Demming
Financial Services Corp.

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1ST QUARTER 2021

Special Notes:

We are back in our offices and our brand-new building addition!

We are excited to welcome in 4 new members to the Demming Financial Team!

Reminder: Please be sure to send in your 2020 Taxes!

Gambling vs. Investing

The financial media took a brief break from predicting everything that will happen in 2021 (don't laugh; it's their yearly habit) to bring us the engaging story of how masses of small amateur investors managed to bid the share prices of three largely-unprofitable companies—GameStop, AMC Entertainment Holdings and Blackberry—up nearly 1,000 percent, collectively. GameStop alone rose more than 14,300%—surely some kind of record for a firm whose market share is eroding and which most analysts think is clinging to an outmoded business model. (The company sells video games through bricks-and-mortar retail outlets in a world where everything can be downloaded.)

The story was allegedly about David (the small investors) pitted against Goliath (several prominent multi-billion-dollar hedge funds), and the only reason you heard about it is because the small investors won and nearly put the hedge funds out of business.

Market professionals recognize the story as a classic short squeeze: investors on one side (in this case the hedge funds) borrow the stock of companies they think are overpriced, expecting to buy them at a discount after the fall, allowing them to pocket a quick profit. These short sales have an expiration date, so if the stocks unexpectedly rise in price,

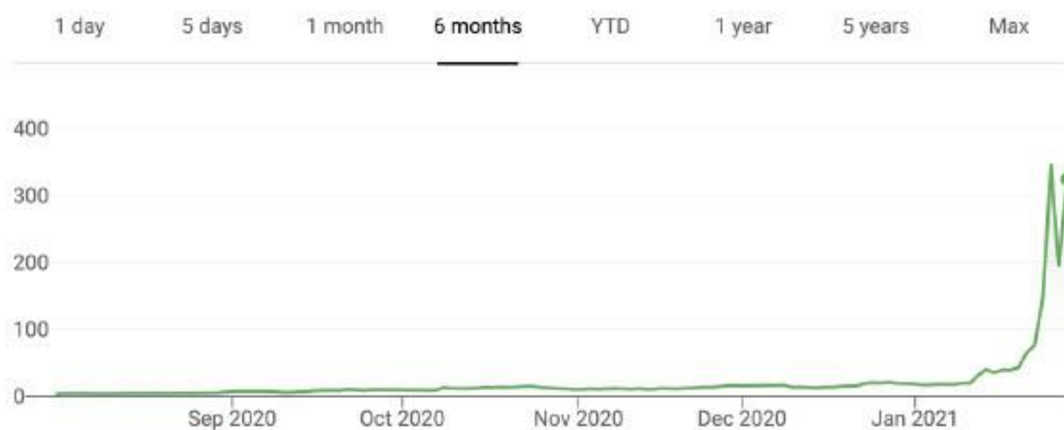
the short-sellers have to scramble buy the stock at the inflated price to limit their losses. On the other side of the gaming table were a group of amateur investors who engage in online conversations on subreddit r/wallstreetbets, who ganged up to raise each others' bids. When the hedge funds were forced to buy to close out their positions, the share prices went through the roof. The hedge funds, meanwhile, lost an estimated $5 billion on their bets; roughly $1.6 billion on January 29, when GameStop's stock jumped 51%.

What the financial media neglected to mention is that this activity is not investing; it is, instead, a form of gambling, and the story tells us a great deal about the mindset of many retail investors these days. When their goal is to make bets, and destroy other gamblers at the table, the game for everybody else becomes increasingly dangerous. Take a look at the past 6 months of GameStop's stock price and see if you can pinpoint when the gamblers started taking an interest.

Toward the end of every bull market cycle, there is an invisible line that is crossed, when the public starts to think of the stock market, not as a way to share in the growth and profits of public enterprises, but as some kind of roulette wheel where the ball always seems to stop on a higher price. These share owners cease to be long-term investors, and prices are bid up not based on the underlying value of the companies, but on the expectation that whatever you buy, at whatever price, someone else will come along and pay a higher price.

