Investment Perspective

The "art of investing" is one's ability to distinguish between potential returns, the chatter of concern and potential danger. There is always something to worry about and some worries are realized for unforeseen reasons. In retrospect, last winter's fear was "the age of the expansion" and a potential recession as the pandemic fear was not yet prevalent. Ironically, the longest U.S. economic expansion since 1854 ended in April followed by the deepest and shortest recession in modern times. We did experience the feared recession, but for unforeseen reasons. Surprisingly, the stock market's performance during this pandemic and recession has been an unexpected positive. This outcome reinforces a key principle of equity investing: "Time in the market is more important than timing the market." It is most difficult to accurately forecast stock prices. The future trend rewards those with patience and confounds those in doubt.

Surprisingly, the stock market's performance during this pandemic and recession has been an unexpected positive

What can we expect in 2021 given the strong advance in stock prices? We are likely to experience a favorable environment for equity investors, but with higher than usual volatility. The market's strength will be supported by above-average growth in GDP, corporate sales and earnings. However, a portion of the economic rebound will be related to deferred demand caused by the pandemic. Low inflation and interest rates combined with above-average earnings growth are fundamentally underpinning the investment environment. But the recent rise in market momentum and higher valuations create more risk. A summary of index returns for the year ending December 31, 2020 is as follows:

Dow Jones Industrials	9.0%	Russell 2500	20.0%
MSCI EAFE	8.5%	S&P 500	17.6%
NASDAQ Composite	44.7%	Wilshire 5000	22.2%

GLOBAL ECONOMY

Welcome to the Roaring '20s! World economic growth (ex. U.S.) should increase more than 5% in 2021 after a decline of 3.5% last year because of the Covid-19 pandemic. The global rebound is expected to be strong despite the fragile health of many industries and high unemployment. This recovery will be supported by strong fiscal and monetary policy, vaccine deployment and unprecedented pent-up demand that will jumpstart normal economic activities. Among major regions, Europe experienced the sharpest downturn in 2020 with GDP contracting 7.1% accompanied by declines of 5.1% in Japan and 3.5% in the U.S. However, China grew 2.3% because the virus was contained early in the year. Despite an improving forecast, uncertainty persists because of the virus's unpredictability. Although we have limited experience with economic recoveries from pandemics, we continue to learn, adapt and adjust.

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The U.S. economy is expected to recover with 5% GDP growth this year following a contraction of 3.5% in 2020 — the largest since WWII. Some experts estimate that 6-7% is possible. Growth will be supported by most major sectors including consumer spending, capital expenditures, housing, information technology and inventory rebuilding. Demand will be underpinned by enormous quantities of fiscal and monetary stimulus and a reopening of the economy. It is clear the economy will experience a surge of growth as the population gets vaccinated and develops herd immunity. The next challenge will be achieving full employment and reducing the sizable government deficits. As economic activity begins to normalize, it will be critical to regrow the tax base through business formation, employment gains, home sales and community redevelopment. Work-from-home trends may have significantly altered future commuter trends, housing preferences and the desire to relocate to low tax states. These changes may speed the recovery or hinder growth in various regions. The unemployment rate improved to 6.7% in December from 14.8% in April and further job gains are expected in coming months. However, the unemployment rate does not fully reflect the state of underemployment since more than two million people left the labor force, primarily because of the pandemic. There is a meaningful opportunity to get people back to work as the recovery unfolds. Many service industries are operating significantly below capacity. The manufacturing sector is also operating below capacity because of bottlenecks and Covid-19. Consumers are experiencing shortages for appliances, autos, consumer electronics, home furnishings and lumber because of pent-up demand and supply problems. Business equipment spending on information technology remains strong due to technological upgrades that include more demand for cyber-security technology, networking and software. With vaccine deployment, the worst appears behind us and the economy will soon recover. Moving forward, the key question will be how to sustain the economic momentum beyond an initial surge of pent-up demand. On a positive note, the pandemic has improved productivity which will aid earnings growth. The outlook has brightened, but it will be a tough and uneven road to recovery.

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CORONAVIRUS PANDEMIC

The U.S. continues to experience a rapid spread of the coronavirus across all regions as cases per day have increased sharply over the last three months. Since the beginning of the pandemic, a total of 27 million Americans have contracted the virus with approximately 450,000 deaths. The pace of deaths has accelerated since October with approximately 3,400 daily compared to less than 1,000 in September. At least one new coronavirus variant has been identified that is more contagious and dangerous. Experts expect this variant to spread quickly and potentially become the dominate variant by March. Many hospitals are at capacity. Fortunately, a global vaccination process has begun, and the Biden administration plans to vaccinate 100 million people in 100 days. In the U.S., there are two vaccines approved that require two shots with other single shot vaccines expected shortly. A rapid vaccination process has been hindered by distribution bottlenecks and confusion as only 26 million people have received their first shot. Later this year, several hundred million doses will be available from four or more

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manufacturers. In the meantime, it is essential to follow the mask and social distancing guidelines to reduce the contagion. There is light at the end of the tunnel with the vaccine rollout occurring, but the next few months will remain challenging due to new virus variants and the potential for rising cases. The pandemic will be beaten, but not yet.

