Investment Commentary: Fourth Quarter 2020

A Tale of Two Economies

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- It was the best of times and the worst of times for the U.S. economy
- Credit markets continue to recover as the economy reopens
- Stocks close out a bizarre year near all-time highs

As 2020 has come to a close, we can't help but reflect on what is sure to go down as one of the most unpredictable years the financial markets have ever seen. The pandemic that rocked the entire globe in the first quarter has changed the world forever, with the end results still very much up in the air. New industries have literally been created overnight, while others have likely seen their fate sealed through no fault of their own. The year 2020 will serve as a reminder to always be prepared for the unexpected.

Economic Review & Outlook

Although 2020 will mark one of the steepest declines in economic activity the U.S. has experienced in decades, what really matters will be what the recovery looks like in 2021 and beyond. The numbers mask the real story - one of rapid change. Companies that can adapt quickly to the new environment will likely prosper, while those stuck with an outdated business model or lack of vision are destined for failure. This mass uncertainty surrounding so many industries makes it extremely difficult for politicians and central bankers to provide support to those who need it most. Thus far, their actions have been to err on the side of overstimulating the economy with record breaking stimulus packages and monetary policy efforts enacted at warp speed. The initial result has been a positive one for financial markets, but the longer-term effects are still very much unknown.

Some investors are suggesting a level of caution may be warranted given the potential financial burden the actions taken in 2020 may cause. Federal debt is now in excess of 100% of GDP, the first time this has occurred since World War II. Policy makers have compared the Covid-19 pandemic to a military war effort, so perhaps the comparison isn't so alarming. The obvious concern is the potential for inflation and interest rates to rise sharply as the economy recovers.

Here is a staggering statistic highlighting how crucial debt is to the growth of America: Despite an increase in federal debt from $5.5 trillion in 1998 to $27 trillion today (a rise of nearly 400%) interest payments have only increased by 50% over the same period. This increased debt burden with minimal additional cost has helped finance two decades of economic growth in America. Low interest rates are the "glue" holding the entire economy together. Thus, rising interest rates would be a huge hurdle for our economy to overcome.

Fortunately, the probability of interest rates rising sharply remains remote (at least in the short term), primarily because we operate in a global financial system. Although many Americans believe interest rates in the U.S. are low, Europeans may beg to differ. Take a look at the table below. Be sure to notice the last entry - Greece. This is a country that was in the midst of extreme austerity just a few years ago, and now they can borrow money at a rate lower than the U.S. This should help put your mind at ease the next time someone mentions how low interest rates are in the U.S.

Country	**Credit Rating**	**10 Year Government Bond Yield**
United States	AA+	0.91%
Germany	AAA	-0.61%
United Kingdom	AA	0.17%
Spain	A	0.02%
Portugal	BBB	0.00%
Greece	BB-	0.61%

Source: Bloomberg (yields) and tradingeconomics.com (ratings) as of 01/04/2021

As long as interest rates remain accommodative, economic growth will likely see a sharp rebound in 2021. According to a Wall Street Journal economic survey in December, GDP is expected to rise 3.7% next year after falling 2.7% in 2020. If the vaccine rollout goes smoothly, consumer confidence may rise faster than anticipated. This could result in upside potential to this estimate, so cautious optimism is the theme as 2021 begins.

