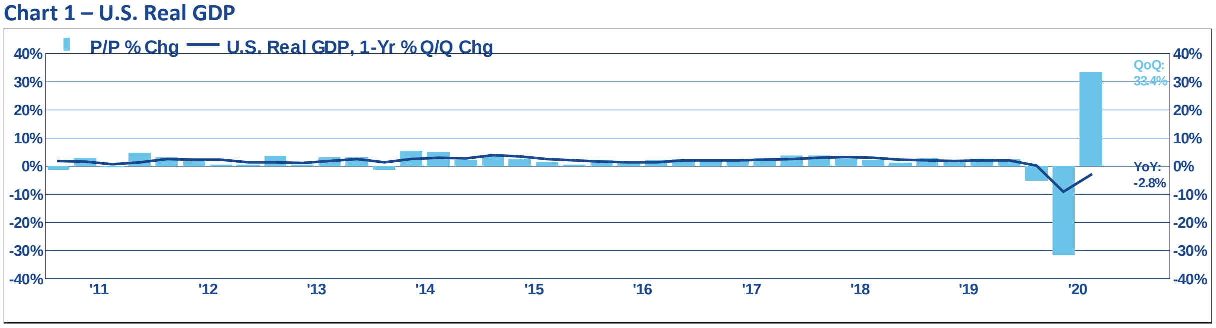
Summary

After setting record quarterly U.S. economic decline and advance last year, overall economic trends have normalized this past quarter and the economy is expected to grow at a moderate pace the next couple of years. While the U.S. economy rebounded quicker than commonly expected, considerable hurdles remain that heighten uncertainty and may hinder the pace of the recovery. Regardless, stock markets continued to move higher with the S&P 500 closing the year at an all-time high along with considerably stretched valuation levels. Given the hurdles that still remain, pricing in three-plus years of earnings growth seems rather enthusiastic.

Commentary

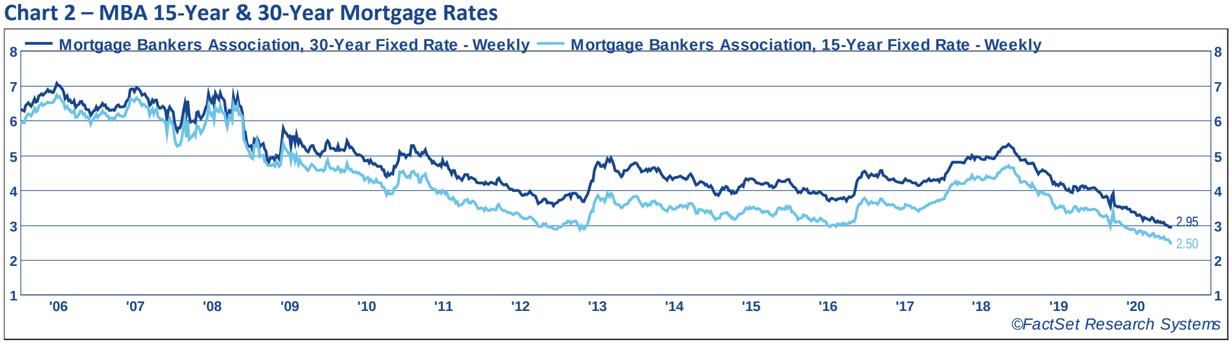
Covid-19 ushered in the greatest historical quarterly U.S. economic decline and advance last year with second-quarter GDP dropping -31.4% followed by a strong rebound in third-quarter GDP of +33.4%. While the level of U.S. economic activity has not yet surpassed pre-Covid-19 levels, the rebound in the third quarter reflects the underlying fundamental strength of consumer households and businesses heading into the crisis and the aggressive actions taken by the Federal Reserve (Fed) to lower interest rates and stabilize financial markets. The housing market has certainly benefitted from these factors and has been a solid contributor to the economic rebound.

Chart 1 – U.S. Real GDP



The combination of consumer strength, need to work remotely, and historically low mortgage rates unleashed a tidal wave of mortgage refinance activity and rocketed demand for new and existing homes. Interest rates plummeted at the onset of the pandemic crisis, and with the Federal Reserve signaling rates are going to be lower for longer, mortgage rates have moved to historic lows.

