QUARTERLY REVIEW

December 31, 2020

Economic Commentary

The market turned in another excellent performance in the fourth quarter, with the S&P 500 gaining 12.1%, and completing a strong second half of the year that resulted in a full year return of 18.39%. Given the economic and social disruption created by the Covid pandemic starting in the first quarter, the market's performance has been a bright spot in an otherwise forgettable year. While the market did drop slightly prior to the November elections, the market promptly rose in the aftermath. The tech laden NASDAQ posted the best return for the year at 45%, but we did see a perceptible shift in the fourth quarter to more cyclical, value, and small cap segments of the market performing better. While Covid numbers continued to worsen later in the quarter, the Fed and Congress continued to pursue policies to provide liquidity and fiscal support to the US economy. The Fed has done their part with their balance sheet ballooning by over 75% in 2020 to $7.3 trillion currently, from $4.1 trillion in January, and Congress has appropriated over $3.4 trillion in Covid relief programs. The objective of creating a bridge to a vaccine has largely worked as unemployment has retreated from its April high of 14.7% to a current 6.7%, and GDP bounced back at a 33.4% annualized clip in Q3. The labor market rebound has slowed, and the unemployment rate should decline going forward, but the rate of decline will slow. The early part of 2021 is likely to experience some tough times as Covid cases spike post the holidays, and partial shutdowns and hits to consumer confidence may occur in the short term. We would expect these to be short lived as vaccine distribution increases and warmer weather ensues. Regardless, there is significant damage to the economy that will need to be addressed (small business owners, commercial real estate, travel and leisure), not to mention the mountains of debt (national debt now exceeds $27 trillion) that have been created to bolster the economy. However, 2021 should provide a more hopeful backdrop to attack some of these issues, and a return to some degree of normalcy (or new normalcy) as the year progresses.

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Q4 2020 Equity Commentary

While the S&P returned 12.1%, there was a definite cyclical rotation in Q4 as prior sector laggards such as Energy and Financials moved to the head of the pack in Q4. Crude prices rose approximately 25% in Q4 as mobility globally began to increase from the lows of Q2. The energy sector gained 28.6% in Q4 but is still down 37% for the year. The financial sector rose 21.4% in Q4 as the recovering economy, improving employment, and government stimulus have created a much better credit picture for banks than previously expected. With that realization, the Fed has now given banks the green light to start buying back stock again in Q1 2021, and it's likely that banks will release some of the funds previously reserved for bad loans back into earnings. Materials and Industrials completed the cyclical rotation with both sectors up over 14%. The manufacturing sector has been surprisingly strong throughout the pandemic and should continue so as global GDP recovers. Laggards in the quarter were the "risk off" sectors such as Real Estate (+0.9%), Utilities (+3.5%), and Consumer Staples (+5.8%). Defensive characteristics were not in vogue in Q4. With the brief recession now behind us, it appears that a new economic cycle has begun, and as typical, value and small cap stocks have outperformed the broader market coming out of recession.

Stock Market Index				
Market/Index	**2019 Close**	**2020 Close**	**Quarterly Change**	**YTD Change**
DJIA	28,538.44	30,606.48	10.73%	9.72%
Nasdaq	8,972.60	12,888.28	15.67%	45.06%
S&P 500	3,230.78	3,756.07	12.14%	18.39%
Russell 2000 (Small Cap)	1,668.47	1,974.86	31.36%	19.93%

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What can we expect in the months ahead? We believe that 2021 could be a tale of two halves. The first half of 2021 should exhibit more volatility and more economic weakness until we get to the point of widespread vaccinations. There are undoubtedly hard days ahead as hospitals and ICU's continue to fill with Covid patients. Some of the current business restrictions on restaurants and gatherings will continue, and some will be made more rigorous. This will impact economic data more so in the first quarter of 2021, and then should start to dissipate as we move deeper into the year. The second half of 2021 should look markedly better as virus rates of transmission decline, hospitals move past the breaking point, and consumers can begin to return to more normal activities. US GDP should improve throughout the course of the year, and unemployment should move down, but at a slower rate. GDP for 2021 should be 5% or greater and could exceed 2019 levels of gross output. It is likely that the Biden administration will provide additional stimulus late in Q1, as well as begin work on an infrastructure program now that Democrats will also control the Senate. The additional spending expected from a Democratically controlled Congress should result in more fiscal spending and be near term stimulative for the economy. The debt incurred to battle the Covid shutdown will need to be dealt with at some point. Taxes will have to increase in the future if we even pretend to care about reducing the debt. The budget deficit for 2020 was the largest since WWII. However, those issues will take a back seat in the short term to getting the virus under control.

