Financial Fitness for Life℠

Quarterly Client Update

2020 – An unprecedented year of contrast

The year 2020 will forever be marked as the year of COVID-19; a virus that saw more than 20 million infected and took more than 300,000 American lives; more than 1.5 million around the globe; a pandemic that forced the entire world to shut down. This virus is still impacting our lives and infecting more than 200,000 every day. Recent vaccine developments finally offer some light at the end of the proverbial tunnel and reasons for optimism.

On the heels of the outstanding market performance of 2019, we entered 2020 with caution, fully expecting to experience increased levels of volatility, especially with an approaching presidential election in the second half of the year. We never imagined what would unfold over the ensuing months, making 2020 truly a year of extreme contrasts.

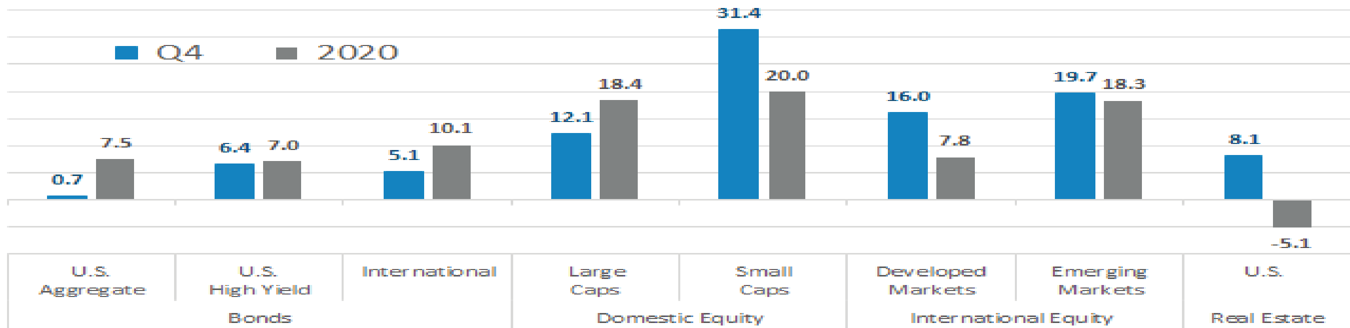
Much happened in 2020. We opened with the longest bull market and economic expansion in our nation's history, only to see a pandemic shutdown the global economy, forcing the S&P 500 to endure its worst quarter since 2008. April through June snapped back, delivering its best quarter since 1998, and effectively gave us the fastest bear market, followed by the quickest bull market, ever. On the economic front, the nation contracted sharply into recession with the second quarter's annualized historic collapse of -31.7%, quickly bouncing back more than 33% in the third quarter, both marking the largest single quarter of economic quarter-over-quarter GDP contraction and expansion in our history. Oil futures went into negative territory but closed the year just under $50/barrel. We witnessed the election saga unfold that flipped the script in early 2021, giving political sweep to the Blue Team and providing President Elect Biden with little opposition to advance his agenda. The S&P 500 hit 33 record highs in 2020, and experienced moves greater than 1% up or down in 110 of the 253 trading days, compared to 38 days in 2019. In March we experienced a single day drop of -12% along with two rallies more than +9%. Looking back on 2020 is a mind-numbing task, to say the least.

Fourth Quarter Market Performance

The final three months of 2020 got off to a rocky start. As the election approached, volatility increased and large cap equities grinded lower, with the S&P 500 selling off -2.7% for the month of October. With political clarity of sorts and vaccine optimism, the markets turned in solid consecutive months to close out 2020. The S&P 500 finished up +12.1% for the quarter and +18.4% for the year. In these results, Big Tech was yet again the darling, with the NASDAQ closing out the quarter up +15.4%, and +46.6% for the year. As the economic recovery continued and multiple vaccines were approved, small and mid-sized companies, as measured by the Russell 2000 and S&P MidCap 400, caught a bid, gaining +31.4% and +24.4% respectively for the quarter and +19.96% and +13.66%, respectively for the year.

