Fourth Quarter 2020

ECONOMIC & MARKET REVIEW

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Bravo! Bravo! What a Performance in 2020…

2020 can be described as one of those suspenseful horror films that eventually surprised everyone with its twists and turns towards a happy ending — in this case for the financial markets. After an initial shock last March when the global pandemic dropped the curtain on the world economy, the stock market delivered an unbelievable performance last year. Smashing through all previous box office records, the S&P 500, Nasdaq, and Russell 2000 indexes reached new all-time highs in 2020 with returns of 18.4%, 44.9%, and 20.0%, respectively. Even the bond market put in a star-studded performance of 7.5% for the year that saw 10-year yields fall to a record low of 0.50%.

S&P 500 Index Throughout 2020

As lead actor, the Federal Reserve deserves the Oscar for its role in turning the stock and credit markets around after intense fear from the unknown COVID-19 virus gripped investors. Pulling out the script from the 2008-2009 Great Financial Crisis, the Fed immediately cut rates to 0% and reintroduced its favorite classic — the quantitative easing program, casting first-time guest appearances by investment grade corporates, municipal bonds and even exchange traded funds. Best supporting actor awards go to the White House and Congress for the CARES Act which provided an income bridge for small businesses and individuals until the economy could begin to reopen last summer. And, finally, the award for best picture has to go to the U.S. medical science community for developing the vaccines we had all been hoping for, and setting the stage for the next act.

Now Bring on the 2021 Encore

While the snapback in the real economy has been remarkable so far, we are likely to experience a near-term intermission in the recovery until the vaccine

Key Points

- Capital markets have responded favorably to the vaccine news as well as supportive fiscal and monetary policies.
- Deteriorating virus trends negatively impacting the pace of the near-term recovery.
- Financial markets are anticipating improved economic and profit growth with the efficient distribution of an effective vaccine.
- National election results provide more clarity around future fiscal policy.
- In 2021, expect consumers and excess savings to be released on the global economy.

Q4 Performance	
S&P 500	12.2%
Russell 2000	31.4%
Barclays Aggregate Bond	0.7%
MSCI EAFE	16.1%
MSCI Emerging Markets	19.7%

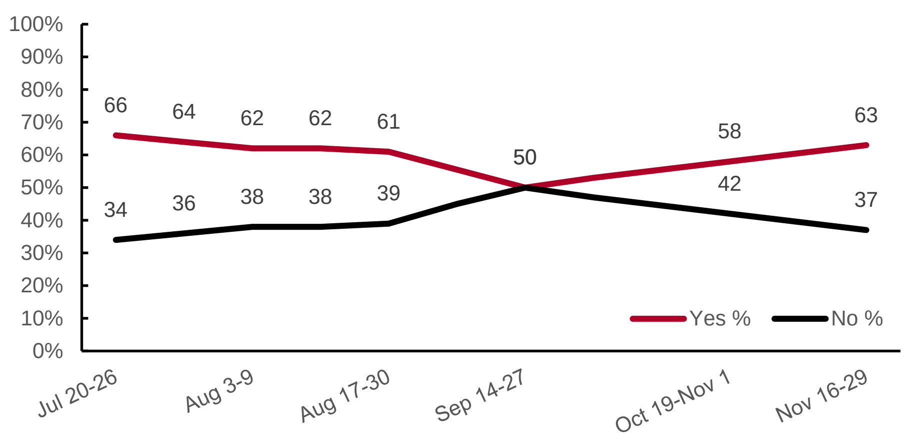
is more widely distributed in the second and third quarters of 2021. With the recent surge in virus cases, hospitalizations, and deaths in the U.S. and in Europe, the house lights are starting to dim again on the economic recovery as a result of increased shutdowns. The line of unemployed workers waiting to get in to file first-time jobless claims is still wrapped around the block, and small business revenues are starting to roll over again. Fortunately, the Republicans and Democrats in Washington were able to make concessions in December and deliver another $900 billion COVID-relief package (approximately 4% of GDP) to help areas of the economy that are still stuck in their seats.

