Fox-Smith Wealth Management Quarterly Commentary

First Quarter - 2021

"Fear and Uncertainty Give Way to Recovery and a Long Overdue Rotation in Market Leadership"

Economic Outlook and Market Commentary – Gustin D. Fox-Smith, AIF®, ChFC®

I have written an annual market commentary for many years now and never have I been as happy to see a year come to a close than I am today. I am happy to see 2020 pass into the rear-view mirror and I am hopeful that 2021 will be a more rational and less fearful time for all of us. We certainly deserve it.

2020 – Year in review

As usual, I like to start my 1st quarter commentary by looking back at where we have been. I also like to provide a reminder of the predictions we made in the last year so that I can enjoy the things we got right and hold myself accountable for the times I was wrong. Fortunately, we were correct on many decisions in 2020, which allowed us to deliver solid results in an otherwise stressful year.

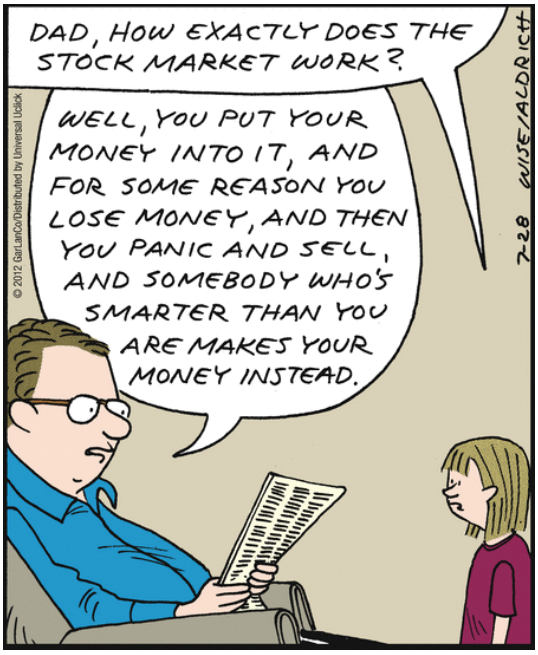
2020 INDEX PERFORMANCE	
S&P 500 (US Large Stocks)	+18.40%
Russell 2000 (US Small Stocks)	+19.95%
MSCI EAFE (Int'l Stocks)	+7.82%
Barclay's U.S. Aggregate (Bonds)	+7.75%
Morningstar Alts. (Alternatives)	-2.43%

Source: Morningstar

In my commentary one year ago, I was convinced that my 2019 predictions of a mid-2020 recession were off the mark. On this call I was dead wrong, but no one could have seen the cause of last year's recession coming. At that point, things were on the upswing and I predicted another growth cycle without a 2020 recession, but I was hesitant to move out of our defensive positions without seeing some manufacturing growth to confirm my view.

As much as I would like to take credit for our strong performance in the face of the Covid decline, I often say "I would rather be lucky than good." And already being positioned for defense ahead of a virus hitting the scene was definitely serendipitous. By the time manufacturing data started to give the "all clear" signal in late February, we had just been introduced to Covid-19. The virus caused us to remain cautious with our portfolios just as the first lockdowns were implemented. Our defensive positions helped to hedge all of our strategies from a large portion of the decline that quickly ensued in March. While the S&P 500 index posted a peak to trough decline of over 32% in just 3 weeks, *(Source: Morningstar)* our portfolios were properly positioned to endure the market's volatility. From that point, the market was primarily driven by the ups and downs of Coronavirus related news for the remainder of the year.

