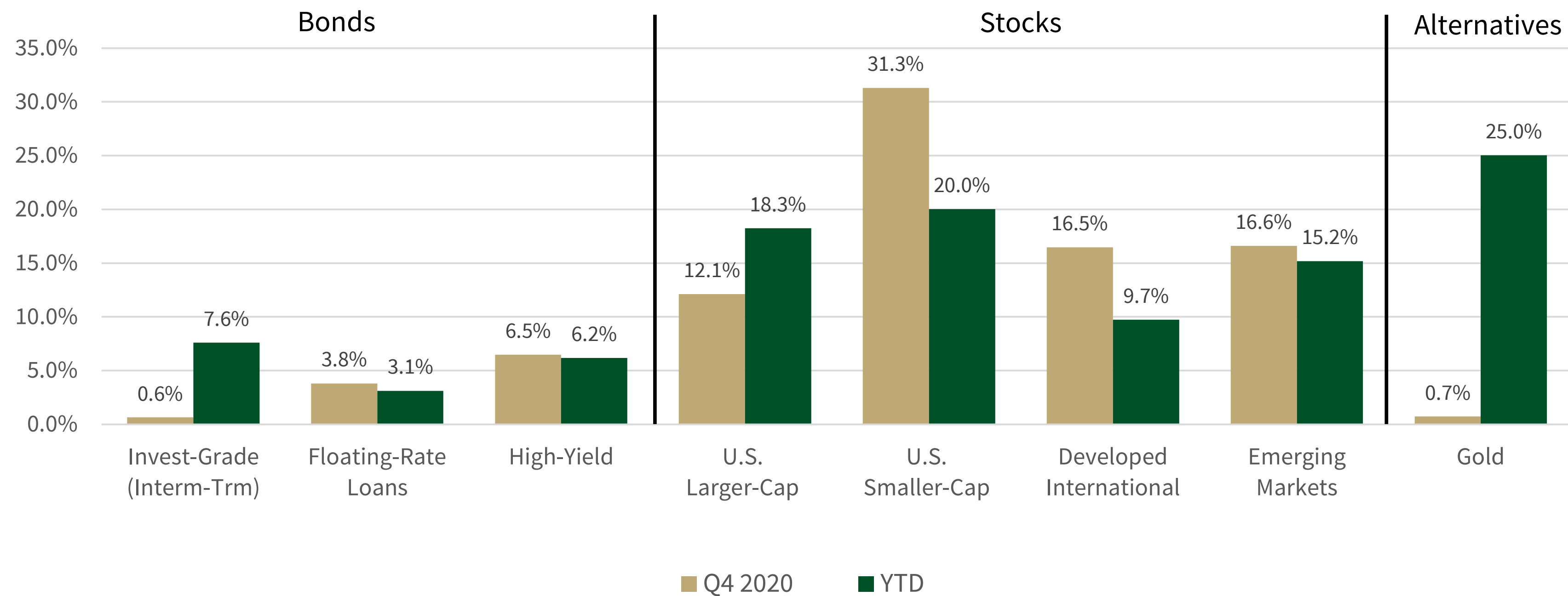
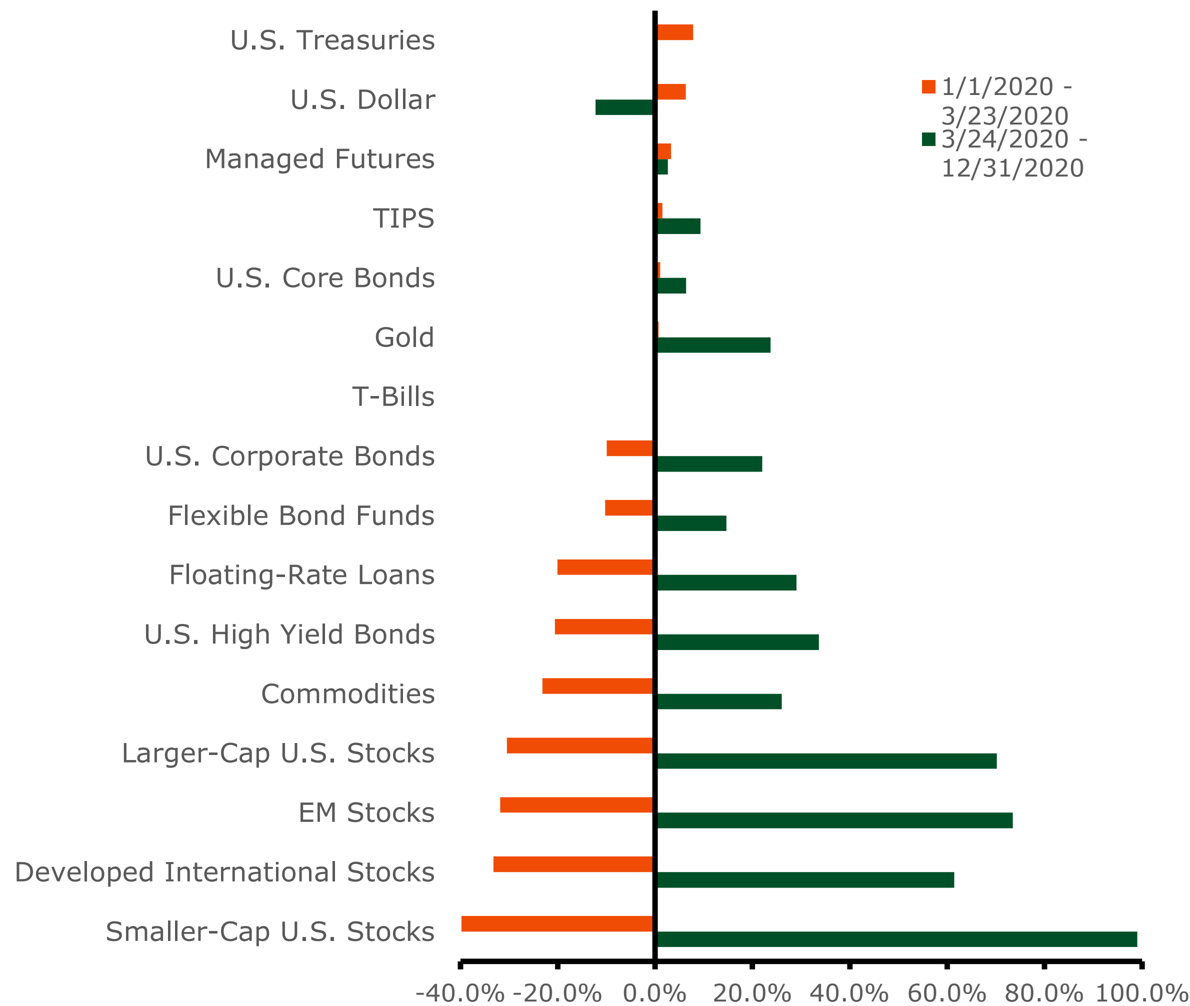
Market Review



