QUARTERLY MARKET UPDATE

JANUARY 2021

MARKET LANDSCAPE

Name	2020 Return (%)
Barclays US Aggregate Bond	7.5
Barclays US Credit	9.4
S&P 500 TR USD	18.4
Barclays US Corporate High Yield	7.1
MSCI Emerging Markets	18.3
MSCI EAFE	7.8
Russell 2000 TR USD	20.0

Data Source: Morningstar Direct

Year in Review

2020 will certainly be a year not soon forgotten. Not only from social, political and health perspectives, but from economic and investing viewpoints well. Regarding the US stock market, the Standard and Poor's (S&P) 500 climbed almost 70% since its March low and finished the year up over 18%.

There is no doubt that this result defied expectations; the S&P 500 had a better year than its historical average of around 10%, despite a near 35% decline from the February peak to the March bottom. While equity markets fared well, the broad economy is not nearly fully recovered. Millions more people are unemployed than in the beginning of 2020, and the US recession that began in February has not been officially categorized by the National Bureau of Economic Research (NBER - they are the official body that categorizes economic cycles) as over.

This dichotomy is not unusual, though, as markets tend to be forward looking, and investors quickly surmised that the economic damage from the coronavirus would be contained sufficiently to avoid a more critical and prolonged economic crisis. Further, the US Federal Reserve (Fed) provided action to stabilize markets. In addition to returning the federal finds rate to 0.00% - 0.25%, the Fed unveiled new quantitative easing (QE) measures and loans of various types to help sustain business activity.

Within the broad equity markets, there were certainly uneven results relating to sector leadership. Shares of technology companies led the market throughout the recovery, creating a distorted perception; positive market results were being generated by a very narrow set of stocks, while most companies were languishing. Broadly, growth stocks outperformed value stocks by the largest margin in decades.

More recently, though, there has been a slow erosion of this dynamic, as value companies have begun to show greater resiliency in comparison to some favored growth firms. The prospect of large-scale immunity to Covid-19 due to the introduction of vaccines is generating hope of return to normalcy, at least to a small degree. This optimism benefits the market more generally, rather than narrowly on just a handful of winners.

Regardless of the relative outperformance/underperformance of any given sector or style, it is reasonable to assert that the low interest rate environment created (and announced to remain for the indefinite future) by the Fed is responsible for the strength of stocks this year. It is also the mainstay of support for positivity moving into 2021.

Sector Returns

S&P 500 Sectors	2020 Return (%)
Information Technology	43.9
Consumer Discretionary	33.3
Communication Services	23.6
Health Care	20.7
S&P 500	18.4
Consumer Staples	13.4
Materials	11.1
Real Estate	10.7
Utilities	0.5
Industrials	-1.7
Financials	-2.2
Energy	-33.7

Data Source: Morningstar Direct

Macro Outlook

Strong commitment from central banks and governments in the form of monetary and fiscal support is undeniable, and the phrase of "lower for longer" as it relates to the Fed's bearing on interest rates is well recognized. And while these monetary (and perhaps fiscal) tactics have been projected to last years, the nature and strength of the economic recovery remains uncertain.

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Certain sectors of the economy experienced devastating slowdowns, and the downstream effects have yet to be fully realized. The unprecedented nature of government support to combat these dislocations has created questions as to how monetary actions and debt levels will be reversed, if not in the immediate future, long term, and what the ramifications of these measures will be.

The Federal Open Market Committee (FOMC) meeting in December outlined the Fed's policy directive as one where the Fed "will continue to increase its holdings of Treasury securities by at least $80 billion per month and of agency mortgage-backed securities by at least $40 billion per month until substantial further progress has been made toward the Committee's maximum employment and price stability goals."

Like prior years, these easy money policies are hoping to spur sustained Gross Domestic Product (GDP) growth in a manner supportive of muted inflation. It is likely that these actions will achieve the desired dampened inflation profile even if inflation increases over time to its targeted level of 2% (or beyond) but will probably continue to deliver sub-optimal growth rates throughout 2021 and into 2022.

Encouragingly, as initial lockdown restrictions were loosened this summer, consumer spending rebounded, driving a rapid bounce back in GDP growth and employment. This same phenomenon was expressed in many different categories of economic data. This resiliency engenders optimism regarding future outcomes relating to the current seasonal infection dynamic. On balance, while still diminished in strength, the US economy still exhibits a notable flexibility in response to the unexpected conditions introduced due to coronavirus.