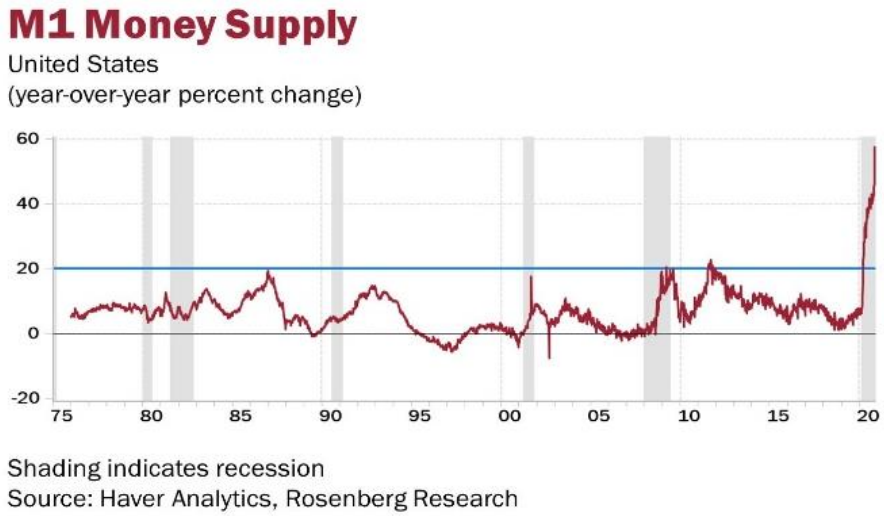
Source: Yahoo Finance

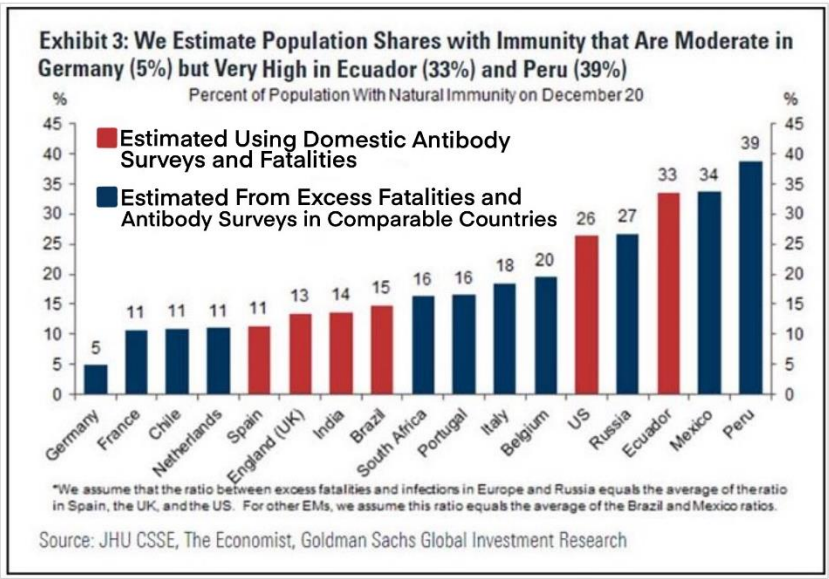


We made another successful call during the worst days of the Covid market correction. At that time, I was publishing an article roughly every other week to help calm nerves and explain what was happening in a frightening market. In one of those pieces, on March 18, I wrote and published an article titled *"Bottom Signals are Forming"*. In this piece I described current trading activities and stated that *"There is no doubt that those with a steel will are able to find opportunity in a crisis and I believe that the time is close at hand to think bullishly about what comes next mainly because of one word, Capitulation."* On this one I hit the bull's eye as the market hit its lowest point March 23rd, just 3 trading days after publication of the article. But accurate prognostication isn't worth anything unless you have the will to act upon it. Seeing the opportunity that presented itself in certain sectors of the market, we eschewed fear and capitalized on far oversold prices. In our Sector Rotation portfolios, we bought Leisure stocks within a few days of market bottom and it has been a great move so far, contributing a large portion of our outperformance this year.

2021 – Market Outlook

In spite of a tumultuous election season (and, as I write this, an even more eventful elector certification day), the markets fully recovered from the Covid correction quickly and posted healthy gains by year end, in spite of the fact that large portions of the private economy are still locked down. With markets hitting new highs and a monumental amount of cash and liquidity in the financial system, it is my view that it will be difficult for the market to deliver losses in the year ahead. As of today, U.S. households and institutions have amassed over $5 Trillion in cash, equal to roughly 25% of annual GDP. Eventually, as people begin to feel things are improving, this cash should begin to re-enter the system as demand for goods and services or investments, either of which will likely have a positive impact on the financial markets. Because of these factors, it is my view that we have another year of gains ahead, though I expect the gains will be more modest than last year.



