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Market Newsletter
December 31, 2020

EXECUTIVE SUMMARY

- All asset classes had strong performance in the fourth quarter and for the full year 2020.
- The pent-up demand among consumers and businesses could lead to a strong economic recovery in 2021.
- Fiscal and monetary conditions are extremely easy and covid-19 vaccination programs are underway.
- Despite a contentious election, the market is rejoicing the removal of political uncertainty.
- Some areas of the market are stretched, and stocks are not cheap as compared to history. However, record low interest rate and an improving economy should continue to support stock market performance.
- Events in the last year have reinforced the need to have a well-diversified, robust portfolio that can weather all environments and to stay invested in the markets.

Table 1: Market indices

(*Returns include dividends*)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	12.15%	18.4%	18.4%	14.18%	15.22%
S&P Mid Cap 400	24.37%	13.66%	13.66%	8.45%	12.35%
S&P Small Cap 600	31.33%	11.29%	11.29%	7.74%	12.37%
MSCI Emerging Markets	19.77%	18.69%	18.69%	6.56%	13.22%
MSCI EAFE	16.09%	8.28%	8.28%	4.79%	7.97%
Investment Grade Credit (C0A0)	2.99%	9.81%	9.81%	7.04%	6.71%
Non-Investment Grade Credit (H0A0)	6.48%	6.17%	6.17%	5.89%	8.43%
Bloomberg Commodity Index Total Return	10.19%	-3.12%	-3.12%	-2.53%	1.03%
Dollar Index (DXY)	-4.22%	-6.7%	-6.7%	-0.8%	-1.83%
Vanguard Total Bond Market Index (VBMFX)	0.64%	7.61%	7.61%	5.3%	4.36%
10 Yr Rate	0.92% 12/31/2020	1.92% 12/31/2019	1.92% 12/31/2019	2.40% 12/31/2017	2.27% 12/31/2015

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 01/09/2021			
	Latest Release	Recent Trend	Notes
Non Farm Employment	-140,000	Positive	The seven month run of jobs growth came to an end, hurt by losses in leisure and hospitality, which were affected by renewed shut downs. Wage growth was strong as lower paying jobs rolled off. Unemployment rate was unchanged at 6.7%. The last two month's job's numbers were revised upward.
Weekly Claims for Unemployment Insurance	787,000	Positive	Claims have been steadily dropping but still remain elevated. 4 week average was 818K
ISM Manufacturing Index (over 50 points to growth)	60.7	Positive	New orders and backlogs boosted this index. Manufacturing has bounced back sharply after the March trough.
ISM Non Manufacturing Index (Over 50 points to growth)	57.2	Positive	The services sector continued to grow for the seventh month in a row. 14 of the 18 underlying sectors grew last month. Supply chain bottlenecks and employment weighed on the index.