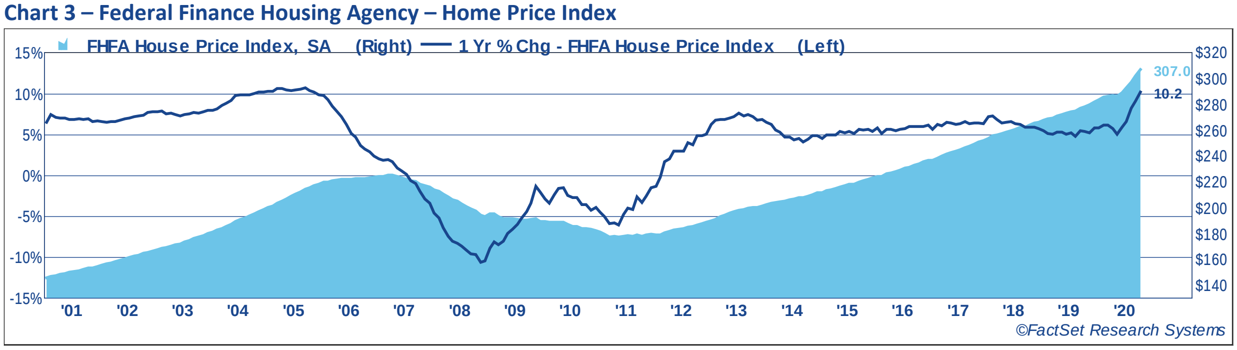
Chart 2 – MBA 15-Year & 30-Year Mortgage Rates



Existing home sales reached an annualized sales rate of 6.9 million units in October 2020 which is the highest rate since February 2006 and slightly below the September 2005 all-time high annualized rate of

7.3 million units. Prior to the crisis, there already was a housing supply and demand imbalance as new and existing home inventories have been very low for quite some time amid steady home buyer demand. The involuntary necessity and subsequent strong appeal to work remotely has further widened this imbalance and propelled average home prices to all-time highs. According to the Federal Housing Finance Agency October Home Price Index report, U.S. home prices have risen 10.2% over the past year and the average price of a U.S. home is $307,000. Existing and new home sales have risen sharply since early spring but pulled back in November.

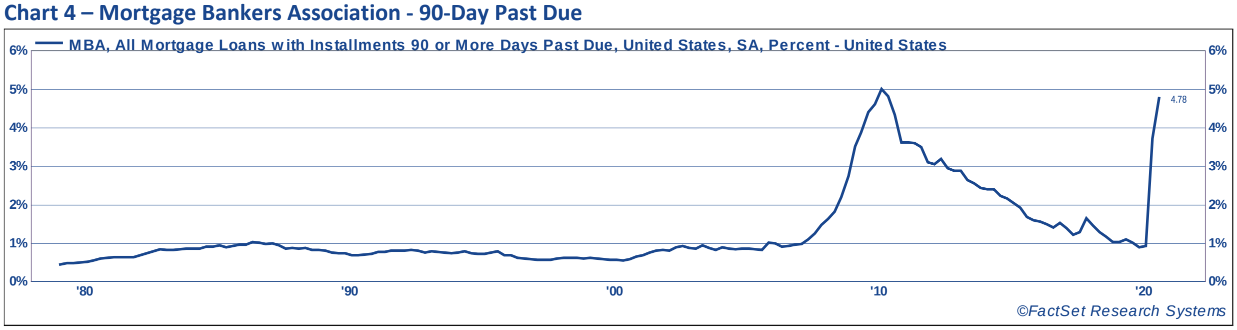
Chart 3 – Federal Finance Housing Agency – Home Price Index



There are some darkening clouds looming on the housing market horizon that will likely raise existing home inventory levels and cool-off home price gains. The Mortgage Bankers Association recently reported the number of 90-day mortgage payments past due has risen sharply since the onset of the crisis to 4.8% as of September 30, 2020, which is the highest level since June 2010 and slightly below the all-time record high of 5.0% in March 2010.