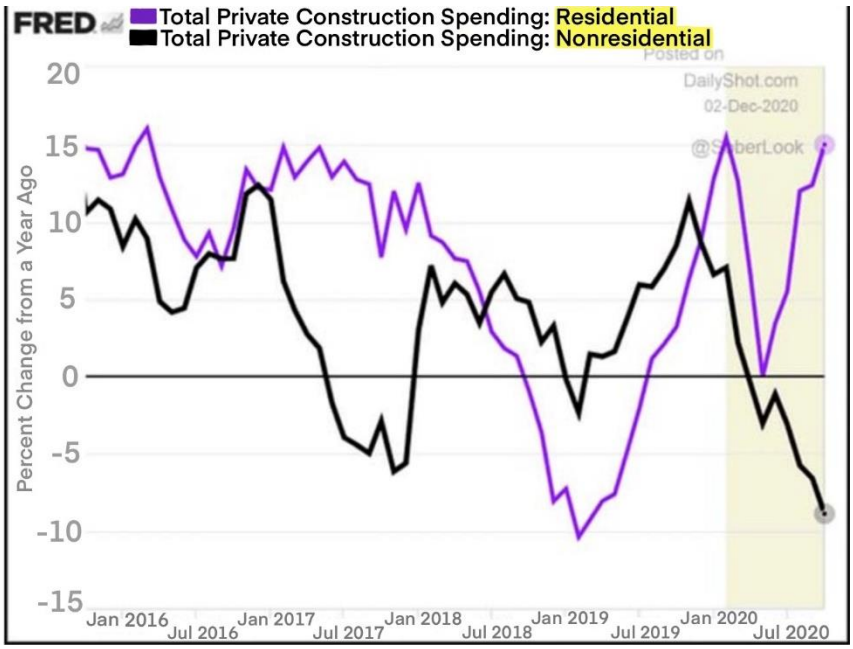


Looking beneath the broad market, there are several things that I expect we will see in 2021. First, now that the Coronavirus vaccine is here and being distributed rapidly, we expect that the economy will reopen in stages and that the worst is now

behind us. This should release a flood of pent-up demand for goods and services due to the record levels of cash and low debt in the financial system. As long as we do not continue lockdowns too much longer, you may be surprised by how quickly things recover and start to feel close to normal. That being said, there are some things we were used to before Covid-19 that I think may not be coming back. For example, buffet restaurants and the need to actually leave your home to buy necessities are both unlikely to return.

Another effect of the virus has been an acceleration of the trend of household formation for Millennials. This demographic shift began in 2018 and was well underway. Recent events have only served to increase housing demand. Ask yourself, would you want to continue living in a large apartment or condo complex with a deadly virus moving through your city?

Year over year, we saw a 22% increase in mortgage applications between October 2019 and October 2020, and this was after removing refinancing applications from the data. *(Source: JP Morgan GTM) So*, the growth is from home purchases alone. This has driven demand for single family homes to an all-time high and has resulted in inventories of unsold homes reaching historic lows. We expect this demand will continue for several years and creates an opportunity for investment in residential real estate. It should also make your current home's value grow rapidly in the coming years and may result in a glut of vacancies in multi-family properties soon. With rental prices far above affordable levels in most metro areas, the corresponding decline in rental costs should be a welcome result.



As demand for homes exploded, the flip side of that coin saw retail and commercial real estate collapse as firms cancelled office construction projects and the shift to online shopping became a necessity, crushing traditional brick and mortar stores.

On another note, Large Growth stocks have outperformed every other broad asset class for several years. For the last 9 months we have been calling for this to change, but they just kept marching on. We have also seen U.S. stocks outpacing International stocks for one of the longest periods on record. As a result, we have been expecting that the rotation to a season of foreign market leadership was imminent as well.

Immediately following the election, the market began trading very differently. The last 60 days of 2020 saw U.S. Small Cap stocks explode to the upside, nearly tripling the S&P 500's gain for the same period. Small Caps gained so much more that the Russell 2000, the most widely referenced U.S. Small Cap Index, had blown past the S&P 500 to end with a much larger gain for the full year. The second best performing broad market index in Q4 was the MSCI EAFE, which represents International stocks. It too beat the S&P 500 in the 4th Quarter, but did not go quite far enough to outperform the S&P for the full year. *(Source: Morningstar)*

I believe the market rotation we have been predicting has now begun and that we will see the new leading asset classes continue to outperform last year's stars through at least the end of 2021. We think Growth will outperform Value, Small Caps will outperform Large Caps, and that the Developed and Emerging Foreign markets will post larger gains than U.S. markets this year.

Many have asked me what effect the outcome of the elections will have on the markets this year. Because I am a certifiable financial nerd, fascinated by economic history, I will make another history-based prediction about the coming year. Now that the Georgia election re-do is complete, a single party will be in control of the Presidency, the Senate, and the House of Representatives for the next 2 years. This is the primary reason I believe market gains will slow significantly going forward.

History shows us that markets do best when Washington is gridlocked and the reasons for this are common sense. When a single party controls everything, the number of new rules and regulations that are passed and signed into law is much higher than when control is split. This results in large institutional investors and corporations slowing down their spending and investment activity. When putting a large amount of capital at risk, gridlock allows an assumption that the rules will be similar when you realize your gains, thereby eliminating a major unknown and unmanageable risk. Alternatively, with single party control, the government is often referred to as a "rubber stamp" government because any bill passed by the House will also be passed by the Senate and signed into law by the President. This rapid rate of legislative change causes the largest players to slow down and wait and it has typically had a dampening effect on the markets. This correlation exists not just for the stock market, but also for jobs, GDP growth, and other metrics in the economy

The chart below shows the average market returns under various control variables in Washington. As you can see, the difference in market returns under Democrat Presidents and Republican Presidents is less than 1%, close enough to be statistically insignificant. However, when a single party is in full control, the worst average returns are achieved and it does not matter which party is holding the reins. When in full control,

Financial Trivia

Last quarter's trivia question was:

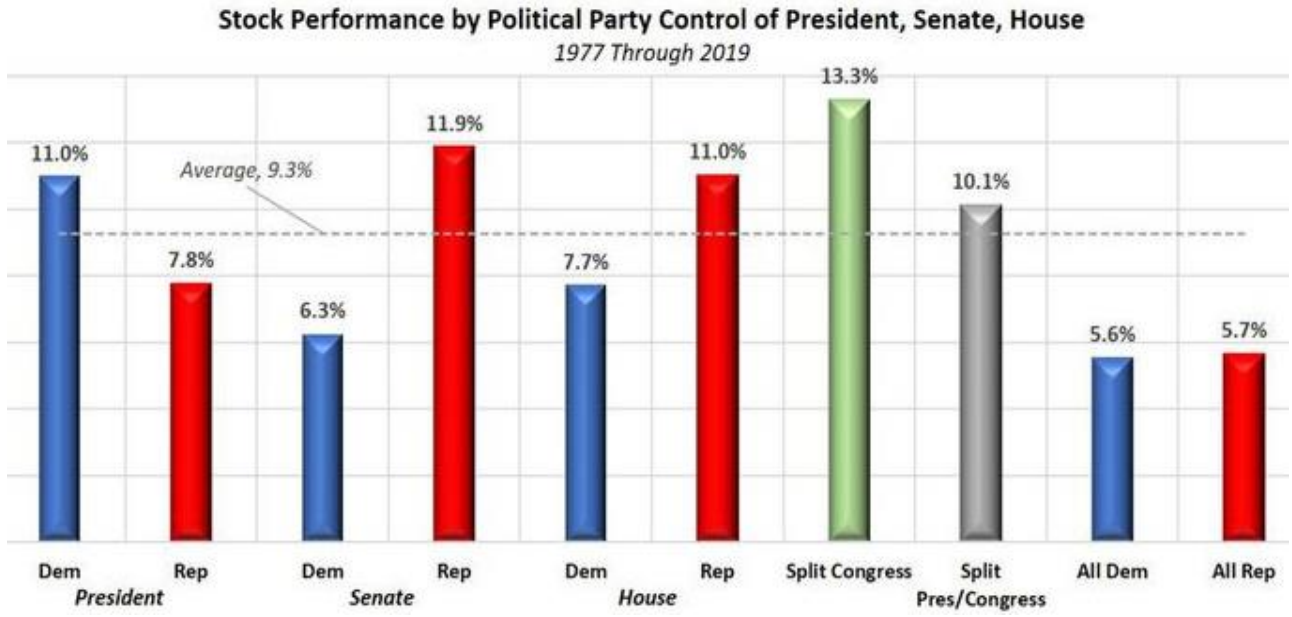
Why do we call shares of ownership of a company a "Stock"?

