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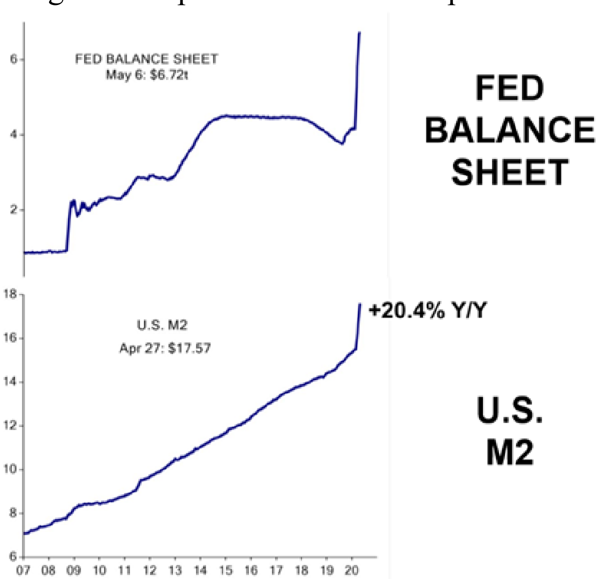
Looking Back at the Past Year

2020 began benignly enough. The economy was on strong footing and poised, we believed, to accelerate. Unemployment at 3.5% was the lowest in fifty years. Consumer net worth was at an all-time high fueled both by a buoyant stock market in 2019 and a strengthening housing market. The Federal Reserve remained accommodative, leaving its federal funds target range of 1.5% - 1.75% with inflation hovering just below the Fed's target of 2%. Stock valuations were historically elevated but perhaps justified by expectation of corporate earnings growth and low real interested rates.

Enter COVID-19. The novel coronavirus, first detected in Wuhan, China in December 2019, had rapidly spread to over 100 countries when the World Health Organization (WHO) declared a global pandemic on March 11. Stocks (which had moved to all-time highs on February 19) proceeded to fall 35% over the next twenty-three trading days, the largest drawdown in such a short span of time.

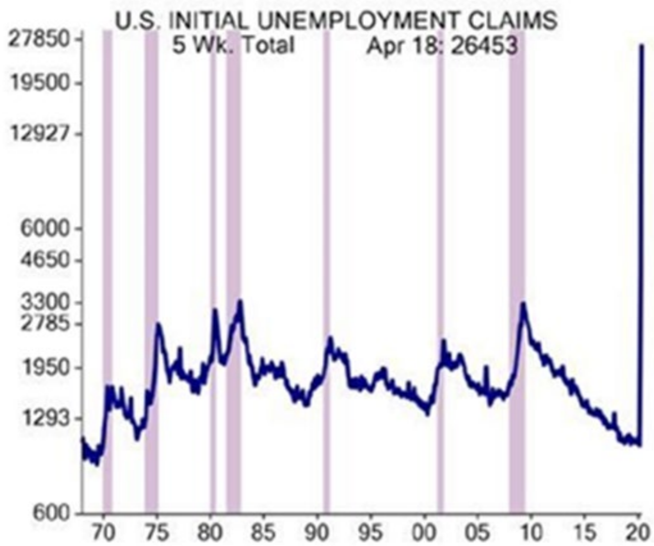
The factors which helped reverse the trajectory of the downfall for the stock market in 2020 include the Federal Reserve lowering its federal funds target to 0%-0.25% on March 17, and the $2.2 trillion CARES Act signed into law on March 27. These monetary and fiscal policy initiatives were historic in size and in how quickly they were implemented. In addition to reducing its target rate, the Fed reintroduced its bond buying or quantitative easing (QE) program, which helps to lower longer dated rates. Also, the Fed said it would purchase corporate and municipal bonds in addition to US treasuries and mortgages. Simply by declaring its intentions, the Fed effectively unfroze credit markets, thus paving the way for credit spreads to narrow significantly, allowing both corporations and municipalities to raise funds cheaply.



