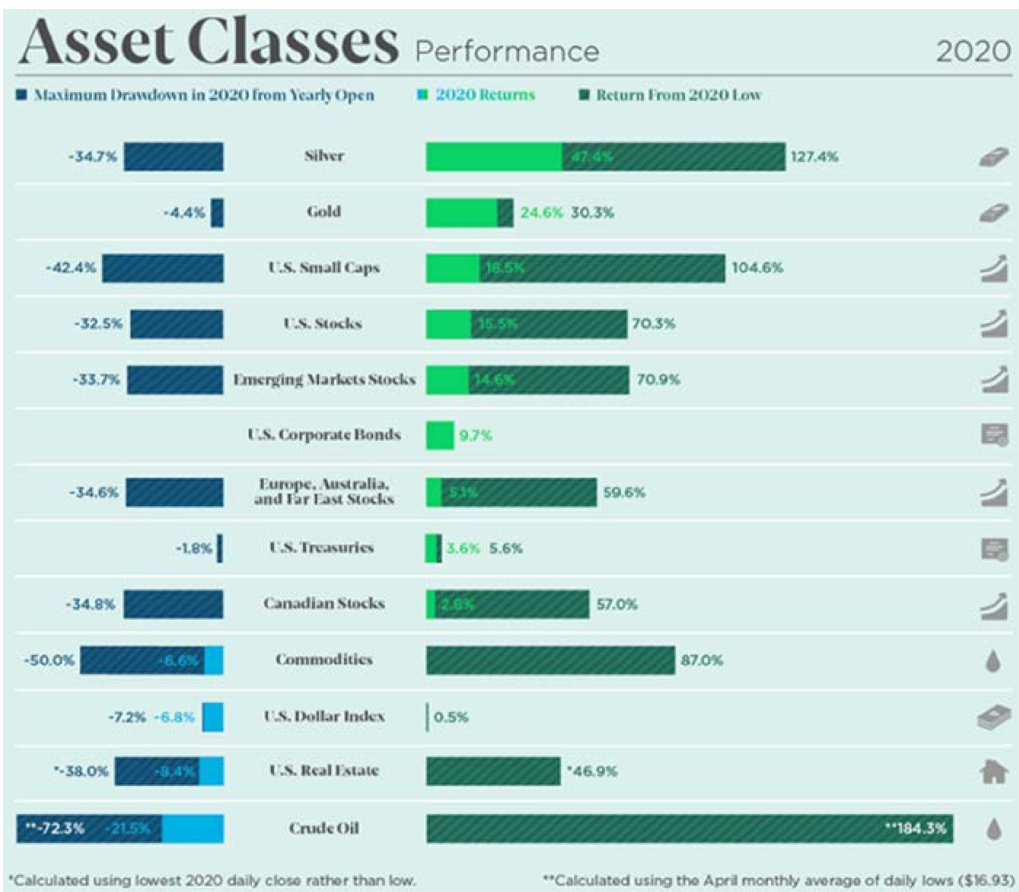
Market Commentary Q4 2020

How many times have you heard the phrase, "is it 2021 yet?!" As we all know, 2020 was a year of surprises. The COVID-19 virus upended many lives in ways we couldn't have imagined. The speed at which the pandemic escalated, the severity of the lockdowns, the size of the government stimulus measures globally, and the magnitude of the equity market rebounds, had all of us on edge as to what would transpire next. Perhaps the biggest surprise is that after all we have been through, global equities through the eyes of the MSCI ACWI Index finished the year up 14.3%.[1] I think we can all agree that this was an outcome few would have predicted during a global pandemic. As we look towards the new year, we have the U.S. election behind us and effective vaccines on the way, investors have become bullish, pushing domestic markets to record highs.

