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2021 Financial Markets Outlook

Realistic Expectations for COVID and Stocks Looking Forward

Why We anticipate Another Positive Year for Stocks in 2021

Is it True: There Is No Other Alternative (“TINA”)?

We expect another positive year for stocks driven by an improving economic outlook globally and TINA (more on this below). We are less sanguine over the outlook for bonds in 2021. However, we view these assets as an essential component of a diversified client portfolio due to their ability to stabilize portfolios during periods of heightened uncertainty.

TINA Is Indifferent to U.S. Stocks Valuations

There is no denying that U.S. stocks appear expensive. As of January 7,2021, the Standard & Poor’s 500 Index (“S&P 500”) was valued at 22.6x (pronounced “22.6 times”) expected 2021 earnings per share (“EPS”) as compared to its 25-year average forward price-to-earnings (forward “P/E ratio”) of 16.6x[1]. Put another way, the S&P 500 has been more expensive on a forward P/E basis only 3.2% of the time over the past 25 years (assuming a normal distribution of returns).

While the S&P 500’s current forward P/E is higher than its historical average, it is still substantially lower than the 27.2x peak multiple reached during the height of the early 2000 “dot com” bubble. The only comparison between today’s bull market (i.e., a term used for an extended period of upward price moves) and the dot com boom was that each stock market rally was led by a concentrated set of innovative companies. That is where the similarities end. The market leaders throughout most of the current rally have been comprised of highly cash flow generative companies with meaningful revenue and/or earnings growth whereas in the early 2000s, leadership was largely represented by negative cash flow generating companies with unproven business models.

The strategists we consult with anticipate U.S. stock valuations will remain elevated given the expectation for low interest rates over the next 2-3 years. This expectation is based on the U.S. Federal Reserve’s (“Fed’s”) projection that it does not anticipate raising its 0.00% to 0.25% target for short-term interest rates until sometime in 2023 when the average rate of inflation has trended above its 2.0% target and the unemployment rate has dropped to a range of 3.5% to 4.3%. For reference, the unemployment as of 12/31/20 was 6.7% and the rolling two quarter average for the Fed’s preferred measure of inflation, core personal consumption expenditures (“core PCE”), was 1.3% as of quarter end 3Q 2020. The Fed is also expected to continue purchasing $120 billion per month of U.S. Treasury bonds and agency mortgage-backed securities (“MBS”) to suppress mid-to-long term interest rates.

Not only do low interest rates reduce the discount applied to future cash flows of companies, thereby inflating their stock prices, but prevailing historically low interest rates also limit the return potential for bonds given more limited scope for rates to decline. (A bond price is inversely related to its yield; bonds are worth more when interest rates fall and less when interest rates rise.) The upside potential for bonds is further hampered by reduced opportunity for meaningful credit spread tightening as most spreads have compressed back to their pre-COVID level. (A credit spread is the yield differential between a non-U.S. Treasury bond, otherwise known as a credit, and a U.S. Treasury bond of the same maturity). This dynamic has fostered greater acceptance of the TINA concept among investors or the view that "There Is No Alternative" but to continue investing in stocks.

There is no more compelling argument for TINA than looking at the earnings yield ("EY") spread, which is the difference between the forward earnings yield for the S&P 500 (consensus analyst estimates of EPS over the next 12 months divided by the price of the S&P 500) and the Moody's Baa (lower investment grade) seasoned corporate bond yield. As of 01/07/21, the EY spread was 1.11% or 105 basis points higher than the historical average spread over the past 25 years of 0.06%. Not only have U.S. stocks been cheaper only 30% of the time since 1996 (again, assuming a normal distribution of returns), but if the S&P 500 repriced to the 25-year average EY spread of 0.06%, assuming no change in consensus forward EPS, the index would rise by another 31%.

Expect Another Positive Year for U.S. Stocks

While we do not expect the S&P 500 will rise by 31% over the next 12 months, we do think that the potential for an increase of 10%-15% is not unreasonable considering underlying EPS is expected to grow by 21% to 31% in 2021[2]. We anticipate as COVID vaccinations ramp up and the rate of infections decelerate, the U.S. economy will likely experience a substantial boom in activity, particularly in sectors most impacted by the COVID pandemic (e.g., leisure, hospitality, and restaurants). We also expect to see more economic stimulus and the potential for an infrastructure spending plan now that the democrats control the presidency and both houses of congress. Due to these factors, we expect the U.S. stock rally to continue broadening out into more cyclically oriented and economically sensitive industries that have lagged the overall market due to unfavorable economic conditions. This does not mean that the handful of mega capitalization ("cap") technology companies and "stay-at-home" stocks whose business thrived because of the lockdowns will not continue to rise, but rather the equity rally this year will be much more broad-based and less concentrated.

