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Artwork by Anna Petrova

As the strange year of 2020 draws to a close and I sit here after another month of social distancing, I can't help but think about the horror movie classic *The Shining* directed by the great Stanley Kubrick and based on the novel by Stephen King.

Released in 1980, it is a horror film where the ghosts are both real and imagined. The plot features a family isolated in a remote and vacant resort hotel in the Colorado mountains. The principal protagonist, Jack Torrance, played by Jack Nicholson, is an aspiring writer who takes a job as the hotel's winter caretaker so he can use the solitude to help him complete his new novel.

Soon enough, Jack loses his grip on reality, turns violent and threatens his wife and young son Danny with an axe. The son possesses the shining, an ability to conjure up images from the distant past. These images haunt both Jack and Danny throughout the movie. Predictably, the film has a "happy" ending. Before Jack can harm his family, he freezes to death while chasing Danny through an elaborate outdoor maze during a vicious snowstorm.

The Shining reminds me of 2020 for three reasons. First, the stresses placed on the Torrance family after a month or so of isolation are not dissimilar to the stresses our society has experienced during the pandemic. Extreme isolation—Kubrick seems to be saying—is a perfect breeding ground for social discord, violence and aberrant behavior.

Second, the year 2020, like Jack in the movie, has been "haunted" by events from the distant past—a serious pandemic which last occurred in 1918, a surge in the popularity of socialism last seen in the 1930s and racial strife and social unrest unlike anything since the 1960s.

Third, Kubrick was a master of bizarre and absurd plots and scenes. In *The Shining*, both the audience and characters often didn't know if the events that confronted them were real or imagined. In today's highly polarized political and media environment, investors likewise have a difficult time determining what is "fake news" and what is reality.

So far at least, the 2020 horror show, despite its human tragedies, seems poised for a "happy" ending because it seems our worst fears about the pandemic never materialized. An economic recovery is now underway. Home prices are on the rise and housing construction is surging. Interest rates are low and credit is easily available.

Bond prices are up sharply over the past year. Stock prices are more of a mixed bag. Led by a handful of technology related issues, large capitalization market indexes like the S&P 500 have posted modest gains for the first three quarters. However, small cap indexes have posted declines.

Looking ahead, 2020's events from the distant past will continue to influence the markets and the economy in the months ahead. The pandemic probably less so. Socialism and social unrest, probably more.

While it's true that new cases of Covid-19 are now rising in the US and Europe, I doubt that this "new wave" will derail the emerging global economic recovery. Covid-19 is a much more manageable disease today than it was just a few months ago. Death rates are not rising as sharply as case rates. Undoubtedly, many retailers, hotels, restaurants, travel and commercial real estate companies won't survive the pandemic. But the broader economy will likely continue to recover led by housing, technology, healthcare, and manufacturing-related capital spending. Jobs in these growing sectors vastly outweigh those laid low by the coronavirus. For investors, the pandemic is still important, but today it represents less uncertainty in the economic outlook and therefore less risk to the capital markets.

United and powerful forces

In my view, the rising popularity of socialism coupled with the political fallout from recent social unrest poses a potential risk for equity investors in 2021. My rationale is based on the observation that the political forces backing socialist ideas and social injustice protests have become much more unified and powerful in 2020.

For example, during the 2016 election, Bernie Sanders was the lone standard bearer for socialist ideology. Many of his supporters became alienated from the Clinton campaign due to email disclosures suggesting unfair treatment by the Democratic leadership. This time Sanders' supporters are firmly in the Biden camp. In addition, the "democratic socialists" have seen the rise of another standard-bearer, Alexandria Ocasio-Cortez, who defeated a 10-term Democrat incumbent in 2018. In 2020, a Sanders and AOC acolyte, new to politics, soundly defeated another 10-term incumbent in a New York primary.

The rising influence of Sanders and AOC in the Democratic Party is occurring at a time when many Democratic candidates are benefiting from the political energy and financial support generated by recent social injustice protests. The upshot is a growing probability of a Democratic sweep in the 2020 election. This, in turn, could lead to adverse 2021 tax legislation, such as an increase in the capital gains tax rate or in the corporate tax rate.