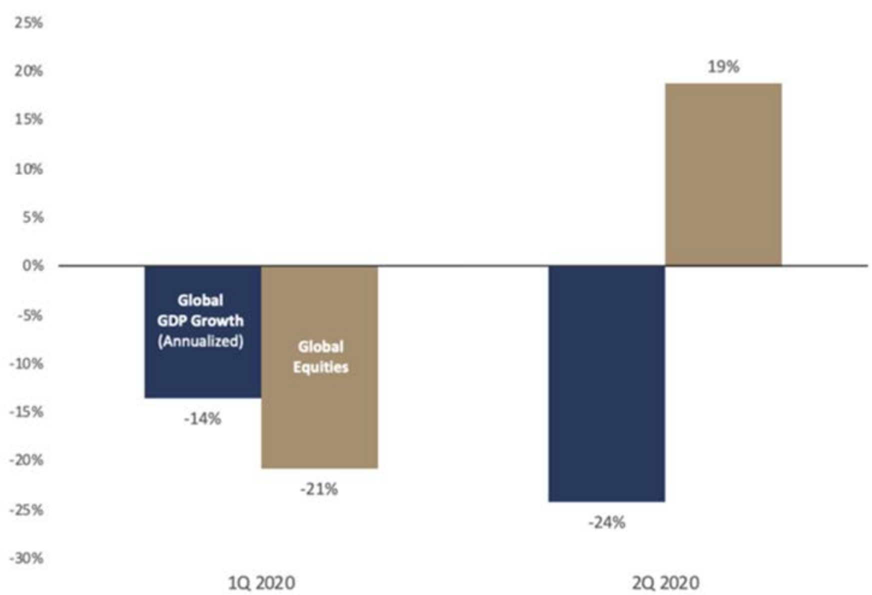


Source: Morningstar Direct[1]

A remarkable aspect of the year was how quickly things changed. We witnessed a near-complete shutdown of the commercial lives of countries across the globe, new forms of social interactions that involve staying six feet apart, wearing masks, and using so much hand sanitizer that we have become a nation of chapped hands. In turn, the pandemic has hastened changes in work arrangements that were trending for years. Healthcare and education, two of the most change-resistant sectors, were forced to morph into virtual doctors' offices and classrooms. Changes in the retail sector accelerated as social distancing and consumer wariness to rub elbows with fellow shoppers made brick and mortar shopping even more unappealing than it was already. In these and many other cases, there is no undo button that can reset us to where we were, and these changes will likely endure in some form going forward.

The pandemic wrought significant damage to the economy in the first half of the year with the S&P 500 experiencing its fastest-ever bear market, clocking in at just 33 days before its third-fastest recovery to a breakeven level in about five months![1] In the second quarter, global GDP dropped at a 24% annualized rate, adding to the 14% first quarter decline (see below). Global equity markets dove 32% in March (down 21% for Q1) reflecting the economic devastation.[1] Peak to trough the S&P 500 drop was an eye-watering 34%![1] As we moved into the fall, we saw the market collapse from exhaustion with the S&P 500 falling 9.6% in a three-week span in September, nearly qualifying as a market correction, before once again rallying into the end of the year.[1] Even with the U.S. elections looming in November and the more recent surge in COVID-19 cases, stock prices climbed, and the market reached new all-time highs.

EXHIBIT A: GLOBAL GDP GROWTH AND GLOBAL EQUITIES RETURNS



Source: Bloomberg. Fiduciary Trust Company. World GDP growth from Bloomberg Economic Global GDP Growth measure and reflects seasonally-adjusted annualized changes from the prior quarter. Global Equities are total returns based on the MSCI ACWI index. Data as of December 17, 2020.

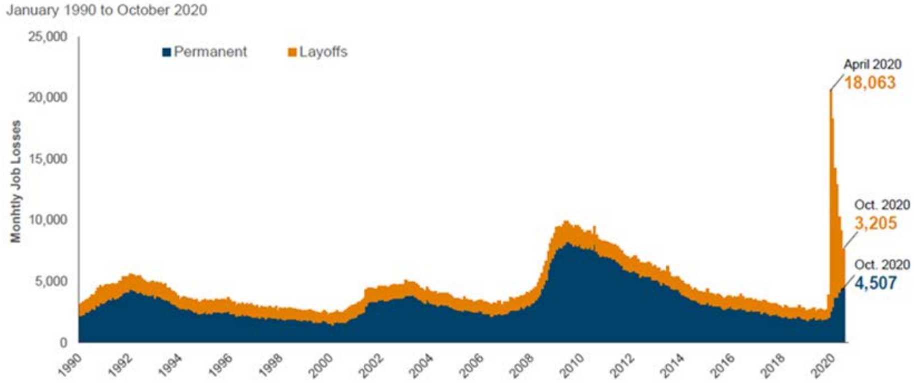
EXHIBIT B: S&P 500 TOTAL RETURNS - FIRST HALF 2020

Source: Morningstar, Fiduciary Trust Company. Data as of June 30, 2020.