Most of these reported past dues are in mortgage forbearance via Fannie Mae and Freddie Mac and emanate from the massive Covid-19 related layoffs from last March and April. Unfortunately, it appears there is going to be some pain on the home front for individuals and families. The issue here is how many jobs can be gained back before the eventual sunset of mortgage forbearance.

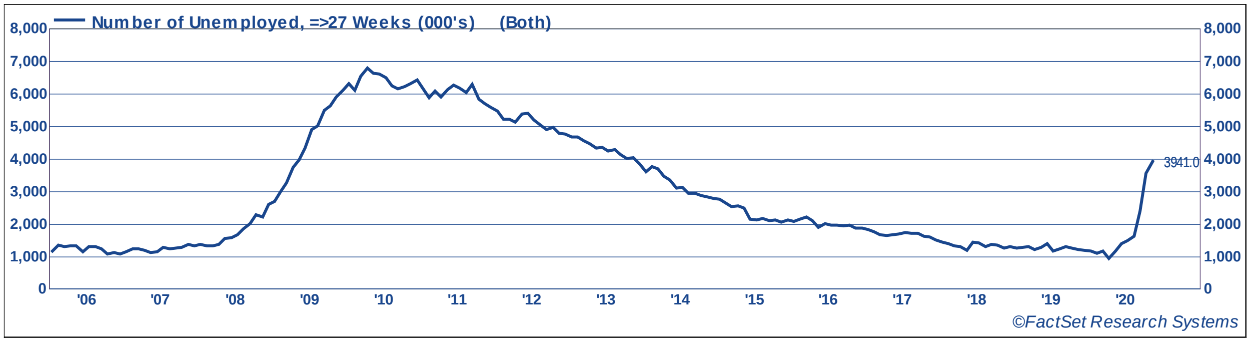
Chart 4 – Mortgage Bankers Association - 90-Day Past Due



Early last spring, 22.4 million people were laid off due to the pandemic crisis. Since then, there has been considerable progress made on the employment front but there is still a lot of ground to recover. Between May and November last year, 12.4 million jobs were gained back leaving 10.0 million people still unemployed. To put the 10.0 million people still unemployed into perspective, during the Great Recession between January 2008 and December 2009, a total of 8.6 million people lost their jobs.

The labor market took a major blow last spring and significant cyclical labor issues persist. Since the onset of the crisis, the civilian labor force has decreased by 4.0 million workers meaning the number who have dropped out of the workforce and given up looking for work; the number of people who are working part-time (due to business conditions) but want to work full-time has risen by 2.4 million people; weekly initial unemployment benefit claims rocketed and remain extremely elevated, which does not bode well for near-term monthly job gain growth; and the number of people unemployed greater than 27 weeks has risen by 3.0 million to 3.9 million.

Chart 5 - Number of People Unemployed Greater Than 27 Weeks



This last point was a main reason the Fed held off on raising rates for so long after the Great Recession and is a primary concern today. Back then, the ratio of people unemployed greater than 27 weeks compared to total unemployed peaked at 44.4% in April 2010. Presently, this ratio stands at 36.4%. Long-term unemployment is a very serious situation for people and families as savings are depleted as well as most other financial resources like 401ks and IRAs.

It is rather likely, and much hoped, that the current level of long-term unemployed will recover more quickly than during the Great Recession as this situation was self-imposed more adversely affecting service-oriented industries and companies such as hospitality, travel, and retail. Although there is a fair amount of irreparable harm done, the development and approval of numerous vaccines provides optimism this could be the case.

Despite the persistent labor market and Covid-19 related concerns, financial markets have been firing on all cylinders driven higher by economic relief packages, monetary policy, expected corporate earnings growth, and the most welcome prospect of a return to normalcy. After the depth of market lows last spring, stock markets sharply rebounded rising seven of the last nine months with the S&P 500 Index closing at an all-time high of 3,756.07.

