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Market Update

Q4 2020 Review and Outlook

Markets rallied into year-end. Investors rotated toward Value over Growth and Small-cap over Large-cap stocks during the quarter. Bond markets posted modest returns and the 10-Year Treasury yield reached to nearly 1%.

PWM Research

January 15, 2021

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The Markets at a Glance

Asset Class	Representative Benchmark	Q4 Return	YTD Return
US Large Cap	S&P 500	12.2%	18.4%
US Small Cap	Russell 2000®	31.4%	20.0%
International	MSCI EAFE	16.1%	7.8%
Commodities	Bloomberg Commodity	10.2%	-3.2%
Municipal Bonds	BBgBarc. Municipal	1.8%	5.2%
Taxable Bonds	BBgBarc. Aggregate	0.7%	7.5%
Cash	FTSE 3-Month T-Bills	0.0%	0.6%

Performance returns are as of 12/31/2020

Q4 Recap

Equity markets closed out the year strongly, as the election uncertainty abated and multiple highly effective vaccines for COVID-19 were introduced. Although the economy remains shaky, markets continue to exhibit optimism for a future characterized by widespread vaccination and significant pent-up demand. Monetary and fiscal policy both provide a tailwind, as well.

The S&P 500 again hit new highs in the fourth quarter, returning 12.2% to cap a YTD return of 18.4%. The market rotated toward cyclical assets, as Value outperformed Growth for the first time since 2018. Risk-on sentiment also led to a 31% Small-cap rally in Q4 .

Foreign markets rallied, as well. Developed and Emerging Markets returned 16.1% and 19.7% respectively, outpacing the S&P 500 during the quarter. A weaker dollar was again a tailwind for investors. For the full year, Emerging Markets outpaced Developed by 10% largely thanks to Emerging Asia tech and consumer-oriented firms, which were resilient in the pandemic.

The broad fixed income market returned 0.7% in Q4, though High Yield (6.5%), Global (3.3%) and Investment-Grade (3.1%) all outperformed safer assets. Yields continued their march higher, as the 10-yr Treasury ended at 0.93% and the 2/10 curve closed near 2020 highs.

Hindsight's 2020

The Reopening Trilogy

In many ways, 4Q20 was about setting the stage for 2021: 1) the removal of election uncertainty; 2) the approval of several highly effective COVID-19 vaccines; and 3) the $900B in fiscal stimulus that should both provide a bridge to the reopening and a lasting boost to our consumer-driven economy. Further, both the expectation of more fiscal stimulus in 1Q21 and the near-guarantee that the Fed will remain highly accommodative should provide tailwinds to risk assets.

Still, it's worth noting that this outlook is likely to get off to a rocky start. The economic recovery that was ascendent in the middle of 2020 began stalling late in the year as the rapid coronavirus spread hurt consumer confidence and damaged the labor market. Though the 2021 outlook is bright, it will take a greatly improved vaccination rollout to get the party started on time.

Rogue 2021?

But what does this economic outlook mean for stocks? Many investors learned the hard way in 2020 that dislocations between the real economy and the stock market are fairly common. Last year, the stock market began rallying strongly despite a roiling pandemic, historic unemployment, and the deepest recession on record. The S&P 500 returned +18.4% in the face of what will almost certainly be negative annual GDP growth.

The question now is: will that dynamic flip in 2021? Among many reasons stocks rallied so strongly in 2020 (particularly in Q4) was the expectation of the outlook described above playing out. Stock prices are forward-looking mechanisms, after all. Now, with equity valuations at historic levels and broad stock indices near all-time highs, it remains possible that the blockbuster economic growth most are forecasting does not result in similarly high stock returns. Read our partners at Strategas for more on this theme.

Figure 1: Value vs. Growth Over Time

The Age of Rotation

The implication of that idea doesn't mean that stocks will necessarily be down, however. It just means investors may have to look elsewhere from the Large-cap Growth names that drove returns for most of 2020 (e.g. FAANGM stocks). In fact, this rotation away from Large-cap, US, and Growth actually began in late 2020, where Value, Small-caps, and international all outperformed their counterparts.

