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Quarterly Update & Economic Commentary—December 31, 2020

Quarter in Review

The fourth quarter was a great quarter for stocks. The S&P 500 was positive by 12.15% during the quarter. While a double-digit return in a quarter is impressive, the S&P 500 was a lagging index. The Russell 2000, which is made up of U.S. small-cap stocks, returned 31.37%, its strongest quarter on record. International stocks also outperformed the S&P 500. The MSCI EAFE, which consists of developed, foreign stocks, returned 16.05% and the MSCI Emerging Market Index returned 19.70%. In addition to small-cap and international stocks outperforming the S&P 500, value stocks outperformed growth stocks during the quarter. The S&P 500 Value Index returned 14.49% during the quarter, compared to 10.66% for the S&P 500 Growth Index. The strong fourth quarter returns helped solidify a strong year for stocks. The S&P 500 finished the year positive 18.40%, the small-cap based Russell 2000 was positive by 19.96% (however, the S&P SmallCap 600 only returned 11.29%), the MSCI EAFE returned 7.82% and the MSCI Emerging Markets finished 2020 with an 18.31% return. The Energy and Financial sectors were the best performing sectors during the fourth quarter, returning 27.77% and 23.22%, respectively, but both sectors were negative for the year. The Energy sector lost 33.68% and Financials lost 1.69%; the only other S&P 500 sector to post a negative 2020 return was Real Estate, losing 2.17%. The top performing sectors of the year were Technology (43.89%), Consumer Discretionary (33.30%) and Communication Services (23.61%).

Not only did investors in stocks have a good year, but bond investors also had a good year. The returns were not quite as high as stocks but it was impressive compared to historical precedent. Interest rates across the yield curve dropped throughout the year. The 2-year rate fell from 1.58% to 0.13%, the 10-year from 1.92% to 0.93% and the 30-year from 2.39% to 1.65%. When interest rates fall, prices rise, which helped the total return for bonds in 2020. The Barclays US Aggregate Bond Index returned 7.51% for 2020. High yield bonds, which carry more credit risk and have a higher correlation to stocks, returned 7.11%.

Commodities were mostly positive during the fourth quarter but a mixed bag for the calendar year. Energy was a strong performer during the fourth quarter; Brent Crude was up 22.46%, WTI Crude Oil was up 20.64% and Natural Gas was slightly positive by 0.47%. For the year, Energy returns were not as good; Brent was down 21.52%, WTI Crude down 20.54%, but Natural Gas was up 15.99%. Silver, Copper, Nickel and Platinum all had a great quarter and a great year, while the most closely followed shiny metal, Gold, was flat during the quarter but had a good year. For the year, Gold was up 24.42%, Silver 47.38%, Nickel 18.48%, Copper 25.83%, and Platinum 10.37%.

The fourth quarter was a big quarter for news and events. The two biggest events during the quarter were the results of the United States Presidential election and the approval and beginning roll-out of vaccines for COVID-19.

Let's start with the election. The election was highly contentious with a record number of Americans showing up at the polls. In the end, former Vice-President Joe Biden was the winner and although the final electoral college votes looked decisive, 306 for Presidential-elect Biden and 232 for President Trump, the election was much closer when considering the margin of victory in the swing states. The President-elect received just over 51% of the popular vote compared to President Trump's 46.9%. This was the result that Wall Street was expecting. What surprised some were the results in the other races involving the House and Senate. As expected, the House remained in Democratic control. Republicans did pick up some seats. The Senate majority was close and came down to a two race Senate run-off in Georgia on January 5. Republicans needed to win one seat to maintain control. However, both seats went to Democrats and the Vice-President, Kamala Harris, will hold the vote to break ties. Many believed if Republicans held onto control of the Senate, then tax increases would be delayed for at least two years. From a market perspective, higher taxes were one of risks to President-elect Biden's presidency. Prior to the election, the market seemed fine with a Democratic sweep, so when the market began to believe a split government was possible, it was a reported as goldilocks scenario. From the early market reaction following the Georgia Senate election results, the markets seem fine with the prospects of higher taxes; the outlook of a more robust stimulus bill may outweigh any concerns of higher taxes.