Of course, markets only work that way for a short time, typically at or around market tops. Eventually, the share prices of GameStop, AMC Entertainment Holdings and Blackberry—and perhaps many other stocks that are being gambled with at the moment—will return to something that more closely resembles the real value of the real company. Long-term investors have tended to win the kitty over every past historical time period, while gamblers have seen their short-term winnings evaporate in the ensuing bear market. The jubilant traders on subreddit r/wallstreetbets (does that name not suggest gambling?) can enjoy their winnings today, but it may not be long before they're counting their losses and wishing they hadn't gambled away the money that could be used to buy shares when they finally go on sale.

GameStop Share Prices for the Past Six Months



Where To Look For Inflation

Conventional economics tells us something that would seem to be obvious: when the government creates more money, there is more money available to buy things, and therefore the prices of things rise—and we get inflation.

For some reason, this logical sequence of events seems not to be happening today. The amount of money in the U.S. economy is 25% higher than it was at the start of 2020—the fastest pace of growth since the U.S. Federal Reserve banking system was established in 1913. You can see from the chart that we have experienced steady growth of the money supply until around 2009, when the slope increased (remember the Great Recession?), and then in early 2020 the growth of dollars in the system made another dramatic shift upwards.

Yet the published inflation rate, as measured by the Consumer Price Index, was up just 0.4% in December, and we finished calendar 2020 with the CPI up 1.4%-1.6%. Inflation, despite the flood of new dollars, appears to be extremely tame.

But is it really? There is evidence that the inflation effect is, at least temporarily, being squeezed into a few sectors that are not accounted for in the CPI. One of them is the cost of buying a house. U.S. housing prices, in aggregate, rose 8.4% last year, and median listing prices for houses on the market were up 14.4%—two numbers which would be considered highly-inflationary. And if we are looking for the pain caused by inflation, then you can point to the housing affordability crisis that is emerging in 2021.

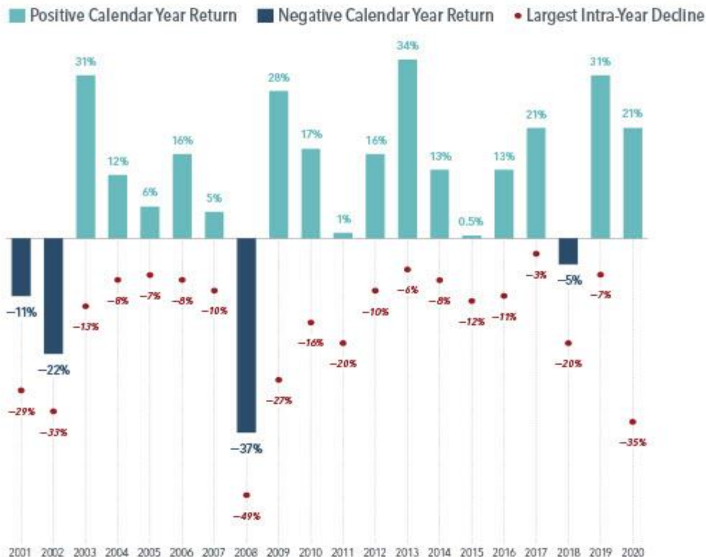
An even more dramatic example of inflation is a place where most people tend not to look for it: in the investment markets. A recent article took an unusually perceptive look at the impact of record stock prices and historically low bond rates. Noting that high stock prices reduce the value of dividends proportionately, and low bond rates make interest income more expensive, the authors looked at how much it would cost to "buy" $1,000 a year of income in the investment markets. Historically, if you invested $25,000 in a 50/50 stock/bond portfolio, that portfolio would generate $1,000 a year of income. That figure is roughly $80,000 today—and you can see from the chart that we are way, way above historical norms since 1870.

The rise in housing prices, stocks and bonds suggests that the influx of dollars is being felt in the economy, just not in ways that impact the CPI.

Do Downturns
Lead to Down Years?

Dimensional

US MARKET INTRA-YEAR DECLINES VS. CALENDAR YEAR RETURNS,
January 2001–December 2020



Stock market declines over a few days or months may lead investors to anticipate a down year. But the US stock market had positive returns in 16 of the past 20 calendar years, despite some notable dips in many of those years.

- Intra-year declines for the index ranged from 3% to 49%.
- Many years with large intra-year declines saw positive annual returns. In 16 of the last 20 years, US stocks ended up with gains for the year.
- Even in 2020, when there were sharp market declines associated with the coronavirus pandemic, US stocks ended the year with gains of 21%.

