FINANCIAL MANAGEMENT STRATEGIES

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Vaccine Optimism, Election Drama & Market Movement Higher to End 2020
January 2021

My Dear Client:

We happily turned the calendar page from the Year of the Pandemic (actually, the Year of the Rat in the Chinese Zodiac) into a happy 2021, Year of the Vaccine (really the Ox). The themes that drove the markets in the fourth quarter were positive economic data, talk of another stimulus package and the first COVID vaccines being distributed around the world.

While election noise raged throughout the quarter, in many respects the markets seemed to ignore the political chatter. Unfortunately, the political turbulence from 2020 came into 2021 as domestic terrorists stormed the U.S. Capitol on January 6th seeking to halt the certification of newly elected President Biden. Yet as it did during the fourth quarter and much of 2020, the stock market continued its climb.

The fourth quarter of 2020 saw the furtherance of the “Fed Put” belief that the Federal Reserve Board will continue to come to the rescue at all costs with unlimited liquidity and low interest rates to buoy U.S. markets. Further, the beginning of vaccine inoculations at the end of December gave relief and encouragement to billions across the globe that normal life is only months away. These beliefs help explain why, regardless of the source of turmoil and upheaval, equity markets led by the NASDAQ reached new all-time highs.

Standard & Poor’s (S&P) 500 returns grew 12.1 % in 4Q20, 18.4% for the year; the Dow Jones Industrial Average (DJIA) returned an additional 10.2% for 4Q20 and 7.3% in 2020, and the NASDAQ returned 15.7% during last quarter and finished 2020 up a sizzling 43.6%. U.S. small-cap stocks, international and emerging markets (especially smaller) were the other big stars, with all three posting record numbers for either part of or the entire fourth quarter.

Like an early present three days before Christmas, the U.S. Department of Commerce released the “third” estimate of real gross domestic product for the third quarter – and it was revised to a new record, from 33.1% to 33.4%. Of course, this is a complete contrast to the horrific -31.4% decrease reported in the second quarter, when daily Covid-19 hospitalizations and deaths reached record highs and states renewed lockdowns, of varying severity.

In the overall economy, retail sales and household incomes fell sharply in November while household spending contracted for the first time since April. The U.S. unemployment rate continued to report improvement, now standing at 6.9%. But in December, weekly jobless claims hit their highest level in over three months, and even the robust housing sector showed signs of moderating.

Personal income increased; personal spending decreased, led by a massive -$535B year-over-year plummet in spending for services (which naturally helped personal savings skyrocket – the *New York Times* reported that personal savings rose 173% above 2019 levels).
We start 2021 with ample reasons for optimism and caution.

Domestic equity market

Value stocks decisively beat growth stocks and small caps trounced large cap stocks this quarter.

The historic performance gap between growth and value narrowed this quarter across all market capitalizations. The Russell 1000 Growth was up 11.4%, versus a 16.3% gain for the Russell 1000 Value. Though Large-cap growth lagged large-cap value 5% for the quarter, it still was the far-away winner between the two styles for the full year 2020.

Yet most noteworthy was Small-cap (Russell 2000) posting a spectacular 31.4% gain for the quarter and a 20% rise for 2020 compared with the Large-cap (Russell 1000) 13.7% gain for the quarter and 21% return for the year.

A deeper look during the fourth quarter shows Small-cap growth stocks up 29.6% and Small-cap value stocks up 33.4%. This year-end surge by smaller capitalization stocks signals market belief that we are within a year of: a) economic activity returning to a form of normalcy, b) small caps much cheaper than larger cap, c) a long trend of a weak dollar that hurts companies that sell products overseas and helps those that sell in-country and d) some combination of all of these.

Economically sensitive sectors made the strongest gains, with more defensive sectors making more solid progress. All economic sectors saw positive returns in the fourth quarter, with Energy up ~~(~~29.5%~~)~~, reversing its terrible prior quarter and stemming its year-long dive. The other double-digit leaders this quarter were Financials returning 25.4%, Communication Services 18.15%, Industrials 17.6%, Materials 17.5%, Consumer Discretionary 14.9%, Information Technology 13.8% and Health Care 10.1%. Real estate (9.3%), Utilities (7.7%) and Consumer Staples (7.2%) also had good year-end quarters. The broadening of leadership to more value-oriented sectors that we saw in prior quarters was even more pronounced, with the massive upswing in Energy and Financials.

The Federal Reserve doubled down on its supportive message that it will continue with current levels of quantitative easing. Chair Jerome Powell and multiple other Fed governors have made it clear that they are not "thinking about thinking about raising interest rates" and "are comfortable if the economy goes slightly past their 2-percent inflation target."

These statements, paired with the monetary infusion of replacement dollars by Congress and White House ("stimulus" is the wrong pronouncement since these dollars are to replace income and wages lost due to Covid-19), mean there will continue to be a lot of dollars at rock- bottom interest rates chasing assets.

International markets

International markets had a very good quarter. As with those U.S., Value stocks performed better than Growth; smaller beat larger.

During the fourth quarter, emerging markets were once again the performance leader in non-U.S. stocks. Developed international equities as measured by the MSCI EAFE Index (net of taxes) were up an impressive 16%. Emerging-market equities (as measured by the MSCI Emerging Markets Index) rose even stronger, up 19.7%. EM equities generated their strongest quarterly return in more than a decade, with a weak U.S. dollar boosting gains. Korea, Brazil and Mexico were the leading outperforming countries. China finished positively, yet lagged.

