



WOODWARD
DIVERSIFIED CAPITAL

Index Performance

- In January, China and US Small-Caps were amongst the leaders (up 8.09% and 6.15%, respectively). Other notable moves include Broad-based Emerging Markets and US Mid-Caps which increased by 3.17% and 1.53%, respectively. Meanwhile, International Developed equities were down 0.74% and US Large-Caps fell 1.02%.
- Bonds struggled as Investment Grade Corporate Bonds fell 1.83%, the US Aggregate Bond Index declined by 0.75%, and High Yield Credit decreased by 0.38%.
- Commodities produced mixed returns. Crude Oil (+6.57%), Broad-based Commodities (+2.19%), and Silver (+1.71%) were amongst the leaders while Gold fell 3.22%.

Euphoria? January saw enormous interest from the individual retail community. Some notable returns to point out are Koss Corp. (KOSS) +1,760%, GameStop Corp. (GME) +1,625%, AMC Entertainment (AMC) +525%, and Bed Bath & Beyond Inc. (BBBY) +99%. This type of individual investor engagement hasn't existed in the stock market since the late 1990s.

Unemployment: The broad U-6 unemployment rate is currently 11.7% and the regular U-3 unemployment rate is 6.7%. Unemployment is higher today than about 73% of the time since 1950. This is a large reason why we continue to see unprecedented fiscal and monetary stimulus which in part explains why stocks continue to perform well.

Real GDP declined by 2.5% in 2020, marking the first year of economic contraction since 2009. Fourth quarter GDP rose 4.0% Q/Q, slightly

below consensus estimates (est. 4.1%).

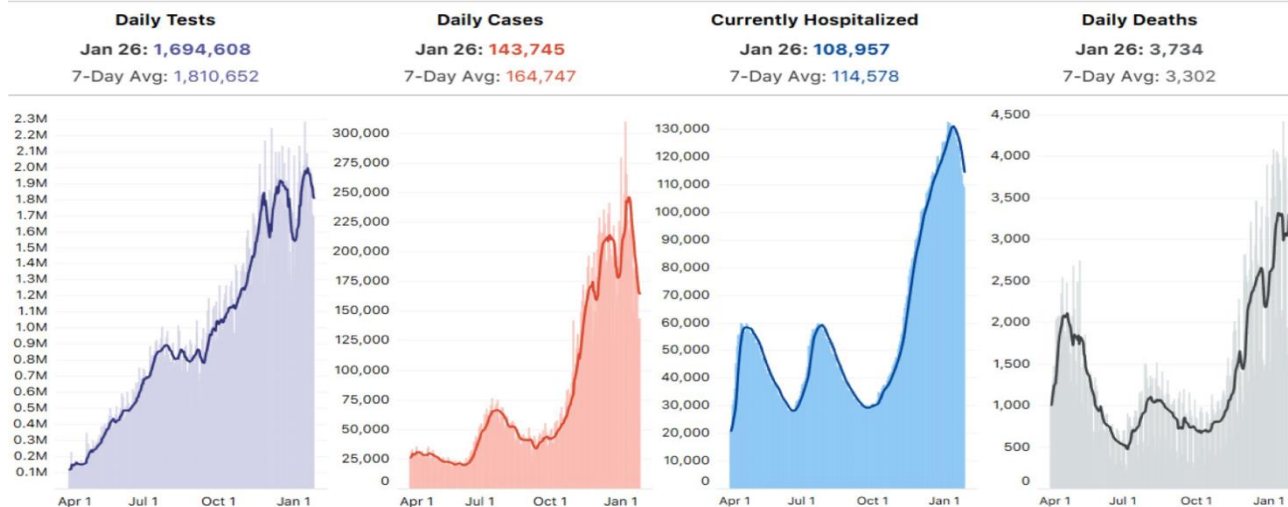
Biden: Newly elected President Biden is targeting a \$1.9 trillion-dollar fiscal package. Individuals are expected to receive an additional \$1,400 on top of the \$600 received in December. While the package has not yet been approved and could be smaller in size, it's worth remembering that when paired with the \$900 bln package enacted in December, this is significant support for the US economy. The full effect of the stimulus is anticipated to hit the US economy in the second half of this year just when most Americans will be vaccinated.

COVID-19: President Biden has indicated he wants to distribute 100 mln shots of the COVID-19 vaccine within the next 100 days. It appears as though the curve has stopped going parabolic (see chart below).

Exhibit 1

NATIONWIDE COVID-19 METRICS. 7-DAY AVERAGE LINES

Apr 1 - Jan 26



Source: The COVID Tracking Project

Should you worry about the price volatility of GameStop and AMC?

In recent weeks, a small handful of stocks have seen their prices disconnect from their fundamentals. Meanwhile, a separate group of hedge fund investors has tried to take advantage of this disconnect by shorting these companies. Ultimately, this becomes a vicious feedback loop if stock prices soar higher (which they did). Those hedge funds are then forced to de-risk their portfolio by selling other companies, further creating market stress and dislocations. On Wednesday, Jan 27, the VIX Index (a measure of volatility) spiked to 32, an increase of 40% from Tuesday, Jan 26.

Does this increase in price volatility matter?

Not if you are a strategic long-term investor and have a balanced portfolio across stocks, bonds, and alternatives. We suggest taking advantage of any stock market weakness to dollar cost average, further diversifying your portfolio, rebalancing back to your strategic asset allocation, and tax loss harvesting.

Is the US stock market expensive?

The S&P 500 forward Price to Earnings ratio (a measure of valuation of how expensive/cheap US Large-Caps are) is currently 25 which is where it was 1 year ago. Ironically, the S&P 500 Index is only up 6% over the past 5 months. Most of the movement we've seen in stocks is away from the broad US Large-Cap space. For instance, the Russell 2000 Index (a measure of US Small-Caps) is up 33% over the past 5 months.

Inflation

The broad M2 Money Supply grew 25% in December. Our fiscal deficit is about 15% of the US GDP. Currently, the returns of commodity equities suggest that a rise of inflation is plausible. For instance, since Nov 4, 2020, Copper Miners are up 35% and US Metals and Mining stocks are up 33%. Higher inflation could negatively impact the performance of bonds. Perhaps this is the reason why bond returns have been muted (the US Aggregate Bond Index is only up 0.40% over the past 3 months).

Potential risks from higher taxes

It is conceivable that the current corporate tax rate of 21% could be lifted to 28% which is halfway back to the 35% that prevailed prior to the Tax Cut and Jobs Act of 2017. Higher capital gains and higher effective tax rates on dividends are being discussed by market participants. High income earners could face higher taxes on dividends and capital gains.

Bull markets last for years, not months

Taking a step back, it is important to look at the big picture. We are seeing unprecedented fiscal and monetary support of epic proportion which should further support the market. Moreover, corporate earnings have inflected meaningfully higher and macro-economic data has notably improved. While markets have materially increased over the past year, we remain constructive on stocks and believe in globally diversified portfolios to help weather the storm.