PALUMBO
WEALTH MANAGEMENT
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PWM Weekly Observations

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A Holiday Gift for America?

The consensus right before the election was that a Blue Wave would create a very large (around $3 trillion) stimulus package, and without the Blue Wave, something a bit less would be more likely. But with the Trump Administration pushing their number up towards $2 trillion pre-election, **the expectations were that no matter the election outcome, a substantial stimulus deal would be forthcoming, possibly during the lame duck session**, but certainly after the inauguration.

With weaker economic numbers hitting the press, now there indeed appears to be some hope for a scaled down deal in the lame duck session by **splitting the $908 billion bi-partisan proposal into two parts. The first part is $748 billion, aimed primarily at small business (under 300 employees) and the unemployed.** The remaining $160 billion includes the more contentious sections; namely the liability shield preferred by Republicans and the state and local government aid sought by the Democrats.

That second section has little hope of passage at this point, but the separation opens the door for passing the much-needed small business aid in the first part. Despite the relatively small number, the targeted response toward the most affected was seen in a very positive light by the stock market.

The chart on the following page shows the progression of the main proposals for a second stimulus package. (Yes, it really does date back to May of this year!) As the week closed, talks remained positive, but time is running short. **Our best hope may be that Congress does not want to leave for the holidays without getting something done, and the time pressure may just force a deal that has been 7 months in the making.** The bottom line is that we are optimistic that there will be something extra in America’s stocking this year.

There are a few changes even from the chart below with the latest proposal including **a new round of direct stimulus checks of roughly $600, increased unemployment benefits of $300 a week, about $325 billion for small businesses as well as money for transportation, vaccine distribution and schools.** The total package is expected to approach $1 trillion.

Does it seem odd to you that only two months ago, the Republican bid was $2 trillion and the Democrat ask was $2.4 trillion, and we could not reach a deal, yet here we are about close a deal for $1 trillion? Politics simply confounds logic.

Coronavirus Relief and Fiscal Stimulus Proposals

	House Democrats (May 2020)	House Democrats (October 2020)	Treasury Proposal (Oct. 2020)	Senate Republicans (Oct. 2020)	Senate Republicans (Dec. 2020)	Bipartisan Senate Proposal (Dec. 2020)
State fiscal aid	996	492	300			160
Education grants	90	225	150	100	105	82
Public health	197	198	175	50	47	51
Stimulus payments, child tax credit	584	360	340			
Unemployment insurance	440	390	230	186	14	180
Rental/homeowner assistance	200	89	60			25
Child care	10	65	25	15	15	10
Safety net programs	40	26	15			13
Health insurance	99	10				
Business assistance, incl. restaurants	268	408	246	257	335	300
Student loan relief	192	44	25			4
Pension relief	53	59				
Transportation	31	48				45
Air carriers		27	20			
Broadband	6	15	15			10
Farm subsidies				21	20	13
Eliminate SALT limitation for 2020	137	65				
Reverse CARES tax loss provisions	-254	-254				
Other	356	131	199	18	35	15
Total cost ($bn/10yrs)	**3445**	**2398**	**1800**	**647***	**571**	**908****
Total cost (% of 2020 GDP)	**16.5**	**11.5**	**8.6**	**3.1**	**2.7**	**4.3**

* Roughly $130bn higher than official cost estimate due accounting for second-draw PPP loans as new spending, where CBO counts these as using existing apprpriations.

** $748bn excluding state and local aid

Source: Congressional Budget Office, Data compiled by Goldman Sachs Global Investment Research

The CAPE Ratio is Back Above the 1929 High

Several media outlets this week picked up that the CAPE Ratio was back above its 1929 high of 32.56, an indication that stocks are over-valued. **The CAPE Ratio is an acronym for the Cyclically Adjusted P/E Ratio and was developed by Professor Robert Shiller at Yale University.** Historically, the CAPE Ratio has been **a very good indicator of future stock market returns, although a very poor indicator to call market tops or bottoms**.