Building on that, both Value and Small-caps tend to be more highly correlated with economic growth, and should be big beneficiaries if one of this year's more optimistic scenarios plays out. Of course, as mentioned above, the S&P 500 is highly concentrated by historic standard: the ten biggest stocks (nearly all tech-adjacent growth firms) comprise almost 30% of the index. So while a big rotation makes sense and has some momentum entering the new year, it may result in broad stock indexes actually underperforming the economy (so to speak), while Value, International, and Small-caps have their day in the sun.

We'd be remiss if we didn't also mention the large performance gap between Growth and Value over the recent decade **(see fig. 1)**. In addition to the case built above, there is also a simple mean-reversion argument to be made for Value. Markets are cyclical, and while this can test investor mettle, they do tend to mean-revert over time.

Diversification: An Investing Story

And while legging into more cyclical areas of the market seems prudent (in fact, our Partners at Strategas just recently updated their Asset Allocation to reflect it), getting the timing right remains incredibly difficult. Just as equity rallies tend to begin far earlier in recessions than most feel they should, broad market rotations can do the same.

Markets can be both volatile and unpredictable. Diversification is the practice of reducing risk by spreading your investments across different sectors, styles, and asset classes. While at times it can be frustrating to lag the highest-flying performers, a diversified portfolio is a key part of managing risk and ensuring that you reach your ultimate financial goals.

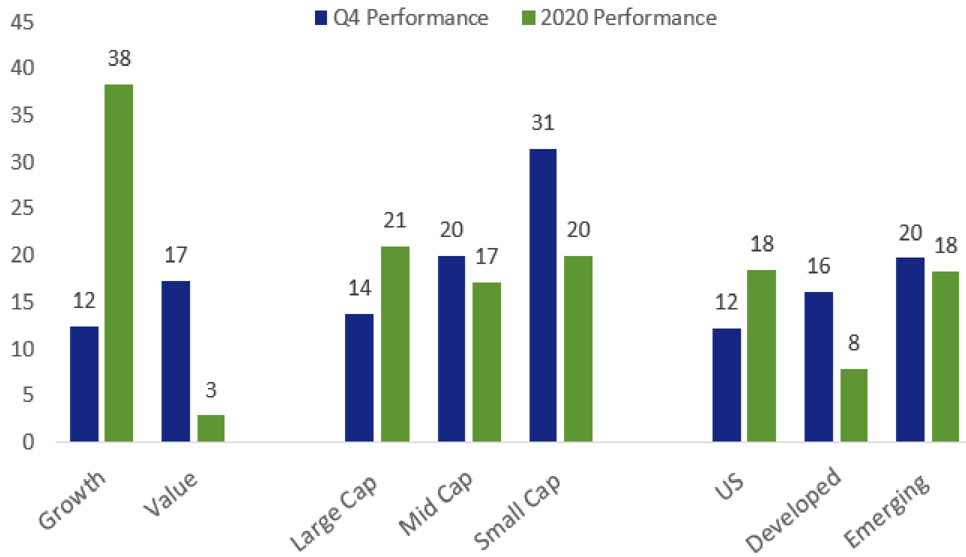
Equity Markets

US Equity Market Benchmarks

Equities	Representative Benchmark	Q4 Return	YTD Return
US Large	S&P 500	12.2%	18.4%
US Mid	Russell Midcap®	19.9%	17.1%
US Small	Russell 2000®	31.4%	20.0%
US Value	Russell 3000 Value	17.2%	2.9%
US Growth	Russell 3000 Growth	12.4%	38.3%
Dev. Int'l	MSCI EAFE	16.1%	7.8%
Emg. Int'l	MSCI EM	19.7%	18.3%

Performance returns as of 12/31/2020

Figure 2: Shifts in Equity Performance—Q4 and 2020



Source: MorningstarDirect

Equities at a Glance

Equity markets closed out the year strongly as the S&P 500 hit new highs, gaining 12.2% in Q4 and 18.4% for 2020. Vaccine optimism, expectations of broad -based economic growth, and prolonged accommodative monetary and fiscal policies led to a rally in Value (+16.3%) over Growth (+11.4%) and catapulted Small-cap stocks 31.4% to a historic quarter. Abroad, Emerging Markets outperformed Developed, while international outperformed domestics as the dollar continued to weaken.