Volatility is a normal part of investing. Tumbles may be scary, but they shouldn't be surprising. A long-term focus can help investors keep perspective.

2021 First Quarter Report

What a difference a year makes! Unlike the situation in the first quarter of 2020, U.S. stocks posted healthy gains since the start of the year, and there is optimism that the recent flurry of government checks to individual consumers, plus the huge infrastructure project on the drawing board, will give the economy a shot in the arm. Other countries are looking at the U.S. bull market with envy, and the American economy seems to have weathered its biggest challenge since at least 2008.

Just about every investment saw gains in the first quarter. The Wilshire 5000 Total Market Index—the broadest measure of U.S. stocks—gained 6.49% since January 1. The comparable Russell 3000 index is up 6.35% so far this year. Looking at large cap stocks, the Wilshire U.S. Large Cap index gained 5.80% in the first quarter. The Russell 1000 large-cap index finished the quarter with a similar 5.91% gain, while the widely-quoted S&P 500 index of large company stocks has gained 5.77% so far this year. Meanwhile, the Russell Midcap Index gained 8.14% in the first three months of 2020.

As measured by the Wilshire U.S. Small-Cap index, investors in smaller companies, experienced a dramatic 13.53% gain in the first quarter. The comparable Russell 2000 Small-Cap Index is up

12.70% in the year's first three months. The technology-heavy Nasdaq Composite Index is up 2.78% for the year, as tech stocks finally took a back seat to their peers in other economic sectors.

International investors saw far more modest gains. The broad-based EAFE index of companies in developed foreign economies gained 2.83% in the first quarter. In aggregate, European stocks are up 3.52% so far this year, while EAFE's Far East Index was up just 1.74%. Emerging market stocks of less developed countries, as represented by the EAFE EM index, gained 1.95% in dollar terms in the first quarter.

Looking over the other investment categories, real estate, as measured by the Wilshire U.S. REIT index, posted an 8.81% gain during the year's first quarter. The S&P GSCI index, which measures commodities returns, gained 15.77% in the 1st quarter.

In the bond markets, the rates on longer-term securities jumped from historically low rates to simply low rates. Coupon rates on 10-year Treasury bonds rose to a 1.67% yield, while 3 month, 6-month and 12 month bonds are now sporting barely positive yields for the first time since this time last year. Five-year municipal bonds are yielding, on average, 0.50% a year, while 30-year munis are yielding 1.79% on average.

This is obviously a big change from this time last year, when stock markets in the U.S. and abroad were reeling from a historically rapid downturn. Today, most analysts believe that the market is overvalued, and many professional investors are cautious. But any move to get out of the markets when this overvaluation became evident would have meant missing huge gains in the markets, proving once again the folly of trying to time the market. Also, we are looking at a multi-trillion dollar infrastructure proposal which would inject additional life into the U.S. economy.

Better news: analysts have increased their earnings estimates for S&P 500 companies by 6.0%—which is a record—and unemployment rates have been trending lower since the start of the year. Finally, the progress of vaccination against COVID appears to be picking up, with some estimating that all adult Americans will be vaccinated in the next couple of months. A return to normalcy could be viewed as another positive sign.

The only dark clouds on the horizon—and these are really gray, not black—is the rise in longer-term interest rates. The U.S. Federal Reserve Board continues to hold down short-term rates to essentially zero, which means several things. First, we have a steepening yield curve, which is often an indicator of economic health. Second, people who invest in longer term bonds are finally getting paid something for their trouble. But higher long-term interest rates make bonds competitive with stocks for investor dollars, which could trigger a shift in investment flows which, in turn, could lead to lower stock prices.

All of this is a long-winded way of saying that it is impossible to predict whether the markets will continue the long bullish run or take a break. It is not impossible that stocks will eventually return to more historical valuations—suggesting prices at least 30% lower than they are today—but that could happen gradually, as companies boost their earnings while market returns go back down to single digits. The sudden, unpredicted appearance of the pandemic shows us how little we know about what is to come.

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New Team Members

Tyler Colton, CPA- Associate Advisor

Andrea Kahn- Operations Manager/CSA

Jake Smail- Financial Planning Associate

Michael Straus- Operations Associate

New Building

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