Answer: The stock market is named after the Boston Bruin enforcer, P.J. Stock's great, great, great grandfather who started a scam selling shares of a company that didn't exist. He named the fictitious company after himself, "Stocks, Inc."

This quarter's question:

Who said "In this world, nothing can be said to be certain except death and taxes."?

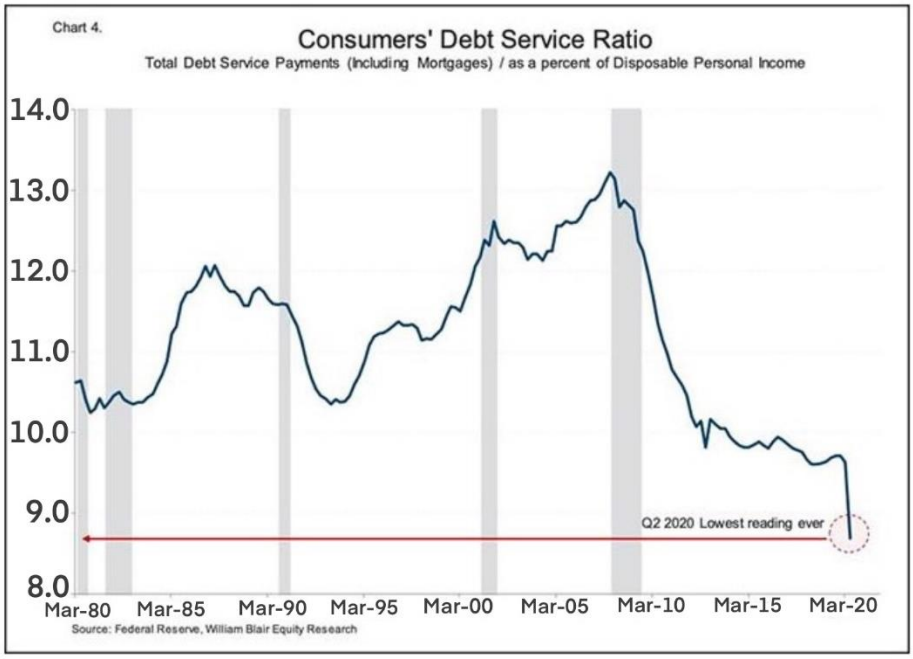
E-mail your answers to Erin at erin@fswealth.biz and we will award a prize to the first correct answer *(Be honest, no "googling" it!)*



Source: Forbes

Democrats and Republicans have delivered average returns of just 43% of the gains seen when control is divided and results under either party differ by only 0.1%

The largest gains are seen when the House and Senate are split, regardless of the President's party. The next best outcomes, trailing those under a split congress by less than 1%, are seen when the House and Senate are both controlled by a single party, but the Presidency and the veto power of the office are held by the opposing side. Again, it does not matter which party holds control of what body, what matters is that split control provides a check on any extreme left or far right legislation and slows the action of government in general.



Knowing that things are much better when the government does very little, I pose a question for you to ponder. Who would join me in supporting a 5-year sabbatical for all of our Federal officials, just to see how much growth we could experience in their absence?

In conclusion, I will summarize that I believe the election results have left us with an undesirable makeup of our federal government and it will mean slower returns for the next 2 years. However, the unprecedented levels of cash in the system will likely give us respectable gains, regardless of what the elections have given us. Further enhancing this is a current record low level of consumer debt service vs. income, which means that consumers have the ability to spend and drive the economy forward.