Bond Market Review & Outlook

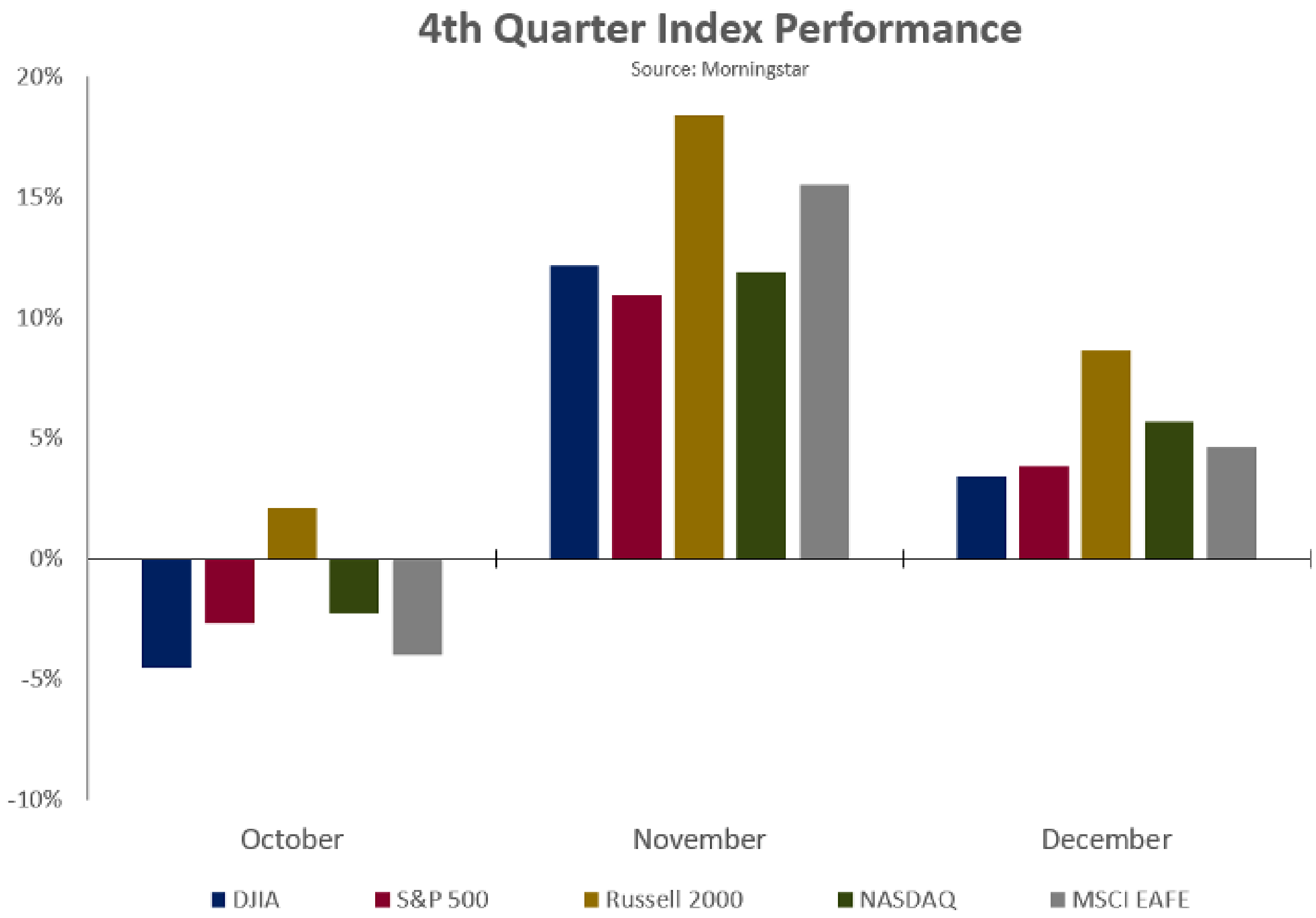
The recovery in the bond market continues with higher yielding, lower quality debt outpacing core bonds for the third consecutive quarter. This outperformance by the credit sector is what would be expected during any economic recovery and this one has played out no differently. Unfortunately, it has left bond investors with little to be excited about moving forward as yields have dropped to low single digits for corporate bonds and not much above mid-single digits for high yield bonds.

Given the drop in yields, bond investors should be prepared that returns from here are likely to be subdued. Yet, as we pointed out in our economic review, interest rates in other parts of the world are much lower than in the U.S., so while it may seem unlikely, it is possible interest rates may decline further. Stocks have already rallied sharply and may be priced too richly for what the economy has in store for 2021. Should expectations exceed reality, stocks could reverse course next year making bonds just as important as ever when it comes to building a well-diversified portfolio.