Trimming Tactical Overweight to High Quality Bonds in Favor of U.S. Small Cap and Cyclical Stocks

Since 3Q 2019, we have generally advocated tactically owning more high quality bonds and less stocks relative to each clients' long-term strategic asset class targets. Initially, this decision was based on the view that U.S. stocks were going to enter a bear market as the U.S. was nearing the end of a very long economic growth cycle (bear markets are periods of extended stock losses and tend to occur just prior to or during an economic recession). We maintained the tactical overweight to bonds as COVID-19 transitioned from an epidemic to a pandemic and through the recent recession. Now that the U.S. is progressing into the early phase of a new expansion cycle, we are more comfortable recommending many clients assume more (equity) risk to enhance the return potential of their portfolios. However, we are still maintaining a slight overweight to high quality bonds (relative to clients' long-term strategic targets and those needing portfolio distributions) given likelihood for higher stock volatility over the coming months.

For many of our clients, we plan to sell a portion of high quality bonds to purchase U.S. small cap stocks and to increase exposure to more cyclically oriented stock sectors. Smaller cap stocks tend to outperform large cap stocks during the early phase of an economic expansion due to their more domestically focused businesses. Smaller cap stocks are also entering a new "small cap leadership cycle" after underperforming large cap stocks during the prior market cycle. Historical trends show that when small cap returns have outpaced large cap, like what has occurred during 4Q 2020, they continue to lead the broader stock for extended periods of time (on average 84 months and historically never less than 40 months).[3]

We also plan to redirect a portion of the reduction in our high quality bond tactical overweight allocation to increase direct investments in the industrial sector and to buy financial sector stocks for many clients. Industrial sector stocks, as well as our clients' direct investments in information technology and communication services, will be direct beneficiaries of any infrastructure spending package approved over the coming months. These sectors will also benefit from a boost in EPS growth as result of an accelerating global economic recovery.

Financial sector stocks are attractive given their leverage to the early phase of an economic cycle and as a hedge against an unanticipated, extended rise in interest rates. Within financials, U.S. banks have successfully weathered the COVID recession due to regulatory rules put into place in early 2020 that required globally systemic banks to carry much higher levels of capital to cover "severely adverse" economic scenarios. In December 2020, the Fed conducted its second (typically annual) Comprehensive Capital Analysis and Review ("CCAR"), and none of the banks analyzed failed to have enough capital reserves necessary to operate in severely adverse scenarios. As a result of these findings, the Fed reinstated banks' ability to repurchase shares and raise their dividends, which will alleviate investor concerns over "trapped" capital (i.e., an inability of banks to release excess capital to investors through share repurchases and higher dividends). Banks also provide an ideal TINA opportunity for investors looking to earn a higher dividend yield as compared to the prevailing yield paid on an investment grade bank issued bond[4]. Lastly, banks provide a hedge against rising interest rates given the net interest margin earned between what it lends out and how much it pays on short-term deposits.

We continue to recommend clients maintain their direct investments in the healthcare sector. Healthcare stocks underperformed global stocks in 2020 primarily over fears that a massive "blue wave" election result in the U.S. would lead to significant regulatory reform as it relates to universal healthcare and drug price controls. As a result of this concern, healthcare stocks are trading at their cheapest discount relative to the S&P 500 in 40 years.[5] We expect healthcare stocks to close this valuation gap in 2021 given the low likelihood of any meaningful industry reform being enacted over the next two years. We view the healthcare sector as an enduring, tactical investment opportunity since company earnings are supported by constant innovation and increased healthcare utilization due to aging demographics in developed markets and the wealth effect in emerging economies.