The other big news of the quarter was the approval and beginning roll-out of a COVID-19 vaccine. Both Moderna's and Pfizer's vaccines were approved for usage in the U.S. Both vaccines showed incredible efficacy of above 90%. There was much deserved excitement about the approval and effectiveness of these medicines. The goal was for about 20 million doses to be given out in the U.S. by the end of 2020, however, only about 2 million doses were actually delivered. While everybody knew the logistics of rolling out the vaccine would be difficult, the end result was disappointing. Despite the lack of doses currently available and the disappointment of the initial roll-out, many still see some light at the end of the tunnel.

In more direct financial news, the third quarter earnings season was good. According to FactSet, 84% of the S&P 500 companies that reported earnings outperformed analyst estimates. This is the highest percentage since FactSet began tracking this metric in 2008. The top growth sector was Health Care, which saw 13% growth. Overall, the S&P 500 saw earnings decline by 6.6%, its fourth worst decline since Q3 2009. The future of earnings remains cloudy; of all the S&P 500 companies, only 69 companies provided guidance which is well below the five-year average of 104.

The unemployment rate in the U.S. is well above the recent multi-decade lows, but it continues to recover from the spike in unemployment suffered earlier this year when lockdowns were first announced. The current unemployment rate is 6.7%, down from the April reading of 14.7%. Inflation readings remain tame, which allows the Fed to remain accommodative for much of 2021 and possibly even 2022. Other readings on the economy have been mixed. Existing homes sales have fallen for the first time in five months and U.S. consumer confidence has fallen for two consecutive months, reaching its lowest level since August. New orders for key U.S.-made capital goods has increased for seven straight months. This suggests business investment is picking up from consumer spending which has been hurt in recent months by the government's inability to pass a stimulus bill. The final reading for third quarter economic growth, defined by the U.S. GDP rate, was a record 33.4%. However, this followed a decline of 31.4% for the second quarter. The second quarter drop was a result of self-imposed lockdowns to prevent the growing number of deaths and over-crowding hospitals. The snapback in the third quarter was driven by some businesses ability to re-open and learn to do business in a temporarily new normal and from government stimulus being absorbed in the economy.

Britain formally left the European Union's trade bloc on December 31. Both sides finally agreed on new rules for trade just days before the year-end deadline. There are expected to be disruptions in business activity with the new deal, but both sides are pledging to working through this together. Recent polling has showed that U.K. citizens would vote to stay in the European Union which feeds the speculation that the U.K. may one day return as a member of the European Union. For now, though, Britain is on its own.

A Look at the Numbers

Name	4th Quarter Returns	2020 Returns
DJ Industrial Average TR USD	10.73	9.72
S&P 500 TR USD	12.15	18.40
S&P MidCap 400 TR	24.37	13.66
S&P SmallCap 600 TR USD	31.31	11.29
NASDAQ Composite TR USD	15.63	44.92
MSCI EAFE NR USD	16.05	7.82
BBgBarc US Agg Bond TR USD	0.67	7.51
Wilshire US REIT TR USD	10.62	-7.90
IA SBBI US 30 Day TBill TR USD	0.02	0.44

A Look Ahead

The overall general sentiment going into 2021 is excitement. There is excitement about the prospect of some normalcy; people want to get out and spend money on experiences, whether it be trips, ball games, museums or simply just seeing family and friends they have not seen in a while. Parents are excited to get their kids out of the house and back to school, or to their jobs, or anywhere! All joking aside, 2020 was hard on many families, but it was good to slow down life, enjoy the simple pleasures and spend time with our kids and spouses. That said, for many it is time to get back to some routine.

