MARKET COMMENTARY

Redefining Normal

Q4, 2020

- While COVID-19 remains a critical health issue, positive vaccine developments and abundant liquidity provided in 2020 boosted the prices of risky assets.
- Government spending was going to be substantial regardless of the composition of the government, but the "blue sweep" by Democrats increases the odds of further fiscal and monetary accommodation for the foreseeable future.
- The year is shaping up to be one in which Wall Street gets continued support from the Federal Reserve in the form of a zero-interest rate policy and quantitative easing, while Main Street is supported with continued checks from the government.
- With a legitimate path to an end to the COVID-19 crisis, a key to navigating 2021 will be redefining normal – areas that we see as undergoing the most substantial transformation are inflation and real estate.

Overview

While stocks were already heading higher after the presidential election, announcements of effective vaccines rejuvenated even lagging areas of the market.

Global equities and other risky assets rallied significantly during the quarter, driven largely by positive vaccine developments and abundant liquidity. Stock markets were already headed higher after the presidential election, and news of effective vaccines rejuvenated even previously lagging areas of the market as the Pfizer-BioNTech vaccine announcement on November 9 kicked off a recovery in value stocks.[1] On that day, the Russell 2000 Value Index outperformed the Russell 1000 Growth Index by 9%, the largest single-day relative gain since 1992. For the quarter, the MSCI All Country World Index increased by 14%, pushing it to all-time highs and leaving it up 16% in the tumultuous year that was 2020. The rally also extended to below-investment-grade bonds, with the Bloomberg Barclays High-Yield Index higher by over 6% in the quarter, leaving it up 7% for the year.

The Fed and Treasury will likely work seamlessly on distributing cash to Americans.

On December 27, President Trump signed a $900 billion COVID-19 relief package that included payments of up to $600 for each qualifying American adult and child.[2] But, as President-elect Joe Biden put it, this package was just a "down payment" on what will come in 2021.[3] If future payments become more frequent and more timely, as Biden suggests they will, then the federal government will likely need a more efficient medium to disburse them. The Federal Reserve appears poised to help as they published two papers during the fourth quarter of 2020 in which they discussed how Central Bank Digital Currency ("CBDC") could help fiscal policymakers in this area.[4,5] In one paper, the Fed concludes, "If the central bank can increase the quantity of CBDC to satisfy this demand, the reduction in real economic activity is less severe, attenuating the decline in spending and therefore welfare."[4] We expect that the Fed and Treasury will work seamlessly on this and other endeavors, especially since Janet Yellen, former Federal Reserve Chair, has been nominated to take over as U.S. Treasury Secretary under the Biden administration. In December, Yellen launched a Twitter account and posted comments that suggest continued aggressive government support, "The Treasury Department must be an institution that wakes up every morning thinking about the American people. Your jobs, your paychecks. Your struggles, your hopes. Your dignity. And your limitless potential. We will work to restore that public trust and promise."[6]

Democrats will ostensibly control the Senate which should create a coordinated dynamic between the inbound government, U.S. Department of Treasury, and the Federal Reserve.

On January 5, the Georgia Senate runoffs resulted in both Democratic Party nominees defeating the Republican incumbents. Ostensibly, Democrats will control the Senate, which should create a coordinated dynamic between the inbound government, the U.S. Department of the Treasury, and the Federal Reserve.

The relationship between massive spending and the need for further tax hikes and/or debt monetization will be crucial. Given the lack of progress on a fiscal spending package in the second-half of 2020 and the nearly $1.7 trillion in cash held at the Treasury, fourth-quarter debt issuance was cut by $600 billion and pushed into the first quarter of 2021.[7,8] As a result, in early November, the U.S. Treasury announced that it expects its first-quarter 2021 issuance to be an astronomical $1.1 trillion.[8] Through its quantitative easing program in which it buys Treasuries and mortgage-backed securities, the Fed bought $240 billion of Treasuries or 39% of total issuance in the fourth quarter. At its current pace, the Fed would only be buying 22% of first-quarter issuance, which suggests the program may need to be increased, especially with longer-term interest rates currently on the rise.[9]

