SYMONS® CAPITAL MANAGEMENT

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A TALE OF TWO MARKETS

THE BIG PICTURE

Charles Dickens' *A Tale of Two Cities* begins with the famous line "It was the best of times, it was the worst of times . . ." Now, like then, the time seems to be more turbulent than usual, and now, like then, observers of and investors in financial markets reach different conclusions and take different paths — even though everyone is looking at the same information.

Is there something more we should know about our current economy and markets? Even with the continuing economic damage caused by the pandemic lockdowns, the broad stock market is back to all-time highs. The government's plan is that more stimulus checks will result in excellent (short-term?) economic data, and the seemingly endless flood of money into markets will create a further blast higher, easily lifting the S&P 500 to ever greater heights. What we have started to see is some faltering, particularly with the high growth parts of the market like ARKK (ARK Innovation ETF) entering bear market territory (down more than 20% from its February peak). While Symons Capital has a tilt toward managing portfolios for the long-term, a significant portion of investors focus on short-term trends. These two types of investors often make different investment decisions based on the same information.

So what's going on with all the economic and market cross currents? Nobody seems to really know. That leaves us with educated guesses, and we do have those. First, the amount of stimulus money entering the financial markets appears to be lower than expected. There is a smaller cohort of people getting the money, and those people have a greater tendency to use the money for other purposes, principally paying bills and adding to savings. Thus, we haven't seen a wild ride of retail purchases of call options surging into the high growth stocks to send them flying.

Second, the excellent economic data that was widely expected has been somewhat disappointing. It shouldn't be a big surprise that things didn't work out perfectly, with all the supply chain disruptions and other problems, but here we are. Europe's reopening is happening at a glacial pace, the US has had some weather issues, and China is tapping the brakes on credit expansion. The synchronized global reopening doesn't seem to be happening.

There also is some evidence that larger investors are exiting stocks and selling off to retail investors. Recent retail flows into the market have been the stuff of records, but the market has only moved in fits and starts. We've also seen a lot of strong market openings and weak closes. In general, retail often buys the open, while institutions tend to sell the close.

So what should we do with the uncertainties? Dealing with uncertainties is why we engage in forward-looking macroeconomic research in an attempt to see possible turns in the road. We don't mind stepping out of ideas somewhat early. As J. P. Morgan said, "I made all my money selling too early." While we didn't expect to see market turbulence so early in 2021, we believe we were reasonably prepared for it. In general, we pared some positions that seemed to have gotten out of line with their long-term potential due to the excitement from the hoped for economic reopening, which helped us avoid some of the current uncertainties. We also added some positions that we thought were likely to do well by the end of the year. These incremental adjustments give us options, whatever may happen. So, what do we think the future holds?

Again, there are always uncertainties, but at the same time there usually are probabilities we can discern (but never certainties). High growth stocks have gone down a fair amount since mid-February, more or less to a level that's seen buying interest in the past. That's probably going to continue, at least for a while. Thus, in addition to the temporary but massive government supports, this seems like a lousy time to panic. We've also seen consistent buying at the start of a quarter, which could be part of an opportunity for us to incrementally exit any positions we decide may be potentially less attractive down the road.

Longer term, stresses may be appearing faster than we expected. Could we see a decent decline coming shortly? Maybe. There's certainly a chunk of people who are now calling for that. But for our part, we still believe the likelihood of stimulus and short-term good economic news in the first half of the year is too high to expect a major hit to markets. So, while a near-term decline doesn't seem unreasonable, we believe it would be one of those low panic affairs like we've seen a few times since the market bottomed in March 2020.

Once we get closer to the second half of this year, we believe market uncertainties could get more dangerous. Economic expectations are sky high, with many pundits calling for economic growth at a level we haven't seen since the 1950s. For our part, with the huge differential from then of our added debt and deficit burdens, we think we'd be lucky if we get the growth experience of 2009. That's quite a difference, and with expectations so high, the difference between current expectations and future reality could hurt stocks that are expecting a post-WWII style of rally.

Bottom line, we see a wide range of possible outcomes by the end of the year. We'll continue to take what comes and incrementally adjust as conditions change. Right now, investors seem way too optimistic. For instance, financial stocks are pricing a higher interest rate environment in which their profits should increase, while many tech companies are pricing in a lower interest rate environment that lowers their borrowing costs. They can't both be right.

THE ECONOMY AND INVESTMENT MARKETS

In today's Tale of Two Markets, there is a big difference between expecting future returns based on past price behavior (short-term trend momentum) and expecting more durable future returns based on fundamentals. As stock prices increase more than does GDP growth, trend investors continue to expect more of the past returns. But based on the same information of weak GDP growth, fundamental investors usually expect future price returns to be weak.

Right now, because of low interest rates, the values of bonds are high, and it is reasonable to expect that future returns on bonds will be low. Right now, the valuations of stocks are around historical highs, which suggest that future returns on broad stock indices will be low. It is hard to figure out how broad market returns for the next decade for either bonds or stocks can replicate the returns of the past decade. Symons Capital has built an investment process (Intelligent Risk Management) that is intended to address problems like this.