Table 1 – Stock Index Total Returns as of December 31, 2020

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
NASDAQ	5.71	15.63	44.92	44.92	24.39	22.12	18.46
Russell 2000	8.65	31.37	19.96	19.96	10.25	13.26	11.20
S&P 500	3.84	12.15	18.40	18.40	14.18	15.22	13.88
MSCI Emerging	7.35	19.70	18.31	18.31	6.17	12.81	3.63
S&P 400	6.52	24.37	13.66	13.66	8.45	12.35	11.51
Dow Jones Industrial	3.41	10.73	9.72	9.72	9.90	14.65	12.97
MSCI Developed	4.65	16.05	7.82	7.82	4.28	7.45	5.51

After languishing most of the year, the fourth quarter was particularly strong for riskier small-cap, mid-cap, and emerging markets stock asset classes which rose +31.4%, +24.4 and +19.7% respectively. For the year, the clear leaders were large-cap tech stocks which benefitted greatly from the shelter-in-place mandates as the heavily technology-weighted NASDAQ Index rose +44.9%.

Looking at sector returns of the S&P 500 Index for the year also confirms the same as the top three performing sectors of the Index were Info Tech, Consumer Discretion, and Communication Services. Dispersed among these top-performing sectors are the largest big-cap tech names specifically, Facebook, Apple, Microsoft, Amazon, Netflix, and Google (FAMANG), which account for roughly 25% of the S&P 500 index weight. Financials, Real Estate, and Energy were the sector laggards.

Table 2 – S&P 500 Index Sector Total Returns as of December 31, 2020

Sector	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Information Technology	5.74	11.81	43.89	43.89	29.19	27.79	20.68
Consumer Discretionary	2.53	8.04	33.30	33.30	19.81	17.53	17.68
Communication Services	3.08	13.82	23.61	23.61	12.79	11.84	10.07
Materials	2.54	14.47	20.73	20.73	8.66	13.14	9.00
Health Care	3.91	8.03	13.45	13.45	13.43	11.63	15.88
Industrials	1.20	15.68	11.06	11.06	7.60	12.38	11.96
Consumer Staples	1.78	6.35	10.75	10.75	8.99	9.14	11.79
Utilities	0.70	6.54	0.48	0.48	9.74	11.50	11.27
Financials	6.28	23.22	-1.69	-1.69	4.15	11.13	10.79
Real Estate	1.50	4.94	-2.17	-2.17	7.26	7.18	10.08
Energy	4.40	27.77	-33.68	-33.68	-15.31	-5.20	-2.67

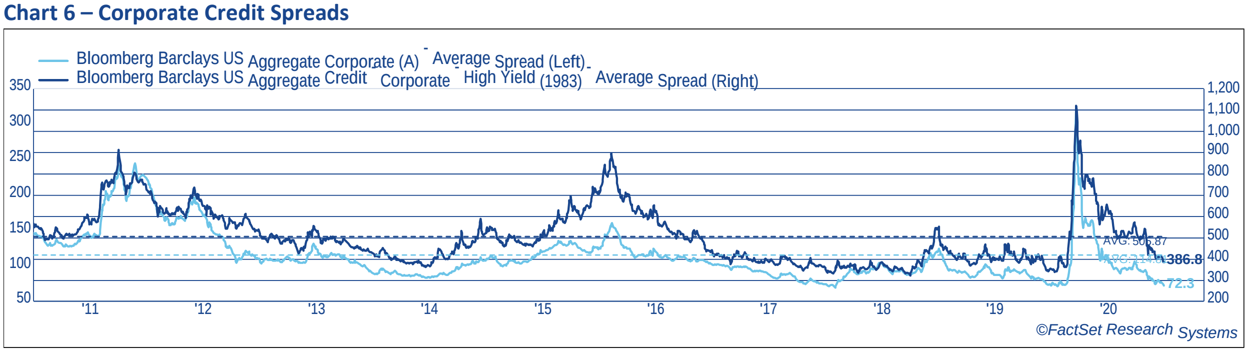
A primary rationale of these lofty returns and well-above historical average valuations has been monetary policy actions taken by the Fed. Fed December FOMC economic projections indicate short-term interest rates will remain low though 2023. Additionally, the Fed is purchasing $120 billion worth of treasury and agency bonds each month to provide liquidity, keep interest rates low, and promote economic growth. Fixed income returns benefitted from this low interest rate environment as well.

