THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – JANUARY 2021

U.S. Markets and Economy

U.S. stocks celebrated the start of the new year with a strong January rally right up until the end of the month, when a wave of selling over two days took major large-cap averages down enough to wipe out the previous gains. The S&P 500 index finished a volatile month down 1%, and the Dow Jones Industrial Average fell about 2%. Most of the monthly gain for the NASDAQ was also wiped out by the late selloff. Small stocks did much better, with the S&P MidCap 400 index up more than 1% for the month and the S&P SmallCap 600 index up more than 6% for the month. Small caps have been outperforming their larger-cap brethren since the fall, when the economic recovery "reflation trade" came into fashion with positive vaccine trial results.

Are these patterns connected? You bet! Many small-cap "zombie" stocks came back to life in January, led by an eye-watering explosion in the price of GameStop, a money-losing retailer, which rose in January from $18 to as high as $483 before collapsing in early February to $50. A number of other zombies, like money-losing theater chain AMC, also had gigantic—albeit temporary—increases in the month. These dramatic bubbles unsettled some investors, as they demonstrated that a group of determined day traders could use social media and leverage to create market instability, threatening the orderly financial markets that the U.S. needs for successful capital formation (and sensible long-term investors need for portfolio growth).

World Markets and Economy

European stocks followed the U.S. up in January but also sold off at the end of the month, erasing all gains for the month. Europe has been somewhat slow in getting vaccinations done, and the European economy may be headed back into recession, dragged down in part by Brexit and the difficulties of implementing fiscal policy. In addition, Italy has returned to crisis mode and government instability, which could threaten its ability to use funds already allocated by Europe to help the Italian economy recover. The FTSE MIB Index for Italy dropped more than 4% for the month. The British FTSE All-Share index also lost its January gains at the end of the month; this index is still down 10% since the start of the pandemic as Prime Minister Johnson grapples with Brexit and new, more-contagious variants of the virus.

In Asia, Chinese stocks also lost their January gains at the end of the month. The new Biden administration has already shown that it will take a tough line on China's human rights violations, which could further impact trade between China and the U.S. As the U.S. pivots toward Asia, economic competition between the two countries will intensify—and could even lead to more instability in the region. Chinese client state North Korea could further inflame tensions with missile launches and the resumption of nuclear testing. Rising tension in Asia could affect stock markets everywhere.

Japanese stocks, as measured by the Nikkei 225 index, also mirrored those in the U.S. for January. Japanese stocks remain near multi-decade highs, though, even though new Prime Minister Suga has seen his popularity plummet. Tokyo continues to plan for the Olympics, although a resurgence of the virus could imperil these plans. Without spectators, almost all the economic boost would disappear. Consumer prices began falling again in December, which further complicates efforts to push the economy forward.

Outlook

The wild gyrations in Reddit-driven small stocks temporarily obscured the economic fundamentals behind the January rally and selloff, and the Biden administration is working hard to ramp up vaccinations so that the economy can safely reopen. At the same time, the new president will probably use the "reconciliation" process to push his $1.9 trillion COVID relief package through Congress. This additional fiscal stimulation, combined with pedal-to-the-metal monetary policy, should accelerate economic growth in 2021, even before the U.S. achieves herd immunity.

But the news is not all good: the economy was staggering at the end of the year as new restrictions on economic activity sharply weakened growth and employment gains. Even more ominous, the virus kept mutating—as most do—which could reduce the high efficacy of the vaccines already approved for use. It really is a race between vaccination and mutation; the faster the world vaccinates, the fewer opportunities the virus has to create successful mutations. Right now the vaccines are winning, with almost 10% of Americans having received their first dose, but, as Yogi Berra said, "it ain't over 'til it's over."

As the economy continues to recover (U.S. jobs are still 10 million below the January 2020 peak), corporate profits will also recover from depressed pandemic levels. Meanwhile, very low interest rates should also support rising stock prices. However, bad news on the virus front could lead to sudden and sharp selloffs, as in late January. Long-term investors, unlike the Reddit mob, see even more clearly that the road to riches requires patience, discipline, a well-managed portfolio, and no "bubble baths."