FISCAL & MONETARY POLICY

This $2.2 trillion stimulus bill was the largest stimulus package in U.S. history representing approximately 11% of GDP

From a fiscal perspective, Congress and the President approved $3.1 trillion worth of aid packages in 2020 in two separate deals. Last April, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) was approved to provide subsidized payroll loans for businesses and enhanced unemployment benefits. This $2.2 trillion stimulus bill was the largest stimulus package in U.S. history representing approximately 11% of GDP. In December, $900 billion was approved by Congress to further support the programs initiated last spring. This round of relief benefited small businesses, travel industries, universities, broadband suppliers and some transportation agencies. The Biden administration also recently proposed an additional $1.9 trillion package in fiscal aid. These measures have raised concerns about the growing federal deficit which equaled 14.9% of GDP in 2020 — the largest as a percentage of GDP since 1945 — versus 3.8% in 2018. However, as Treasury Secretary Janet Yellen said, “It is time to go big to regrow the economy and not worry about the deficit.” Despite these massive policy initiatives, it will take time for employment to recover as businesses and schools gradually reopen.

The central bank has committed to supporting the economy with liquidity measures as needed and will keep credit cheap to foster maximum employment and price stability

The Federal Reserve continues to do “whatever it takes” for as long as the coronavirus threatens economic stability. Short-term interest rates are effectively zero (the federal funds rate is set at a range of 0-25 basis points) and the Fed is managing long-term bond yields with quantitative easing. These efforts have successfully lowered borrowing costs as the 10-year Treasury yield is approximately 1.12% after hitting 0.53% last summer. The central bank has committed to supporting the economy with liquidity measures as needed and will keep credit cheap to foster maximum employment and price stability. The objective is to support borrowing, investment and spending to promote economic growth. These actions have provided the markets with ample liquidity since last April as evidenced by the record quantities of underwriting for corporate bonds and equities in 2020. In addition, the Fed recently modified its policy framework and adopted “average inflation targeting.” The objective is to achieve inflation moderately above 2% for some time so that inflation averages 2% over time, thereby allowing for employment gains across all segments of the population. The Fed is comfortable taking an accommodative view of inflation to regain its ability to use interest rate management as a policy tool instead of quantitative easing. Today, inflation is modest, but may gently rise from these unusually low levels in line with the Fed’s 2% objective. The CPI inflation indicator is 1.3% y/y and the core PCE inflation measure is 1.4% y/y. Overall, the Federal Reserve played a significant role in successfully steering the economy to safety during the pandemic.

INVESTMENT OUTLOOK

The globally synchronized monetary easing that started last year is driving an economic recovery, improving consumer confidence and boosting stock markets. The broad-based market uptrend that began in late March will likely advance further due to the favorable combination of earnings growth, low interest rates, tepid inflation, strong liquidity and improving confidence. This year, we expect S&P 500 operating earnings of $174 per share, slightly above the 2019 level, with $195-200 in 2022. Earnings growth will be strong this year compared to the depressed levels of 2020. The S&P 500 is valued at 22.0x estimated 2021 earnings, supported by a 10-year Treasury yield of 1.12% and core PCE inflation of 1.4%. Additionally, the S&P 500 dividend yield of 1.58% is competitive with both Treasury yields and core inflation.

Today, bullish sentiment is evident in many sectors of the financial markets

What is new in the current environment? Today, animal spirits are fueling a rising market. This enthusiastic sentiment for equities has been absent for most of the last two decades. The prior bull market that ended in March 2020 was described as "the most hated bull market in history." Today, bullish sentiment is evident in many sectors of the financial markets. Valuation has become a concern for the first time in 20 years. The S&P 500 forward earnings multiple is higher than its long-term average of 16.6x and somewhat above its average of 21x during periods of low inflation and interest rates. The reasons for this reasonable premium include extraordinary stimulus measures, above-average growth, improving confidence and the relative attractiveness of equities compared to fixed income or real estate. Nevertheless, the previous skepticism that provided healthy fuel to the strong markets has moderated and is being replaced by more exuberance, a potential concern.

Breadth, price momentum and other confirmatory indicators suggest the advance is durable and sustainable

From a technical perspective, the stock market is healthy, although it may be overbought on a near-term basis. Breadth, price momentum and other confirmatory indicators suggest the advance is durable and sustainable. The NYSE advance/decline ratio is making new highs confirming the secular uptrend. The VIX option volatility index is moderately elevated at 30 indicating some risk of higher volatility ahead. An elevated VIX reading in the context of a rising stock market warrants more attention than during a sharp correction. What about the Chinese zodiac indicator? This is the Chinese "Year of the Metal Ox" that signifies dependability, determination and strength. Since 1936, the S&P 500 increased 71% of the time during Ox years with an average gain of 12.2%. Finally, the Democratic Party controlled the White House and Congress 18 times since 1951 and the DJIA and S&P 500 experienced average increases of 15.7% and 13.2%, respectively, during those periods. These indicators are positive for equities in 2021.

We look forward to above-average returns in the year ahead as the stock market benefits from tremendous global liquidity, strong fundamentals, asset flows and enthusiasm for equities. It is important to note that momentum trends can be sustained for longer than expected, especially with the relative attractiveness of equities versus fixed income securities. Also, the stock market increases most years (about 73% of the time) despite periodic 5-15% intra-year corrections. We favor adding to equities during periods of individual issue or overall market weakness. The key risks include Brexit, coronavirus contagion, cyber-attacks, disappointing earnings, European deflation, global debt problems, military conflicts, political feuding in Washington, social unrest, unexpected inflation and vaccine failure. In our opinion, quality small and medium-sized growth companies remain likely to achieve above-average annual returns over the next few years. We continue to remain optimistic.

Appendix: Summary of Key Economic and Financial Measures

	Yearend 2019	Yearend 2020	Difference/ Change
Fed Funds Rate (%)	1.75	0.25	-150 bps
10 Yr. Treasury Yield (%)	1.92	0.93	-99 bps
Inflation (CPI y/y % ch.)	2.30	1.29	-101 bps
Gold ($/oz.)	$1,523	$1,891	+24.2%
Oil ($/barrel)	$61	$48	-21.3%
Euro per Dollar	0.89	0.81	-9.1%