The coupling of a stronger economic recovery and weakening dollar led to solid returns for emerging markets in the fourth quarter of +19.77%, and +18.69% for the year, as measured by the MSCI Emerging Market index. Conversely, already on fragile ground entering 2020 with the Eurozone barely squeezing out positive growth and Japan contracting in the fourth quarter of 2019, the developed nations outside of the US have lagged in the recovery. MSCI EAFE Index outpaced the S&P 500 in the fourth quarter by gaining +16.09%, but the benchmark lagged its US counterpart for the year, gaining only +8.28%.

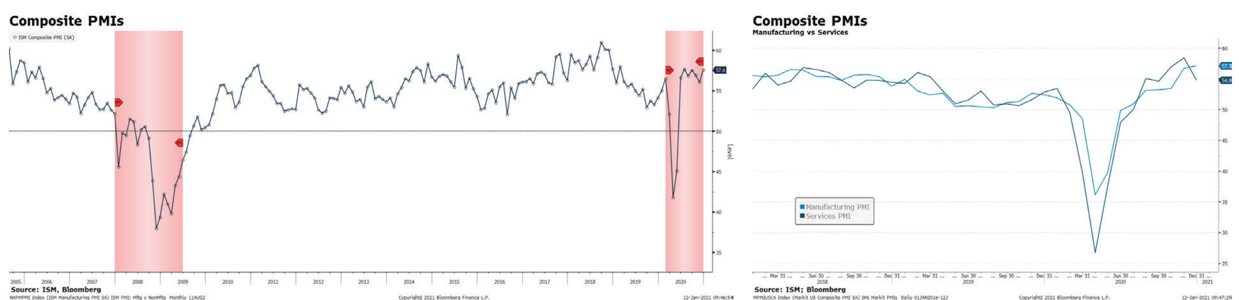
Entering 2020, the yield on the 10-Year Treasury note sat at 1.91%, with expectations of moderate increases from this level. However, when COVID-19 hit, and lockdowns began, investors fled all risk assets (equities and bonds) in favor of US Treasury securities; pushing the yield to historically low levels below 0.50%, before normalizing and increasing to close out the year at 0.87%. With the Federal Reserve in aggressive accommodation mode, dropping rates to zero, minting a new policy framework and launching Quantitative Easing IV, their purchases continued to support Treasury and mortgage-backed securities. Even with the yield on the 10-Year Treasury note inching 0.23% higher over the quarter, the Bloomberg Barclays U.S. Aggregate Bond Index still eked out a +0.67% return, bringing the index's 2020 return to +7.51%.



