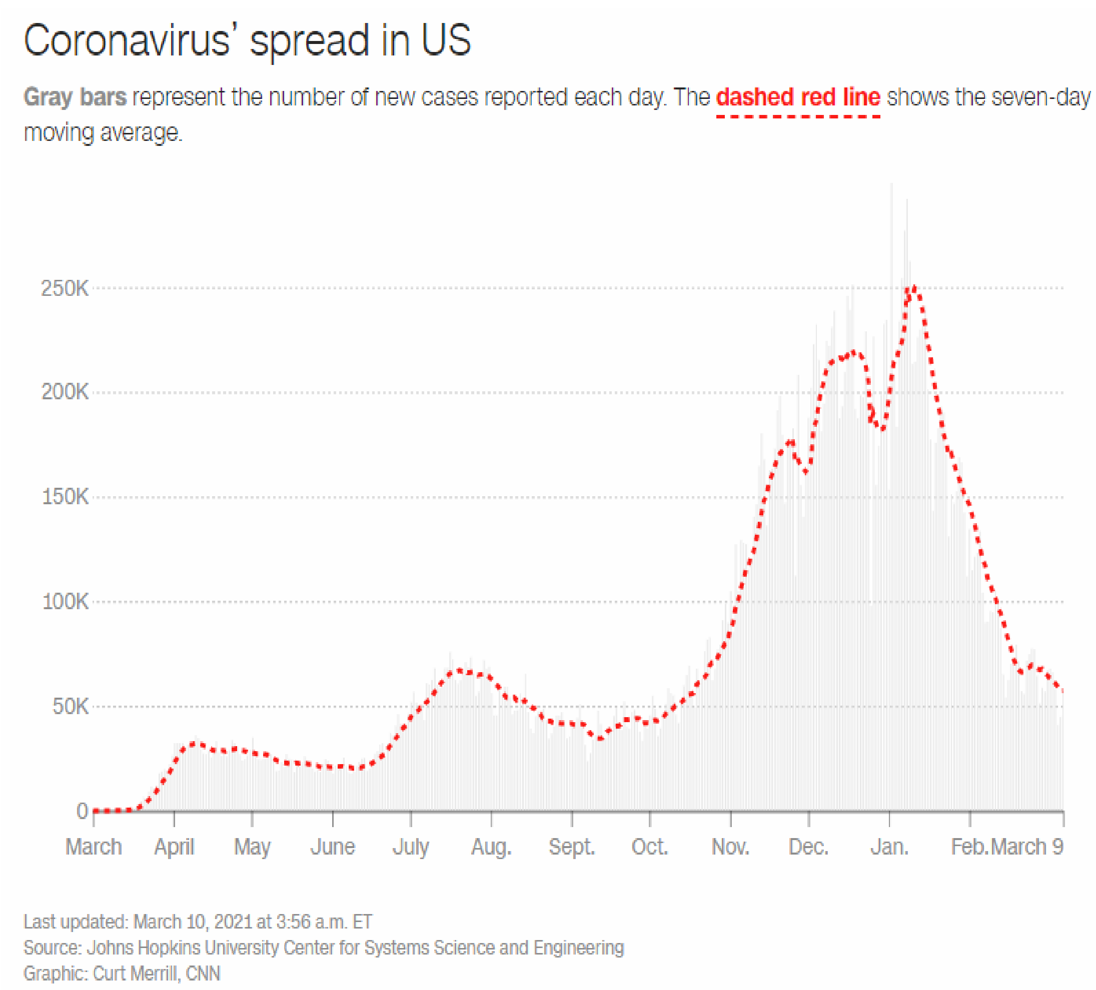
Chemung Canal Trust Company and Capital Bank, a division of Chemung Canal Trust Company

Investment Outlook - March 2021

COVID-19

Major stock market benchmarks have soared to new highs as Covid-19 case counts have slowed dramatically from the surge in December and January, and the pace of immunizations has quickened. Approximately 10% of the U.S. population is now fully immunized, and another 10% have received their first dose and will be fully immunized within the next four weeks. Those numbers were barely 1% six weeks ago, and the pace is quickening. Experts are now becoming less concerned about the availability of vaccines, and more concerned about those who will be reluctant to be vaccinated. This is a major – and welcome – change in the outlook in just a few short weeks. There is every indication that there will be enough doses for everyone by mid-summer.



States are making plans for schools to resume or expand in-person learning. Restaurants and theaters are operating at reduced capacity. Airlines are filling more seats, although the number of flights is still below normal levels. There's talk of Broadway theaters reopening in the foreseeable future, and fans will be welcomed back to March Madness, if at reduced levels.

Jobs and the Economy

The labor market has rebounded since December, with job gains in February rising to an above consensus 379,000. There were also minor upward revisions to the prior two months' reports, as well. While the February report is encouraging, the economy still has replaced barely half the jobs that were lost in the early weeks of the pandemic, and the unemployment rate edged down just 0.1% to 6.2%. We expect that the job market will continue to strengthen as the vaccine rollout accelerates and at least some workers in the most affected industries will be able to return. And, as we have pointed out in the past, while the number of people working is still significantly below the number working a year ago, incomes are actually up due to the massive stimulus measures enacted by Congress, with another $1.9-trillion on the way.

The manufacturing boom continued in February, as well, with the ISM Manufacturing Index coming in at a better-than-expected 60.8. An index above 50 is indicative of an expanding manufacturing economy, and the Index had been as low as 41.8 in the depths of the 2020 recession.

The ISM data so far points to real GDP growth in the first quarter at close to 5%, well above trend. The Atlanta Fed has been tracking real GDP growth at levels closer to 9%, which would amount to a *nominal* growth rate in double digits. Whatever the number, all signs point to a recovery that is more robust than our recovery from the 2007-09 recession, rendering comparisons to that period a poor barometer for the current cycle.

Another critical difference between the current recovery and all previous peacetime recoveries is the elevated levels of liquidity in the financial system due to the unprecedented fiscal and monetary policies put in place over the past year. Michael Darda, Chief Economist for MKM Partners, describes this as "dry tinder to fuel aggregate demand as reopening intensifies and broadens in the months ahead." The last several recessions never experienced such growth in liquid assets and household savings, and you have to go back to the post World War I and II periods to see liquidity at such levels in the face of potentially explosive pent-up demand. Both post-wartime periods experienced heightened levels of growth and inflation, and it is likely that we will be increasingly focused on these developments as we go forward.

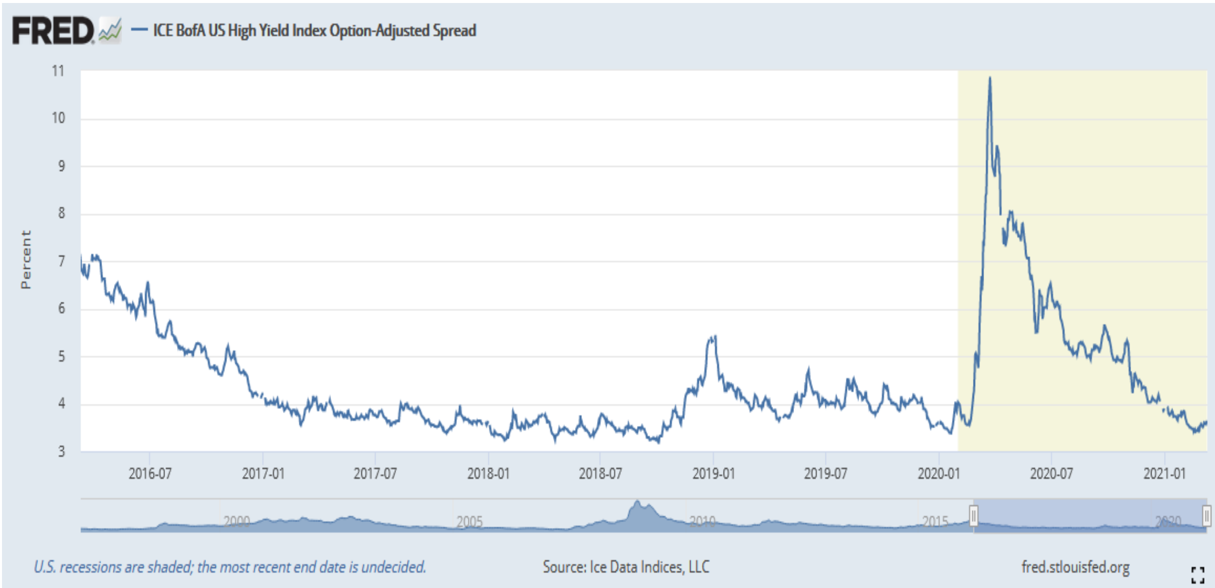
Interest Rates and the Federal Reserve

Recently, much attention has been paid to rising interest rates. On March 9th of last year the yield on a U.S. Treasury Bond maturing in ten years was 0.54%. That yield has since risen to 1.60%, a significant increase but still below the pre-pandemic level of 1.92% at the end of 2019.

It's important to keep in mind that there is an inverse relationship between interest rates and bond prices. As interest rates fall, bond prices rise; this effect accounted for much of the 7.51% return for the Bloomberg Barclays U.S. Aggregate Bond Index in 2020. Of course, the inverse is also true, and rising interest rates have resulted in negative returns for bond investors so far this year.

The important point is that the move in bonds is rooted in growing optimism for the economy, and not in anticipation of an impending change in the Federal Reserve's accommodative policies. Fed Chair Powell has indicated that there is no reason to act in the face of rising yields, and that he believes the inflationary pressures the economy is experiencing are transitory. The prices of energy, raw materials, food and other inputs have risen as economic growth has accelerated, and they are expected to continue to rise as the economy reopens. However, once we return to a more normal growth path, the Fed expects inflation pressures to ease. We shall see.

It is also important to note that the rise in yields has been almost entirely focused on government bonds. Corporate yields have risen comparatively more slowly and high yield bonds have barely budged. For most of the last five years, the yield spread between government and lower rated debt had hovered in a narrow range between 3% and 5%, until the economic shutdown caused the spread to widen to more than 10%. Now, credit spreads have returned to their pre-pandemic level, another sign that the macro environment is improving.



The X Factor - Inflation

Inflation concerns are rising as a result of the massive stimulus measures enacted over the last year, unprecedented levels of liquidity and savings, and a Federal Reserve committed to keeping its Fed Funds Rate Target near 0% until at least 2023 while continuing to expand its balance sheet for the foreseeable future.

Inflation can be transitory or it can be sustained, with the latter the far more concerning of the two scenarios. The Fed has spent the last four decades fighting inflation until it got too low, and received major assists in those efforts from globalization and technology. Are we on the other side now, with the Fed committed to increasing the inflation rate to a level above its target rate until we get too much of it? It is too early to say, but it is a possibility that we must factor in for the long term. For now, however, we are still far from the levels of capacity utilization and full employment that have been known to usher in periods of inflation, and it rarely pays to fight the Fed in the near term.

Corporate Earnings

Nearly all of the companies in the S&P 500 have reported their 4th quarter results, and it is clear that the earnings recession is over. According to FactSet, S&P earnings grew 3.9% for the quarter, the first year-over-year increase since the end of 2019. As recently as the beginning of December, consensus estimates were that earnings would decline 11% due to surging Covid counts and the potential for a double-dip recession.

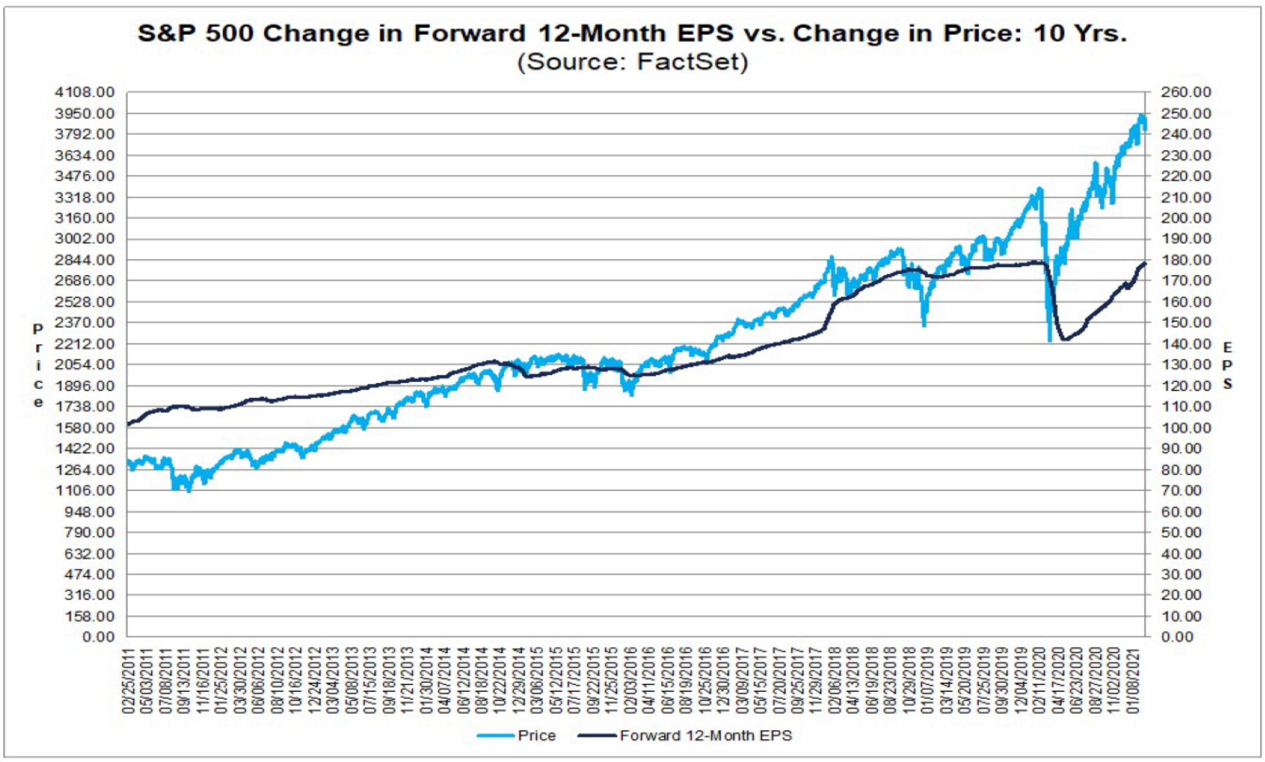
Of the companies that have reported, 79% have exceeded expectations, the third-highest percentage of S&P 500 companies reporting positive earnings surprises since FactSet began tracking this metric in 2008. Almost twice as many companies have guided future expectations upward than downward, and analysts are now projecting double-digit earnings growth for all four quarters of 2021.

In the face of generally good news on the earnings front, we would offer the following cautionary notes:

First, comparisons for 2021 will be against the distressed results or 2020. The actual level of expected earnings is still below 2019's results.

Second, it is assumed that most of the stimulus payouts will be spent, rather than saved. However, it is estimated that 73% of the monies paid out in prior stimulus measures were not spent, but put aside. Perhaps a brighter economic and jobs outlook will give consumers more confidence to spend.

Third, much of the optimism over future earnings is likely already reflected in current stock prices. The following chart shows that the gap between the S&P 500 index (blue) and expected earnings (black) is historically wide, and by more than just a little.

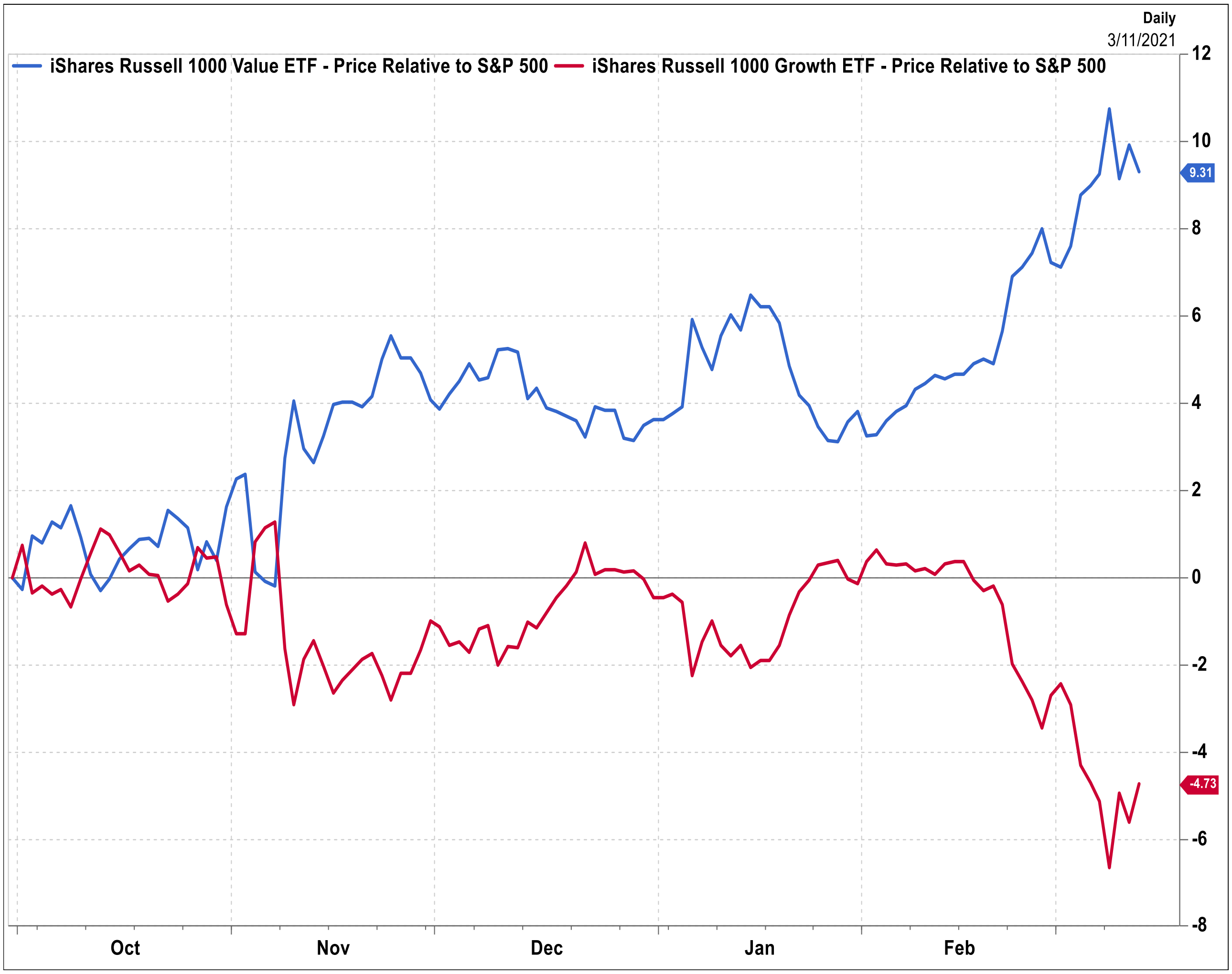


The Stock Market

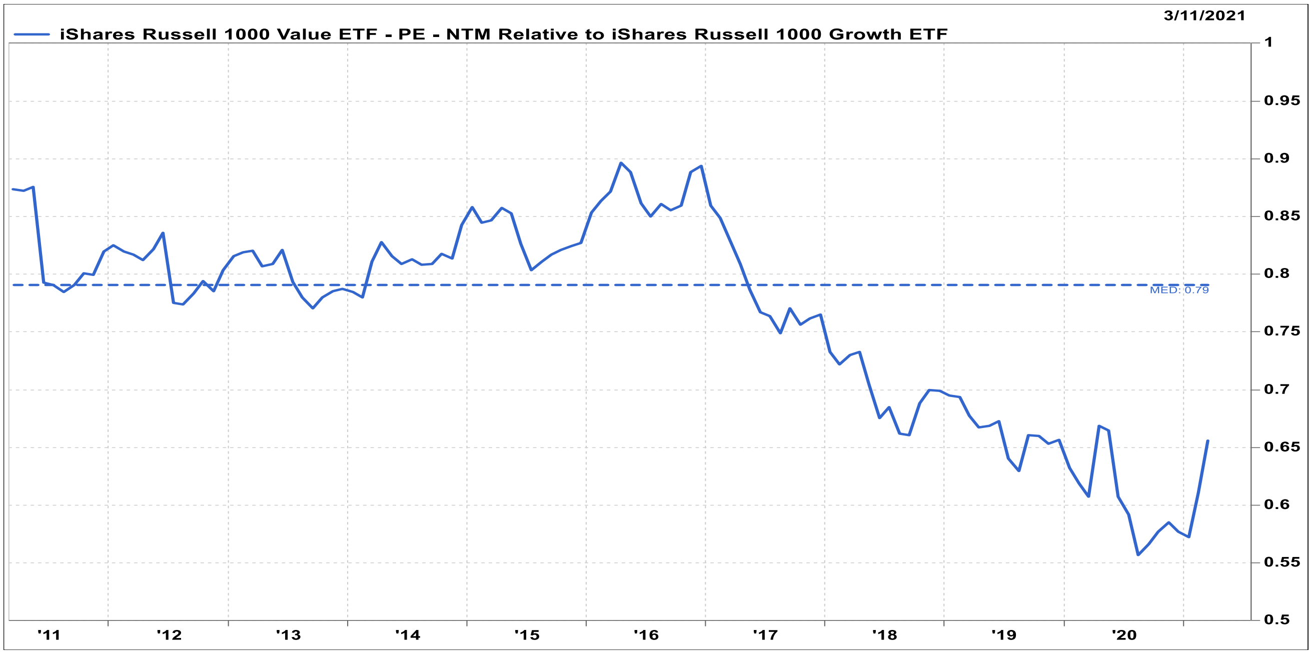
Last August 31st, Exxon was replaced in the Dow Jones Industrial Average by the software company, Salesforce.com, Inc. Exxon had been a Dow component since 1928 and was its longest serving member, and its removal in favor of another tech company was viewed as a "sign of the times." Since that date, Exxon shares are up 63%, while Salesforce shares have declined 21%. This is illustrative of the change of leadership that has taken place in the market as the economy emerges into a post-Covid recovery.

The recent weakness in technology stocks, and growth stocks in general, have raised concerns about a possible market correction. But what we are seeing is an ongoing market rotation into the more fairly valued, cyclical sectors of the market. Energy, financials, industrials and materials have been the best performing sectors year-to-date, while health care, staples and utilities have under-performed. These trends are more indicative of the early or middle stages of a market advance than the late stages. It is also encouraging that market breadth remains strong. More than 80% of S&P stocks are trading above their 200-day moving average, and the average stock has outperformed the Index by 450 basis points since January 1.

So called “value” stocks have out-performed “growth” stocks by a wide margin since the market began to broaden out in the fourth quarter of last year. This is significant since economically sensitive sectors are largely concentrated in the value component of the index. The chart, below, shows the performance of value (blue) and growth (red), relative to the S&P 500 since last October. Again, value tends to outperform growth early in a market cycle.



Despite the dramatic outperformance of the more cyclical, value stocks over the last 6 months, there is no reason to expect a reversal of this trend so long as the economy continues to reopen as expected, and the valuations of value stocks relative to growth do not become extended. In this regard, the economic data continues to improve, and “value” is still cheap relative to “growth” on an historical basis, despite the recent gains (chart, below).



Finally, we are occasionally asked about our thoughts on the so-called "meme stocks" like GameStop and AMC Entertainment, that have an annoying tendency to disrupt the market for brief periods. In the case of GameStop, for example, day traders on social media coordinated their buying of a distressed, thinly traded and heavily shorted (by hedge funds) company on Robinhood's no-commission brokerage platform, driving the price from $39/share to $483 in just 8 days. This resulted in huge losses for the hedge funds that had to buy back shares at higher prices to cover their short positions, which was the Robinhood crowd's purpose in the first place. GameStop shares subsequently fell 90% to $50 before rising 5-fold again to $260, all in the span of a month. GameStop has closed almost 2,000 stores over the last three years and lost more than $1.5-billion, but earnings don't matter, just eyeballs. Like all schemes, this one will work until it doesn't, and we should all remember Warren Buffett's admonition that, "Only when the tide goes out do you discover who's been swimming naked."

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