Table 3 – Fixed Income Index - Total Returns as of December 31, 2020

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Barclays Aggregate	0.14	0.67	7.51	7.51	5.34	4.44	3.84
Barclays High Yield	1.88	6.45	7.11	7.11	6.24	8.59	6.80
Barclays Inter Gov't/Credit	0.20	0.48	6.53	6.53	4.70	3.64	3.11
Barclays Municipal	0.61	1.82	5.21	5.21	4.64	3.91	4.63

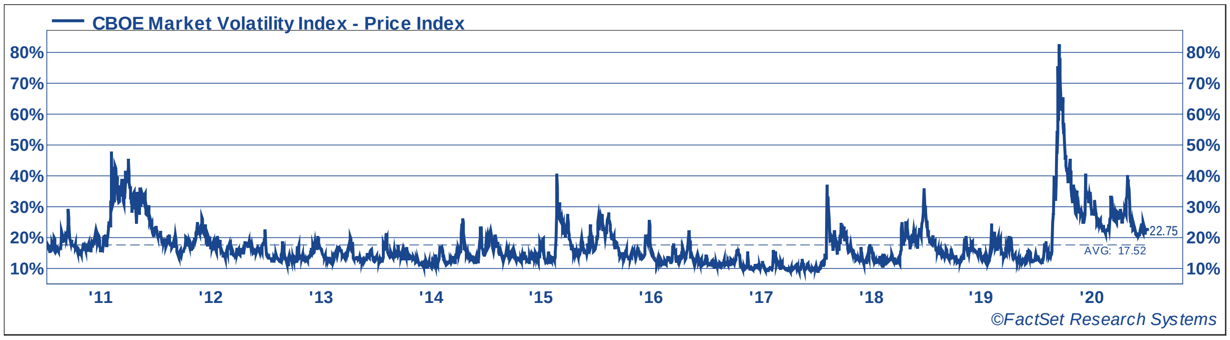
Last quarter, higher credit-risk high-yield bonds markedly benefitted rising +6.5% as credit spreads plummeted to well-below historical averages. As aforementioned, the aggressive actions taken by the Fed last spring and early summer helped to loosen tight financial conditions and stabilize capital markets, which have been functioning normally for quite a while.

Chart 6 – Corporate Credit Spreads



A testament to this capital market normalcy is the robust level of merger and acquisition, bond issuance, and initial public offering (IPO) activity. Companies typically will not pull the trigger on these types of activity during periods of high near-term uncertainty. It is important to note a risk measure that remains surprisingly elevated is the VIX Index which measures expected near-term stock volatility.

Chart 7- VIX Index



Full-year 2020 U.S. economic projections have improved sharply over the past six months. The Fed's first read on the 2020 economy back in June 2020 called for a decline of -6.5% which has since been upgraded twice to -3.7% (September 2020) and -2.4% (December 2020). The Fed's current full-year 2021 and 2022 projections show growth of 4.2% and 3.2% respectively.

While the economy is forecasted to grow at a moderate pace over the next couple of years, the main near-terms risks are related to labor market cyclical issues, the ongoing spread of Covid-19 and related mandates, the deployment and effectiveness of the vaccine(s), the policy initiatives of the incoming administration, and historically high market valuations.

According to FactSet, current S&P 500 Index earnings per share (EPS) growth estimates for 2021, 2022, and 2023 are $165.5, $193.4, and $211.5, respectively. This equates to percentage EPS growth of +22.1%, +16.9% and 9.4%, respectively. For the last 10-years, the average 12-month forward valuation on the S&P 500 Index is 15.9x and the current 12-month forward valuation stands at 22.7x. Stock markets are always forward-looking, but given the identified risks that remain, pricing in three-plus years of earnings growth seems rather exuberant.

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Sources: FactSet, Bureau of Labor Statistics, Mortgage Bankers Association, Federal Reserve, Bureau of Economic Analysis, National Association of Realtors, U.S. Census Bureau, and Federal Housing Finance Agency