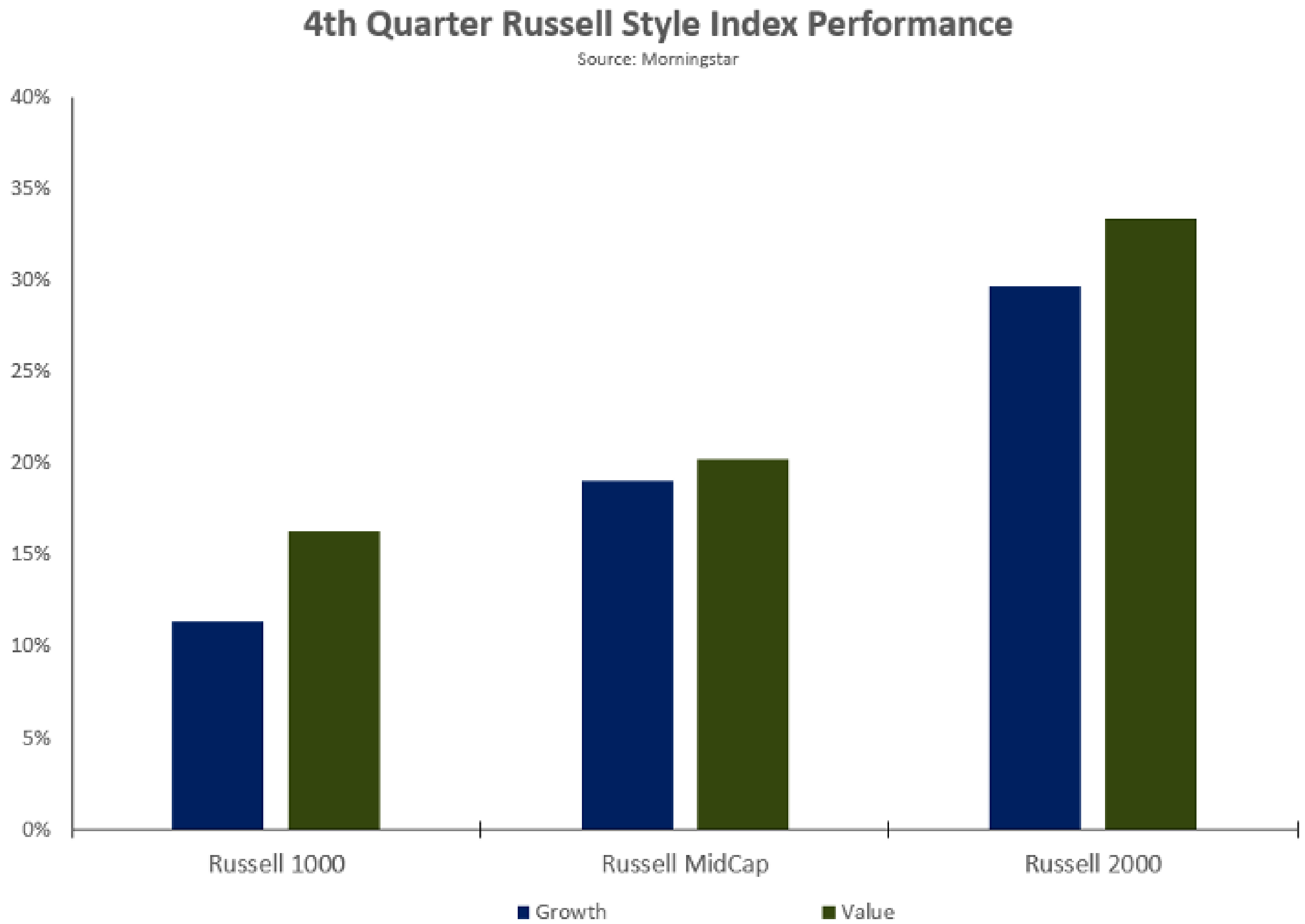
Stock Market Review & Outlook

Stocks have shown no signs of weakness since bottoming in March of 2020. In fact, November was the best monthly return for the Dow Jones Industrial Average (DJIA) since January 1987. For the quarter the S&P 500 and DJIA delivered gains of 10.9% and 12.1%, respectively. Small caps were the leaders this quarter as the Russell 2000 returned 31.4%. The NASDAQ continues to generate impressive gains, rallying 15.6% last quarter. Finally, international stocks outperformed large cap domestic equities, producing a very respectable return of 16.1% for the quarter.

When the stock market delivers the type of breathtaking returns we have seen over the past nine months, investors typically have one of two reactions. Some find the gains to be totally unjustified, resulting in what might be referred to as a “fear of heights” situation. Others can become emboldened by the gains, causing a sense of complacency as though the good times will roll on forever. Now more than ever is a time to be reminded that making dramatic changes to your portfolio due to either of these emotions is fraught with danger. Timing the market has been consistently shown to be detrimental to most investors who attempt it. There is always a feeling of…this time is different. This can make an investor believe what they are doing isn’t actually timing the market. Controlling one’s emotions during an extreme year like 2020 is what separates successful long-term investors from those who end up with inferior returns. Pushing back against both the fear and greed narratives that have run through markets for decades couldn’t be more prudent during a time like now.



Perhaps the biggest surprise in the fourth quarter was the outperformance by value stocks. We have been talking at length for the past couple of quarters about the dominance of growth stocks. Shares of the most popular technology and consumer related companies have been the driving force behind the gains in the stock market in 2020. With a vaccine now on the immediate horizon, investors have begun to move back into some of the most beaten down sectors of the market. These sectors such as energy, financials, and industrials are mostly value industries. If the recovery picks up steam in 2021 it is possible leadership may shift to value stocks. With many investors having reduced exposure to this segment of the market, any shift in demand could be a windfall for value investors. The current IPO craze is centered around high-flying growth stocks in the same sectors that led the recovery. Saturation in these sectors could make gains more difficult in these areas next year. Maintaining exposure to value stocks is as important as ever, especially if you are expecting an economic recovery next year.



Alternative Investments & Hybrids Review & Outlook

The broad Alternatives universe concluded the year up 3.0% as measured by Morningstar's Multi-Alternative category. Uncorrelated strategies, such as managed futures and merger arbitrage, were flat to modestly positive for the year. The S&P Real Assets Index, which includes real estate, commodity, and infrastructure assets, closed the year up 1.2% staging a robust recovery as economic conditions improved through the year. Commodities were a mixed basket. Precious and industrial metals posted banner years while many energy products suffered significant losses due to dramatic shifts in demand. Hybrid managers, which allocate amongst stocks and bonds, ended the year with mid-single digit to low double-digit returns for 2020 as managers participated in the sharp recovery in equities during the latter half of the year.

Conclusion

Most investors will likely remember 2020 as one of the strangest years they have ever experienced. The portfolio returns at the end of the year would have been unthinkable during the depths of the pandemic fear. However, despite the unbelievable recovery we have seen in the financial markets, the real feat we can all be proud of is the development of a vaccine in record time. This is a testament to human ingenuity and advancement. Although this may have been a scientific achievement, it should remind investors that people always find a way to move forward. Recessions and bear markets undoubtedly lie ahead of us, but our will to forge ahead is what investors should always focus on when the storms arrive. Let 2020 be a constant reminder of that.

Wealth Management Team
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