From my reading of recent polls and the betting markets, I put the probability of a Biden victory at 70% and the probability the Democrats win the Presidency, House and Senate (a sweep) at 50%. Obviously, if Biden wins the Presidency, but Republicans keep the Senate, the risk of adverse tax legislation is greatly reduced.

Still, a sweep is a non-trivial risk and one that many investors may want to consider hedging, i.e., realize some long-term capital gains in 2020 and take steps to reduce taxable income in 2021 and beyond.

The specter of inflation

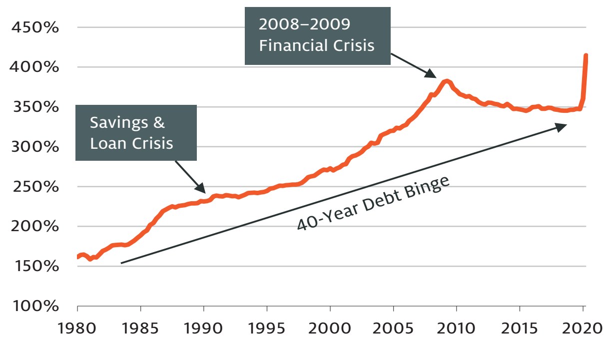
While adverse tax legislation would primarily impact the stock market, there's another specter from the distant past that could haunt the bond market in the years ahead. That specter is the return of inflation and with it rising interest rates. (See Exhibit 1.)

Currently, conventional wisdom holds that inflation is down-for-the-count. Indeed, for the past decade, the Federal Reserve and most developed world central banks have been trying to head off deflation, not control inflation.

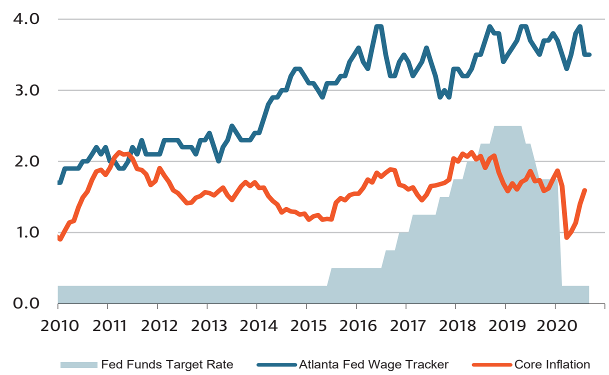
The Fed's favorite inflation indicator, the "Personal Consumption Expenditures index, ex food and energy" (shown as core inflation in Exhibit 1) is running at 1.6%. In August, the Fed released a new policy which indicated it would no longer throttle back the economy when inflation approached 2%, but rather aim at "averaging" 2% inflation over the economic cycle and sometimes tolerate inflation above 2%. What's more the Fed indicated it expected to keep rates low for an extended time. The Fed seems to be

Exhibit 1: A specter from the distant past, inflation could haunt the bond market in 2021. The left chart measures the nation's debt burden. US interest rates peaked in 1981 at 15.7% on the 10-year Treasury and fell over the next 40 years to a record low of 0.5% (50 basis points) last August. The forces of globalization, technological innovation and immigration helped keep inflation in check and drive rates lower. Will all this continue? Unlikely. The right chart compares recent inflation trends to the fed funds rate. Note how the Fed jacked up rates in 2016 as inflation pressures emerged. Now the Fed has pledged to be slow to act, despite wage growth at 3.5%.

Total Credit Market Debt as Percent of GDP



Wage Growth and Core Inflation vs. Federal Funds Rate (%)



Sources: Federal Reserve System, Bureau of Economic Analysis as of September 30, 2020.

throwing caution to the winds and lulling bond investors into a false sense of complacency about inflation.

There are straws in the wind suggesting an inflation problem is brewing. For one, the US money supply (M2) is now growing at an annual rate of 24%. In the Great Recession of 2008-2009 its growth rate reached only l0%. Remember the old saw about too much money chasing too few goods.

Here's another straw. Precious metal prices are surging. Gold prices were the best performing major asset class for the first nine months of 2020, up 25%. Silver leaped 26% in the third quarter. Oh, and the US dollar is weakening on world currency markets. All are leading indicators of inflation.

What's more, the steady rise in the nation's debt-to-GDP in the face of the persistence of low or declining interest rates is beginning to look like an economic "free lunch." Something's gotta give. My bet is that rising rates will eventually break the back of the 40-year debt binge.