- This year was a tragic one. Yet global stocks finished up 16.3% for the year. U.S. stocks did a bit better, with large caps up 18.2% and small caps up 20.0%. Developed international stocks gained almost 10% and emerging-market stocks gained over 15%. The comforting full-year returns mask the incredible volatility and stress investors faced earlier in the year.
- Within the fixed-income markets, core investment-grade bonds gained a strong 7.6% for the year, providing positive returns both during and after the market crisis period. In typical fashion, early in the year Treasuries and high-quality corporate bonds benefited from falling rates amidst a deflationary shock. Interest rates have risen modestly since the positive vaccine news in November, but they are still generally much lower than they were at the start of 2020.

Source: Morningstar Direct. Data as of 12/31/2020.

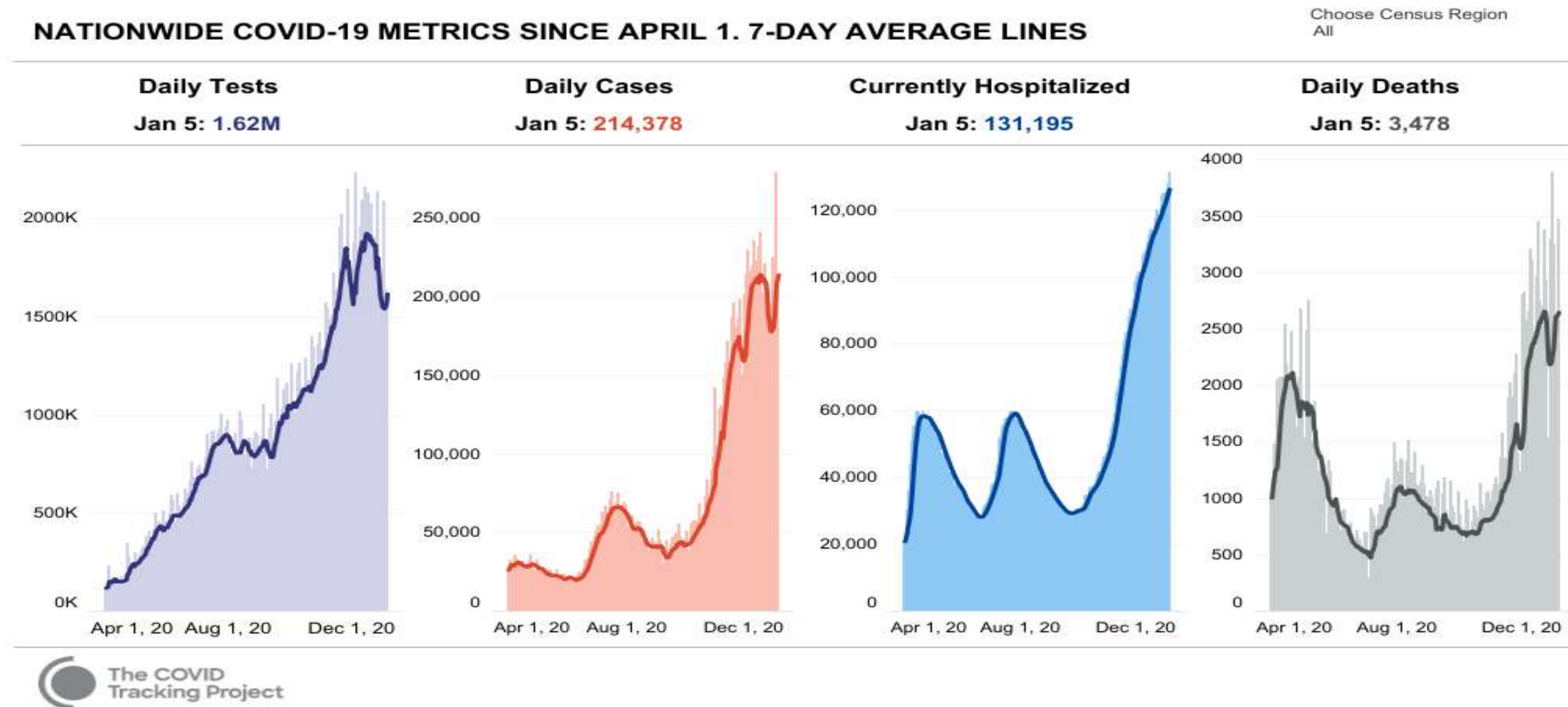
A Tumultuous but Ultimately Positive Year for Stocks and Risk Assets



- Positive full-year returns masked the incredible volatility and stress investors faced earlier in the year.
- From the beginning of the year to the March low, stock markets around the world were down between 30% and 40%, in what was the quickest/sharpest bear market in history.
- From the March low, stocks skyrocketed into year-end; the S&P 500, developed international, and EM stock indexes all roared back more than 65%. Smaller-cap U.S. stocks soared nearly 100%.

Source: Ned Davis Research. Data as of 12/31/2020.