The (Mega) Trend is Your Friend

In the future, we anticipate adding more long-term, thematic-based, tactical investments into client portfolios where appropriate. These investments will provide direct exposure to the innovative "megatrends" shaping the future and tend to be more counter cyclical given their structural impact on the economy. We anticipate these growth opportunities will be even more coveted by investors as the pace of economic recovery in the U.S. and other developed markets begins to decelerate during the second half of 2022. As we shift client portfolios back to their long-term strategic asset class targets over the coming quarters, we anticipate diverting a portion the tactical overweight we have had in high quality bonds, relative to their long-term strategic asset class weighting, into these investments. We also plan to source capital from other tactical and diversified equity investments since many of the key megatrends we are evaluating are expressed in these assets but in a more diversified, less impactful way.

COVID Vaccines … a Blessing and a Curse (of Volatility)

When valuations are high there is less embedded discount to "cushion" price fluctuations caused by a negative news event. This means U.S. stock valuations will be more sensitive to any information that suggests the economic outlook may worsen. The rapid progress on developing COVID vaccines has enabled investors to look past the health crisis and economic carnage caused by the Coronavirus. The better-than-expected clinical results and accelerated approvals of the two messenger RNA ("mRNA") vaccines further solidified the market's expectation that the U.S. economy will be on a path towards recovery over the course of 2021. Given the economy's (and U.S. stock market's) dependence upon the success of these vaccines, any negative report on the supply, distribution, and/or uptake of these vaccines will serve as the primary source of market volatility over the coming months.

Herd Immunity by the End of July?

We remain optimistic over the rollout of the mRNA vaccines over the next few quarters. Production estimates provided by the manufactures of these vaccines infer as much as 476 million doses will be produced by the end of July. This would be enough vaccine to inoculate 238 million people or roughly 70% of the U.S. population, which is the approximate estimate needed to achieve herd immunity according to the Mayo Clinic and MD Anderson. (Herd immunity occurs when enough people in a population are protected against a disease to meaningfully reduce its transmission.) While distribution of mRNA vaccines requires a complex "cold distribution" chain, one of the mRNA manufacturers has been able to leverage its expansive national logistical network to distribute its vaccine throughout the country. The other mRNA vaccine will be shipped by the largest drug distributor in the United States, McKesson Corporation, via its collaboration with the U.S. government's (formerly known as) Operation Warp Speed program. McKesson is not only the largest distributor of flu vaccines in the U.S., but it has extensive experience transporting biologic drugs and materials. McKesson was also responsible for distributing the H1N1 vaccine for the U.S. government during the 2009-2010 pandemic.

We view the biggest obstacle to achieving herd immunity to be the "last mile" of distribution or getting the vaccines from local/regional storage facilities to injection locations. The reengagement of the federal government under the Biden Administration will be instrumental in providing the funding and logistical support needed to speed up the establishment of “mega site” injection venues and 24/7 injection locations across the country. People’s willingness to get a COVID vaccine may be another obstacle given the objections many American’s have had to wearing masks and social distancing. However, we are encouraged by a recent Kaiser Family Foundation survey that showed 71% of respondents would “definitely” or “probably” get a COVID vaccine, up from 63% in an August/September 2020 poll.

Fortunately, the virus responsible for COVID, SARS-CoV-2, is mutating at a much slower rate as compared to seasonal influenza[6]. This means the duration of effect for COVID vaccines could last longer than the annual flu vaccine. Initial data also suggests the U.K. “B.1.1.7” and the South African “B.1.351” variants may be more contagious, but do not appear resistant to any approved drug treatment or vaccine[6]. Should this prove otherwise, a developer of one of the mRNA vaccines stated that the company “could reset the shot to counter a new strain within just six weeks, if needed.”[7]

Do Foreign Stock Gains Portend a “Reversion to the Mean?”

As COVID vaccinations ramp up worldwide, the global economic recovery will continue to gain more steam. This will disproportionately benefit international/foreign developed market and emerging market economies relative to the U.S. since they derive a higher share of growth from cyclically oriented industries, such as industrials, materials, and financials. Since foreign economies are much more dependent upon exports relative to the U.S., they stand to benefit from a potential softening of trade restrictions as President Biden seeks to reestablish relations with key trading partners.

