MONONGAHELA CAPITAL MANAGEMENT

PERCEPTIONS

4th Quarter, December 31, 2020	12/31/2020	% Change 4th Quarter	% Change Year to date
Dow Jones Industrials	30,606.48	10.73 %*	9.72 %*
S & P 500	3,756.07	12.15 %*	18.40 %*
Russell 2000	1,974.86	31.37 %*	19.96 %*
BC Aggregate BD Index		0.67 %	7.51 %
10 YR. Treasury Yield	0.91 %		
30 YR. Treasury Yield	1.64 %		

* *Includes reinvested dividends*

The Perils of Consensus Forecasting

"If we become increasingly humble about how little we know, we may be more eager to search."
John Templeton

John Templeton, one of the most successful investors and mutual fund managers of the 20th century, invested with a worldwide growth philosophy through the lens of a value investor. His Templeton Growth Fund, established in 1954, averaged a 14.5% annual gain over the next 38 years, outperforming broader stock indexes. An initial investment of $10,000 with dividends reinvested would have grown to $2 million by the time he sold the Fund to Franklin Resources in 1992. He was also a noted contrarian, understanding one of the keys to outperformance was going against the grain, avoiding the popular groupthink of the day. Templeton focused on value as opposed to outlook and trends.

With prices in many markets at record highs, we thought it would be relevant to examine interest rate risk from a value perspective. The prices of all investment assets tend to rise as interest rates fall; the reverse is also true. Almost all investment analysis involves some form of forecasting interest rates in order to estimate future cash flows or earnings. With short and long term yields near historic lows, the present value of future earnings increases, raising the underlying asset price. As an example, the price of high yielding long term quality bonds purchased years ago at 10% has risen significantly because the future cash flow is much more valuable in a low interest rate environment. Likewise, technology stocks over time are expected to grow revenue and earnings faster than industrials, utilities or pharmaceuticals.

This expected higher future revenue stream is reflected in the pricing of some of the technology growth stocks like Tesla, Google, Amazon, Netflix and Apple. These growth companies are leaders in innovation and understanding the changing consumer landscape. At the same time, as long-duration assets, they are beneficiaries of the low interest rates used in modeling the value of future revenue streams and cash flows.

It is almost a universally held belief that interest rates will stay low for the "foreseeable future," a phrase that has always seemed nonsensical to us. The Federal Reserve, the European Central Bank and large Wall Street banks are forecasting a benign interest rate environment with low inflation for years to come. As we examine the various forecasts for pricing assets, very few analysts, public or private, consider the possibility of a higher interest rate variable or higher inflation environment. When we plug the possibility of higher rates into our proprietary discount models, asset pricing declines, especially for long-duration assets.

It is interesting to note the slight rotation away from highly valued large capitalization technology stocks into value stocks in the fourth quarter occurred at the same time that interest rates began to climb. The 10-year Treasury was yielding 0.55% near the COVID crisis mid-year low and, in mid-January is yielding 1.10%. For some perspective, the 10- year yield was 3% in November of 2018. A return to higher yield levels would likely let air out of the exuberant pricing in some market segments, like SPAC's, hot IPO's, Robinhood trading stocks of the day, and priced for perfection technology issues.

As the economy continues to recover, the almost universal consensus view of low rates ad infinitum will be challenged. Like the late John Templeton, we are humble enough to recognize that no one knows with certainty when interest rates will rise, but we would be remiss in our forecasting if we did not price in the possibility of higher rates. A significant change in direction will be seismic in recalibrating style and sector allocations. The change will present risks but also opportunities in sectors that have historically performed well when rates are rising. We will rebalance your portfolio accordingly.