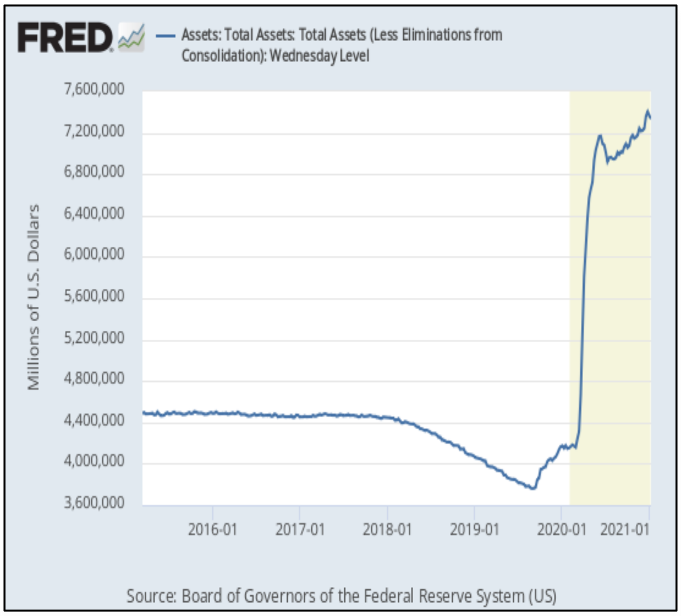
	Latest Release	Recent Trend	Notes
Consumer Prices (Month over month change)	0.2%	Positive	Inflation is subdued as overall prices increased 0.2% for the month and 1.2% over the previous year. Excluding food and energy, prices were up 1.6% last one year.
Producer Prices (Month over month change)	0.2%	Positive	Like consumer prices, producer price inflation is contained as prices appreciated 0.1% for the month and 0.8% for the year. Excluding food and energy, prices were up 0.1% and 1.4% for the month and year respectively.
Retail Sales (Month over month change)	-1.1%	Negative	Retail sales fell in November for the second time in a row, hurt by social distancing and falling income.However, early estimate for the holiday spending in December showed a healthy 3% gain buoyed by online sales.
Consumer Confidence (Conference Board)	88.6	Negative	Weak labor market conditions and falling income led consumer confidence to a 4 month low.
Durable Goods Orders (Month over month change)	0.9%	Positive	Core capital goods new order, a measure of business spending was up 0.4% for the month and is up 6.5% for the year.
Industrial Production (Month over month change)	0.4%	Negative	Industrial production was up for the second consecutive month, helped by auto production. The level is still 5% off the pre-pandemic level reached in February 2020
Capacity Utilization	73.3%	Positive	Capacity utilization is climbing back up from the lows set in May 2020 but there is still considerable slack in the economy.
Housing Starts	1.547 Million	Positive	Housing activity is strong as starts rose 1.2% to within reach of the 1.567Million level in February 2020.
Home Prices (Case-Shiller 20 city Index- Month over Month)	1.69%	Positive	Home prices have been increasing steadily helped especially by suburban sales and low interest rates. The 20 city index is up 6.9% for the year.
GDP (Real, Annualized)	33.4%	Positive	US GDP increased at an annualized rate of 33.4% after falling by almost as much in the second quarter.

Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ism.ws, www.nahb.org.

All asset classes rose in the fourth quarter of 2020 adding to gains in the previous quarter. Smaller stocks and value stocks (Stocks that trade at prices equal to a lower multiple of their earnings) had a banner quarter propelled by hopes that covid-19 vaccination programs currently underway could lead to a recovery in the economy sooner than expected. Stocks had a good year overall-a remarkable recovery from the trough reached in March when shutdowns and social distancing were wreaking havoc on the economy and markets were crashing in response. In 2020, among all the asset classes, only commodities were down for the year hurt by economically sensitive raw materials.

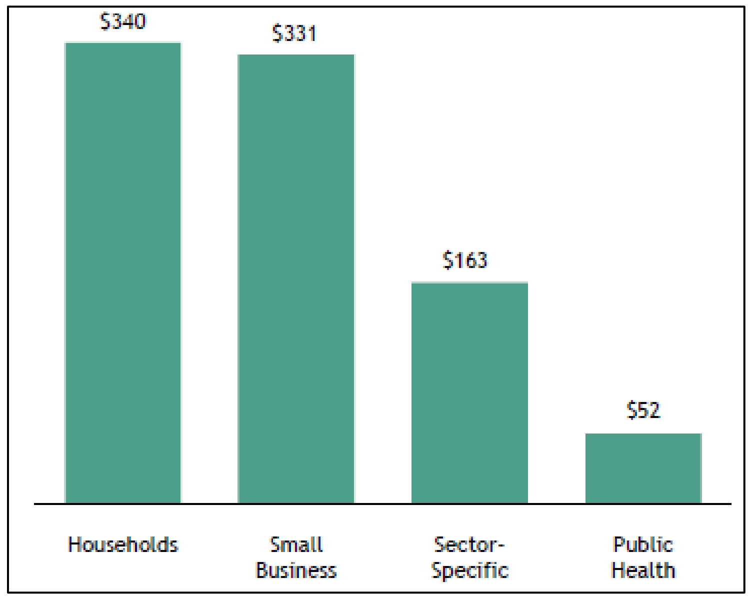
The economy is making its way back up from the abyss in the second quarter of 2020 although, the recovery is uneven. Industries such as technology and consumer discretionary are in great shape as social distancing and stay at home policies have helped them considerably, but industries such as hospitality and travel are reeling from lack of activity. Reflecting this dichotomy, the jobs situation among higher earning individuals working from home is strong, while lower earning individuals in high contact industry are suffering. Paradoxically, this has led to a strong overall wage growth recently, as lower paying jobs have dropped out of the wage calculation.