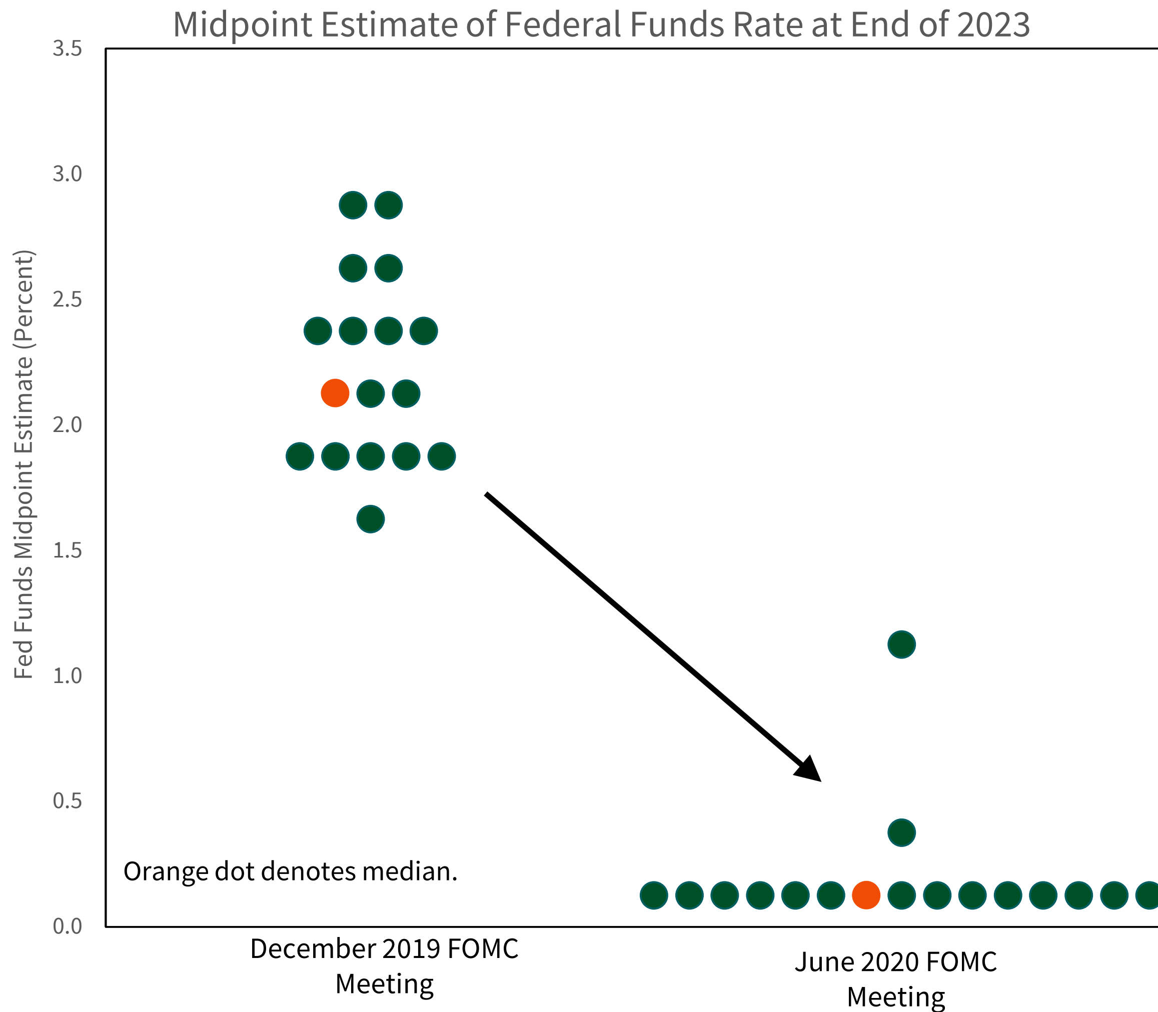
The Path of the Economy Will Depend Significantly on the Course of the Virus



- The public health impact of COVID-19 in the United States is increasingly severe, reaching all-time highs in daily deaths and hospitalizations.
- This is leading to increasingly aggressive, yet still localized, economic lockdowns across the country.
- These lockdowns raise the risk of a sharp slowdown in the economy, if not an outright contraction, heading into 2021.

Source: The COVID Tracking Project.

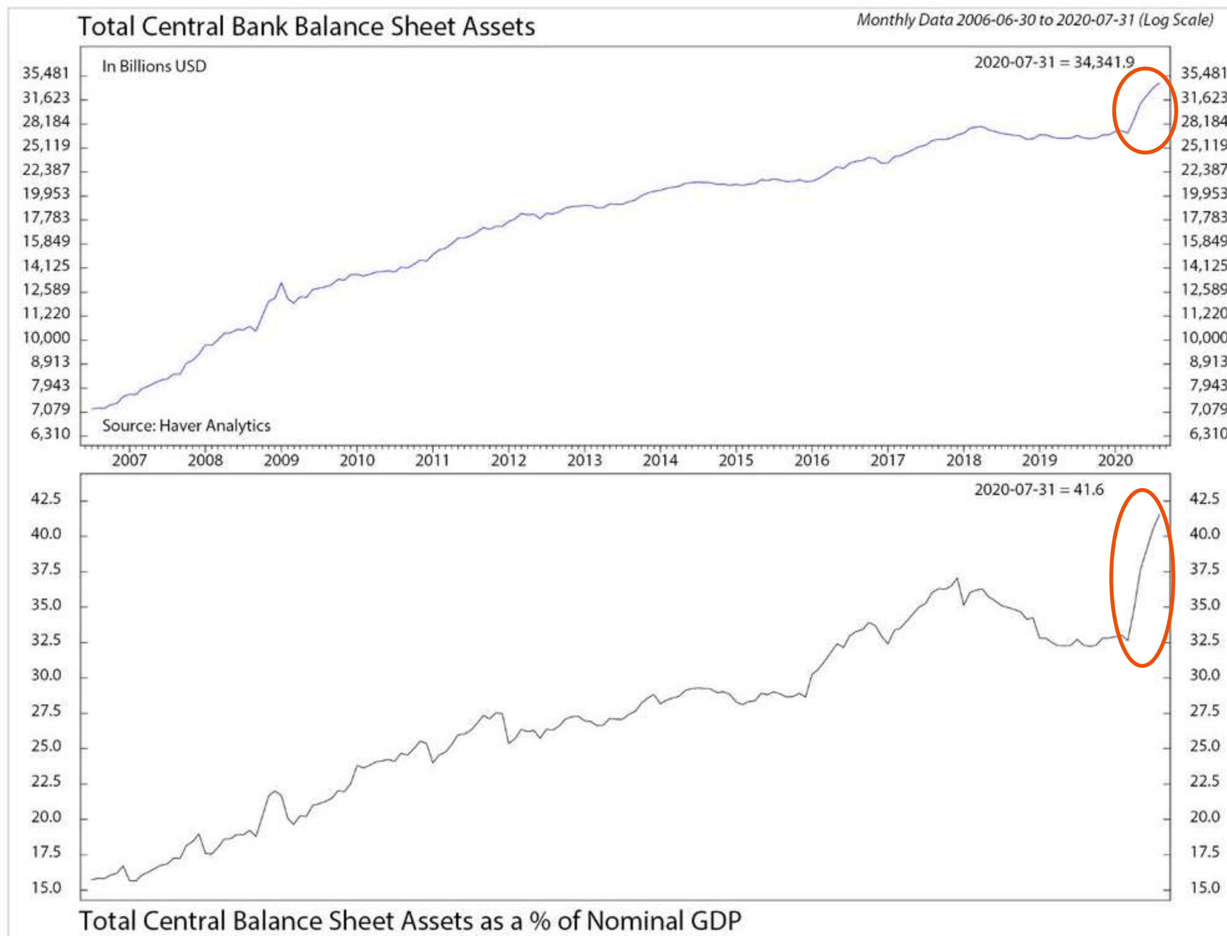
The Fed Doesn't Expect to Raise Rates Above Zero Before 2023



- Of course, the Fed also cut interest rates, and its members expect rates to remain at near-zero levels through the end of 2022.
- To that end, Fed chair Jerome Powell said, "*We are strongly committed to use our tools to do whatever we can, and for as long as it takes, to provide some relief and stability, to ensure the recovery will be as strong as possible and to limit lasting damage to the economy. … We are not thinking about raising rates. We are not even thinking about thinking about raising rates.*"

Source: Federal Reserve Board.