Recent years have produced enormous investor confidence that the Fed's purchases of debt can permanently backstop the financial markets. But ultimately that backstop is largely in the minds of investors because the Fed can't buy it all in a panic. Even if the Fed could do that, long term stock prices correlate to GDP growth, which has been getting steadily weaker since the 2008 Great Financial Crisis. And that hope assumes that valuations never retreat from their current high levels.

All of this is OK with us, because we always seek to be positioned to deal with the range of possibilities on the horizon, and to be flexible enough to navigate the possible changes. We seek to position portfolios so that we don't have to sell expensive stocks into an illiquid market at a big drop in price. Today we are dealing with multiple high risk conditions, such as generally low interest rates, generally high stock valuations, signs of nascent inflation or stagflation, an economy being propped up by temporary government and Fed supports, large and increasing debt loads, and continuing unemployment concerns. With this backdrop, how do we position portfolios?

INVESTMENT STRATEGIES AND PORTFOLIO MANAGEMENT

We don't try to slot our portfolio holdings to a style. We try to go with the best available risk/reward. Sometimes that's deep value, sometimes that's GARP (Growth At a Reasonable Price), sometimes that's growth, sometimes that's momentum. Value is what we are most comfortable dealing with, but we always are looking for sensible opportunities. Right now, for instance, we have a mix. We have a fair amount of value stocks, like precious metals, utilities, and food, but we also have growth stocks like the pot stocks. We think that's ideal — to look for sensible opportunities at sensible prices. We want to be long term, patient and disciplined.

The current environment in which we manage investment portfolios is becoming increasingly chaotic. The commonality for the last year has been that the junkier the equity the better the returns, which perhaps reached a crescendo with GameStop this year. What we are focusing on are companies that aren't participating in some wild ride. For instance, defense companies seemed to get a fair amount of money from the 2020 rounds of stimulus, but aren't priced high at all. Similarly, there are boring food and drug stocks that have pretty reasonable prices.

Interest rates are at the center of a lot of narratives. Do we hit 2% on the 10 Year Treasury? Would that be a problem for some stocks more than others? We're already seeing an impact from this move in the downturn in the high growth stocks (think ARKK or TSLA). In general, it seems likely we shouldn't see interest rates climb much more, as it causes so much damage to a heavily indebted country that has leaned on low rates to finance good times. Both the Fed and international central banks have made noises about preventing rates from moving very high.

Along those same lines is the inflation question. It seems like the whole world sees the coming of inflation, but when? The Fed is confidently declaring that inflation is transitory, while others are confident that sustained higher inflation is going to stick around. Inflation is always messy — it always depends where you look. We can already see sustained food inflation, and then there is health care and education. How about housing?

With these variables, we believe the safest places are defensive stocks that can be found in areas like staples, health care, and defense. They've generally been ignored in the middle as people have been buying the barbell of technology and cyclicals (e.g., financials and energy).

Part of the middle is some legacy positions we've owned for a while. First are utilities. At this point we think they have a lot going for them with their steady top-line revenue and attractive dividends. Plus, a lot of them represent cheap plays on green energy. If and when rates retreat as the economy underperforms current great expectations, utilities should increase in popularity.

Lastly are precious metals miners. As expectations of economic growth get better, miners tend to do worse — and vice versa. We believe it makes enormous sense to invest in gold and silver miners here. The risks at these levels seem low, while the long term rewards seem quite high. The only problem is that we never know when to expect liftoff. Will we need to wait for signs that the expected economic boom isn't what it's cracked up to be? Or for greater fears of inflation due to the stimulus package and the coming infrastructure stimulus? History suggests that anytime you see an explosion of debt, you end up with higher precious metals prices down the road. We are willing to be patient.

We are sure we don't have everything right, but we think we're in a reasonable position, and we would like to think that becomes more readily apparent as the year moves along.

CONCLUSION

We want to make money, but it is even more important to make sure that we don't lose it. We can't predict the future, but understanding how past markets have been affected by the range of ever-changing macroeconomic and fundamental information often helps us to identify and gauge possible risks. Managing risks can matter greatly in building durable returns and financial security. If we can earn pretty good returns that don't disappear, then the magic of compounding can take hold.

Managing the risk events matters greatly, but it isn't easy. The same Wall Street pundits that told us "not to worry" in 1999 and 2007 also told us in 2001 and 2009 that "no one could have seen it coming." But we did see some risks and were able to make some portfolio adjustments that helped us to protect capital. There is a speculative cycle that you have to manage. In addition to hard data, human psychology plays a big part in the cycle — from optimism to pessimism. People go from being completely indifferent to risk to avoiding all risk. Today many believe that the risks of market cycles have been eliminated by the Fed. Because of the Fed, we do have an extended up-half of a full cycle, but we doubt the cycle has been eliminated.

Yours sincerely,

Ed Symons, JD
Chairman & Founder

Colin Symons, CFA
Chief Investment Officer

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