Source: Bloomberg

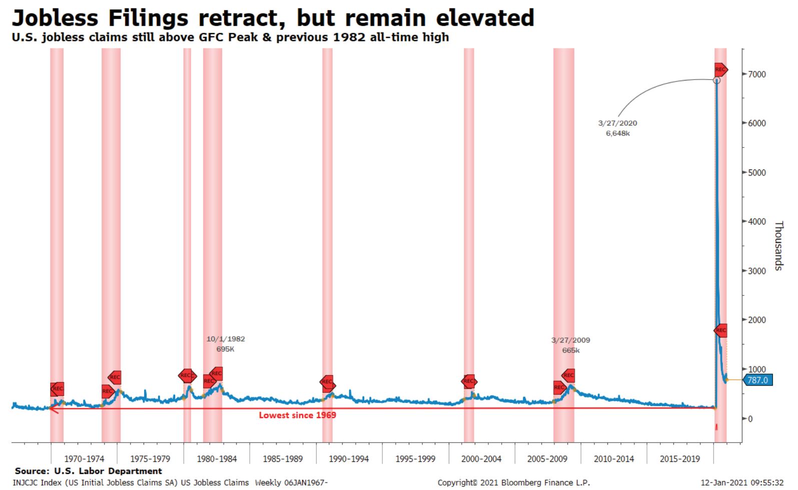
Uneven Recovery

While equity markets continued to soar to new highs, the clear gap between the markets and economic fundamentals widened, highlighting the disconnect between Wall Street and Main Street. Given that this recession is non-traditional in that it was not caused by a financial disaster, rather a natural disaster/global pandemic, the remarkable 'V' shaped recovery we witnessed once lockdown mandates were lifted was not so surprising. However, as we wrote in our third quarter update, many areas of the economy have started slowing because of spiking COVID-19 cases and the resulting new mandates that were enforced; with many of service-oriented businesses (restaurants, hospitality, and travel) hit the hardest. A prominent indicator measuring economic activity, the composite Purchasing Managers Index (PMI) has moderated recently, though continued the 'V' shaped recovery since bouncing from its sub-30 April reading, to levels last seen pre-COVID at +57.6. For perspective, a reading above 50 indicates expansion, while a number below 50 indicates contraction. Perhaps more telling are the two components of the composite PMI, Manufacturing and Services PMI. Given the service-oriented industries such as leisure, travel, hospitality, dining, and other major service-oriented sectors were shut down in March, we witnessed a larger contraction in services, yet as mandates were lifted, or loosened, activity in these sectors picked up and in a major way, spiking to levels we have not experienced in nearly two years. Given the transition from a manufacturing-based economy to a more services-based economy that our nation has undergone over the past several years, the health in our services sector is extremely important to a sustainable recovery, since services now make up about 2/3 of our nation's growth. As COVID-19 mandates and job losses in the service sector increased, December saw the Services PMI tick down to 54.8 from 58.4 in November. This indicator's trend will be important to monitor as the first quarter progresses and vaccines



are administered. Following our nation's largest fiscal and monetary stimulus programs implemented to combat the economic fallout from the coronavirus, consumers took to the street, purchasing homes, cars and other discretionary items to drive spending back towards pre-pandemic levels. Though like the PMI, retail sales and consumer spending has stalled as of late. Despite a last-minute fiscal stimulus package, moderation in economic activity over the last several months has led many to lower their fourth quarter GDP outlooks; Bloomberg forecasts a mere +2.5% real GDP output in the fourth quarter, which would leave GDP for the full year -2.8%.

April saw the unemployment rate peak at post Great Depression highs of 14.7%, and while the headline unemployment rate has continued to recover with November and December's unemployment rate holding at 6.7%, the bottom line is that like other areas of the economy, the labor market's recovery has been gone from moderating to worsening. Weekly first-time unemployment claims and continuing claims halted their downward trend from their April highs, with both reversing courses as of late. Unemployment claims, or those filing for unemployment for the first time, remain under one million, with the weekly average elevated over the peak of the 2008 Great Financial Crisis. Perhaps a better guide to employment, continuing claims, or those that are still filing for unemployment benefits, have retraced from close to 26 million in April to a four-week moving average of approximately five million in recent weeks. Late November saw the first weekly unemployment claims increase since April; November as a whole showed the first monthly drop of more than 74,000 in household employment since April. As a result of new daily high coronavirus cases and increased social distancing measures, unemployment claims remained elevated throughout December, which resulted in the first negative jobs report since the late spring recovery. While 140,000 jobs were lost in December and the unemployment rate held steady at 6.7%, it is important to remember that like most economic indicators, the jobs report is backward looking. December's disappointing labor market report only contained data through the middle of the month and given the surging COVID cases to close out the year, it is reasonable to believe the figures are both outdated and underestimate the actual number of jobs lost during the year's final month, especially given December's report showed most of the job losses appeared in the hospitality sector.