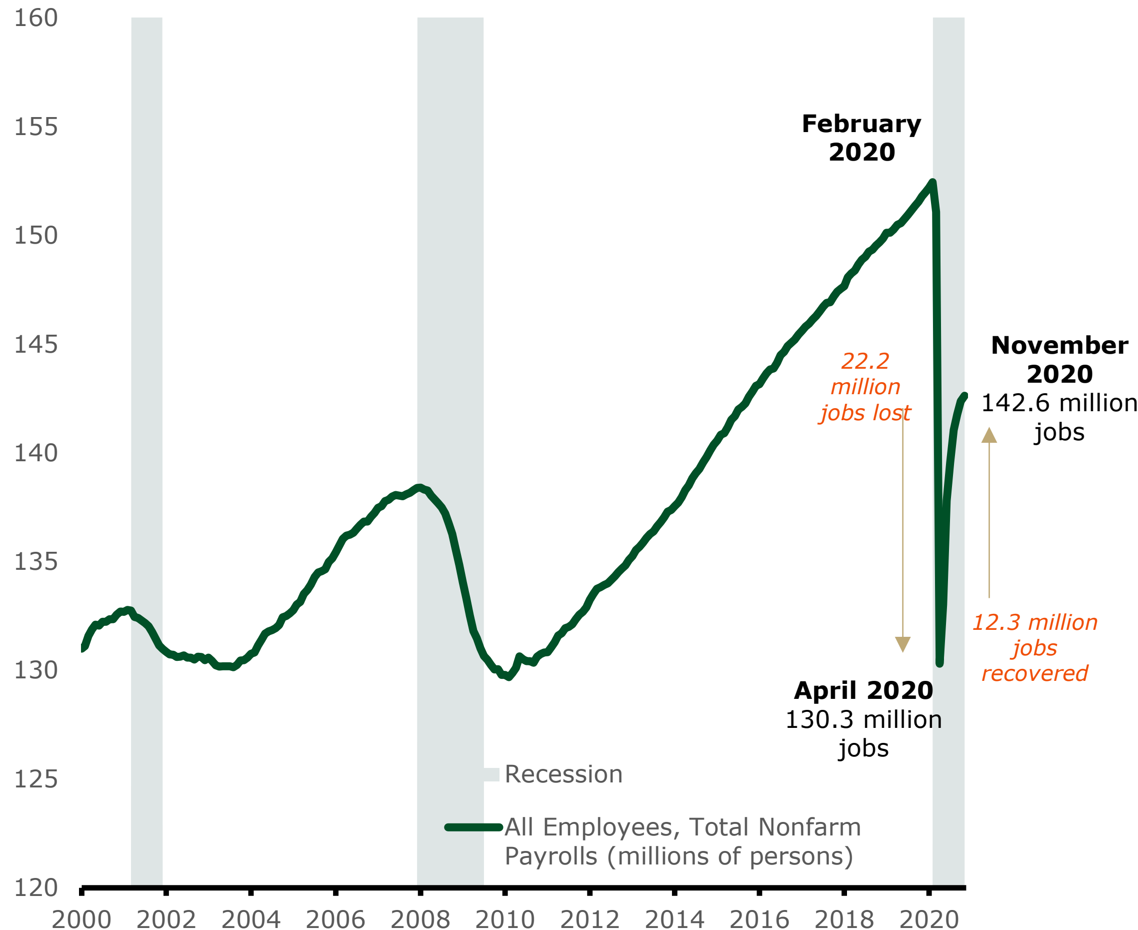
Extremely Accommodative Monetary Policy Has Supported Risk Assets



- In response to the pandemic, the Fed pulled out all the stops, flooding markets with liquidity, purchasing government and corporate bonds (quantitative easing, or “QE”), and cutting the federal funds rate to near-zero.
- The Fed also said it will continue to buy at least $120 billion of Treasury and agency mortgage-backed securities per month (QE) indefinitely. Since March, the Fed has purchased roughly $3 trillion of assets for its balance sheet, which has swelled to a record percent of GDP.

Source: Ned Davis Research.