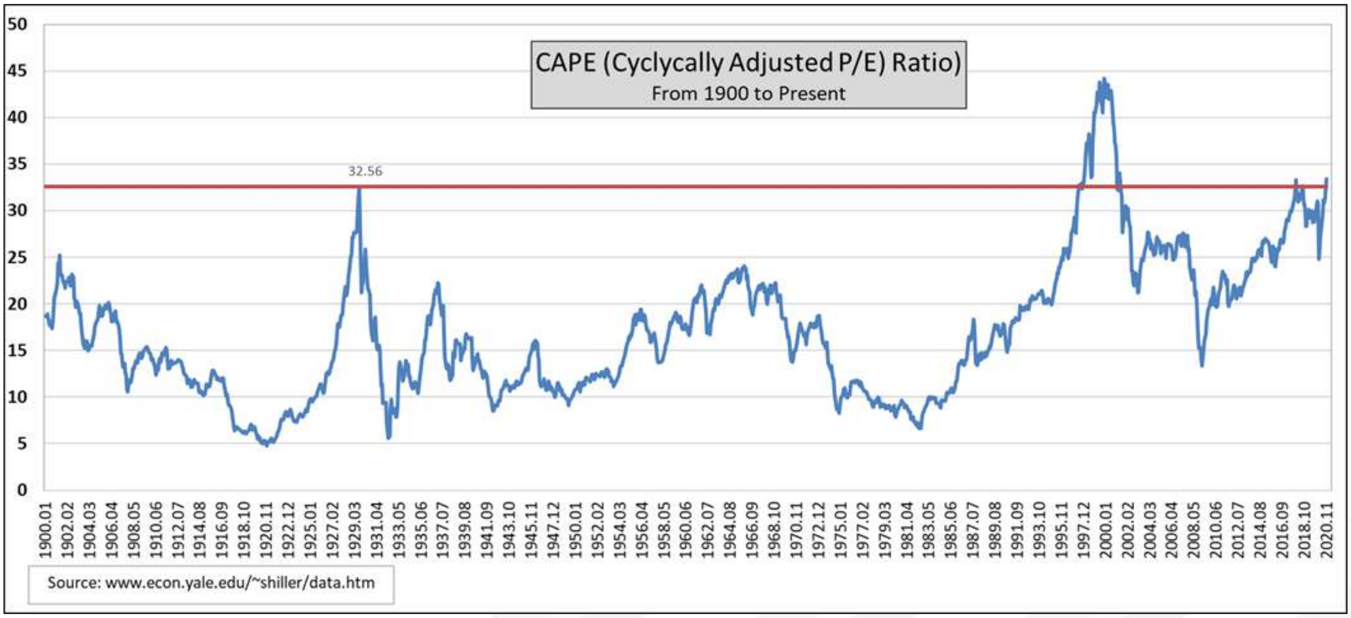
- P/E ratios are a common way to value individual or groups of stocks. **The P/E ratio is the price per share divided by the annual earnings per share which produces a valuation as a multiple of earnings**. For example, stock with a price of $15 and earnings of $1.25 has a P/E ratio of 12. (15 divided by 1.25), or expressed as a multiple, the stock is valued at 12 times earnings. Obviously, a stock with a higher multiple is priced more richly, on a relative basis. The market P/E is, of course, the average P/E of all the stocks in the market.

The problem with P/E ratios is that we don't know what earnings number to use – past or future. If we use the last 12 months of earnings, then we have a precise earnings measurement. However, as we know, stocks discount the future, which makes the case for using the next 12 months of forecasted earnings to calculate the P/E ratio. The problem is that it is an estimate. We don't know exactly what earnings will be over the next 12 months. Either method leaves something to be desired.

- The CAPE Ratio is calculated as follows: $\mathit{CAPE\ Ratio} = \dfrac{\mathit{Share\ Price}}{10\ \mathit{Year\ Average\ Inflation\ Adjusted\ Earnings}}$