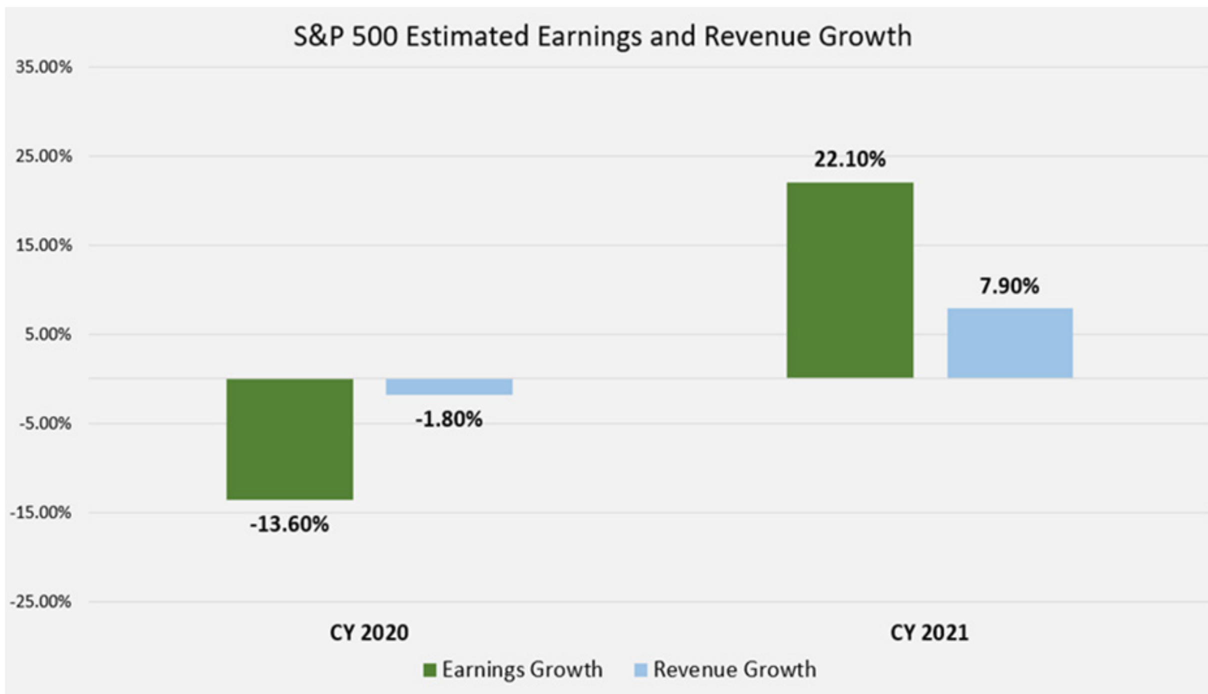
Equities

Capital markets reside in the context of the macro-economic backdrop, and the removal of perceived threats to the environment buoy confidence. Equities ended the year solidly as a couple of uncertainties achieved resolution; the outcome of US presidential election become known and a more accurate timeline for a coronavirus vaccine rollout materialized. This allowed markets to focus on relevant macro issues, primarily corporate earnings.

The continuation of low interest rates is in our view the crucial element in constructing an outlook for stocks. Money supply, interest rates, credit spreads, and liquidity all align to provide support for stocks this year. The increased liquidity is particularly impactful to small-cap companies, which require access to capital markets for ongoing financing needs. As such, we hold a reasonably positive view for equities in 2021.

However, investor sentiment and revenue/earnings forecasts

Chart 1 – Earning Forecast



Source: Y- Charts

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for 2021 seem somewhat hopeful, which may lead to price consolidation early in the new year if reality proves less favorable than projections. Because even with optimistic earnings expectation, relative valuation multiples across most sectors reside at levels well above historical norms. This, along with sentiment risk, warrants caution in the short-term, irrespective that valuation is a poor, stand-alone predictor of markets.

Again, though, long-term, we believe markets should head higher, even considering possible short-term volatility. Even if corporate profit estimates prove to be overly optimistic, over time, valuation multiples will compress as earnings increase, regardless of the rate.

And again, a return to some semblance of normalcy should reinforce investing positivity. The delivery of a coronavirus vaccine will have a substantially constructive impact. Progress on this front has already improved the outlook in cyclical sectors, widening market leadership and market stability, even though it will take some time for the vaccine to work its way through the population.

Lastly, the runoff election outcomes in Georgia will disrupt the prior conventional surrounding congressional gridlock in Washington. With Democrat control of the Executive branch and both houses of Congress, additional questions relating to tax policy, fiscal stimulus measures, regulatory initiatives etc. now exist, as greater latitude to effectuate desired policy programs is available to them.