Source: Evercore ISI

Many investors, including ourselves, believed the government response, both monetary and fiscal, was sufficiently massive enough to limit the downside to the economy and put a floor in stocks. Not surprisingly, stocks and bonds rallied sharply. We, like most, expected a retest of the March lows as is typical after a violent fall and rebound in share prices. However, notwithstanding several corrections, stocks continued to rise throughout the year, leaving March 23 as the trough.

Unlike stocks, the macro economy continued to slide to depths not seen since the Great Depression. Gross Domestic Product (GDP) fell at a 5% annualized rate in Q1 and at a 31.4% annualized rate in Q2. Weekly initial jobless claims jumped from 282,000 on March 13 to 3.3 million on March 20, peaking at 6.6 million on April 4.



Source: Evercore ISI

The overall unemployment rate jumped from 4.4% on March 20 to 14.8% on April 20, with unemployment rates of some demographic groups much higher. As the weather improved and draconian government business shutdowns were scaled back, the economy bottomed in Q2, sharply rebounding with annualized GDP growth of 33.4% in Q3 and 4% in Q4. Although the economic data implied a V-shaped recovery, it was an uneven recovery in which some sectors of the economy did well (such as housing) while other parts of the economy, particularly in the services sector, struggled to recover.

Owning large capitalization technology oriented companies represented in the S&P 500 worked well in 2020, although such an outcome was hardly obvious in March. After the government intervened with monetary and fiscal stimulus, the S&P 500 index rose 67% off the low to finish the year up just over 16% in price terms, 18% including dividends. Of course, the S&P 500 is a capitalization-weighted index, heavily influenced by mega-cap, tech-oriented stocks including the so-called FAANGM stocks which include Facebook, Amazon, Apple, Netflix, Google's parent Alphabet, and Microsoft. These six stocks contributed almost 80% of the S&P 500 gain for the year. In fact, more than 50% of the stocks in the index were down in 2020, and more than 25% of the stocks in the S&P 500 were down at least 20% at year-end. The remaining non-

FAANGM 494 stocks in the S&P 500 were up a mere 4%, reflecting the unevenness of the recovery.

Non-U.S. stocks overall also underperformed their U.S. counterparts with the MSCI World ex-U.S. index up just over 6% for the year. Non-US stock indices tend to be less technology laden and a bit more value oriented. Indeed, even the Russell 1000 Value index was only up about 3% in 2020. Of course, with such relative outperformance of a small group of stocks comes potential concentration risk. According to Barron's, the five largest U.S. stocks made up just over 10% of the market ten years ago. By year-end 2020, the five largest U.S. stocks made up 21% of the market. This is the highest market concentration in two decades, or around the peak of the dot.com bubble.

The surge in mega-cap technology stocks in 2020 shares several threads. First, even before the global pandemic, many of the largest technology companies, despite their size, were generating higher-than-average growth rates in both revenue and cash flow while maintaining historically high profit margins. Economic theory suggests such high profit margins are unsustainable in the long run. Some have argued that the lack of competition due to the high economic moats these companies have built will allow them to maintain their profit margins in the future. Shifting political winds in recent months might suggest at least some risk to this thesis going forward.

The second catalyst for technology stocks in 2020 – and for non-tech companies which had used technology to build a successful multi-channel distribution mechanism – was, of course, the global pandemic which accelerated what was already a secular trend toward on-line commerce. It is our belief that this secular trend will continue in the future, although the companies that benefit the most may look different from those which enjoyed the greatest success in 2020. This is not to suggest that internet-focused companies or the companies that provide the picks and shovels – data centers and chips, for example – won't continue to thrive, but that more companies using technology can increase productivity, margins and cash flow if they make smart investments.

Of course, in a well-diversified equity portfolio, some sectors and industry groups will lag the overall market in any given year. This was certainly true in 2020. While technology and stocks that benefit from people staying at home soared, Energy, brick-and-mortar Retail, Travel and Leisure, and Financials were hit particularly hard. Energy stocks were already under pressure to begin the year due to the surge in oil supply created by hydraulic fracturing in the U.S. When the pandemic struck, demand collapsed for air and auto travel, further depressing prices. Retailers who hadn't fully developed their multi-channel, internet-driven capacity also saw a collapse in demand with wide-spread government shutdowns of non-essential services. Financial companies that rely on loan growth and a relatively steep yield curve – long-dated interest rates higher than short-dated interest rates – significantly underperformed in 2020 due to the increased risk of loan defaults and falling interest rates.