The launch of an antitrust investigation into Alibaba and further escalation in the U.S.-China tensions dragged on sentiment. In December, the U.S. added four more large state-owned enterprises (SOEs) to its investment blacklist of stocks deemed to have links with the Chinese military. As one of the final acts, the outgoing President signed the Holding Foreign Companies Accountable Act, requiring foreign publicly traded firms to comply with U.S. audit rules within three years or be delisted.

Market leadership tends to last for many years, even a decade, before reversing at the start of a new cycle. For example, after international stocks outperformed in the 1980s, the 1990 recession saw a shift to U.S. stock outperformance. The 2001 recession saw a switch back to international outperformance, and the 2008 recession flipped the switch again to U.S. outperformance. And now, the start of a new cycle may once again signal a switch to international stocks.

A new economic cycle is beginning as the global economy emerges from the virus-induced economic downturn. This could lead to outperformance by international stocks supported by better economic growth, lower equity valuations and a weaker U.S. dollar. Since the end of April of last year, when global economic data appeared to have hit the low point for the cycle, international stocks have been outperforming U.S. stocks. If global growth resumes, many expect it can bolster international equities' continued outperformance in 2021.

Bond markets

The U.S. bond market, as measured by the Bloomberg Barclays Aggregate, had 0.7% gain in the last quarter, almost identical to 3Q20 and finished the year up 7.5%. The U.S. Treasury yield curve moved slightly steeper and Credit spreads continued to tighten between Investment grade and High Yield bonds. Investment Grade (IG) corporate bonds returned 3.05% in the fourth quarter. Municipal bonds both taxable and tax-exempt did well again during the quarter, providing returns outperforming comparable Treasuries by nearly 3%.

For much of the year markets often seemed out of sync with current economic conditions. In this case, the bond market is focused on the potential for stronger growth and higher inflation in 2021. Languishing near record lows for most of the year, 10-year Treasury yields finally pushed above 1%, their highest point since March 2020.

A Fed patiently waiting for inflation's return before considering raising rates should lead to higher interest rates, especially in longer maturities. The combination of vaccine hopes, fiscal spending under the Biden administration, and the Fed's determination to keep interest rates low is driving inflation expectations higher. Under its new framework, the Fed won't start to raise interest rates in advance of a rise in inflation above its 2% target. Instead, it intends to let inflation run above its target level in hopes of driving the unemployment rate lower.

The combination of these three factors is driving inflation expectations higher. The implied inflation rate derived from the Treasury Inflation-Protected Security (TIPS) market has risen sharply in the past few months, signaling expectations that inflation will reach the Fed's 2% target. And should the extraordinary fiscal spending combined with Fed actions breach this level in 2020, the bond markets' reaction will be swift and volatile.

A Look Ahead

The year 2020 will last in our memories for generations and testify to the unpredictability of life. The market's historic peak to trough to rebound is likely the best modern example of the adage "the market seeks to climb a wall of worry."

In the third-quarter commentary I said the market was "providing investors a *golden opportunity to reevaluate their portfolios and risk exposures."* The explosive upward moves in U.S. small caps, emerging and international, and the NASDAQ stocks seems to reaffirm that we should be patient and prepared to act quickly.

The U.S. stock market continues to rise higher regardless of its record valuation levels, as the Fed seemingly forces investors up the risk curve. I heard these phenomena of chasing/needing higher returns best described by a former Goldman Sachs partner, Leon Cooperman: "T-bill purchasers are buying T Bonds, who are buying Industrial Bonds, who are now buying High Yield debt, which are buying Structured Credit, which now is trying their hand at Equities, and Equity investors now want to own Bitcoin."

GMO founder Jeremy Grantham, drawing on his experiences of being two years early for the collapse of Japan in 1989, three years early for the dot-com bubble of 2000, and nearly spot-on for the 2008 Great Recession, simply calls today's market "an epic bubble like the South Sea Bubble, 1929 and 2000."

Technology is 6% of GDP and 2% of employment, but it represents 38% of the market capitalization of the S&P 500- comparatively small business is 50% of GDP 47% of private employment ***and 0% of the stock market!***

The damage to the U.S. economy, most notably to small entrepreneurial business, is only worsening entering the new year despite the federal and state aid that was approved at the end of 2020. For far too many of them and the communities they serve there will be no recovery.

My portfolio considerations, while thematically consistent with those of the past year, offer further adjustments to enhance your asset allocations. Maintain a risk-balanced focus, multi-asset class approach and evaluate opportunities and be ready to invest when larger short-term declines occur. Consider:

- Maintaining overall U.S. equity allocation to portfolio targets and below maximum range;
- Raise cash from Large-cap growth stocks and private U.S. equity sales for increasing investments in Emerging and International stocks and more Small/Mid-cap allocations;
- Underweight overall fixed-income portfolio allocations and maintain diverse high-quality bond portfolios and proven opportunistic credit strategies for yield;
- Seek niche, opportunistic and secondary illiquid private investments including some VC, Real Estate opportunities (which are beginning to appear), along with Infrastructure; and
- Continue prior asset allocation adjustments in public equities~~,~~ for further rebalancing – and *having cash* inside your portfolio is still a good idea.

We will maintain disciplined, pragmatic approaches and patience to strategically deploy capital, riding the Fed's wave without reaching for extra risk to your portfolio to meet our long-term objectives and goals.

Lastly, many investors' interest in the "E" for environment (as well as in "S" for social and "G" for governance) of ESG continues to grow. Please know that this has and always will be a deep part of our firm's DNA that we can happily talk about at length.

As always, it is a pleasure to serve you, and I look forward to continuing our work together. Stay safe and healthy.

Appreciatively,

Walid L Petiri

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Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board, New York Times, Small Business Administration.