May the Force (of Markets) be with You

Value finally took the baton from Growth in Q4, as economic optimism provided a lift to cyclical equities. Still, Growth outperformed Value by more than 35% over the course of 2020 **(see Figure 2).** Also worth noting was the market's shift toward Small-cap. After experiencing its sharpest quarterly draw-down of -30.6% in Q1, the Russell 2000 Index had its largest quarterly gain in the index's 40 year history of 31.4%. Cyclicals led sector returns for the quarter with Energy, Materials, Tech, and Financials all besting defensive areas of the market. In contrast, Health Care, the benchmark's largest sector, led for the full calendar year. As is often the case, cyclical and lower-quality stocks tend to lead after a market correction and Q4 was no exception. The bottom quintile for quality (measured by ROE, accruals ratio, and financial leverage ratios) outperformed the top quintile by 13% in the quarter.

International Awakens

International equities also rallied into Q4 with both Emerging and Developed Markets outperforming US Large-cap. Some of the hardest hit countries for the full-year outperformed in Q4, including Spain (+27.7%) and Italy (+22.4%) in Developed and Brazil (+37.0%), Mexico (+31.0%) and Indonesia (+31.8%) in Emerging Markets. A weakening US dollar was also a boon for investors. Over the full year, however, the story is much different. Emerging Markets (+18.3%) handily outperformed Developed (+7.8%) in US dollar terms, as tech-centric Asian countries (which were less affected by COVID-19) dominated. South Korea (+44.6%), Taiwan (+41%), and China (+29.5%) led the pack. In the MSCI EAFE, the Netherlands (+14.3%), Japan (+24.2%) and Sweden (+23.9%) all performed strongly YTD.

The Rise of Risks

Despite market optimism, risks remain. Political and economic tensions have devolved into rioting and tribalism, while the highest office in the land undergoes a transition of power. US-China relations continue to deteriorate and, while vaccines for COVID-19 are in-production, the distribution effort is challenged and significant portions of the economy remain closed. With equity valuations climbing higher, an unexpected event could affect stock prices.

It is easy to point to these risks and question the decision to remain fully-invested. However, think of the risks that were presented to the market in 2020: a once-in-a-century pandemic, a short yet deep recession, and a contested Presidential election. Against all odds, the markets climbed a seemingly insurmountable wall of worry and finished the year ahead. In retrospect, the greatest risk posed to your portfolio was selling. Therefore, we continue to recommend diversification across equity markets as we enter 2021.

Fixed Income

U.S. Fixed Income Benchmarks

Fixed	Representative	Q4 Return	YTD Return
Taxable	BBgBarc. Aggregate	0.7%	7.5%
Treasury	BBgBarc. Treasury	-0.8%	8.0%
Corporate	BBgBarc. Corporate	3.1%	9.9%
High Yield	ICE BofAML US HY	6.5%	6.2%
Municipal	BBgBarc. Municipal	1.8%	5.2%
Int'l	BBgBarc. Global Agg.	3.3%	9.2%