While some trends may continue beyond 2020, it is likely that some will reverse. With the COVID vaccine approvals, markets are looking forward to the second half of 2021 and 2022 to a more normalized world of consumer activity.

The U.S. election results will likely bring about change as well. With Democratic control over the House, Senate, and Presidency, the odds of additional fiscal stimulus including infrastructure are more likely. This could translate into above trend growth in 2021. U.S. GDP growth of 4% in 2021 seems achievable to us. While this is certainly good news in the short run, it doesn't come without some risk of higher inflation and rising interest rates in the longer run.

Indeed, inflation expectations rose last year, as did bond yields. The 10-year U.S. treasury-note yield bottomed in August at 0.5%, rising to just over 1.1% in January (it currently stands at 1.6%). This increase in interest rates isn't enough in our opinion to derail stocks at this time.

Source: Evercore ISI

That said, interest rates are the discounting mechanism by which stocks find fair value. If interest rates rise significantly, stocks would likely correct, all things equal.

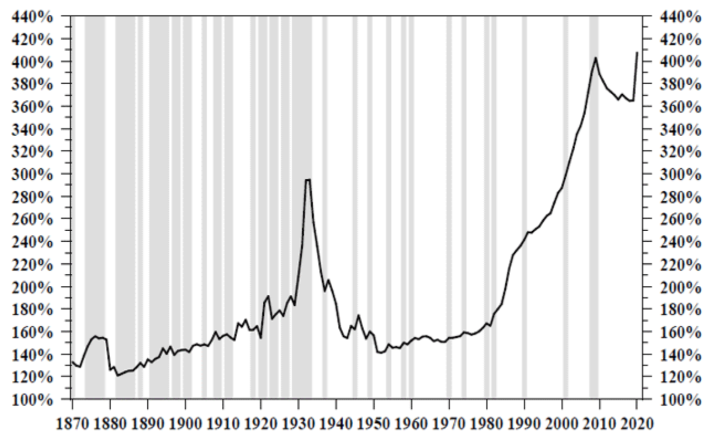
Last August, when yields bottomed, the Federal Reserve articulated a new policy of average inflation targeting. The Fed's inflation target is 2%. The Fed will now allow inflation to run above 2% for some period of time such that the average is 2% before deciding to tighten policy. Because inflation by the Fed's preferred measure has been running below 2%, we expect the Fed to remain accommodative for at least the next year or two.

Source: Evercore ISI

Some economists are concerned that excessive government spending and easy monetary policy will lead to higher inflation. Adding to this argument is the thesis that the disinflationary benefits of globalization will reverse in a world with challenged supply chains and an America first domestic policy. Others have argued that the level of debt both globally and in the U.S. acts as an economic depressant and therefore will be a counterweight to rising inflationary forces.

U.S. Private and Public Debt as a % of GDP

annual



Sources: Bureau of Economic Analysis, Federal Reserve, Congressional Budget Office. Census Bureau: Historical Statistics of the United States Colonial Times to 1970. Through Q3 2020. 2020 is average of Q1, Q2 and Q3.

They would also argue that the pace of technological advancement will continue to enhance productivity which will mitigate the risk of inflation. The best outcome, we believe, is one in which inflation accelerates modestly reflecting improving economic conditions with nominal yields rising but real yields remaining low.

A new economic expansion began in the third quarter of last year. Historically, economic expansions last five years (late 1970s) to eleven years (2010s), according to Evercore ISI. In terms of months, the expansion ending in February 2020 was our oldest at 128 months.

While not the oldest quarterback in NFL history (that credit goes to George Blanda), Tom Brady is the oldest quarterback to play (and win) in a Super Bowl. If only this new economic expansion could last as long as the GOAT – TB12!