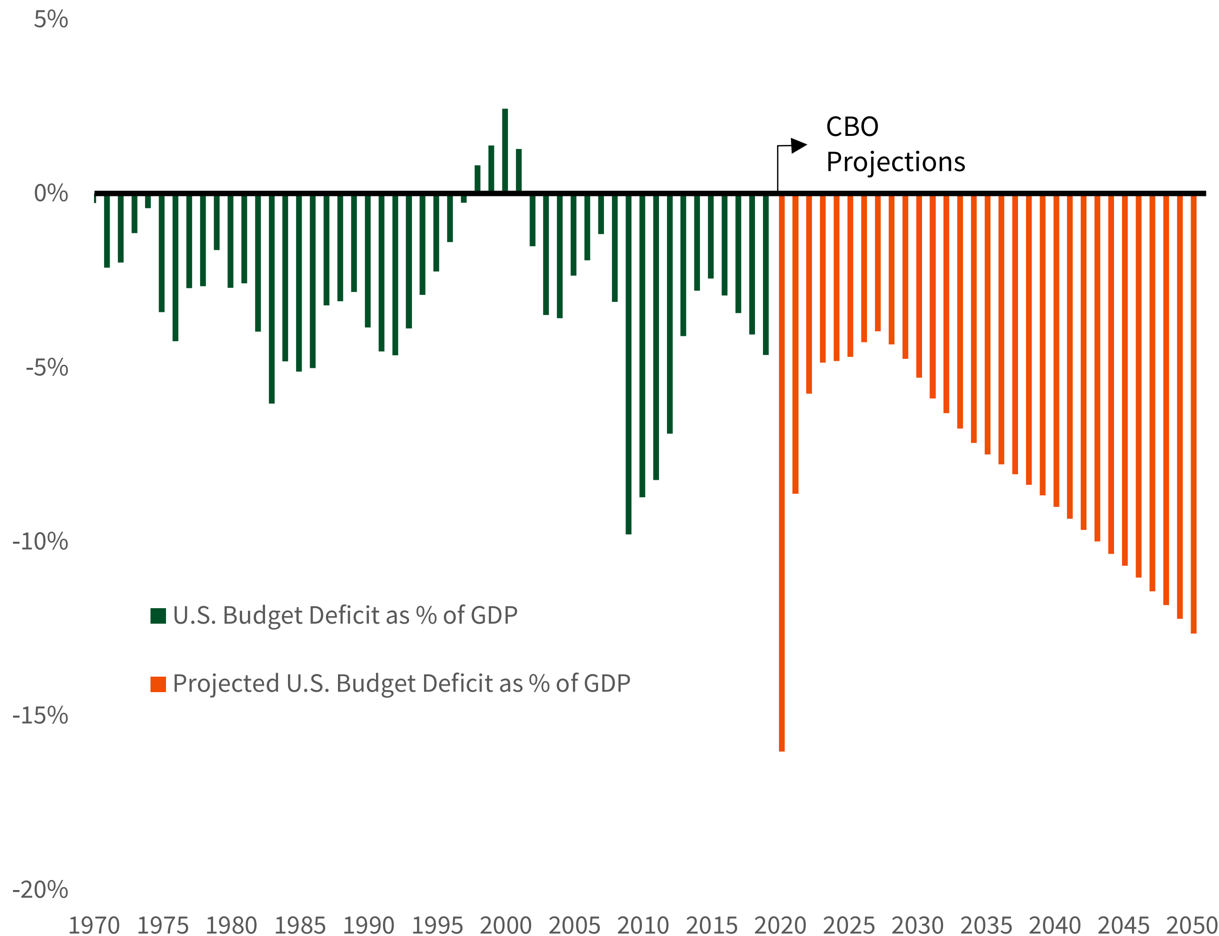
The Economy Has Weakened but Fiscal Stimulus Should Help



- As the recent "third wave" resurgence of COVID-19 forces more economic shutdowns, the risk of a sharp economic slowdown increases. The unemployment rate has fallen sharply from its April high of 14.7%, to 6.7% in November, but that number could spike again in the event of another shutdown.
- Thankfully a $900 billion pandemic relief bill has been agreed on, making direct payments to individuals and extending extra unemployment benefits through mid-March.
- At their mid-December meeting, the Fed reiterated yet again that "the path of the economy will depend significantly on the course of the virus."

Source: U.S. Bureau of Labor Statistics. Data as of 11/30/2020.

The U.S. Budget Deficit Is Set To Balloon



- The massive (and necessary) fiscal stimulus in response to the pandemic will lead to a large increase in the U.S. budget deficit.
- However, the QE bond purchases by the Fed have gone a long way in offsetting (“monetizing”) the debt being issued by the Treasury to fund the massive pandemic fiscal stimulus and deficits.
- These purchases have kept downward pressure on interest rates. Otherwise, the massive increase in bond supply relative to demand would likely have pushed down bond prices, increasing bond yields/interest rates, and increasing the interest expense on the federal government’s huge and growing pile of debt.
- As long as rates stay below the growth rate of GDP, the government debt service cost should be manageable and the debt-to-GDP ratio sustainable.

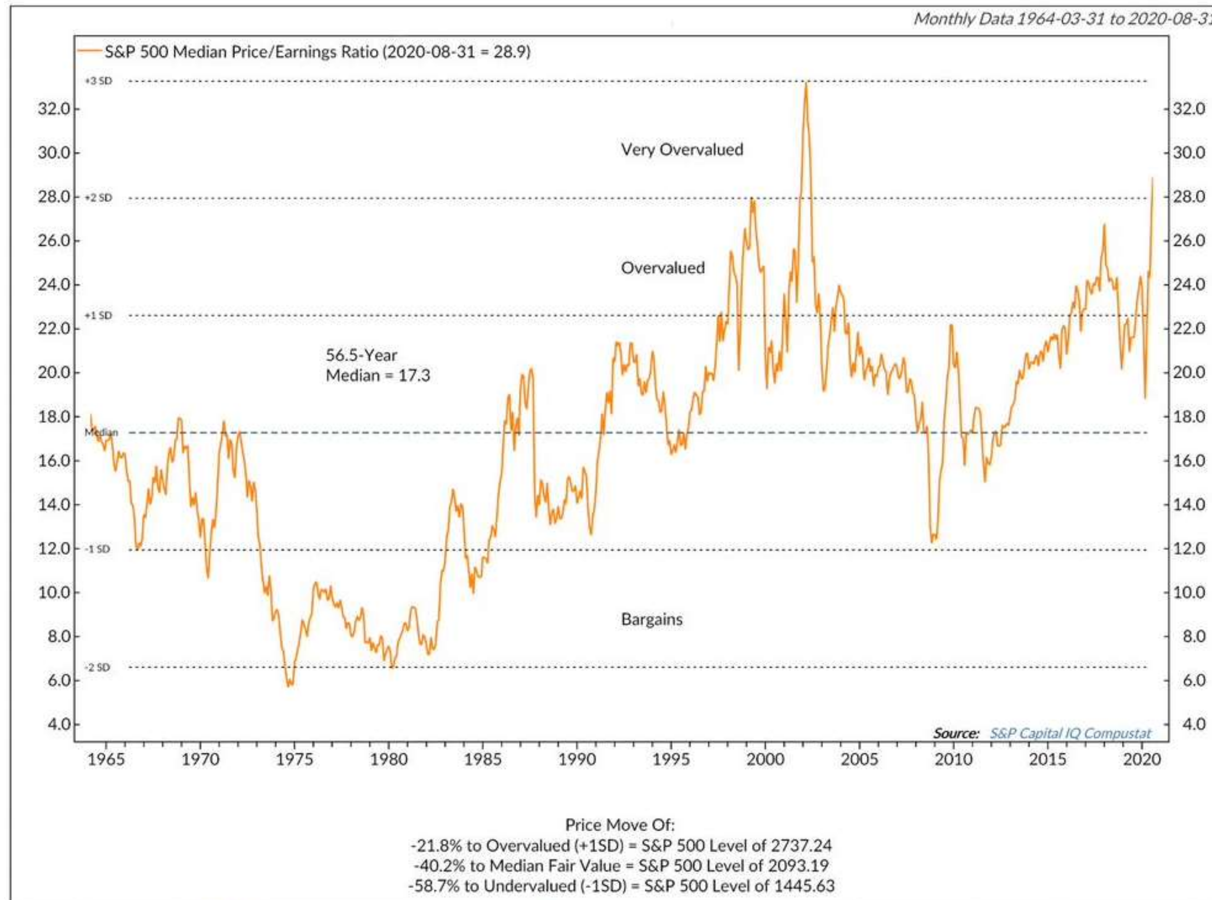
Source: Morningstar Direct. Chart concept courtesy of BlackRock. Data as of 8/31/2020.