Federal Reserve Update

The Federal Reserve continues to provide as much accommodative monetary stimulus as possible through open-ended Quantitative Easing (QE4) and keeping rates historically low. This 'anything it takes' mentality has already seen the Fed's balance sheet balloon from approximately $4 trillion to $7 trillion in a matter of months, with no real signs of slowing. Fed Chair Jerome Powell continues to stress the Fed's concern for the nation's rebound, as they believe containing the pandemic will be crucial for recovery, creating "extraordinary" uncertainties and "considerable" risks. Perhaps lost in the fray of the pandemic, but nevertheless monumental, is the Fed's September decision to change their policy framework. Rather than implementing policy to achieve 2% inflation, and subsequently tightening to prevent the economy from overheating (see 2018 monetary policy), the Fed has adopted a soft, or flexible, inflation averaging policy, whereby the Fed would hypothetically allow inflation to run above 2% for an undisclosed period, with the goal of averaging 2% inflation. Under this framework, should inflation remain suppressed below 2% for long periods of time, when/if inflation rises above 2%, the Fed will allow inflationary pressures for longer periods of time before tightening policy (reducing asset purchases, raising rates, or even engaging on bond sales). This new framework suggests that rates will remain low for longer, which should keep rates on the short end of the curve relatively low.

December's Federal Open Market Committee (FOMC) meeting saw the Fed unanimously agreed to continue their QE program until "substantial further progress" toward their goals was achieved and reiterated the economy is still a long way from obtaining these goals of broad-based full employment and 2% average inflation. The messaging from the Fed's December meeting indicates the market should expect the Fed to continue its $120 billion monthly bond purchases through 2021 before starting to taper. Furthermore, we should expect the Fed to keep short-term rates low for the foreseeable future; perhaps into 2023.

Two items that may cause the Fed to modify its current policy are the prospects of additional fiscal stimulus from a democratic controlled congress or a continued steepening of the yield curve, which would imply stronger economic conditions. While we do not believe this will impact the first two quarters of the year, as we look to the second half of 2021 and beyond, the massive amounts of stimulus could very well lead to inflationary pressures and higher interest rates, both of which could threaten a meaningful recovery.

As mentioned earlier, economic data is primarily backward looking, so it is important to try and extract that data to project forward. During the initial lockdown, the consumer savings rate spiked to all-time highs. This is not surprising, given many consumers were flush with large stimulus checks, yet there was really nowhere consumers could go to spend those checks, and the uncertainty facing future employment status caused many to prudently place their stimulus in savings. Fast forward to year-end, unemployment has significantly decreased, and savings remain elevated, which is already creating pent up consumer demand. Factor in a fresh round of stimulus money, with potentially much more on the horizon, and year-over-year M2 Money Supply Growth (the growth in the total amount of money in circulation) of 25% through November with no signs of slowing in sight, and the economy looks spring loaded for strong economic growth in 2021, driven by the engine of our economy - consumer spending. The first quarter of the year historically experiences growth pressures and now the economy is dealing with surging COVID cases which stand to threaten the recovery and prompted Bloomberg to lower their first quarter real GDP to -0.5%. Given this is a bookend recession that was caused by a virus and should end with a vaccine, the effective distribution and deployment of the vaccine is imperative to achieve economic prosperity, which can likely begin to pick up in the latter part of the first quarter.