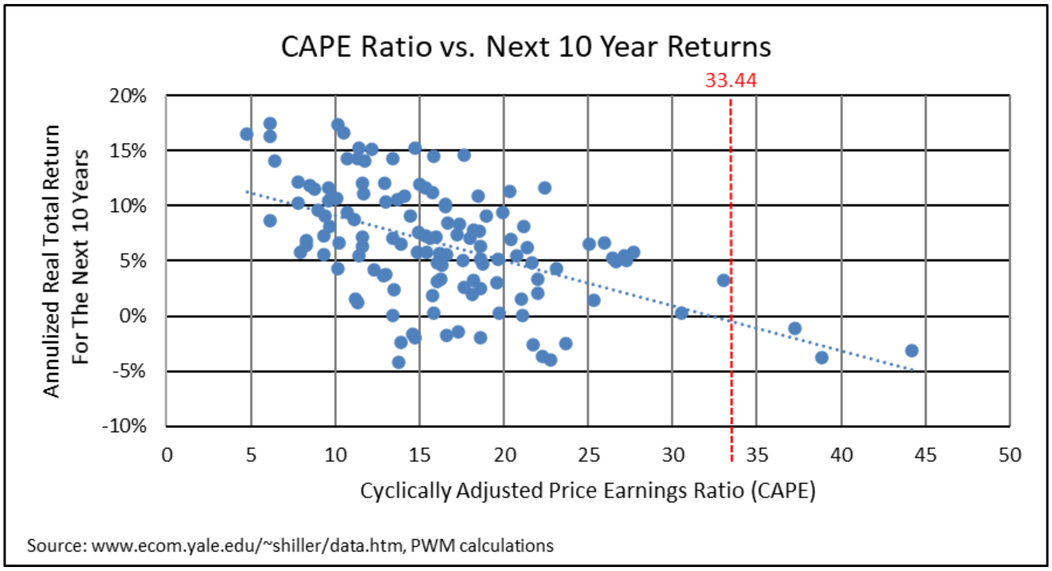
  The CAPE Ratio uses historical earnings per share over the prior ten years, adjusted for inflation. Clearly this is something less than ideal for timing markets. However, it has proven to be a reasonably good predictor of returns from that point forward. In general, the higher the CAPE Ratio, the lower the equity market returns over the forthcoming 10 years.

The chart below shows the CAPE Ratio from 1900 to present. After hitting a high in 1929, just before the crash, it did not return to that level until the late 1990's, the tail end of the tech bubble. The CAPE stayed above the 1929 high water mark for quite some time, implying that there is nothing magical about the level hit in 1929. However, on both occasions, stock returns over the next ten years were very weak. **The current CAPE value is 33.44.**



- The CAPE Ratio, at its current 33.44, is marginally above the high of 1929, just before the Crash. What does that mean? In the near term, it means little. As we said, there is nothing magical about that level. However, **it can be a good indicator of below average equity returns over the next ten years**.

Unless one expects central banks to continue providing liquidity to boost the stock market for another ten years, it is difficult to envision the next ten years to be as easy as the last ten. The CAPE Ratio appears to be confirming that view. The chart on the following page plots the CAPE Ratio on the horizontal axis and the stock market return for the following ten years on the vertical for the years 1880 through 2010. Visually, the relationship is quite clear. Higher CAPE ratios have been consistent with lower returns over the following 10 years. The blue dotted line is a regression line showing the relationship between higher CAPE Ratios and reduced forward returns. Additionally, we plotted that current CAPE reading of 33.44 in red for perspective.



A high CAPE Ratio could mean little for the near term or even intermediate term stock market performance, but 12 years removed from the beginning of the massive stock market rise following the Great Financial Crisis in 2008, **the market could be finally be running out of steam and returns from here could be muted compared with the recent past.**

- **The counter argument to the CAPE is that because interest rates are so low, P/E multiples SHOULD be higher.** There is a fundamental truth to that statement. Theoretically, financial assets are worth the discounted value of the future cash flows. **If the discount rate goes down (in the form of lower interest rates) then valuations go up, and are reflected in higher P/E ratios.** This is simple financial mathematics.

The dilemma here, which affects all serious investment research, is that we don't know where interest rates would be without the FED and other central bank intervention. The theory is based on market rates, and with the central banks clamping down on interest rates for so long, we are far removed from any real market interest rate data. That makes any valuation analysis based on the low interest rates potentially dangerous.

- This dilemma is at the heart of the "TINA" philosophy. TINA (There Is No Alternative) is based on the thought that none of the above matters. **With rates so low, there is no alternative to stocks to earn reasonable investment returns, and as long as that is the case, TINA adherents just keep investing in stocks.**

If all this sounds a bit confusing and confounding, welcome to the club! **One of the major risks investors face is becoming wrapped up in short-term events that push them into poor decisions that feel like good decisions at the time. Using a long-term, time tested, risk balanced model allows us to avoid those short-term impulses.** This bull run may have years remaining or it may have only months. No one really knows for sure. **That's why Palumbo Wealth Management builds portfolios with broad diversification** so we are not totally dependent on equity markets. It is also a key reason we rebalance our clients' portfolios dynamically, to reduce overexposure from inflated markets or to take advantage of markets that are dislocated.