Performance returns as of 12/31/2020

Fixed Income at a Glance

The broad US bond market, as measured by the Bloomberg Barclays Agg Index, rose 0.7% in Q4, another quarter of solid performance. Policy intervention continued to keep rate volatility in check despite worsening coronavirus trends and economic data. The 10-year yield moved higher towards the 1.0% level as the economic outlook improved with vaccine news and looser purse strings in DC. The 2/10 yield curve also reached a multi-year high after briefly inverting in late 2019. It's important for investors to review what's driving yields higher and pushing the US yield curve steeper. As seen in **Figure 3**, nominal yields experienced a decent bump in Q4, a continuation off the lows of early 2020. What's really interesting is the composition of that increase, with a majority of the push higher supported by inflation expectations vs. real yields. The massive policy intervention in 1Q20 further expanded the broad money supply, increased the domestic debt burden and boosted financial asset prices globally. The diverging trend between breakeven inflation expectations and real interest rates boosted relative performance for TIPs, returning 1.6% in Q4. As we move into 2021, the spotlight will be on the FOMC as investors digest the Fed's tolerance for higher rates, and importantly, higher expected inflation.

Corporates Strike Back

As with equity markets, risk-on was the move in fixed income, as High Yield Corporate (+6.5%) and Investment-grade corporate (+3.1%) solidly outperformed Treasuries (-0.8%) and other more traditional safe havens. Despite the strong performance of High Yield into year-end, Investment-grade Corporates outperformed over the course of 2020, returning (+9.9%) vs. High Yield (+7.1%) as a mix of pandemic-related credit stress and sector-specific issues played out. Policy support and risk appetite led to unprecedented new issuance across corporate credit, allowing issuers to raise liquidity, restructure balance sheets and bridge the revenue gap COVID-19 brought on. Although short term fundamental concerns have been laid to rest, a challenging long-term fundamental picture still exists as leverage has mounted, quality has deteriorated, and duration has continued to extend.

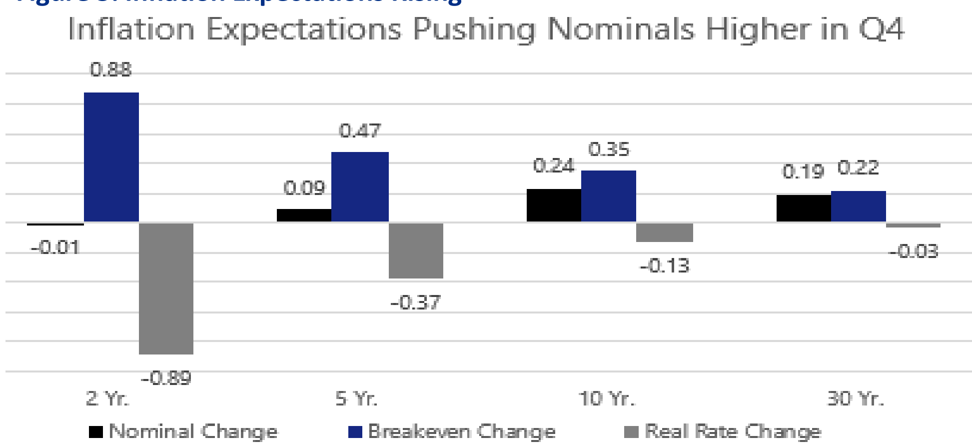
Return of Securitized

Historically low rates and a desire for more space led to a strong housing market in 2020. During the quarter, an increase in rates helped to boost performance of mortgage-backed securities as this sector comes with a negative convexity profile, along with a technical imbalance as the Fed purchases $40B per month. Commercial mortgages and asset-backed securities (ABS), two sectors that materially struggled in 1Q20 gained ground during the quarter as spreads tightened across those capital structures. Consumer ABS fundamentals remain in good shape supported by government stimulus. As investors attain more clarity in DC moving into 2021, fixed income investors will be focused on stimulus measures and its influence on underlying fundamentals.

Municipal Bonds, A New Hope

Municipal bonds returned 1.8% in Q4, outpacing taxable peers by 1.1%. Despite a stimulus bill of $900 billion passing Congress late in the year, fiscal support for states and localities was left out as negotiations around the size and necessity of the aid proved too much to overcome. High Yield (+4.5%) outperformed safer areas on the quarter as the risk-on sentiment bled over from other asset classes. Still, for the year, more conservative investments reigned supreme, as High Yield (+4.9%) underperformed most other major municipal bond categories. All eyes will remain on Washington to begin 2021 as additional stimulus could be in the pipeline, with state and local government support high on the list of Democratic priorities.