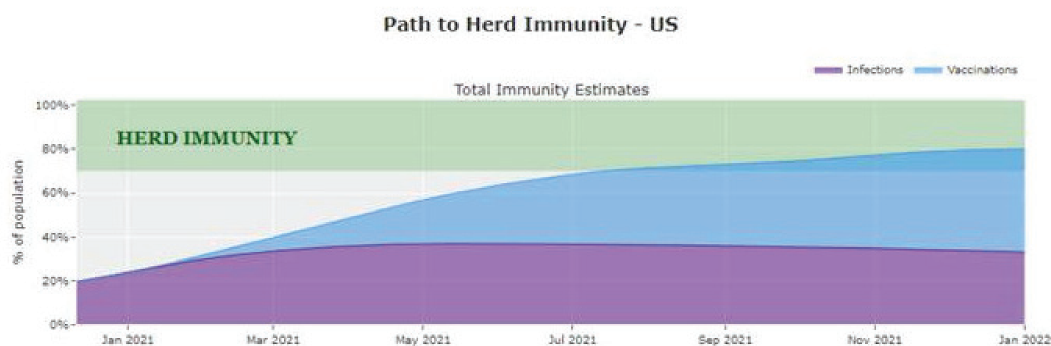
Congressional Stimulus

After several months of deliberation and the clock rapidly expiring in 2020, Congress was finally able to put some of their differences aside and pass a second large stimulus relief package in response to the pandemic. While a far cry from the Democrats initial $3 trillion push, the year-end $900 billion package will provide much needed aid. Surprisingly, President Donald Trump and Speaker of the House, Nancy Pelosi, agreed on something and joined forces to push Congress to increase $600 direct checks to $2,000 per individual and $600 per child, despite their joint efforts having little impact on the rest of Congress, who ultimately ruled in favor of the initial $600. In addition to $600 per individual and $600 per child, the new package extends two pandemic-related unemployment programs which will enhance federal jobless benefits for 11 weeks, through March 14, and provide an additional $300 in unemployment benefits per week. Additionally, the new relief package will provide $82 billion for education, including about $54 billion for K-12 and $23 billion for colleges and universities, and the package set aside $285 billion for additional loans to small businesses under the Paycheck Protection Program (PPP). Missing from the stimulus was additional state and local aid and COVID-related liability protections for employers; concessions each party were forced to make to reach an agreement.

However, with the Georgia Senate run-offs yielding full control of congress to the Democrats, we are likely to see more stimulus on the horizon. In addition to a large infrastructure package, President Elect Biden is already suggesting another relief package which would send additional $2,000 checks directly to the consumer and provide support to state and local governments to help stimulate the economy further.

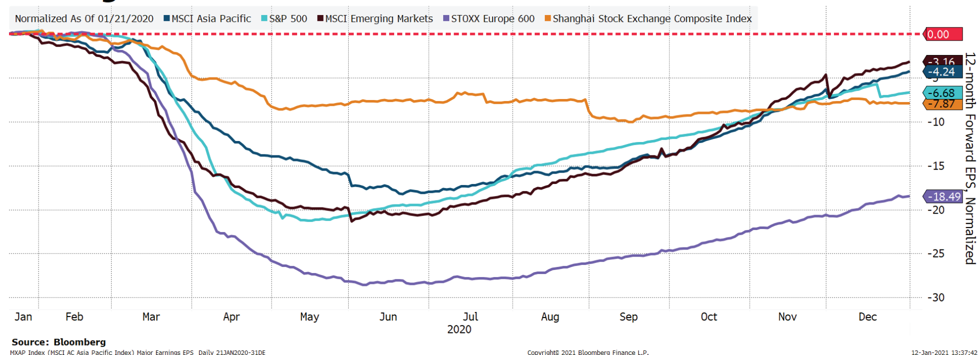
Implications looking forward

Each of us, along with the markets and the economy have shown remarkable resilience through extreme adversity. Despite a trade war with China restraining growth, the US entered 2020 with a relatively strong economy, which is an important factor as we move forward. With the unprecedented amount of monetary and fiscal stimulus poured into the economy since March, we are long-term fundamentally bullish on equity markets, particularly in 2021. That is not to suggest we are in the clear - far from it. The cold winter months will almost certainly add further strains on the hospitality industry as many individuals would rather stay home than be forced to eat outside. The significant spikes in new cases, and fatality numbers, is certainly concerning. People were unwilling to risk catching the virus with a one in ten chance of dying, but at sub-one percent, they may be more willing to engage in behaviors that increase their probability of contracting the virus. Strong efficacy results of vaccines delivering greater than 90% efficacy may encourage more social and public activity. Pfizer and Moderna vaccines are leading the charge of optimism and giving many hopes that our current COVID-restricted lives may soon be able to return to greater normalcy. Youyang Gu, the creator of the YYG model, predicts herd immunity of 70% will be achieved around July/August 2021, which aligns with many analyst expectations. Since July, we have been communicating that we believe this recession is a bookend recession; it was caused by a virus, and as such, should end with a vaccine – fingers crossed the end is near.