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What We're Reading

- What COVID-19 Vaccines Could Mean for Markets **(3 Minute Video)**
- Smart Homes Suddenly Became 'Stupid'
- FDA Authorizes Lucira's COVID-19 Test for Self-Testing at Home
- Google Is Accused of Enlisting Facebook to Aid in Ad-Rigging **(WSJ – subs. req'd.)**
- Driving the Mustang Mach-E, Ford's First Real Electric Car
- Making Moves in the Gaming Market
- Guggenheim's Scott Minerd Says Bitcoin Should Be Worth $400,000
- Buffett and Bogle Both Knew the Other Was Right About Investing
- Toyota's Game-Changing Solid-State Battery En Route for 2021 Debut

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Markets This Week

The heat map has an odd look to it this week with the growth-oriented NASDAQ and reflation trade Small & mid cap stocks all performing well. We suspect that this is an anomaly created by the inclusion of Tesla in the S&P 500 as of Monday. That requires Index funds to add a lot of Tesla and sell an equal amount of everything else on Friday to incorporate this change. This likely resulted in the S&P 500 having a particularly poor week (relative to other indexes). Looking at sectors Commodities and Gold rallied along with Homebuilders for the week. Look for markets to quiet down over the last weeks of the year.

US Equities	1 week	YTD	Fixed Income	1 week	YTD	Sector Breakdown	1 week	YTD
S&P 500 (SPY)	0.79%	16.35%	20+ Yr. Treasuries (TLT)	-1.53%	16.74%	Consumer Disc. (XLY)	2.36%	28.75%
Dow (DIA)	0.32%	7.75%	Barclays US Aggregate (AGG)	-0.20%	6.64%	Info. Technology (XLK)	3.18%	41.34%
NASDAQ (QQQ)	2.70%	46.37%	Intermediate Municipal (MUB)	-0.18%	4.36%	Financials (XLF)	0.11%	-5.54%
Russell 1000 Growth (IWF)	2.72%	36.69%	US Corporate Bonds (LQD)	-0.09%	9.52%	Health Care (XLV)	1.18%	12.39%
Russell 1000 Value (IWD)	-0.16%	1.08%	Barclays US High Yield (HYG)	0.00%	2.45%	Utilities (XLU)	0.08%	-0.99%
Vanguard Mid-Cap (VO)	2.26%	18.28%				Industrials (XLI)	0.08%	10.81%
Vanguard Small-Cap (VB)	2.22%	18.14%				Energy (XLE)	-4.18%	-30.93%
						Materials (XLB)	1.85%	19.57%
International Equities	**1 week**	**YTD**	**Commodities**	**1 week**	**YTD**	Consumer Staples (XLP)	0.91%	9.97%
MSCI EAFE (EFA)	0.68%	6.13%	Commodities (PDBC)	3.35%	-7.70%	Comm. Services (XLC)	0.25%	26.00%
MSCI Emerging (EEM)	0.53%	14.30%	Gold (GLD)	2.29%	23.47%	REITS (VNQ)	0.64%	-6.12%
						Homebuilders (XHB)	5.08%	31.64%

The table above is an analysis of the weekly and year to date returns of various markets/sectors that we follow (More RED = worse performing markets/sectors; More GREEN = best performing markets/sectors). Source: IEX Trading & PWM Research.

Tax Planning:

[Fifty Years of Tax Cuts for Rich Didn't Trickle Down]

Tax cuts for rich people breed inequality without providing much of a boon to anyone else.

Estate Planning:

[Lessons From The Rich And Famous: Why Estate Planning Should Be Part Of Your Retirement Plan]

The tragic recent death of Tony Hsieh, the 46-year-old former CEO of Zappos, reminds us of the importance of estate planning.

Health:

[Top 10 Predictions for the Healthcare Industry in 2021]

1) The COVID-19 vaccine will be widely available ahead of schedule—and vaccine hesitancy will decline. 2) . Biopharma will enjoy a short-lived reputation rebound…and then mess it up. 3) …

Entrepreneur:

[Atmosphere, Price and People: The Key to a Memorable Experience]

Creating a truly unique and memorable experience is rare. It takes an exceptional amount of thought, time, business acumen, and maybe a little bit of luck.