The U.S. Dollar Has Fallen More Than 10% Since Last March

- When the dollar depreciates, it increases the return to dollar-based (unhedged) investors in foreign assets, and vice versa.
- A weakening dollar also eases global financial conditions and bolsters global economic growth by easing the cost of dollar-based debt for foreign borrowers. Emerging markets in particular have historically been beneficiaries of dollar weakening and looser financial conditions.
- The dollar tends to be "counter-cyclical," meaning it moves in the opposite direction of the global business cycle. A rebound in the global economy should be a negative for the dollar and provide a tailwind for foreign assets.

Source: Board of Governors of the Federal Reserve System. Data as of 12/31/2020.

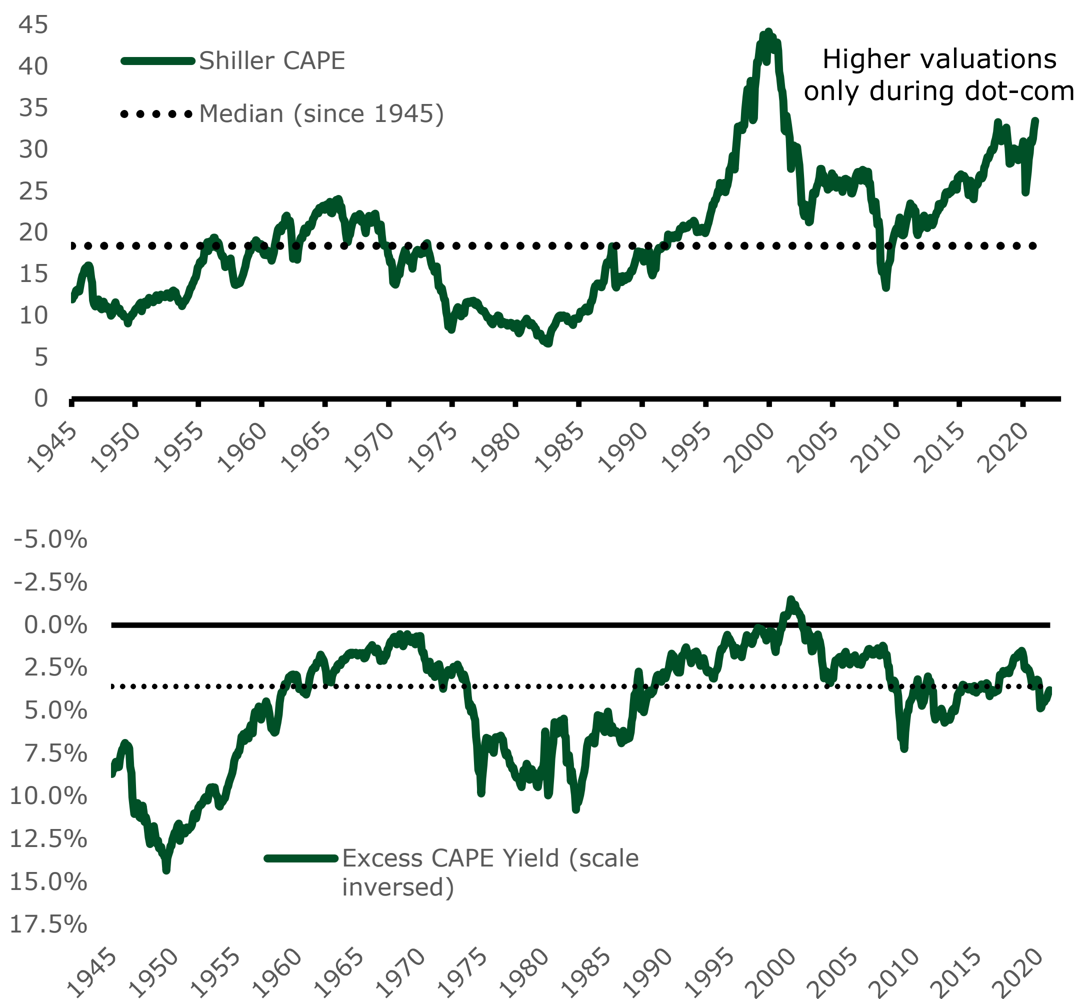
The S&P 500 Is Again Historically Overvalued



- Another reason for caution is U.S. equity market valuation risk. After soaring more than 50% from its March market low, the S&P 500 Index is again in historically overvalued territory (driven largely by a handful of mega-cap tech/growth stocks).
- The last time the median P/E ratio was at levels this elevated was during the dot-com era of the early 2000s.

Source: Ned Davis Research.