Figure 3: Inflation Expectations Rising



Appendix Definitions and Disclosures

Benchmark and Asset Class Definitions

S&P 500 Index (Large Cap / U.S. Stocks): A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally $7 billion plus market cap) companies having growth and value characteristics.

Russell 3000® Growth Index (All Cap Growth / Growth Stocks): Measures the performance of the 3,000 largest U.S. companies based on total market capitalization with higher price-to-book ratios and higher forecasted growth values.

Russell 3000® Value Index (All Cap Value / Value Stocks): Measures the performance of the 3,000 largest U.S. companies based on total market capitalization with lower price-to-book ratios and lower forecasted growth values.

Russell 1000® Growth Index (Large Growth): Measures the performance of those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values. These are equity securities of large capitalization ($7 billion plus market cap) companies having growth stock characteristics (high price to earnings, high return on equity and low dividend yield.

Russell 1000® Value Index (Large Value): Measures the performance of those Russell 1000® Index companies with lower price-to-book ratios and lower forecasted growth values. These are equity securities of large capitalization ($7 billion plus market cap) companies having value stock characteristics (low forecasted price-to-earnings ratio, low price-to-book ratio, high dividend yield).

Russell Midcap® Index (Mid Cap / Mid Core): Measures the performance of the 800 smallest companies of the Russell 1000® Index, which represent approximately 31% of the total market capitalization of the Russell 1000® Index. These are equity securities of middle capitalization ($2-7 billion plus market cap) companies having growth and value characteristics.

Russell 2000® Index (Small Cap / Small Core): Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equity securities of small capitalization (<$2 billion plus market cap) companies having growth and value characteristics.

Russell Micro Cap Index (Micro Cap): Measures the performance of the 1,000 smallest companies in the Russell 2000® Index, which represent approximately 3% of the total market capitalization of the Russell 3000® Index.

MSCI EAFE Index Net (International / Developed Markets): A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. As of May 27, 2010 the MSCI EAFE Index consisted of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

FTSE 3-month T-bill Index (Cash): This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively.

Bloomberg Commodity Index (Commodities): Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Sub-indices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs

MSCI Emerging Markets Index Net (Emerging Markets): A free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of May 27, 2010 the MSCI Emerging Markets Index consisted of the following 21 emerging market country indices.

MSCI Country Indices (Country-Specific Markets): To construct an MSCI Country Index, every listed security in the market is identified. Securities are free float adjusted, classified in accordance with the Global Industry Classification Standard (GICS®), and screened by size and liquidity. MSCI then constructs its indices by targeting for index inclusion 85% of the free float adjusted market capitalization in each industry group, within each country. By targeting 85% of each industry group, the MSCI Country Index captures 85% of the total country market capitalization while it accurately reflects the economic diversity of the market. This includes the MSCI Japan Index. International indices.

BBgBarc Aggregate Bond Index (Taxable Bonds / Bonds): Comprised of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years.

BBgBarc Global Aggregate Bond Index (Global Bonds): Provides a broad-based measure of the global investment-grade fixed income markets. The three major components of this index are the U.S. Aggregate, the Pan-European Aggregate, and the Asian-Pacific Aggregate Indices. The index also includes Eurodollar and Euro-Yen corporate bonds, Canadian government, agency and corporate securities, and USD investment grade 144A securities.

BBgBarc Muni Bond Index (Municipal Bonds): Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, part of a transaction of at least $50 million, issued after December 31, 1990 and have a year or longer remaining maturity.

BBgBarc U.S. High Yield Bond Index (High Yield): Covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (e.g., Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

BBgBarc U.S. Treasury Bond Index (Treasury Bonds): Comprised of U.S Treasury securities with at least one-year maturities.

Appendix Definitions and Disclosures

GICS

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