The US dollar has fallen roughly 7% in 2020 in the face of the debt onslaught and could decline further in 2021. The weaker dollar has inflation implications as imported goods become more expensive for the US consumer. Inflation is evident in some raw materials and food commodities, but with slack remaining in the labor market it is unlikely that inflation can make any substantial headway in 2021. While interest rates have been low in 2020 and the Fed has committed to maintaining rates at low levels for the next several years, we would expect that an improving economy will move the 10 year US Treasury rate higher in 2021. The Fed has already stated that they are comfortable if inflation "overshoots" their 2% target for some period of time. We will be watching to see if the Fed cuts back on their asset purchase programs as the economy improves. The equity market could react negatively to any reduction in asset purchases, but we think it would be a mistake to view the Fed as anything other than accommodative and constructive toward the financial markets. In fact, the money supply is still growing at a 25% year over year pace. Investor sentiment is perhaps the biggest near-term risk to the market as readings of individual investor bearishness are at multi year lows. Individuals have been pouring money into ETF's and mutual funds, and these excessive readings sometimes precede a pull back. However, investors still hold some dry powder in the form of cash reserves, as assets in money market funds are$650 billion higher than pre pandemic. With interest rates low and possibly moving higher, the attraction to bonds is limited. Dividend yields on 63% of the S&P 500 stocks exceed the yield of the 10 year US Treasury. With cash available and limited alternatives, we think that investors will buy dips in the market, and as a result, pullbacks in price will be limited.

Valuation: The market continues to trade at valuation levels above the historical averages. The current multiple of 22.1X forward 12 month earnings is above the 5 and 10 year averages of 17.4X and 15.7X. The current price to cash flow multiple for the market is 15.9X versus the 25 year average of 10.8X. It's difficult to find a valuation comparison today in which the market is not selling above averages. It will be imperative in 2021 for the market earnings to "grow into" the valuations. The market gave companies a pass in 2020 on weak earnings due to the pandemic, but with a brighter outlook ahead we doubt the market will be as forgiving in 2021 if earnings disappoint. Fourth quarter 2020 earnings are now expected to decline 9.7% year over year versus an expected decline of 12.8% as of September 30th. In a typical quarter, analysts cut estimates on average by 4%+, rather than increase estimates. This raises the bar of expectations somewhat for Q4 2020. For full year 2020 earnings are now expected to decline by 13.6%, much better than the 18% decline expected as of September 30th, as earnings have proven to be more resilient. The rebound in 2021 should see earnings grow by just over 22%, which would be the best year since 2010 when the index eps grew 39.6%. Valuation multiples expanded in 2020 as earnings declined but are unlikely to increase in 2021 as earnings rise and interest rates move modestly higher.

We are all glad to place 2020 in the rearview mirror, and with multiple vaccines on the market we can see a path forward to no longer being at the mercy of Covid 19. It's unlikely that the virus will be relegated to the status of measles and polio, and it may well be endemic for at least a few years, and possibly longer. Annual Covid vaccinations may become a ritual much like the flu vaccination. Nevertheless, the future will be brighter, and like most struggles in life we learn to adapt and somehow persevere. We will all be glad to eliminate epidemiology from our required reading, and get back to basic price, valuation, and macroeconomics.

We hope that you will all continue to stay well in 2021 and encourage you to reach out with any questions you might have regarding your portfolios. We thank you for your trust and confidence.

Fixed Income Commentary

2020 will be remembered for the extraordinary measures the Federal Reserve took starting with the emergency full-percentage point cut announced on Sunday March 15th. The Federal Reserve's balance sheet was approximately $4.2 trillion pre-pandemic and increased $3.2 trillion in six months ($7.4 trillion as of 12/23/2020). It is projected the Fed will add another $1.4 trillion to its balance sheet in 2021. It appears the Fed will remain highly accommodative until labor market conditions have reached maximum employment and inflation has risen to 2% and is on track to moderately exceed 2% for some time. Another factor to consider heading into 2021 is the change in composition of the Federal Reserve voting members. The annual rotation of new voters on the Federal Open Market Committee will be comprised of members less likely to tighten monetary policy (Charles Evans replacing Loretta Mester is the most obvious).