Job losses were catastrophic. More than 31 million jobs were lost from the end of February through the end of April.[1] Employment is about halfway back to 2019 levels, while income is about three quarters of the way back (think working from home).[1] By the end of November, there were nine million fewer Americans working than at the start of the year.[1] However, monthly employment gains averaging 1.57 million over the last six months are helping to repair the damage done.[1] We continue to monitor weekly jobless claims and the number of permanent job losses as indicators of the overall health of the job market and economy.

U.S. JOB LOSSES, TEMPORARY VS. PERMANENT

January 1990 to October 2020

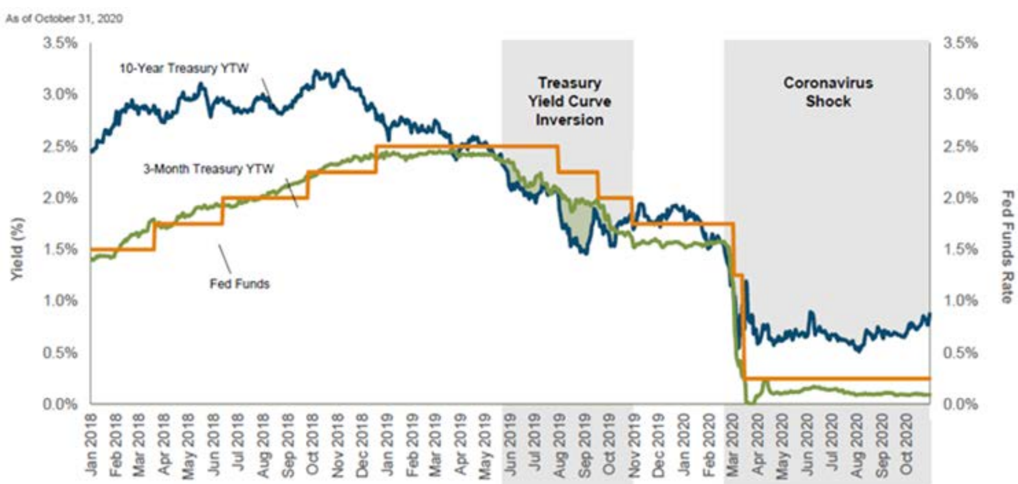


Sources: Haver Analytics/U.S. Department of Labor.

The major economies have been trying their best to escape the pandemic and lockdowns with relatively little long-term economic damage thanks to substantial monetary and fiscal support. Wage subsidies and job retention schemes have prevented unemployment rates from rising significantly in most countries. Here in the U.S., corporate bankruptcies and delinquency rates on consumer loans were lower in the September quarter than the same period in 2019! With that said, the hospitality, tourism, transport and retail sectors have been hit hard, but the overall balance sheet damage to corporates and households has been relatively limited despite the large lockdowns.

The most notable damage from the pandemic is rising government debt. The International Monetary Fund (IMF) projects that gross government debt for the G71 economies will rise by 23% of gross domestic product (GDP) in 2020.[1] High debt makes government finances vulnerable to rising interest rates. This is unlikely to be a significant problem in the next couple of years, but it will matter when spare capacity is eventually exhausted, and inflation starts to rise.

The “lower for longer” theme seems to have been on repeat since the Great Financial Crisis of 2008. Federal Reserve Chairman Jerome Powell has left the world with the strong impression that interest rates will stay near zero until 2023 and that they are not even going to begin thinking about raising interest rates until inflation hits 2%. There is some rumbling about inflation popping up as we start the year, but it seems decisions about any possible overshoot of inflation are “academic” at this point, Powell has said, and can be made once we see the economy rebounding.



Past performance is not a reliable indicator of future performance.
Sources: Bloomberg Finance L.P., Bloomberg Barclays Index Services, J.P. Morgan Chase & Co. (See Additional Disclosures.)