Source: https://covid19-projections.com/path-to-herd-immunity/

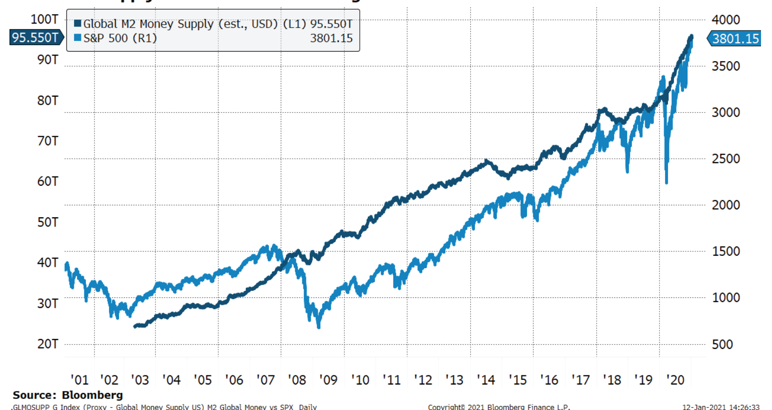
The final earnings season of 2020 kicks off next week, with high expectations after record earnings reports of the third quarter. Europe is still expected to slump by about 18.5%, a mere 6.5% better than the region's third quarter forecast. Given the more cyclical makeup of the European indexes, significant trouble containing COVID-19 and keeping the Eurozone open, a lag in recovery should not come as a surprise. Forecasts for the United States have rebounded from June levels of -20% but are still expected to contract at a rate of almost -6.68%, even accounting for strong third and fourth quarter earnings. According to Evercore ISI Research, this is the smallest and fastest recession period earnings drawdown in thirty years, and with 2021 consensus estimates for the S&P 500 of $167 per share, earnings could see growth up around +20% in 2021. Monitoring companies' performance and messaging as the country continues to come back online is equally important as they adjust to navigating in this new normal.



It is becoming increasingly difficult to ignore headlines touting valuations, and how extreme levels indicate the S&P 500 is in bubble territory. Valuations, as measured by the Price-to-Earnings ratio, are the collective prices of the companies in the S&P 500, divided by their collective earnings. Generally, the lower the P/E ratio, the more attractive

stocks are, as they are considered undervalued. As you can see, we entered the year with already high, and relatively valued prices on equities. Typically, after sharp market pullbacks it is natural to see a pullback in valuations. While prices have risen, earnings fell significantly, and forward projections were much lower. In the absence of earnings, valuations are likely to remain at or around their elevated levels. However, the vaccine optimism, the record low interest rates, non-existent inflation, and unprecedented levels of fiscal and monetary stimulus make a strong foundation for earnings to rebound in 2021. As such, we anticipate multiple compressions over the course of the year, resulting from earnings growth rather than price declines, forcing current valuations lower and more in line with their risk premium.

There is a well-known saying in the investing world, 'Don't fight the Fed'. Looking at the 'Follow the Money' chart, a strong correlation can be observed between the change in money supply and the path of equity markets. To jumpstart the economy, the Fed grew the M2 money supply by more than 25% year-over-year through November 2020, and thus far the market has held up its strong correlation. That is not to suggest that our preference for equities in 2021 is solely driven by expected earnings growth and the Fed. As we alluded above, perhaps the most telling signal is the positive vaccine developments and the optimism surrounding vaccine rollouts. Fed imposed low interest rates, little inflationary pressure, and massive amounts of federal stimulus all provide a positive backdrop in support of risk assets like equities. Then factor in a weakening US dollar, which typically helps boost earnings, especially among globally diversified companies. We have seen cyclical sectors such as financials, industrials, and materials significantly outperform mega-cap tech, especially when optimism led to increased likelihood of reopening. As such, we would expect to see such cyclical, or value-oriented, sectors lead the charge over the first half of the year and perhaps slightly beyond. We are, and will always be, long-term investors. We feel that long-term, companies positioned to capitalize on the strong secular growth trends such as cloud computing, artificial intelligence, machine learning, and e-commerce are all leading the race toward digitization, and those longer-term secular growth trends should persist. The key is identifying those companies that can deliver consistent stable and predictable earnings. Not all tech is created equal and going forward we may witness asset selection favor passive index investing, especially with technology. To summarize, we believe in the short-term, you rent value, but continue to own growth.