We expect the reacceleration of corporate earnings due to improving economic fundamentals for foreign companies will improve investor sentiment relative to U.S. stocks, especially among U.S. investors who have invested only 10% of their equity holdings in foreign stock.[5] To put this in perspective, foreign stocks account for approximately 43% of the country weightings within the MSCI All Country World Index (“MSCI ACWI”).[8] Positive currency trends will also serve as a potential catalyst for U.S. investors since the economists we follow expect the dollar to weaken relative to other major currencies over the course of 2021.

Renewed interest in foreign stocks, especially among U.S. investors, provides the potential for a reversion to historical valuations relative to U.S. stocks. As of January 7, 2021, foreign stocks, as measured by the MSCI ACWI ex-U.S. Index, were trading at a forward P/E of 17.0x versus 22.6x for U.S. stocks (i.e., a 25% discount). If foreign stocks were to revert back to their historical relative forward P/E discount of 13%, foreign stocks would rise by 16%. Foreign stocks also boast a more attractive expected 12-month dividend yield relative to U.S. stocks (2.7% for the MSCI ACWI ex-U.S. vs. 1.6% for the S&P 500), which provides an even more compelling TINA investment opportunity for investors looking for yield.

We are maintaining our recommended weightings to developed international stocks and emerging market stocks, which together generally account for approximately 45% to 50% of many of our clients’ total stock holdings. Within emerging markets, for most clients, we continue to emphasize Asian-Pacific region equities. Companies within China and its close neighbors are expected to experience more pronounced earnings growth versus much of the rest of the world. The reliability of this earnings growth is also greater due to how effective most of these countries have handled the COVID pandemic.

Real Assets: What Are They? What Should We Expect from Them?

Real assets continue to serve as a solid store of value given the relatively stable income streams provided by the underlying real estate and infrastructure investments. A low interest rate environment will continue to support demand for real assets especially for bond investors looking for higher yielding investments with stable cash distributions. Exposure to commodities and natural resource equity sectors also provides growth potential driven by a global economic recovery (i.e., more demand for commodities produced by natural resource companies) while also providing a hedge against continued dollar weakness and rising inflation expectations. An additional potential driver of real asset returns during 2021 will the potential approval of an infrastructure spending package in the U.S. now that Democrats control Congress.

We expect the strong returns in the midstream energy sector (transportation of energy from point to point; no drilling or refining) relative to the broader equity market during 4Q 2020 will continue in 2021. The market is increasingly becoming aware of the midstream energy sector's attractive yields and potential for capital appreciation. Current yields within the midstream sector remain elevated relative to history and especially relative to bonds and other income-oriented investment sectors. Balance sheet rationalization efforts and capital investment reductions within the sector over the past 12-24 months have resulted in significant cash flows, which are increasingly being put towards shareholder friendly capital deployment activities, including share repurchases. Share buybacks send a positive signal to the financial markets regarding the underlying health of a company and the company's view towards the attractiveness of its stock.

We want to emphasize that concerns over the viability of the midstream energy sector in the face of declining oil prices and falling demand were overblown. Midstream energy business models are much more fundamentally sound as compared to the past, evidenced by the fact that only 21 of the 42 dividend paying constituents in the Alerian US Midstream Energy Index had a sequential cut to its dividend during the depths of the COVID recession.[9] There is also an increasing understanding within the market that midstream energy companies benefit from both oil demand and the shift renewable energy sources. Most of the assets owned within the funds we use to invest in the midstream energy sector derive a significant portion of their revenues from the transport of natural gas and liquid natural gas. As the world demands more energy and less carbon, there has been an acceleration in the conversion or replacement of coal-fired plants with natural gas burning turbines globally, which will support continued demand growth for natural gas into the future.

Alternatives Help Reduce Portfolio Volatility

Alternative assets are comprised of assets and strategies that have low correlation (relationship) to traditional stocks and bonds. We continue to view alternative assets as an important portfolio diversifier over the coming months given the potential for increased market volatility caused by rising COVID infections, expanding lockdowns, and setbacks with the distribution and/or uptake of COVID vaccines. When we have greater comfort with the macroeconomic backdrop, we will consider using clients' existing investments in this asset class as a source of capital to redeploy into other equity sectors with more compelling risk-adjusted expected returns.

Bond Rates Are Low and Credit Spreads Are Tight. Why Still Own Bonds?