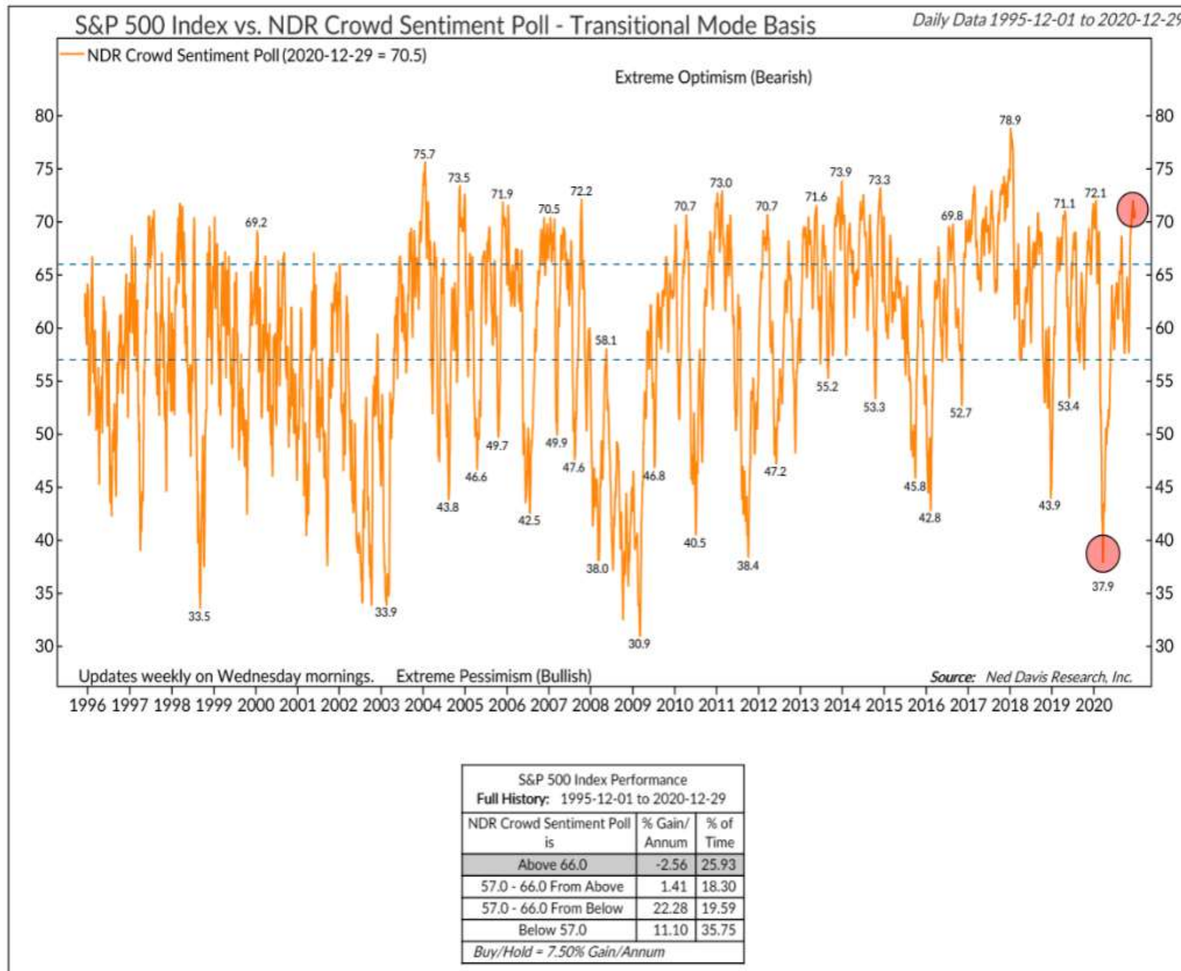
Absolute U.S. Stock Valuations Are Lofty, but Stocks Are Not Expensive Relative to Bonds



- U.S. stock valuations, as measured by the Shiller CAPE (cyclically-adjusted price-to-earnings) ratio, are at a level not seen since the dot-com bubble.
- Our base-case five-year outlook indicates that the U.S. stock market is overvalued on an absolute basis (comparing underlying fundamentals to normalized earnings power).
- However, in this environment of extremely low bond yields, U.S. stocks still look relatively attractive compared to core bonds or Treasury bonds. This is evident by looking at the Excess CAPE yield, which is the excess earnings yield on stocks over the yield on 10-year Treasuries.
- As long as bond yields remain very low and corporate earnings growth is meeting or exceeding expectations, U.S. stocks can continue to perform well.

Source: Morningstar Direct. Chart concept courtesy of BlackRock. Data as of 8/31/2020.

Extreme Investor Optimism Leaves Market Vulnerable to Disappointment



S&P 500 Index Performance Full History: 1995-12-01 to 2020-12-29		
NDR Crowd Sentiment Poll is	% Gain/ Annum	% of Time
Above 66.0	-2.56	25.93
57.0 - 66.0 From Above	1.41	18.30
57.0 - 66.0 From Below	22.28	19.59
Below 57.0	11.10	35.75
Buy/Hold = 7.50% Gain/Annum		

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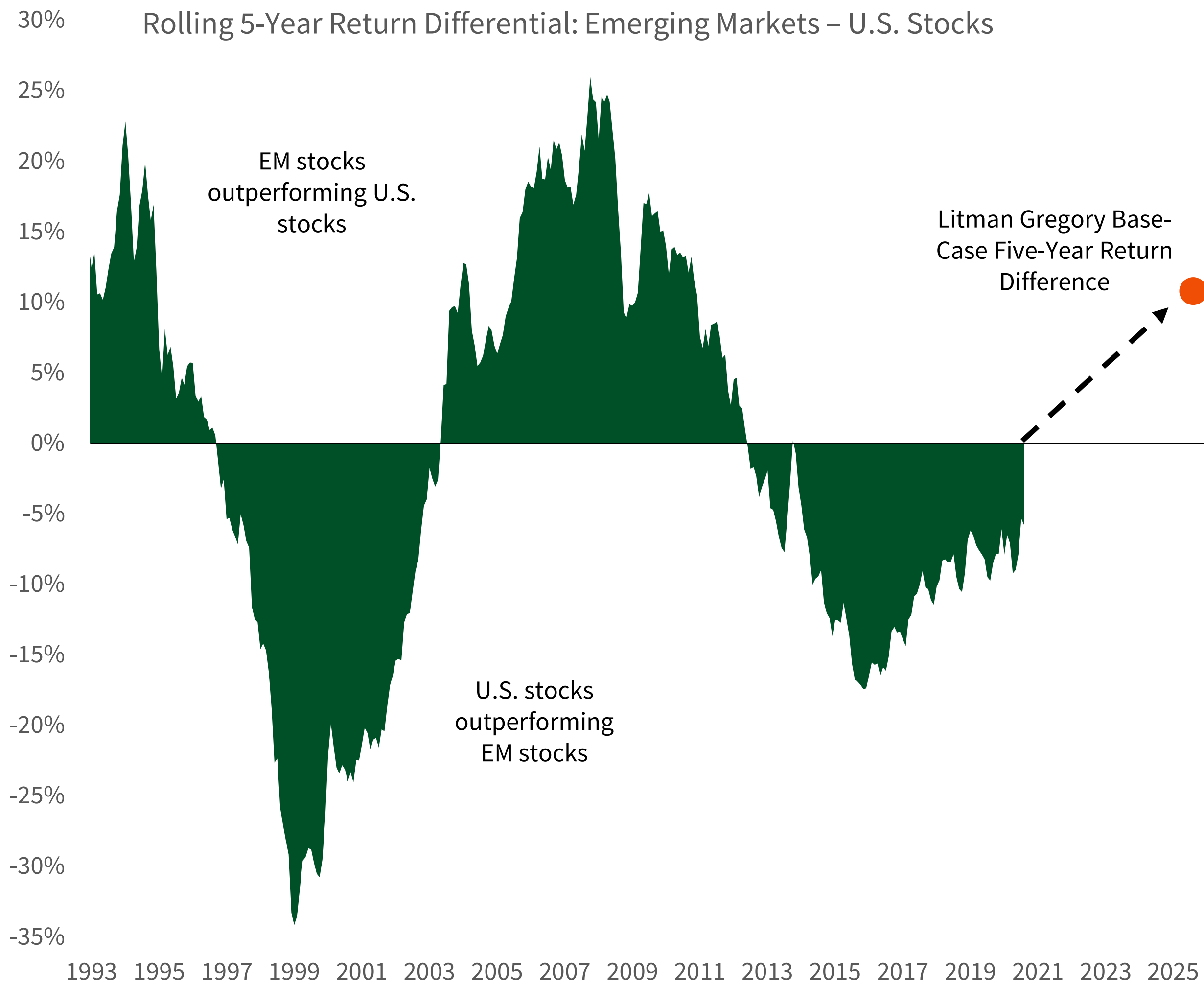
- After the U.S. stock market's incredible rebound since the March low, market sentiment is very bullish and optimistic.
- When sentiment reaches such extremes, it can be a contrary indicator for the market in the very near term.
- This Ned Davis Research chart shows a composite of sentiment indicators. It is currently in the "Extreme Optimism" zone, where subsequent market index returns have historically been negative on average.
- Intuitively, extreme investor optimism implies a lot of good news is already reflected in market prices, leaving the market particularly vulnerable to any type of fundamental disappointment.