Developed economies such as Europe and Japan are still lagging in the recovery. The cyclical makeup of their economies positions their equities favorably as we enter 2021. Not only did many of the East Asian countries control the virus better than most of the developed world, allowing them to lead the rebound, but emerging markets traditionally perform well when the Fed is accommodative, US rates are low, the dollar is weakening, earnings are growing, and a global economic recovery is underway. Since many emerging market countries are resource, or commodity driven, as the global recovery unfolds and commodity prices continue to rise, emerging markets should be the benefactors. Perhaps 2021 is the year we see international equities lead equity markets higher.

With interest rates expected to remain low, we anticipate a relatively neutral or perhaps negative net real return in coming years on investment grade bonds. Often in low interest rate environments, we witness investors subscribe

to the well-known acronym 'TINA', There Is No Alternative. In other words, there is no alternative to equities. Given more than 60% of equities in the S&P 500 have dividend yields greater than the 10-year US Treasury bond at year-end, many investors find themselves weighting equities higher to boost their income production, a decision we caution against. Turning to equities to make up for lost income, or even incorporating more esoteric credit vehicles like bank loans, structured credit (MBS, CMBS, CLOs, etc...), or high yield bonds to boost yield often increases the underlying level of risk, leading to unintended consequences. Our focus remains on quality with a commitment to each portfolio's respective risk target. Looking at 2021, we would anticipate the yield curve to continue steepening, putting downward price pressure on US Treasury notes. Conversely, while yields sit at or near all-time lows, we see further opportunity for spread tightening in both investment grade and high yield bonds, which could ultimately provide a positive return over the course of the year. In addition to emphasizing quality and expectations of further yield curve steepening, we feel it's important to shorten portfolio duration, which reduces interest rate risk, and helps offset expected losses should yields continue to rise. We have found that COVID-19 has magnified balance sheet weaknesses within companies and believe it will also magnify and reward quality and strength during the recovery.

The longer-term backdrop for equities appears supportive in the short-term, but we remain cautious. We see several risks that could dampen our outlook. First and foremost is the containment of the COVID-19 virus. Outside of severe lockdowns mirroring that of April 2020, this should be achieved through successful deployment of vaccinations. Therein lies another risk. Should administering vaccines experience hiccups and/or delays, or the general population refuse to take the vaccine, the July/August expectation of herd immunity would be pushed out and perhaps negatively impact economic recovery. With any new president there are policy uncertainties, and with a Democratic Congress, policy agenda items such a tax increases could hamper recovery, as could Biden's trade stance on China, which is still undetermined. While we do not anticipate great risk with China policy, an unexpected inflation spike, could prompt a Fed policy response, which the markets do not digest favorably.

I think I speak for everyone when I say that 2020 was a unique and trying year. After enduring such conflict, it can be easy to become complacent, or want to jump on the FOMO train (Fear of Missing Out), but we will continue to stay nimble, maintaining a disciplined and diversified approach in our portfolios with a continued emphasis on quality. Most importantly, we look for opportunities to ensure the portfolios that we manage match the objectives and risk tolerance of the clients we have the privilege to serve. We appreciate your business and ongoing trust and invite you to reach out to your advisor should you have any questions or concerns, and to schedule your next review.

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