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Bill Miller 4Q 2020 Market Letter

Bill Miller, CFA

One of the lessons of 2020 was the uselessness of the annual New Year's ritual of market forecasting. A pandemic was in no one's forecast, nor was the worst economic contraction and the highest unemployment rate since the Great Depression. This lesson was not new; we are taught it every year, yet we persist in making forecasts anyway – just another bad habit that is endemic in folks who make their living in capital markets. Ken Arrow, one of greatest economists of the last (and part of this) century, liked to tell the story of his time as a weather officer in the Army Air Force during World War II. He was asked to provide a long-range weather forecast and objected that such forecasts were impossible and therefore useless. He was told to make it anyway, since it was necessary for planning purposes.

There is a kind of ironic truth in that reply, at least as it pertains to stock market forecasts. Those forecasts do have some instrumental value. Although the future comes, as Arrow once said, enveloped in clouds of uncertainty, the reasoning supporting our expectations can provide some insight into the ways in which we can go astray.

I have noted before that just understanding what is going on now is preferable to trying to guess what will happen in the unknown future. Here are some of the things that are going on now: We are in a bull market in stocks that began in March 2009 and that shows no sign of ending. As Sir John Templeton said, "Bull markets are born in pessimism, grow on skepticism, mature on optimism, and die in euphoria." I would characterize the current state of the market as one of optimism that a solid recovery is underway, that corporate profits will be higher in the next year, that inflation will stay low, that the Federal Reserve will continue to provide significant liquidity to the economy and will keep short-term rates at zero, that long-term rates may rise but not sufficiently to derail the recovery, that no adverse Fed policy changes will occur until the economy has achieved full employment which is not likely to happen for at least a few more years, that stock market valuations, as the saying goes, look high and are high, but are not as high as they look given the aforementioned economic conditions.

As the seriousness of the pandemic became clear earlier last year, and its economic effects came into focus, those companies that would benefit from lockdowns and an accelerated shift to much greater online activity separated themselves from the broader market, a trend that continued until late August. Since then, the market's advance has broadened out considerably, and a rotation to "value" has been underway.

I think my general level of optimism about stocks and (muted) pessimism about bonds is the consensus view. Being contrarian—but not a naïve contrarian—usually pays more than being in the consensus, but not, I think, in this case, if being contrarian means believing most of the economic conditions now underway will reverse in 2021.

Where I think the consensus may be wrong is that 2021's economic and profit growth could be considerably higher than is now priced into stocks and bonds, leading some groups that have trailed the market for years, such as banks and energy, to move from laggards to leaders. If growth is stronger than believed, the scarcity value of high growth companies will diminish and the rotation to value continue. This does not mean I think many of 2020's market winners will become losers, rather that the market's gains will be much more broadly distributed than in recent years.

I also think the market is likely underestimating the risks of inflation. So far, the Fed's liquidity provisioning via bond purchases and increasing the money supply have resulted in higher stock prices but not significantly higher inflation expectations. Money velocity remains quite depressed by historic standards. But savings rates are unusually high and, as the economy becomes more "normal" in the second half of the year, it is likely that consumption will accelerate and, with it, money velocity. Lots of liquidity and increasing money velocity could quickly put upward pressure on inflation. Commodities markets have been unusually strong since bottoming in late April and are now considerably higher than they were pre pandemic. Gold and silver have done well this year and that looks to continue in 2021.

Finally, a few thoughts on bitcoin, the best performing asset category in 2020. At this writing, it is trading at over $31,000, up more than 50% since the middle of December. It has outperformed all major asset classes over the past 1, 3, 5, and 10 years. Its market capitalization is greater than JP Morgan and greater than Berkshire Hathaway and yet it is still very early in its adoption cycle. The Fed is pursuing a policy whose objective is to have investments in cash lose money in real terms for the foreseeable future. Companies such as Square, MassMutual, and MicroStrategy have moved cash into bitcoin rather than have guaranteed losses on cash held on their balance sheet. Paypal and Square alone are estimated to be buying on behalf of their customers all of the 900 new bitcoins mined each day. Bitcoin at this stage is best thought of as digital gold yet has many advantages over the yellow metal. If inflation picks up, or even if it doesn't, and more companies decide to diversify some small portion of their cash balances into bitcoin instead of cash, then the current relative trickle into bitcoin would become a torrent. Warren Buffett famously called bitcoin "rat poison." He may well be right. Bitcoin could be rat poison, and the rat could be cash.

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S&P 500 3756.07

Bill Miller will join fellow legendary value investors in a lively discussion/debate on managing portfolios through the current conditions on Thursday, January 7 from 4:30-6PM ET. *Click here* to register.
