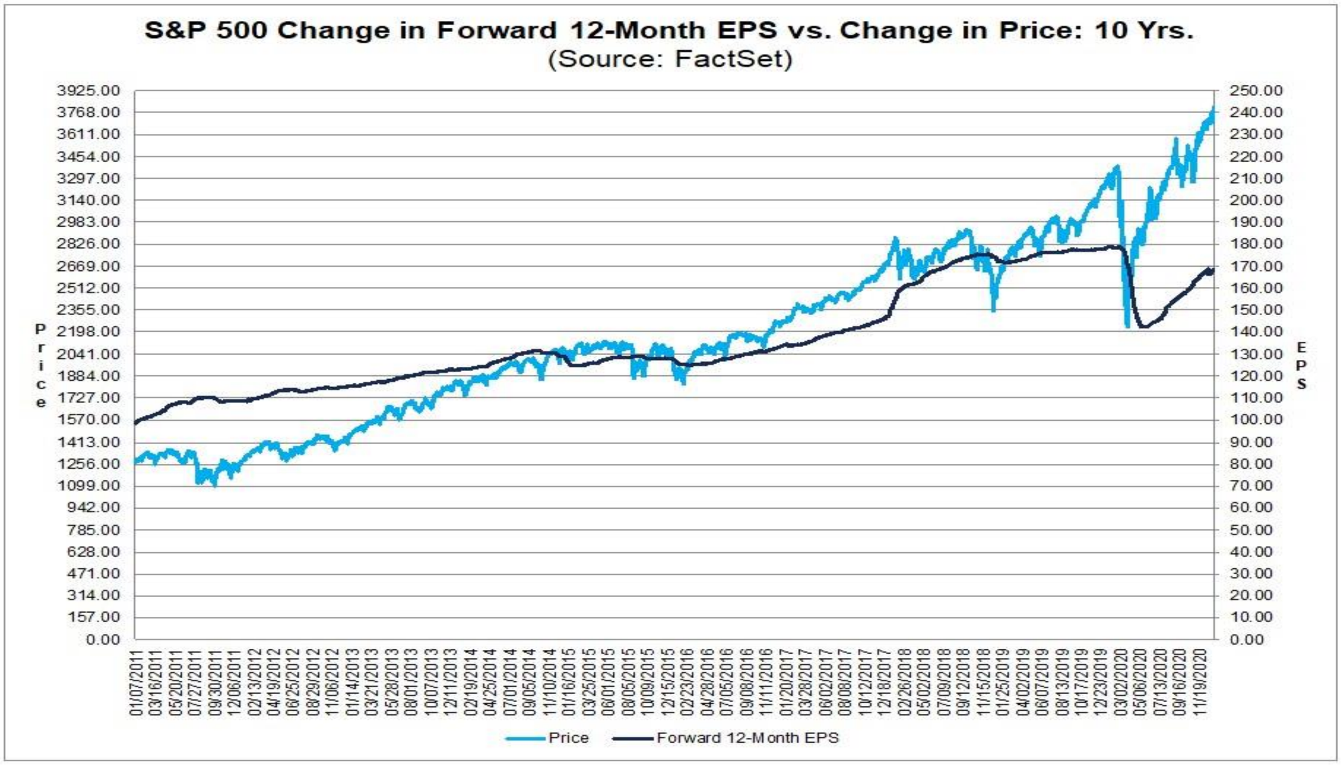
Long Way from a Two Handle



Consensus Outlook

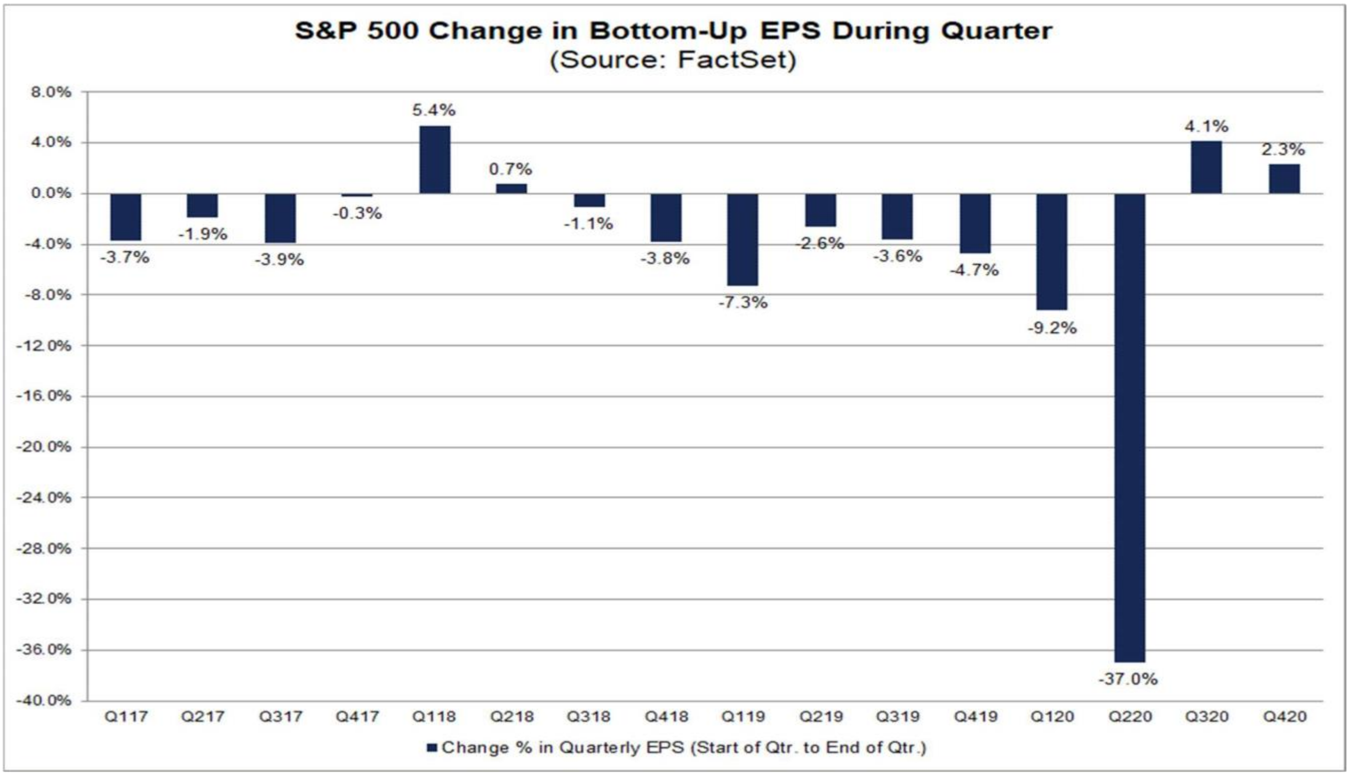
Most any way you look at it, equities are pretty well valued, if not excessively so in some sectors and companies. With the monetary backdrop being so accommodating, it's hard not to understand why. That said, with Covid vaccines being rolled out, and the prospect for higher yields ahead, are we possibly getting near the end of this phase of the most raging of all bull markets? We think so, which clearly puts us in the money losing minority last year. The delta widening between earnings and valuation can only last so long until something has to give.

Stocks Up, Earnings Flat



The biggest, and by that we mean colossal, reason for the flattening of earnings is the cratering in the second quarter of 2020. Especially given the absolute nuclear winter that arrived shortly after Covid brought everything in the economy to a screeching halt. But as the chart below from FactSet shows, we were already in an earnings recession, as Q2 2020 was the eighth in a row for earnings contraction. While that's not a good thing, the rebound is going to be 'wikid pissah' strong.