Fixed Income

The positive developments shaping conditions for risk assets generally apply to the fixed income space as well. Corporate bonds, specifically in certain segments and locations on the yield curve, do provide an acceptable valuation and overall risk-return profile. To provide short-term financial stability, corporations issued large sums of debt in 2020. It seems this dynamic is waning, as liquidity has stabilized, and balance sheets are stronger. This fact, in conjunction with rebounding consumer demand, may bolster inflation prospects.

This could be problematic for fixed income markets, specifically long-term US Treasury bonds. Long-dated government bonds greatly outperformed other sectors last year as the yield curve both flattened and compressed. A reversal of this movement through increased growth and/or inflation prospects will put downward pressure on US Treasury prices. It is because of this that we do not find this sector in bonds very attractive.

While low interest rates are a boon to borrowers, they are a detriment to savers. 2021 will continue to be a challenge for investors searching for yield opportunities, as the preponderance of domestic and global bonds offer meager or even negative yields in certain instances. For many investors, the usual income-generating options, savings accounts, money market funds or government bonds leave much to be desired.

And these conditions do not seem temporary; the Fed is expected to increase its balance sheet, mainly through purchases of Treasury bonds and other securities by approximately another $2 trillion this year. This amount is lower than last year, but substantially more than historical averages. The fact that income generating investment opportunities remain limited will likely increase the attractiveness of credit risk over interest rate risk.

Staying the Course

2020 was a remarkable year on many levels. It saw events that most thought were not possible, not only in terms of the challenges experienced but also in the societal adaptation and resilience offered in response.

The arrival of a new calendar year does not magically erase the many challenges we face. There remain many questions regarding the future in terms of human health, economic recovery, social and political responses, and the lasting impacts of our current policy choices.

However, addressing these issues must be done in sequence, and the current rollout of the coronavirus vaccine is a solid first step in restoring confidence and stability in our economy and financial markets. From there, we will be in a better position to continue to address secondary and tertiary effects of the events of 2020.

Broadly speaking, capital markets have a decent chance to build on the recovery and momentum experienced since the end of the first quarter of 2020, even though there will no doubt be periods of disruption and setback. As 2020 demonstrated, however, investment resolve through uncertain and anxious moments is most often rewarded. This perspective is the hallmark of successful long-term investors and will likely be valuable to possess as we move through 2021 and beyond.

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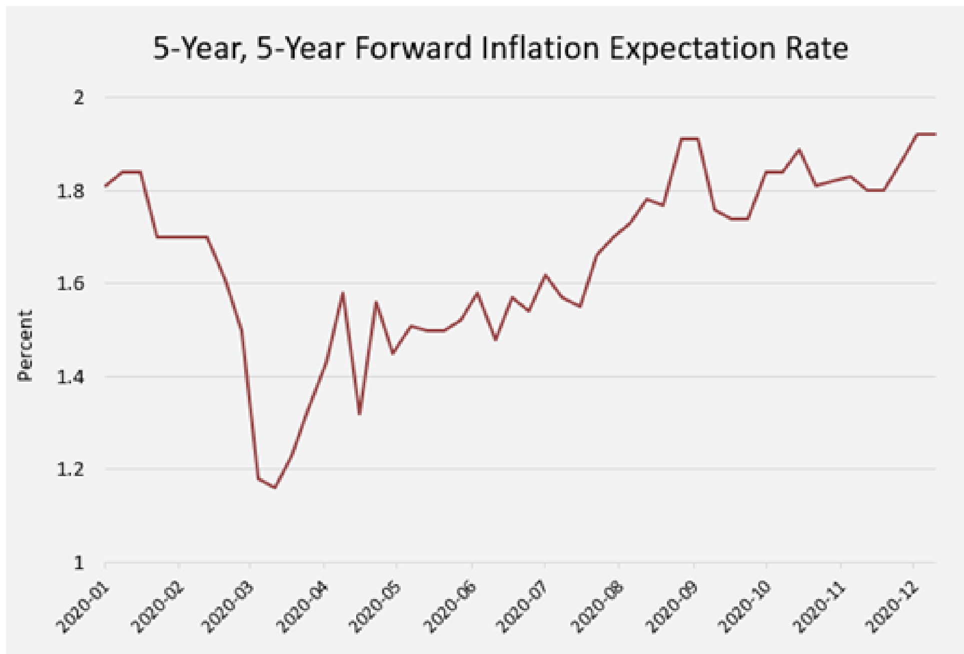
Chart 2 – Inflation Trend



Data Source: : Y-Charts

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by BerganKDV

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