The Federal Reserve met on December 16th and kept a similar tone to what was previously discussed during the November meeting. The Federal Reserve left the fed funds rate unchanged at 0-0.25%, but provided new guidance on the timeline for tapering asset purchases by announcing that it will continue to increase its asset holdings at the current rate "until substantial further progress has been made toward the Committee's maximum employment and price stability goals." Many market participants had anticipated that the Fed would announce changes to the maturity composition of its asset purchases, but they decided to keep things status quo for the time being. Currently the Fed is purchasing $80 billion in monthly US Treasuries and approximately 43% is focused on 10-year equivalents. If turbulence reemerges in 2021, the Fed could lengthen the buying program as another form of stimulus.

The Bloomberg Barclays Aggregate increased 0.67% during the quarter bringing year-to-date performance to 7.51%. The Bloomberg Barclays Intermediate US Gov/Credit index increased 0.48% during the quarter bringing year-to-date performance to 6.43%. Corporate credit outperformed Treasuries during the quarter in line with the positive momentum experienced in the equity market. The fourth quarter generated another positive rate of return for the bond market after interest rates traded in a narrow range during the last three months. The 10-year Treasury ended the year yielding 0.93%, increasing 24 basis points since September 30th. The noticeable area of the bond market that lagged in 2020 was the agency mortgage market. The broad mortgage bond market was up approximately 3.87%, however because of the 100% increase in refi's investors experienced an unexpected wave of prepayments. According to Bankrate, the 30yr fixed rate mortgage started the year at 3.86% and reached a low of 2.85% on December 14th.

After a record year of corporate bond issuance this year, companies are projected to borrow approximately 30% less in 2021 after dramatically increasing cash during the economic shutdowns. Bank of America is forecasting net new issuance (factoring in debt repayments) to be only $63 billion next year, which would be the lowest level since the bank began tracking it in 2002. A sharp decline in issuance should be another positive catalyst for the corporate bond market.

The municipal bond market benefited from ultra-low interest rates, it was common to see states come to market and issue 10-year bonds with yields below 1%. The municipal bond market was up 5.21% in 2020, which was the seventh straight year of gains in the muni market. Similar to the corporate bond market, municipal bond issuance was robust increasing 12.5% from last year. However, 31% of the debt sold was taxable which was double the amount sold last year. Colleges and universities, under financial strain and looking to bolster cash, issued a record amount of taxable and tax-exempt debt this year. The fiscal outlook has improved from earlier this year, as revenue is exceeding expectations with lower operating costs for most states. Certain states continue to face hardship, for instance New Jersey was forced to issue $3.7 billion in general obligation debt to fund its revenue shortfall and Illinois utilized the Fed's emergency lending program. One of the more noticeable changes from the pandemic is the surge in work-from-home which has allowed workers to migrate to lower tax states. Home price appreciation has picked up in areas with either no state income taxes or a lower cost of living.

Heading into 2021, we believe "riskier" assets in the bond market will face a 'Goldilocks' scenario with a combination of strong economic growth and still massive policy support (both fiscal and monetary). After strong returns in 2020 and 2019, we believe returns in 2021 will be more commensurate with the ultra-low yields to start the year. We anticipate short interest rates to remain highly accommodative, however the trajectory of long-term rates is less known and not simply influenced by growth/inflation. Typically, during economic expansions, long term interest rates rise because of the threat of inflation becoming a problem. However, with $18 trillion in global debt yielding below 0%, central bankers aggressively purchasing bonds and the world trying to find a sense of normalcy predicting the path of long-term rates is less certain. The new dynamic in 2021 will be investors are forced to soak up the additional supply of Treasury securities coming to market next year. The Federal Reserve will not be able to keep up with the amount of issuance coming from the Treasury. The 26% increase in money supply in 2020 was unprecedented, going back to 1980 money supply (M2) had never exceeded a growth rate of 15%. The rapid rise in money supply, has not immediately translated into inflation however this will be one of our biggest concerns heading into next year. Since 2013, the Bloomberg Barclays Treasury index has been positive for seven straight years. We are forecasting a tepid return year and would not be surprised to see negative returns in the Treasury market with better opportunities elsewhere in the bond market.

We are here to assist you in any way and to answer your questions. We appreciate the opportunity to serve you and value the trust and confidence that you have placed in us. Stay safe and well.