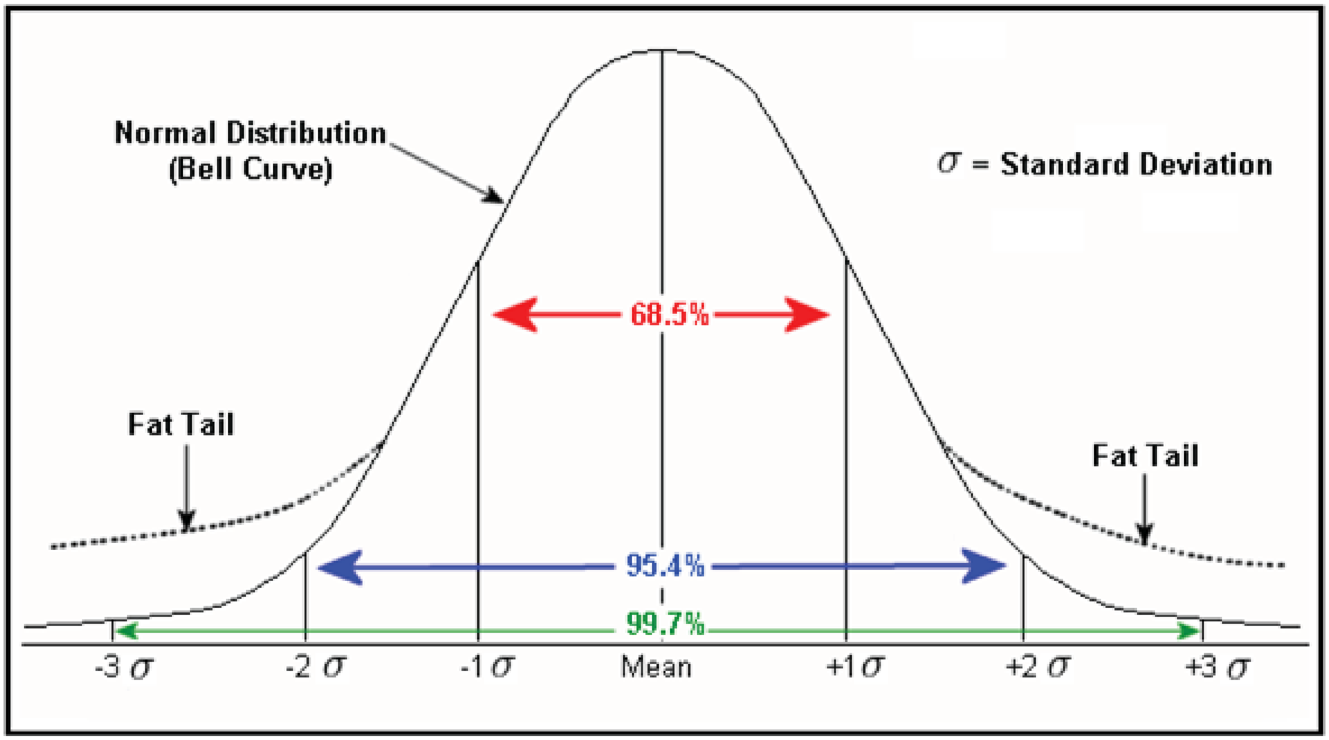
A Coiled Spring



Diminished Tail Risk?

Back to what we said in the beginning, if ever there was a year where the full gamut of the bell curve was run, it was 2020. We quite literally went from a seizing up of the economy and capital markets, to a free for all amongst any company or individual with access to liquidity. The challenge however, is that in a K shaped recovery, a whole slew of individuals and companies, mostly small and private, get left behind. A reasonably thought-out concern of ours, is this kind of bifurcated recovery is going to take a long time to achieve an actual four engine throttle up.

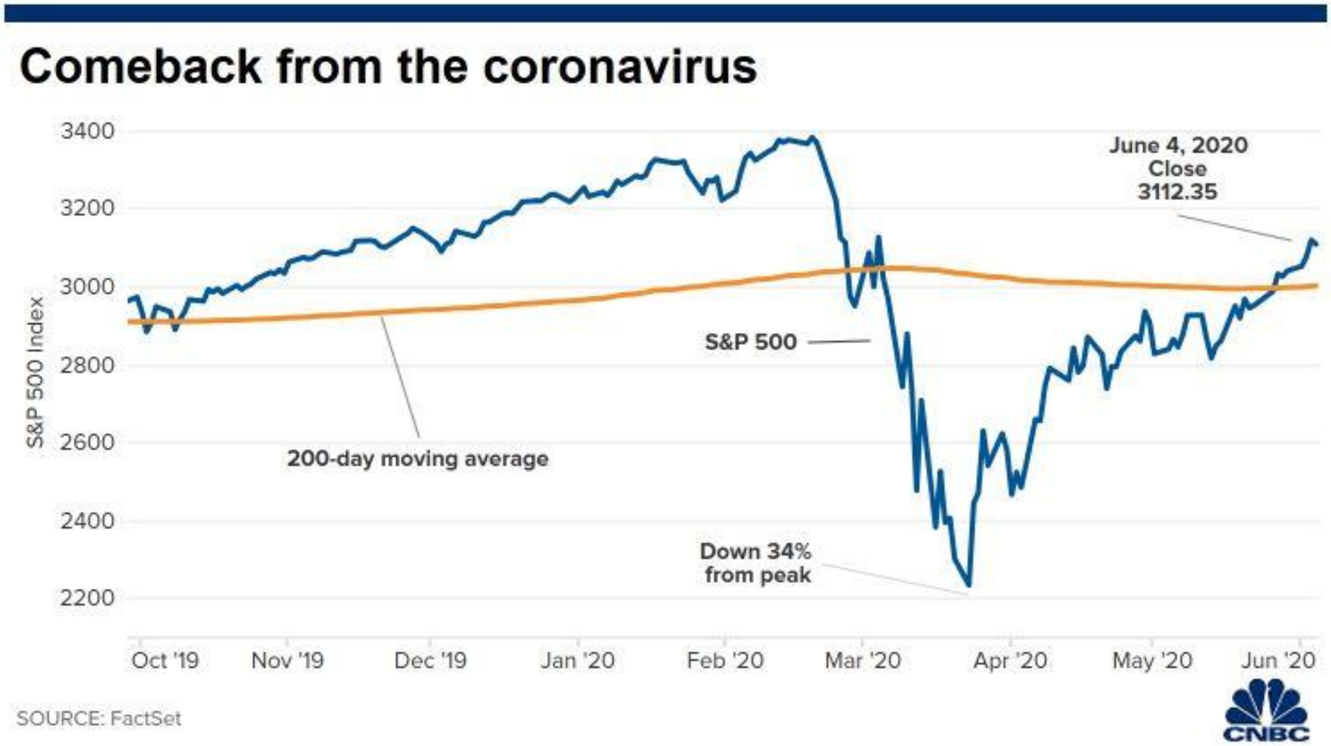
Anyone Up for Normal?



Excused Absence

If you've made it this far, you are probably a regular reader, or at least like the pictures and the big words. If that's the case, you know that the weekly writing has taken a hiatus since the election. This was partly planned, as the marathon that got us to November 3rd was a long and arduous one. But there was also the exhaustion from trying to navigate markets that we have never seen before.

Wild Ride



To add to the 2020 dumpster fire on the home front, there was a death in the family in January, and the Niners lost the Super Bowl a month later. As my fourth San Francisco Irish Catholic buddy Moriarty is fond of saying, "don't lose Super Bowls". But the straw that broke the camel's back was an unannounced nuke that went off in my personal life just in time for Thanksgiving. But back to the writing now, the best drug I know of. It's healthy, free, leaves no hangover, and always has me looking on the bright side of life, no matter how much the near term might be a challenge.

"Always look on the bright side..."

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