Fig 1: Total Assets of Federal Reserve Banks



Source: Federal Reserve Bank of St Louis

Fig 2: Covid-19 Relief Bill- Major Provisions

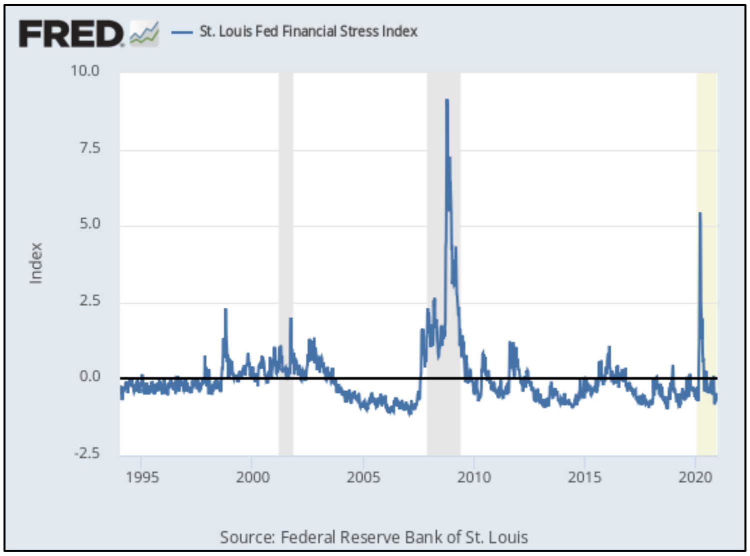


Source: Blackstone

There is considerable pent-up demand as high earners are spending less of their income and businesses are drawing down their inventories. Despite strong GDP growth in the third quarter (+33.4% annualized) and expected growth in the fourth (+8.7% annualized), the US economy is still below the level it was at before the pandemic hit, however, when things get back to some semblance of normalcy, economic activity should pick up vigorously. US consumers are in good financial shape, as debt service ratio and savings ratio are very favorable. Currently, the consensus is for the GDP to grow by over 4% in 2021.

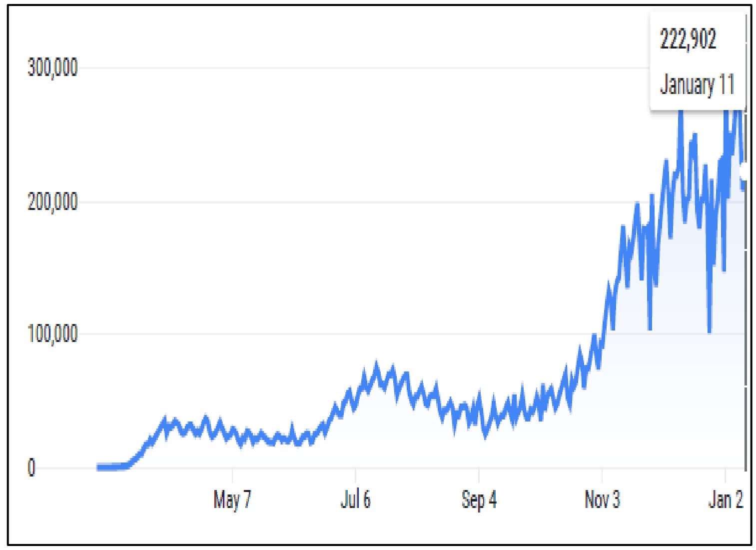
Fiscal and monetary conditions continue to be easy. The Federal Reserve has signaled it will keep interest rates lower for longer and is continuing with its quantitative easing strategy (Fig 1). Fiscal policy has also been supportive, and congress recently passed the second coronavirus stimulus bill (Fig 2), which should help consumers and small businesses. These measures combined, have led to a condition of below average financial stress (Fig 3) in the markets even as COVID-19 cases are near all-time highs (Fig 4). The other reason for optimism was the approval of two vaccines by the Food and Drug Administration, one by Pfizer/BioNTech and the other by Moderna. These vaccines have shown over 90% efficacy and vaccination programs are already underway, with the most optimistic scenario showing mass vaccinations and herd immunity by the summer of 2021. Any way you look at it, the turnaround in the development of these vaccines is an impressive feat of human ingenuity.

Fig 3: St Louis Fed Financial Stress Index



Source: Federal Reserve Bank of St Louis

Fig 4: Daily coronavirus cases in the US



Source: Google, The New York Times

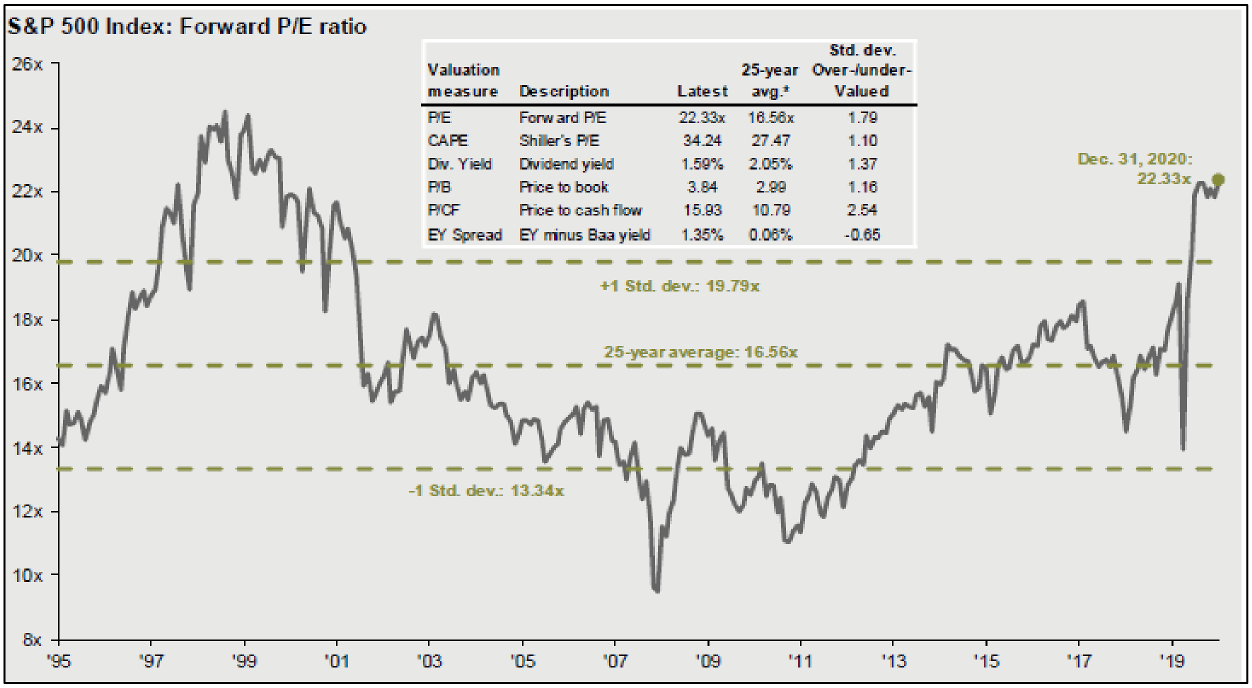
In line with the economy, corporate earnings have improved recently. According to FactSet, after declining 13.6% in 2020, earnings are expected to increase by over 22% in 2021, led by record increases in the earnings of companies in the industrial, consumer discretionary and materials sectors.

This market newsletter would be incomplete if the political situation is not addressed. After a bitterly contested election, Joseph R Biden was declared the winner of the 2020 Presidential election. But that was only the beginning of the drama as there were allegations of a stolen election and results in several states that were too close to call took a while to be finalized. Two senate seats in the state of Georgia went to a runoff- a significant event as the control of the Senate was at stake- and were subsequently won by the Democrats giving them a slight majority in the senate (51-50, if the tie breaking vote of the Vice President is considered). The expectation is that with the control of the white house and the Congress, the next President should be able to enact tax and spending changes, although it is more likely that legislation will lean more towards centrist proposals at least until the 2022 midterm elections. For now, the removal of political uncertainty is a major tailwind for stocks.

The markets, being that they are forward looking (as we discussed our early June mid-quarter letter), have rallied considerably from the lows set in March 2020- the S&P 500 is up 70% from the trough, while the tech heavy Nasdaq is up over 90%. This has led to a stretched valuation as the S&P 500 now trades at 22 times the expected 12-month earnings (Fig 5). The index has been more expensive than this less than 10% of the time historically. Adding fuel to the concern of overvaluation, the largest 5 stocks in the S&P, all technology related, now make up almost 20% of the index and contributed almost all the index's returns last year. There is other evidence of froth in the markets such as a record number of IPOs (480 in 2020) and excessive risk taking by retail investors. The Ned Davis Crowd Sentiment indicator, a measure of how euphoric investors are, is at 71. Historically, a level over 60 has indicated overoptimism among investors, leading to conditions that could lead to a market drop.

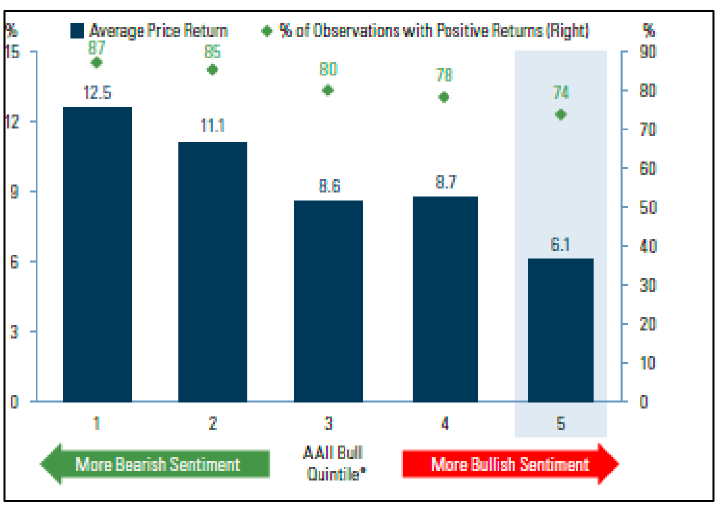
However, there are several reasons to expect the stock market to continue rising. For one, interest rates are extremely low and are expected stay low for an extended period. The US 10-year treasury rate is currently 1.1% while the average level over the last 25 years was 3.7%. Interest rates play an important role in the valuation of all asset classes, and all else being equal, a lower interest rate should support higher valuation (i.e prices) as discussed in the above referenced mid-quarter letter. As mentioned before, the Fed is expected to keep interest rates lower for longer as the economy is still recovering and inflation is not yet a concern. Sentiment is extremely optimistic as noted earlier, but it is not always a concern.

Fig 5: Historical Price Earnings Multiple of the US equity market



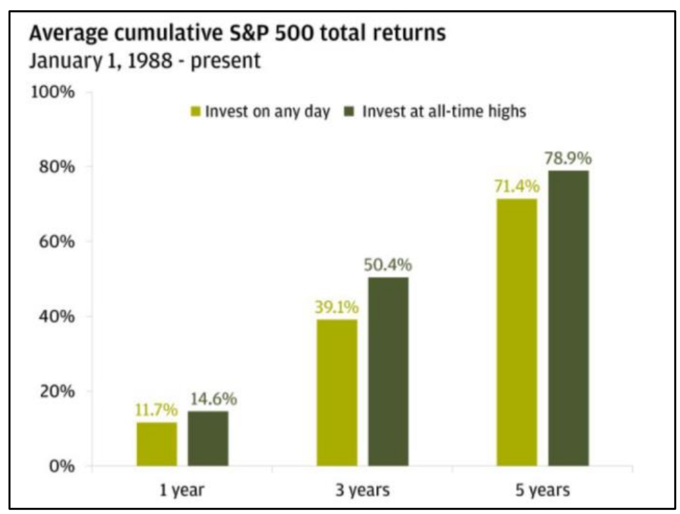
Source: JP Morgan

Fig 6: Bullish sentiment is not a reason to sell stocks



Source: Goldman Sachs

Fig 7: Stock performance after reaching all-time highs.



Source: JP Morgan

Historically, investor optimism has coincided with an improving fundamental backdrop and has led to positive returns over the next 1 year as seen in Fig 6. Markets are at an all-time high, but historically, stocks tend to produce positive performance from all-time highs, as seen in Fig 7. Investors worried about the political environment should remember that making investment decisions based on one's political leanings is not optimal as we argued in our last letter before the Presidential elections. If anything, events in the last year have reinforced the need to have a well-diversified, robust portfolio that can weather all environments and to stay invested in the markets.