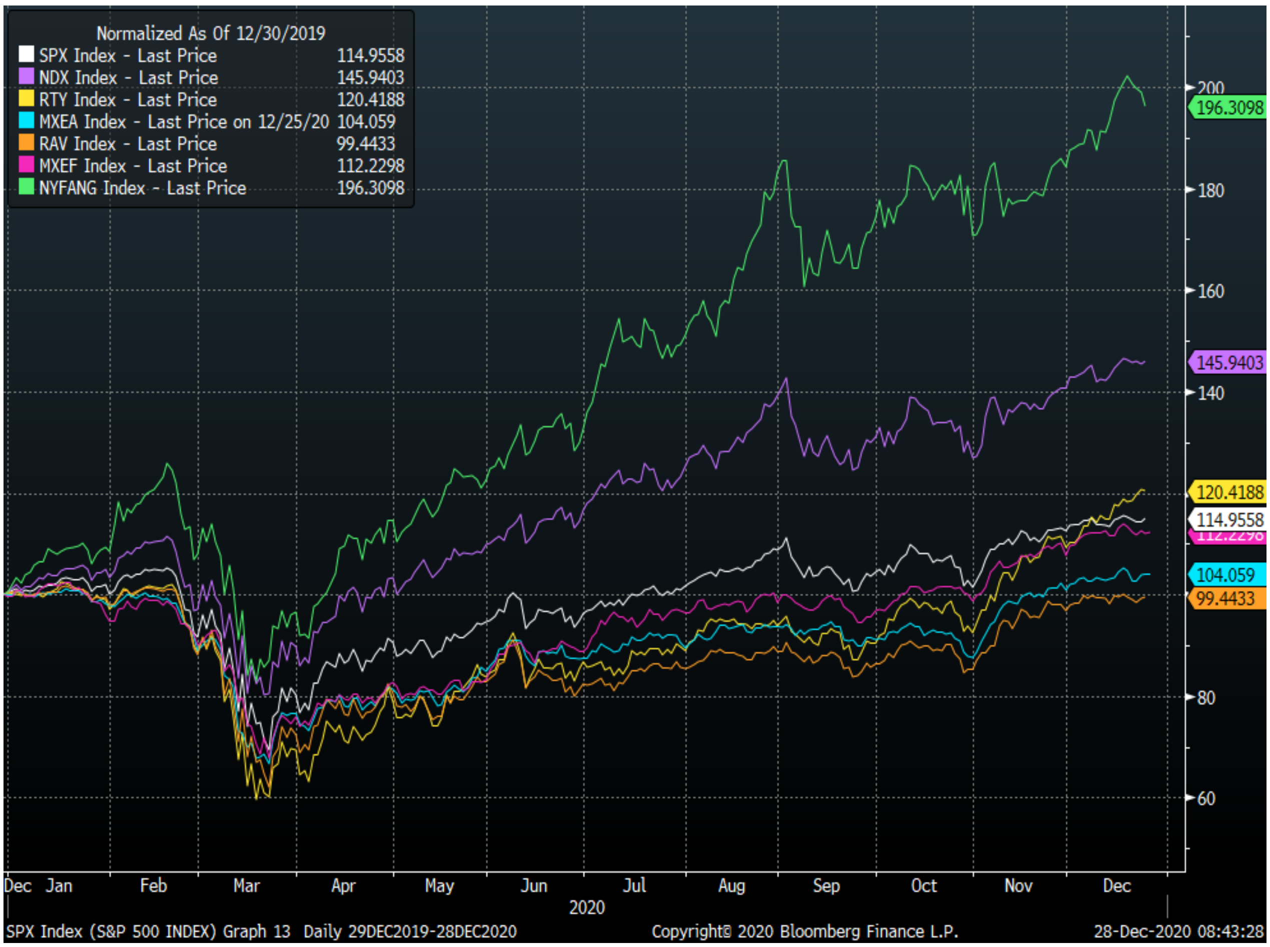
FROM THE DESK OF ERIK OROS

December 2020

In our final letter of 2020, we wrap up a tumultuous year with an eye towards what may shape up to be an equally daunting 2021 in markets. Global markets are poised to end the year in the continued state of Fed induced euphoria that has grown to a crescendo as equities push to new highs. Market breadth, which had eluded the relief rally over the summer has returned with gusto as lagging value and small cap stocks ride the coattails of a reflation trade. While the pandemic remains rampant, optimism over the vaccine has given investors a much-needed light at the end of the tunnel. In this letter we will explore both reasons for continued optimism as well as the multi-factored risks that loom in the coming year.