In tough years like these, I am overwhelmingly grateful for each and every one of our valued clients that have given us the sacred trust of caring for your hopes and dreams for the future. It is an honor to be placed in such a noble position. I want to also extend our deepest thanks for your continued loyalty to us as your primary financial resource. Regardless of the direction of the markets, we have always had nearly unmatched levels of client retention compared to the rest of our industry and that tells me two things. First, that we must be doing something right and second, that you are truly the best group of people we could ever hope to know and serve and I thank you sincerely for giving us the privilege to do just that.

New Years Eve 1918?

Get To Know Your Fox-Smith Wealth Management Team

In order for you to better know your team that are here to serve you at Fox-Smith Wealth Management, we will highlight one of our team members each quarter. This quarter we are featuring the back-bone of our Liaison Client Service Team, the man we all know and love:

Mike Worley

Client Service Director & Chief Client Liaison

Mike was born in Arlington, TX but was raised in the Texas Hill Country. As a boy, his parents and he spent most weekends on the lake fishing, swimming, and water skiing. He actually learned to drive a boat before he learned to drive a car. When Mike was 14, his parents made the decision to move permanently to their lake house, which was amazing. One of his first jobs as a teen was working at the lake marina, pumping gas and fixing boats. One of the great things about this job was that he was able to ride a jet ski across the lake to work, instead of driving his car!

After years in the restaurant industry, Mike switched to finance. He worked for Janus Capital in several capacities from 1999 - 2012. Mike left Janus to start his own business, a mobile video-game party truck, which he sold in 2016. (Coincidently, Gus rented Mike's video-game party services before they knew each other to host his son's 8th birthday party) The world of finance drew Mike back in and he joined Scottrade in 2016. Unfortunately, Scottrade was acquired by TD Ameritrade shortly after he began, and his department was let go during the transition. This event was actually a blessing in disguise as it allowed him to join the team at Fox-Smith Wealth Management and we are so grateful to have him.

He currently holds his Series 7 and 63 registrations and is working on additional certifications.

In his free time, Mike enjoys fishing with his son, hiking with his daughter, playing golf, woodworking, and gardening. Currently, his son and he are restoring an old aluminum fishing boat and are excited to get it on the water as soon as the weather allows. Mike's daughter is a senior this year and will be attending Colorado Mountain College in the fall.

Mike's advice to anyone is to turn off the noise, be more patient with one another, and love & enjoy your family. As 2020 clearly showed us, things can change very quickly.

Many of you already have first-hand experience of Mike's exceptional client service and financial experience. He is a truly wonderful part of your team at Fox-Smith Wealth Management and we are all very glad to have him with us!

~ Disclosures and Definitions ~

The Dow Jones Industrial Average is a widely followed market indicator based on a price-weighted average of 30 blue-chip stocks that trade on the New York Stock Exchange which are selected by editor of The Wall Street Journal.

The S&P 500 Index is a capitalization-weighted index made up of 5000 widely held large-cap U.S. stocks in the Industrials, Transportation, Utilities and Financial sectors.

The Russell 2000 index is an index measuring the performance of approximately 2,000 smallest-cap American companies

The EAFE Index is a stock index offered by MSCI that covers non-U.S. and Canadian equity markets. It serves as a performance benchmark for the major international equity markets as represented by 21 major MSCI indices from Europe, Australasia, and the Middle East.

US Small Caps Stocks describes companies with a relatively small market capitalization. A company's market capitalization is the market value of its outstanding shares. The definition for small cap varies, but generally means a company with $300 million to $2 billion in market capitalization.

Large Growth Stocks is any share in a company that is anticipated to grow at a rate significantly above the average growth for the market.

Small-cap funds may be subject to a higher degree of market risk than large-cap funds or more established companies' securities. Furthermore, the illiquidity of the small-cap market may adversely affect the value of an investment so that shares, when redeemed, may be worth more or less than their original cost. Additional risks are associated with international investing, such as currency fluctuations, political and economic stability, and differences in accounting standards.

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