With President Trump exiting stage left and President-Elect Biden stepping into the scene, U.S economic, regulatory, and international policies are going to change. Passage of the major tax and fiscal spending programs that Biden campaigned on looks less likely following the November general election results for the House and Senate. The state of Georgia has a senate election run-off for the two remaining seats on January 5th. The Republicans secured 50 seats in the Senate following the November national general election, and current betting markets favor Republicans to maintain their majority by better than 70% odds. Financial markets are applauding expectations for a divided government with no major changes in corporate and personal income taxes, and expectations for improved relations with our international trading partners.

Spotlighting the release of the blockbuster vaccines, we are much more confident in our optimistic economic growth estimates for the full year of 2021. The FDA has granted emergency use authorization for the Pfizer/BioNTech and Moderna vaccines, which are currently being distributed according to a phased approach based on dosage supply and people most at risk. Given projected supply production estimates, we expect there to be sufficient U.S supply to vaccinate everyone around midyear, and for the U.S. to achieve herd immunity in the third quarter. There are many known risks around the immunization schedule; chief among them the willingness of the general public to receive the vaccine. We are encouraged by recent surveys indicating that more than 60% of Americans would be willing to take the vaccine.

Americans' Willingness to Receive a COVID-19 Vaccine

Survey: If an FDA-approved vaccine to prevent COVID-19 was available right now at no cost, would you agree to be vaccinated?



Rollout of the vaccine to broader populations during midyear is expected to release pent-up demand for travel experiences and live, in-person entertainment that has been bottled up during the pandemic. U.S. consumers have used their time at home to build up excess savings and have taken advantage of cheap tickets for home mortgages to refinance debts at much lower interest rates. The next round of stimulus checks and extension of the Paycheck Protection Program will likely keep growth popping again in 2021. While the long-term trend for GDP growth is 1.5% to 2.0%, we wouldn't be surprised to see annualized quarterly growth rates hit 6% next summer.

What about the financial markets?

After rave reviews for last year's performance, a standing-room-only crowd is expecting above average performance in 2021. Rarely is the sequel as good as the fans expect, and the extreme bullish sentiment in both the equity and credit markets does give me pause. We are likely to experience above average economic and profit growth in 2021 with the efficient distribution of an effective vaccine. But, much of the anticipated 2021 good news is already priced into current market levels. However, high valuations aren't a sufficient catalyst for us to get bearish, especially since we are expecting better earnings, and interest rates are likely to remain low. The Federal Reserve is expected to continue to support the risk markets with its balance sheet expansion that keeps P/E multiples elevated and credit spreads tight. Unlike the multi-pronged expansion that drove markets higher in 2020, returns this year likely will be driven primarily by earnings, which are expected to be much better.

Like the cinema schedule these days, our expectations are subject to change without notice, but at this point we expect positive equity market performance, particularly for the first half of the year. Given high valuations, I lean towards single digit returns overall for the U.S. equity markets for the full year. With the historic low starting yields in the bond market and improving GDP growth, it's going to be a tough year for high grade bonds to generate much return as long-term rates drift higher. After warming up to the equity markets this past summer, we favored an overweight to U.S. equities with an emphasis on the tech-heavy large cap growth stocks. After realizing earlier than expected gains, we preferred equities even moreso, anticipating the FDA vaccine approval, but swung towards the more cyclical value-based stocks that had been lagging the recovery. After the first round of positive vaccine news was announced in early November and value stocks posted meaningful gains, we reduced our preference to value while still seeing opportunity for value to outperform growth. We continue to monitor the developed and emerging international markets for an opportunity to potentially increase exposure, since the indices are more cyclically exposed and have relatively more upside to run as the global economy improves and the U.S. dollar trades lower on average. Bottom line: We are expecting above average economic growth and average market returns in 2021.

Here's to a prosperous New Year!

Disclosures

Chart data source: Bloomberg, Gallup survey data

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