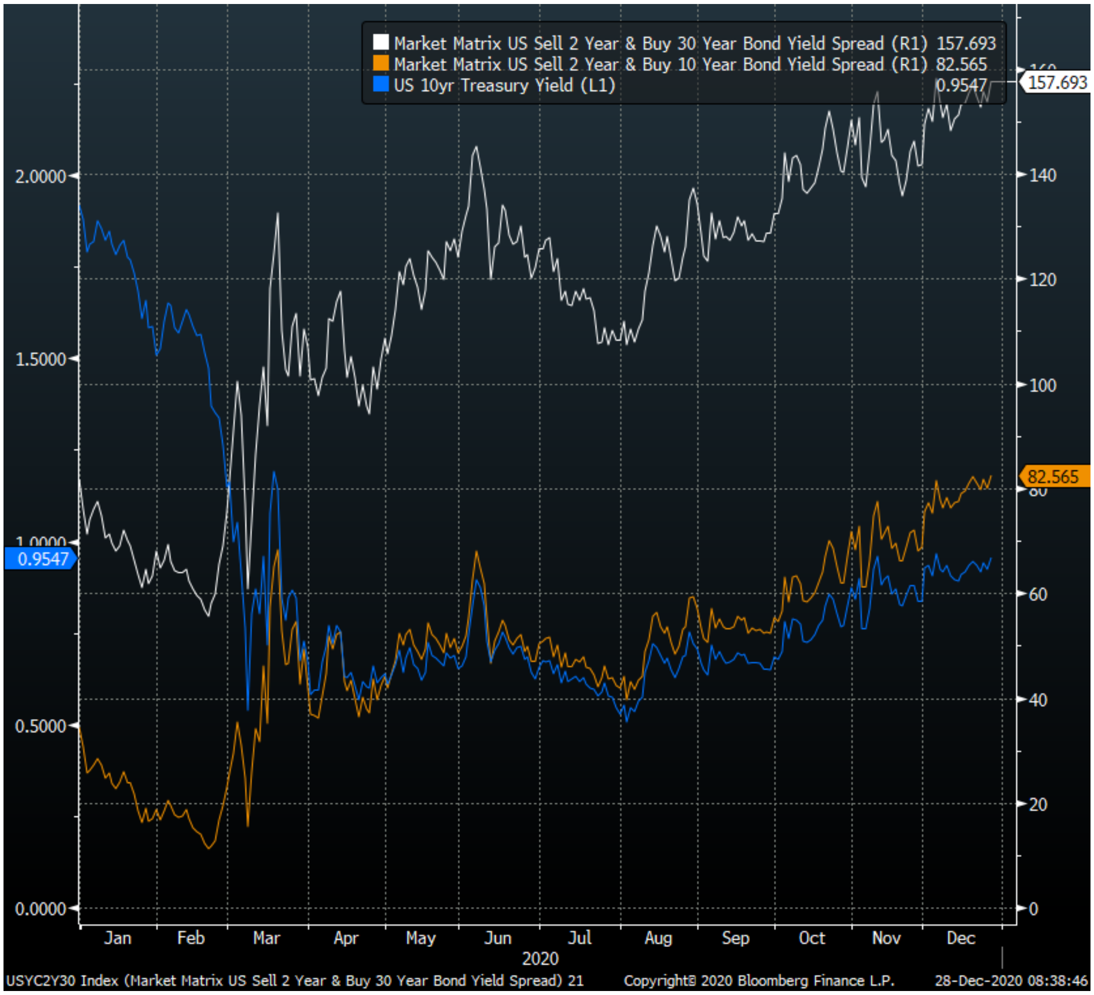
Year to Date Performance of Major Indices



*Past performance does not guarantee future results.

The reasons for optimism around 2020 center around a return of the global economy to growth and normalcy as the effects of the pandemic subside. Economic growth forecasts across both developed and emerging economies remain robust for 2021. With continued vaccine distribution, markets can look forward to relaxation of the shutdown measures that crippled economies for much of 2020. Central banks also remain incredibly accommodative. Interest rates remain near zero or negative, across the developed world, pushing credit spreads lower as well as easing measures remain extended to purchases of corporate credits. This dynamic reinforces the TINA ("there is no alternative") dynamic we have witnessed throughout the year, where equities benefit from the lack of yield in traditional fixed income. Finally, fiscal support remains abundant. Congress is likely to push through a second round of stimulus, potentially followed by even further support from the incoming administration.