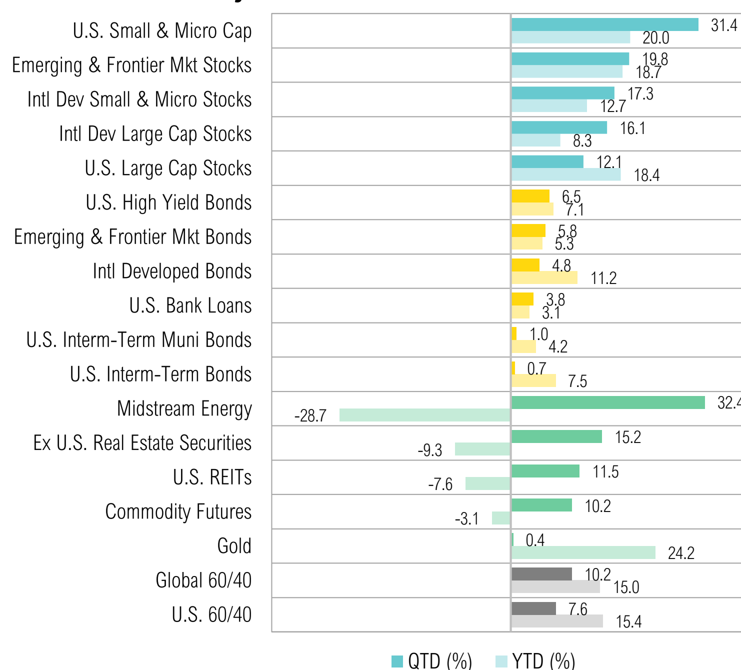
Markets

The strong performance of value stocks in 2020 did little to close its significant gap with growth stocks, a prevailing trend for the past several years.

The S&P 500 was up 12% in the fourth quarter, bringing its full-year gain to 18%. In a reversal of two key trends that had been in place since the pandemic broke, vaccine news pushed value stocks higher compared to growth stocks and smaller companies relative to larger ones. The Russell 2000 Value Index, a measure of small cap value stocks, was higher by 33% in the quarter, beating the Russell 2000 Growth Index by 3%. Similarly, the Russell 1000 Value Index, a measure of large cap value stocks, gained 16% for the quarter, besting the Russell 1000 Growth Index by 5%. This was mainly driven by strong returns in the energy (+28%) and financial (+23%) sectors, which are overrepresented in value benchmarks. But value's 2020 surge did little to close its significant gap with growth, which has dominated the market for several years. For full-year 2020, the spread between the best and worst performing sectors remained skewed dramatically in favor of growth. The 77% spread between the top-performing technology sector (+44%) and worst-performing energy sector (-33%) was the widest since 2000. That year, the top performer was the utilities sector (+57%), and the worst performer was technology (-41%). Outside the U.S., the MSCI EAFE Index returned 16% during the quarter and 8% for the year, trailing its U.S. large cap counterparts. Emerging market stocks, as measured by the MSCI Emerging Markets Index, were higher by about 19% for the quarter, leaving them up about 20% for the year.

A broad measure of taxable fixed income securities, the Bloomberg Barclays U.S. Aggregate Bond Index was up 0.7% in the quarter, capping off a remarkable year of a more than 7% increase. The Bloomberg Barclays Municipal 1-10 Year Bond Index was up 1% in the quarter and up 4% for the year.

December 2020 Key Market Total Returns



Source: Bloomberg

Redefining Normal

With monetary support virtually guaranteed in 2021, economic and market fundamentals may be less meaningful in equity markets.

As of January 8, less than seven million people in the U.S. have received a COVID-19 vaccine.[10] Markets are understandably excited to see light at the end of the COVID-19 tunnel. But a crucial question looms: when, if ever, will life return to what it was before the pandemic? As the idea of mass vaccinations (or herd immunity) becomes reality, investors' focus must shift to what the world we return to will look like.

Consider equity markets, where the pandemic negatively impacted corporate earnings, but monetary stimulus more than offset any potential negative impact to drive an atypical jump in prices. That disconnect between prices and earnings has driven valuations substantially higher. The operating earnings of companies in the S&P 500 Index are currently expected to close 2020 at $120 per share. This would represent a 23% decline from 2019 levels. Expectations for 2021 operating earnings are currently $164 per share, which would represent a 37% increase from 2020. It would also be a new high in earnings, eclipsing the $157 per share mark set in 2019.[11] The S&P 500 currently trades at a one-year forward price-to-earnings ratio of 23 times, not far from the Tech Bubble high of 26 times.[12] If monetary policy were not so supportive, prices might decline now, as life returns to normal, so that they align better with earnings. But monetary support is virtually guaranteed in 2021, and historically, supportive monetary policy has pushed economic and market fundamentals to the back seat.

Inflation may be the clue to determining if and when monetary support starts to decline.

If fundamentals are less relevant, inflation may be the clue to determining if and when the monetary support starts to decline. At its August virtual "Jackson Hole" Economic Policy Symposium, the Federal Reserve formalized a policy position that is more tolerant of overheating markets and inflation levels above 2%.[13] Prior to the speech, the 10-year Treasury yield was at 69 basis points and had risen to 112 basis points on January 8.[14] The Fed's tolerance for higher prices is rooted in its view that further accommodation will support the economy and that economic growth will help heal a labor market left in tatters. While the headline unemployment rate of 6.7% may not seem dire, the fact that 19 million Americans (approximately 12% of the workforce) remain on some type of

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government assistance is of significant concern to the Fed.[12,15,16] The Fed's aggressive and rapid response to the COVID-19 crisis in March helped maintain market-based inflation expectations at levels well above those experienced during the financial crisis, even though COVID-19 could be considered a much more serious deflationary event. Even as inflation expectations have bounced back, the Fed has shown no signs of removing the metaphorical punch bowl. Currently, five-year TIPS-implied inflation expectations are back up to 2.1%, roughly where they were in 2018, when the Fed was raising interest rates and shrinking its balance sheet.[17]

Rising yields on Treasury bonds may reflect investors' attempt to adjust to the new reality of the Fed's willingness to tolerate higher inflation.

Today, however, the Fed seems set on maintaining both $120 billion per month of asset purchases and zero interest rates, policies which have been in place for several months. At its December Federal Open Market Committee (FOMC) meeting, the Fed's press release reiterated its commitment to both.[18]

5-Year Treasury Inflation-Protected Security (TIPS) Breakeven Rate, *1/1/2007 - 1/7/2021*

Source: Bloomberg

The Fed's willingness to tolerate higher inflation—thereby lowering the real (inflation-adjusted) return for investment assets—will be most obvious in the fixed income markets. The rising yields on Treasury bonds (yields and prices move inversely) may reflect investors' attempt to adjust to this new reality as they move away from low-yielding debt in search of higher interest rates or for other speculative investments that will compensate them for the risk of higher inflation. If that occurs, the Fed will need to assuage those higher yields (and lower prices) with increased asset purchases. This situation will be exacerbated by expectations of high Treasury issuance to fund another year of sizable U.S. deficits.[19]

The real estate market will provide meaningful guideposts on how "normal" will be redefined in a post-COVID world.

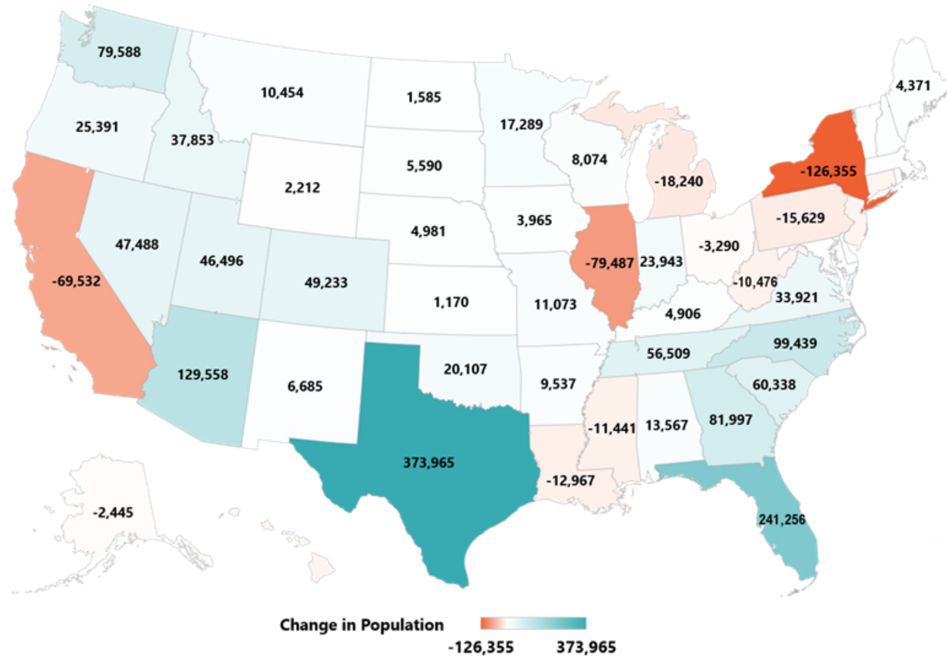
Another market at the epicenter of being redefined is real estate. This segment of the economy will provide meaningful guideposts on how "normal" will be redefined in a post-COVID world. To put its size into perspective, the $20 trillion commercial real estate market is roughly half of the value of the U.S. stock market.[20] Even prior to COVID-19, real estate was changing rapidly. Retail in particular was already shifting due to the well-understood Amazon-effect.

But the pandemic and its aftermath will likely affect the office sector most significantly for a few reasons. First, corporations have started to move headquarters from high tax to lower tax locales. California-based companies, including Oracle, Tesla, and Hewlett Packard, have all recently announced moves to Texas.[21,22] Americans also appear to be

In real estate, the office sector will likely be the most affected as both companies and residents relocate and adapt.

making a personal decision to move states. According to the U.S. Census Bureau, states with the biggest decline in their resident population have been New York, Illinois, and California, with Texas, Florida, and Arizona having the biggest increase in residents.[23] This theme is also evident in the dramatic increases in family migration as vast numbers of Americans leave urban areas in favor of the suburbs. Miller Samuel estimates that in Manhattan the average number of months of supply of apartments has more than doubled to 19 versus a 10-year average of seven.[24] They also estimate that the median level of rent has plummeted to its lowest levels in 10 years.[25]

Change in Resident Population, *July 2019 - July 2020*



Source: U.S. Census Bureau

Vehicle miles traveled are likely to decline in a world with workplace flexibility and changing consumption trends.

As if movement were not enough to redefine normal, corporate management teams are actively pursuing strategies that reduce or alter their commercial real estate footprint in order to cut costs. In a September CBRE study, 60% of respondents indicated they were aggressively pursuing contraction, consolidation, or exit plans. This was up 21% from a similar study conducted just three months earlier.[26] Together, these changes put billions of dollars of carefully placed properties, designed to accommodate people's normal weekday commute, in peril. A flexible workplace and changes in consumption trends will also serve to change real estate as vehicle miles traveled could decline by 9%, according to KPMG estimates. This is the equivalent to 270 billion fewer miles driven per year—or 100 million trips from New York to California.[27] Given these dynamic conditions, it's no surprise that significant uncertainty remains which has caused U.S. REITs to lag behind the broader equity market since the March bottom and posting a loss of nearly 8% for the year.

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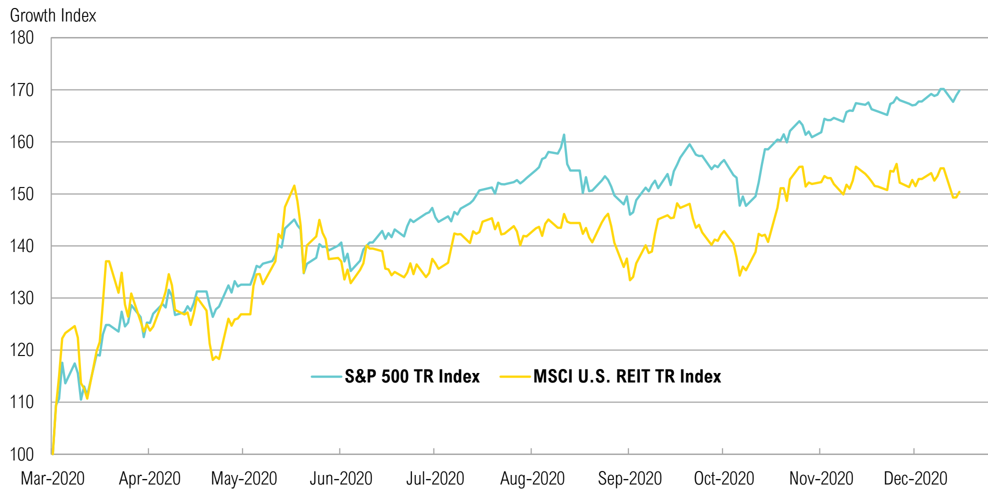
U.S. Large Cap Stocks vs. U.S. REITs, *3/23/2020 - 1/6/2021*



Source: Bloomberg

The virus and potential reopening, massive government spending, and inevitable debt-monetization all make the current environment truly unprecedented.

Looking Forward

An important development in the New Year were the results of the two Georgia Senate run-offs held on January 5. With Democrats winning both seats, the balance of power now shifts decidedly to Democrats. In the 24 presidential elections since 1928, markets have averaged a return of 7.7% from November 1 of the election year to the end of the first year of the next presidential term. The average over that period for divided governments was 10.6%, over 5% higher than the average for single-party sweeps, which generate an average of 5.5%. But investors may want to discount any historical analogs for the current environment. The virus and potential reopening, massive government spending, and inevitable debt-monetization all make the current environment truly unprecedented. As the hurdle for policymakers to withdraw support remains abnormally high, so too does the risk that an already expensive market will continue to move higher, potentially faster than what would be justified by the fundamentals. At the same time, we may be approaching an environment in which investors fear rising inflation— a novel situation to an entire generation of investors, business operators, and even policymakers.

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We continue to be grateful for the many workers who do not have the luxury to work remotely and continue to risk their health and safety in order to provide the services that keep our society safe and functioning.

Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

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DEFINITIONS

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Intermediate-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Intermediate-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index

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