On the fixed income side of the market, we saw the Bloomberg Barclays U.S. Aggregate Total Return index returned 7.51% for the year.[1] While the yield on the U.S. 10-year Treasury note fell to 0.92% from 1.92% at the end of 2019, and short-term interest rates on the U.S. 3-month Treasury bill plummeted to 0.06% from 1.54%.[1] Convertible bonds lead the way due to a high exposure to the technology sector and had an astonishing return of 50.27% for the year.[1] As we move into 2021, we continue to maintain a shorter duration bond portfolio (duration is a measure of a bond's sensitivity to interest rate changes. Generally speaking, the higher the duration, the more a bond will fall if interest rates rise and vice versa.).

At first glance, the municipal ("muni") bond market appears to have moved on from its March 2020 meltdown. Strong investor demand has helped fuel a recovery. However, municipal valuations have not rebounded to the same degree as other credit markets, and the impact of the economic downturn will likely cast a long shadow into 2021. Tax revenue lost during the pandemic leaves some state and local governments with critical budget shortfalls. Likewise, a wide range of muni issuers in sectors such as transportation, higher education, health care and various tax-backed parts of the market have struggled with weaker revenues and higher costs.

We expect to see even greater credit differentiation among muni bonds as fundamentals diverge in the months ahead and with a potentially new stimulus package that could provide additional aide to state local governments, munis could continue to add attractive tax-exempt yields.

Overseas, the second wave of virus infections in Europe has reversed the Q3 V-shaped recovery and the region is on track to record negative GDP growth in Q4. The new lockdowns are working, however, and infections across the region peaked in early November. Lockdowns were being eased in some countries heading into Christmas, but the likelihood is that this winter will see ongoing virus outbreaks and renewed lockdowns until a vaccine becomes widely available, possibly by spring. Europe is poised for a strong post-vaccine recovery. Its economy suffered a big hit from the pandemic and can rebound from a low base. Europe is more exposed to global trade than the U.S. and will be a beneficiary of a recovery in Chinese demand. International equities will be an interesting place to watch in 2021. Developed international markets trailed returns in the United States and emerging markets last year. Given the lack of performance in 2020, a smart earnings recovery could be the catalyst for developed international equities to enjoy a decent year.

The Chinese economy bounced back to almost pre-pandemic output levels; a significant achievement given the depth of the first quarter downturn. The IMF does not expect other large countries to return to pre-COVID economic levels until at least 2022.[1]

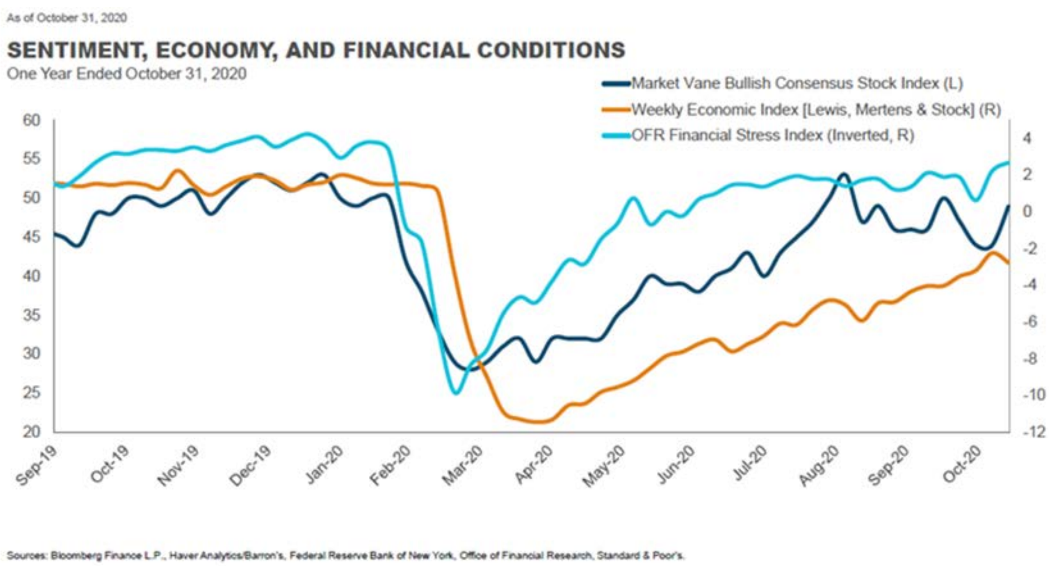
Consumption has played catch-up to production and this is important for the outlook for government policy in China. Their government has a focus on the concept of dual circulation which aims to rebalance the economy towards domestic demand and away from reliance on exports and capital investment. The government and People's Bank of China have been discussing when to start reducing the amount of stimulus. The most likely outcome is a continuation of the hand-over from monetary policy to fiscal stimulus. As a result, fiscal policy should remain supportive through 2021. More stimulus may be announced at the National People's Congress meeting (likely in March 2021) as the government continues to support consumption.