Short answer: for their stability. We continue to recommend that most of our clients hold a globally diversified portfolio of predominately investment grade (core) bonds. The upside potential of bonds is more limited as compared to the past due to low interest rates and tight credit spreads. Market strategists we follow do not expect the Fed and other major central banks around the world to stop actively suppressing yields throughout the maturity curve any time soon. This is due to the need to maintain favorable financial conditions to support economic growth and improve job conditions for the significant number of unemployed individuals as a result of the COVID pandemic. While bond returns will be more muted going forward, this underlying support will filter though to our client portfolios in the form of lower volatility, especially during instances of financial market tumult.

As discussed above, we continue to generally maintain a tactical overweight to bonds as the world is still in the midst of the worst pandemic since the Spanish flu over a century ago. While the recently approved COVID vaccines in the U.S. and around the world appear to provide significant protection against the virus, especially among the mRNA-based vaccines, we are in the early stages of the rollout and there still significant uncertainties over the logistics of distributing the vaccines, people's willingness to take vaccines, and the effectiveness of the vaccines versus variants of the virus. When there is high uncertainty, there is the increased potential for volatility. With that said, there are favorable signs that we will be able to overcome these concerns, which is why we have started to reduce the previous tactical overweight to bonds. We will look to further reduce the emphasis on bonds when we become more comfortable with both the trajectory of immunizations and their impact on the pace of COVID infections.

Within fixed income, we continue to recommend owning investment grade national municipal bond strategies for clients in high tax brackets. We also generally advocate owning emerging market bonds as these assets are one of the few areas within fixed income that still provide compelling, risk-adjusted return opportunities. Emerging market bonds remain an excellent long-term investment opportunity given their higher growth rates, lower debt burdens, and lower default rates as compared to other high yielding sectors (e.g., high yield bonds, leveraged loans). We expect the burgeoning global economic recovery and the potential for more predictable trade policy out of the Biden Administration and a depreciating U.S. dollar will help to improve investor sentiment as we progress through 2021.

Good Riddance 2020 and Hello 2021!

The excitement of the New Year is palpable given the expectation we can finally leave our caves (homes) and socialize again. This of course assumes surveys that show 71% of the population are amenable to taking a vaccine hold true. We are also excited about the potential for much less political theatrics over the next four years as the Biden Administration looks to restore America's leadership position within the free world. While we remain optimistic regarding the outlook for stocks in 2021, we realize we are still not out of the woods in terms getting COVID under control. This is why we are generally maintaining a modest overweight to bonds as they will provide much needed stability should the equity markets experience increased volatility.

We Want to Help You Attain Your Financial and Personal Goals!

The general information in this report is not intended to reflect our specific recommendations for any client portfolio. Please contact us with any questions to discuss your personal goals and your investment portfolio.

We invite you to visit our website at www.ginsburgadvisors.com. Here you will learn more about our services, client value proposition, and our team. The site also has a useful "Resources" section where you can access our previous market commentaries, watch informative videos, download our latest staff contact list, and access useful financial calculators and web links. Please be sure to check our website periodically, as we will be updating the functionality of the site to include a client portal and other useful applications.

We welcome the opportunity to discuss your goals and the most appropriate strategy to attain them. We are also honored to speak to any of your friends, associates, or relatives should they have an interest in our financial planning or investment management services.

Please stay healthy and safe!

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[9] (11/17/20). Bingham, B. "3Q20 MLP/Midstream Dividends: Steady With a Few Cuts". insights.alerian.com

Index descriptions:

-Alerian Midstream Energy Index. The capped, float-adjusted, capitalization-weighted index, whose constituents earn the majority of their cash flow from midstream activities involving energy commodities, is disseminated real-time on a price-return basis (AMNA) and on a total-return basis (AMNAX).

-MSCI All Country World Index ("MSCI ACWI")- MSCI All Country World Index is designed to represent performance of the full opportunity set of large- and mid-cap stocks across 23 developed and 27 emerging markets. As of November 2020, it covers more than 3,000 constituents across 11 sectors and approximately 85% of the free float-adjusted market capitalization in each market. The index is built using MSCI's Global Investable Market Index (GIMI) methodology, which is designed to take into account variations reflecting conditions across regions, market cap sizes, sectors, style segments and combinations.

-S&P (Standard & Poor's) 500. A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the US stock market. It measures the movement of the largest issues. Standard and Poor's chooses the member companies for the 500 based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied.