Can the Markets go Higher?

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We all know 2020 is a tough year but it's important that we all be optimistic. The market is a forward-looking beast and I believe there are many reasons to keep the upward momentum going.

The stock markets around the world have had an extraordinary rebound from the spring lows and many people are asking the same question: is this bounce back sustainable? The question makes sense since the virus is still amongst us and because of the measures that governments have taken to try to contain, or at least mitigate some of the worst economic aspects of Covid-19. Too many individuals and businesses have been hit hard by this virus. The news has wrenching stories of tragedy and magnifies the feeling of helplessness that so many of us are suffering from. Yet, the market is a forward-looking beast and there are many underlying reasons for the uptick in asset prices and this upward trend, in my opinion, is set to continue.

Interest rates are at historical low levels. We have discussed in past posts the various conjectures about why we have these low rates, from demographics to the meddling of the central bank. There is concern about the increasing debt of consumers and governments but this indebtedness is sustainable because there is an offsetting savings. So yes, we owe more but there are huge pools of capital willing to lend.

Only a generation ago few people had individual retirement plans. If you were lucky, your employer may have had a pension. Today, around the world, trillions of dollars are sitting in individual savings accounts looking for yield and dreaming of a 3% government guaranteed annual income. In addition to individual savings there are huge institutional pools of capital whose managers roam the world looking to invest money that has a fixed yield and is secure. Norway, a country of 5 million people, has a sovereign fund of over one trillion dollars. Our own Canada Pension Plan has over 400 billion dollars. There are thousands of these huge funds around the world. These fund managers help keep yields low as they scour the Earth for income.

Monetary policy is the worlds central bank's contribution to low interest rates. The tools and programs that the Bank of Canada and the Federal Reserve in the US, as well as the rest of the world's central banks, have used since February, have continued to be refined since the Great Recession in 2008-09. At that time they used insights from the 1929 Crash and ensuing depression as guidelines to stop some of the worst damage of that very scary period. Their success in preventing a collapse by supporting the banking system was expanded during Covid-19 to buying assets from nonfinancial institutions as well as other novel approaches.

What all the long-term consequences of these interventions will be we don't yet know, but one result is interest rates below inflation. For investors, if your money is actually losing purchasing power sitting in cash or bonds it encourages us to buy assets like equities that have the potential to beat inflation.

Fiscal policy is the collection and distribution of revenues by governments. They have been very focused on the distribution part since March. The massive amount of stimulus that has been poured into the economy with people receiving cheques directly from the government, as well as businesses receiving loans (some of which are forgivable) has truly kept the virus and lockdowns from causing much more severe dislocation.

It had to be done, but we are getting indications that many governments are not ready to stop the giving. Giving is so much more fun than taking away. This political tendency to spend combined with borrowing costs close to zero should have us expecting more stimulus spending coming down the line. This additional money will likely be geared to infrastructure and other asset investments that will help our economy in the long term. This type of fiscal policy is positive for the stock market.

Another reason that the markets could continue to rise is that the severe correction in February and March of this year caused a lot of excesses to be cleansed from the system. These quick, sharp pullbacks have always been considered healthy for the markets since it takes out short term, leveraged investors and moves shares back into long term hands. Though I have been hearing about young Millennials distorting some markets, it isn't a pervasive phenomenon at this time.

We also have to remember how healthy the economy was before the virus swept in. It seems like long ago, but we were mostly booming ,with record employment numbers and a growing economy. Even now, our unemployment rate is 7.9% and improving quickly. We rarely went under 6% unemployment through the 1980-90s.

This is not to say that there has not been some people severely affected, but the underlying resilience of the economy is a fact and this should continue if our current policies stay in place.

My last point has more to do with psychology and it is summed up in the term Animal Spirits. I am not sure when I first heard it, but in the current context it means that once the virus has been beat, lockdowns end and we are free to interact with whomever we want, whenever we want. There will be 'joie de vivre' in the air that will spur a revival of the Roaring 20s!

We shouldn't compare our situation to coming out of WW1 and surviving the Spanish Flu, but there is definitely a pent-up craving for some excitement and human interaction. These animal spirits and the ensuing consumer spending will be a benefit to markets.

There is an old expression "don't fight the Fed" and central banks have been major contributors to helping us get through this pandemic. Going forward, low interest rates, government spending and pent up demand should keep the upward momentum going.