The trade war between the U.S. and China could be less heated under President-elect Joe Biden but we do not foresee a return to pre-Trump era relations with China. If there is such a thing as a bipartisan effort, this is it. Two key watchpoints will offer clues to the future of U.S.-China relations. The first will be the initial meeting between Biden and Chinese President Xi Jinping, and subsequent discussions about the future of the current tariffs and the Phase One trade deal. The second watchpoint will be Biden's attempt (and ability) to forge a multi-country alliance to coerce China into improving access to its markets.

Emerging markets will be worth watching as earnings are expected to achieve levels much higher than in 2019. A continually weakening dollar should help emerging markets catch a bid. China will factor prominently in how these stocks will do. If the past is any indication, China will test the newly elected Biden administration, taking measure of America's new leader which can lead to market questions.

Looking ahead to 2021, a return to normal by the second half of the year could help extend the rotation that began in early November away from technology/growth leadership toward cyclical/value stocks. Something we at Hightower Westchester have been monitoring very closely. During the COVID-19 pandemic, technology and growth stocks enjoyed tailwinds from a boost to earnings and lower discount rates. These tailwinds could become headwinds once a vaccine is available and lockdowns have been eased. This should allow the normal early-cycle recovery dynamics to resume, with investors rotating towards relatively cheaper value and non-U.S. stocks that will benefit from the return to more normal economic activity.

As you can see below, the Nike "swoosh" recovery continues to move along with sentiment picking up. Although forecasting is a devilishly tricky exercise, it should always be done with a healthy dose of humility and awareness that the future should not be considered in the singular, but the plural, as many futures are possible. Furthermore, it is a mistake to think that a new year marks a break with the old. Time is a continuum and forecasting should reflect it.



Any path to a profit recovery will undoubtedly be marred by periods of market volatility as the inevitable setbacks unfold. Intra-year market declines and/or corrections should always be expected, hence our diversification and absence of market timing. In 2021, volatility should be taken as an article of faith as the logistical difficulties of distributing a vaccine, deep scarring of the labor market, and expected rise in bankruptcies become apparent.

In Wall Street jargon, TINA, the acronym for "There is No Alternative…to Equities," will continue to hold sway. Compared to fixed income, U.S. equities, even at the current Herculean valuations, will likely continue to attract capital. The promise of a vaccine along with a recovery funded by Congress and the Federal Reserve, will draw capital into equity markets on the hope of another year of healthy returns.

The vaccine announcements and passing of U.S. election uncertainty have removed two of the near-term worry points about the outlook. The major risk now is the amount of investor optimism since the vaccine announcements. Many are questioning whether the market is overbought or not? Investors are positioned for upside gains, which makes markets vulnerable to disappointing news. This could come from the current upswing in virus cases and a potential demand shortfall in early 2021 as government support programs expire and are not renewed. With all of this in mind, we remain steadfast in our investment approach and philosophy around stripping out the noise from reality. As we always say, diversification is the only free lunch in town.

At the end of the day, capitalism and American perseverance works, and it responds positively to challenges. If you have an entire country, financial or medical community going after a single problem, it's going to get solved. We look forward to another year of helping our clients navigate these markets and we are always here to answer your questions.

To discuss this commentary further, please contact us at 914-825-8630.

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[1] Morningstar Direct

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