Since the record low last August, longer-term interest rates have crept up to 0.75% currently for the 10-year Treasury. By comparison, an A-rated 10-year US corporate bond now yields about 1.5%. Both bonds provide investors no "real" return after backing out core inflation of 1.6%. In the case of lower quality bonds, investors are often provided little incremental yield for the additional credit risk. Thus, I remain cautious on the longer maturity, lower quality bonds. Not only do most bonds provide no premium over current inflation, future returns could be threatened by an unexpected rise in inflation.

In my opinion, better investment opportunities are available in the stock market. Many investors believe the market has done well in 2020 and that they have missed out. But the past year was a "Tale of Two Stock Markets." One very narrow market was dominated by a handful of large, technology-related, pandemic beneficiaries—the likes of Apple, Microsoft, Amazon, Facebook and Google. It performed very well. The other much broader group, which included the majority of stocks, generally turned in performance which ranged from mediocre to awful.

Here are some statistics that may surprise you:

- The top five stocks in the S&P 500 (identified in the paragraph above) represent about 25% of the index and are up almost 40% on average for the first three quarters of 2020. That's one reason that the index, weighted by a company's size, was up 4.1% in price, while the equal-weighted S&P 500 actually declined by 7.4%.

Exhibit 2: The five stock market indications suggest a moderately positive outlook for stocks. Four of the five indicators have changed since June. Two were upgraded to green: 1) longer term interest rates drifted higher, steepening the yield curve and helping the banking system and 2) the leading economic indicators bounced higher following the pandemic induced decline. The stock market's price/earnings ratio indicator turned red as rapidly rising stock prices and recessionary earnings combined to push the P/E above 20 times. Wage pressures intensified pushing that indicator into cautionary territory.

Indicator	Rationale	June 30, 2019		September 30, 2020	
The yield curve: Short- vs. long-term interest rates	When short-term interest rates rise to meet or exceed long-term rates, monetary policy is usually tight enough to eventually cause a recession.	Curve is relatively flat with short rates near zero	Yellow flag	Yield curve has steepened as long rates drift higher	Green flag
Widening spread between high- and low-quality bond yields	A widening spread between junk bond yields and Treasuries indicates deteriorating credit market conditions.	Credit Spreads down from recent peak, but wider than six months ago	Yellow flag	Credit spreads have narrowed, but wider than year end	Yellow flag
Rising wage inflation	When wages rise at a 4% annual rate, it is difficult for the Fed to keep core inflation near its 2% goal. So the Fed usually tightens policy aggressively.	Wage pressures subdued due to high unemployment	Green flag	Wage pressures gathering strength	Yellow flag
S&P 500 P/E ratio over 20 times	Price/earnings ratios over 20 times trailing four quarter earnings makes stocks vulnerable to rising interest rates and inflation.	P/E on trailing earnings at 19.5 times	Yellow flag	P/E on trailing earnings Over 20 times	Red flag
Downturn in Leading Economic Index®	The Conference Board's LEI has peaked and turned down in advance of each recession since 1960. Average lead time is 13 months.	Turning up from very low level	Yellow flag	Strong upturn in place	Green flag

Source: Atlanta Capital as of September 30, 2020.

- Smaller capitalization stocks dramatically underperformed larger cap issues so far in 2020. The Russell 2000 index declined 9.6% in price, while the large cap Russell 1000 gained 5.0%.

- The growth style of stock selection outperformed the value style by the largest amount on record. Year-to-date, the Russell 1000 Growth index returned 24.3% versus the Russell 1000 Value's loss of 11.6%. (The top five stocks in the Russell 1000 Growth are the same as those in the S&P 500, but represent about 37% of the Russell.)

The disparate performance of stocks during the last nine months may provide investors plenty of opportunities in the months ahead. My market indicators shown at the top of the page suggest a positive backdrop for the equity market. Once you look beyond the handful of "pandemic beneficiaries" which made "moon shots" once the virus hit, you can find many stocks with good growth prospects and valuations below the market's richly priced 20 times earnings. As the economic recovery progresses, the stock market should broaden out and investors should turn away from what worked best over the last 12 months to what will work best over the next twelve. The past will not be prologue.

Happy Halloween. ☘

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