Source: Ned Davis Research.

The Outlook for Emerging-Market Stocks vs. U.S. Stocks Is Attractive



- Based on our analysis, emerging-market stocks have much higher five-year expected returns than U.S. stocks.
- As illustrated earlier, U.S. stocks are historically overvalued by some metrics, while emerging-market stocks are attractive on both absolute and relative valuation measures.

Source: : Morningstar Direct. Data as of 8/31/2020.

Investment Outlook

- Our base-case macroeconomic scenario assumes moderate, trend economic growth, both in the United States and globally, and that corporate earnings growth and interest rates normalize over our five-year tactical investment time horizon.
- The U.S. and global economies entered a severe recession in the first quarter of 2020 as a result of COVID-19 and the lockdown efforts to contain its spread. This was consistent with our prior base-case expectation that a U.S. recession was “very likely” within our five-year tactical horizon.
- The depth and duration of this recession remains highly uncertain, given how dependent it is on the course of the virus and the medical outcomes, at least until a vaccine is widely available.
- If there is no widespread resurgence of COVID-19, it appears we have seen the worst of the recession and bear market for this cycle. But if the pandemic materially worsens, it could lead to a double-dip recession and a sharp decline in stocks.
- During the sharp selloff in stocks in March, we increased our allocation to U.S. stocks by an increment. But after the ensuing market rally, they offer sub-par expected returns and we are underweight to them. U.S. core bonds also continue to offer very low expected returns (very low yields).
- As such, our portfolios are tilted toward opportunities we believe offer more attractive reward relative to risk—specifically, international and emerging-market (EM) stocks, non-core fixed-income strategies, and alternative strategies.

Asset Class	Outlook and Positioning
U.S. Stocks	The U.S. stock market is overvalued at current levels, offering poor five-year expected returns in our base case.
Developed International Stocks	Return potential is attractive versus U.S. stocks. However, the structural issues related to the eurozone and Brexit lower our conviction.
Emerging-Market Stocks	Valuations in relation to our estimate of EM normalized earnings power are very attractive, both in absolute terms and relative to U.S. stocks. In the short term there could be relatively more downside risk in EM stocks.
Investment-Grade Bonds	We’re underweight to investment-grade bonds in favor of flexible core bond funds, unconstrained and absolute-return-oriented funds, and floating-rate loan funds we believe can generate higher returns and better manage their sensitivity to interest rate changes.
Alternative Strategies	We own alternative strategies we believe improve the overall risk-adjusted return potential of our portfolios, with different risk and return drivers than traditional stocks and bonds.

Disclosure

<u>Asset Class Descriptions:</u>

Domestic Investment-Grade Bonds (Barclays Capital U.S. Aggregate Bond Index): We are currently using the Vanguard Total Bond Market Index Fund to represent the Barclays Capital U.S. Aggregate Bond Index, an index of domestic investment grade bonds.

Floating Rate Loans (S&P/LSTA Leveraged Loan Index): We are currently using the S&P/LSTA Leveraged Loan Index to represent an index of floating rate loans.

High Yield Bonds (Merrill Lynch U.S. High Yield Master Cash Pay Index): We are currently using the Merrill Lynch U.S. High Yield Master Cash Pay Index to represent an index of domestic high yield bonds.

Domestic Larger-Cap Stocks (S&P 500 Index): We are currently using the Vanguard 500 Index Fund to represent the S&P 500, an index of primarily domestic larger-cap stocks.

Domestic Smaller-Cap Stocks (Russell 2000 Index): We are currently using the Russell 2000 Index iShares Exchange Traded Fund (ETF) to represent the Russell 2000, an index of primarily domestic smaller-cap stocks.

International Developed-Market Stocks (FTSE Developed ex North America Index): We are currently using the Vanguard FTSE Developed Markets Exchange Trade Fund (ETF) to represent an index of international developed-market stocks. Prior to May 2013, this Vanguard Exchange Traded Fund followed MSCI-EAFE. Prior to the July 2007 inception of Vanguard MSCI EAFE ETF, we use iShares MSCI EAFE Index from September 2001 to July 2007, and the MSCI EAFE Index adjusted for 0.35% expenses annually prior to September 2001.

International Emerging-Market Stocks (FTSE Emerging Markets Index): We are currently using the Vanguard FTSE Emerging Markets Index Exchange Traded Fund (ETF) to represent an index of emerging market stocks. Prior to January 2013, this Vanguard Exchange Traded Fund followed the MSCI Emerging Markets Index. Prior to the March 2005 inception of Vanguard MSCI Emerging Markets ETF, we use iShares MSCI Emerging Markets Index from May 2003 to March 2005, and the MSCI Emerging Markets Index adjusted for 0.67% expenses annually prior to May 2003.

Gold: We currently use the ETF Aberdeen Physical Gold (SGOL) as an index for Gold prices.

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