The market expectations for 2021 are also high. The prospect of a vaccine being distributed is encouraging for employers and workers, especially those in the entertainment-related industries which have been some of the hardest hit. Short-term interest rates are expected to remain low, but intermediate- and longer-term rates may move higher if economic growth picks-up. The result of a steeper yield curve could help banking-related stocks, which were underperformers over the last year.

The Georgia election results will make it easier for the President to push his agenda, but the slim margin of control may restrict Democrats from doing anything and everything that they want. It also should be noted that President-elect Joe Biden has stated that he wants to work with Republicans and attempt to amend the recent political divisiveness that has built-up over the last 12 years. The latter will need to be proven out, which is much more difficult in action than in word.

It is expected that the President-elect's top priority will be the roll-out of the vaccines. Some of the current economic concerns of the country will be relieved if the majority of Americans can be vaccinated. However, this will continue to be a complicated task. There is hope that most front-line workers will be vaccinated during the first quarter, and a significant number of other Americans will be vaccinated during the second quarter. Even though there are approved vaccines, which are currently being distributed, it is going to take several more months of caution and some pain before getting back to normal, pre-COVID activities. One of the risks to the market is that the roll-out continues to stumble and that the economic impact carries on much longer than anticipated.

The President-elect has made two noteworthy appointments: former secretary of state John Kerry and former Fed Chair Janet Yellen. John Kerry will be part of the newly created climate envoy, suggesting that Biden intends to go beyond rejoining the Paris Climate Accord and that climate will be a focus of his administration. Janet Yellen will be Treasury secretary. Yellen pushed for fiscal stimulus when she was Fed chair and she also signed a letter earlier this year requesting Congress pass another stimulus bill. Combining her desires and the desires of many other Democratic representatives in Congress, the prospects for additional stimulus checks in early 2021 are high. This would be a boost to the economy in 2021.

The relationship with China is a major topic to be watched and an additional risk to the markets. Outgoing President Trump has been recently pushing for de-listing China related companies from the NYSE and China is expected to retaliate. The Trump Administration has undoubtedly made the U.S. and China relationship more fractured. China has also raised the stakes throughout the year with some of its decisions regarding Hong Kong, Taiwan, Senkaku Islands and its continued push to make China the top superpower in the world. This does not even consider the concerns with China stealing intellectual property and other cybersecurity issues that gain Congressional support from both sides of the political aisle. We believe China will be a major theme and risk for 2021.

Some of the strong fourth quarter returns are attributable to Wall Street analysts raising earnings guidance for 2021. Following what is expected to be a year-over-year earnings decline for 2020, analysts are expecting a big rebound. As of December 18, FactSet has estimated year-over-year earnings growth for the S&P 500 to be 22.1%, compared to the 10-year average growth rate of 10%. The higher earnings estimates are driven by the lower earnings rate in 2020 and strong earnings in the Energy, Industrials and Consumer Discretionary sectors. The potential for higher corporate taxes are not accounted for in these numbers. It is possible that if we see higher taxes that they would not be in effect until 2022.

It is understandable why the expectations for strong returns are high. The vaccines are game changers. Even if they are not fully distributed until late 2021, the market is forward-looking. The Fed is committed to keeping interest rates low, fiscal stimulus is being distributed and larger direct checks to some Americans are expected. There is also optimism for additional spending through an infrastructure bill, although this has been discussed for years with no bill ever being passed. Market returns in 2021 could be good again, but we urge investors resist overconfidence bias. There is always uncertainty and there is always risks. A new administration is a risk. A prolonged delay in getting Americans and people everywhere vaccinated is a risk. Heightened escalation with China is a risk. Cybersecurity is a risk and geopolitical issues in Turkey, Iran and the other parts of the Middle East are risks. These are known risks, but there are also always unknown risks. We believe that the opportunities outweigh the risks, but 2020 taught us that anything can happen.

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