US Treasury Curve Spreads



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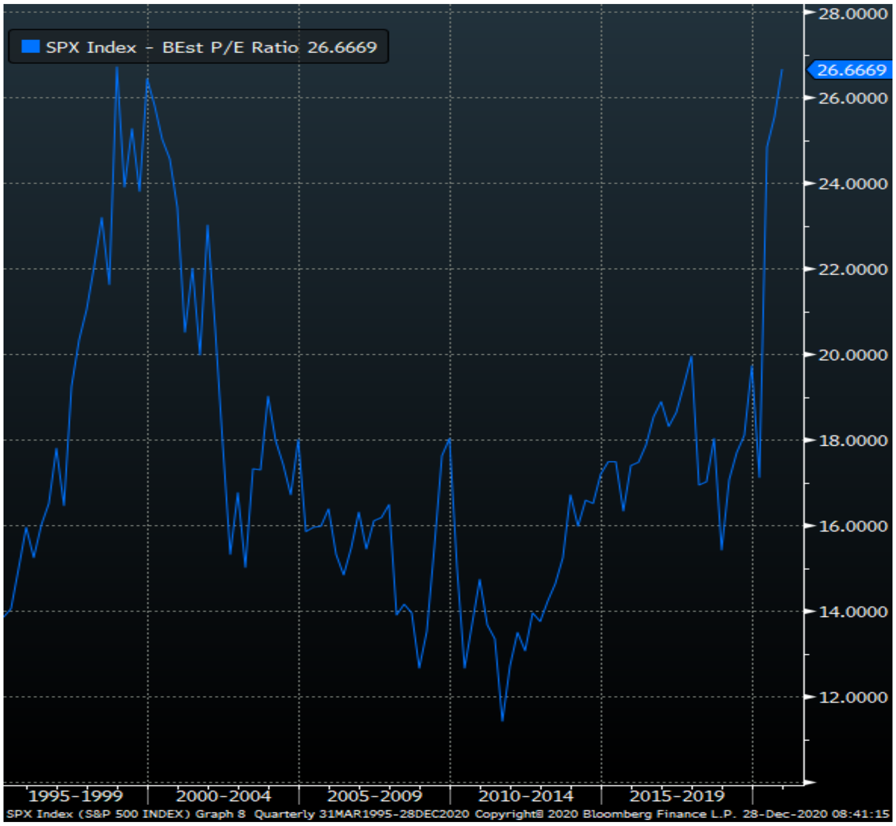
Both fiscal and monetary stimulative measures combined with optimism around lifting of lockdown measures have resulted in robust growth estimates for 2021 earnings. S&P 500 earnings are projected to grow over 22% in 2021, its fastest clip since 2010. While these estimates are certainly encouraging, it is important to note that estimates are subject to revision, and these lofty expectations provide a high bar for companies to deliver in a still very uncertain year ahead. This backdrop coincides with record high valuations on just about any metric. As we have previously pointed out, 2019 was an exceptional year of equity returns but less so from an earnings perspective, with S&P earnings growing just 1.10%. With 2020 earnings expected to fall 8.8%, the double-digit positive price return of 2020 has resulted in multiples that likely reflect the optimism expressed in the coming year's estimates. In all, the S&P has risen 49% since the end of 2018 despite a drop of 7.76% in earnings. This leaves trailing estimates at levels not seen since the dot-com era.

S&P 500 Price to Earnings



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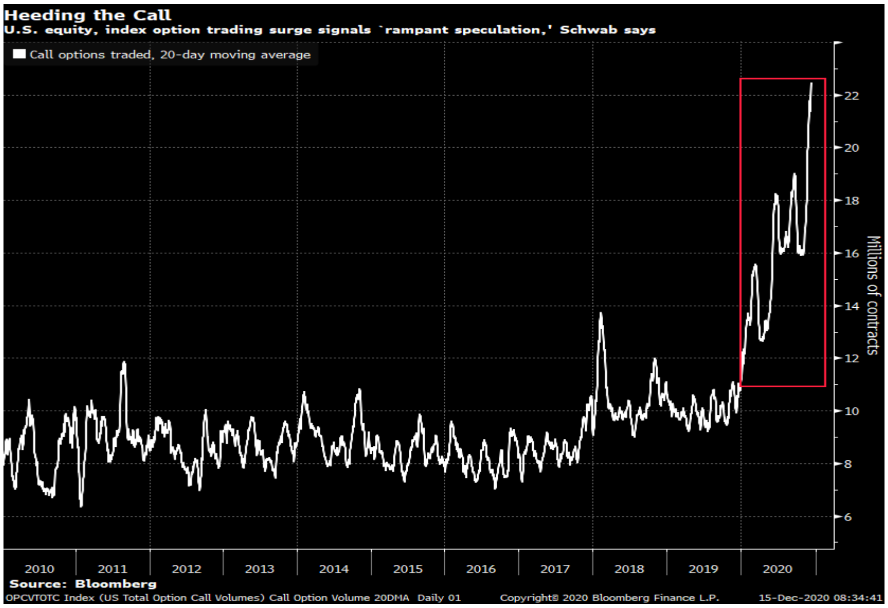
Call Option Activity



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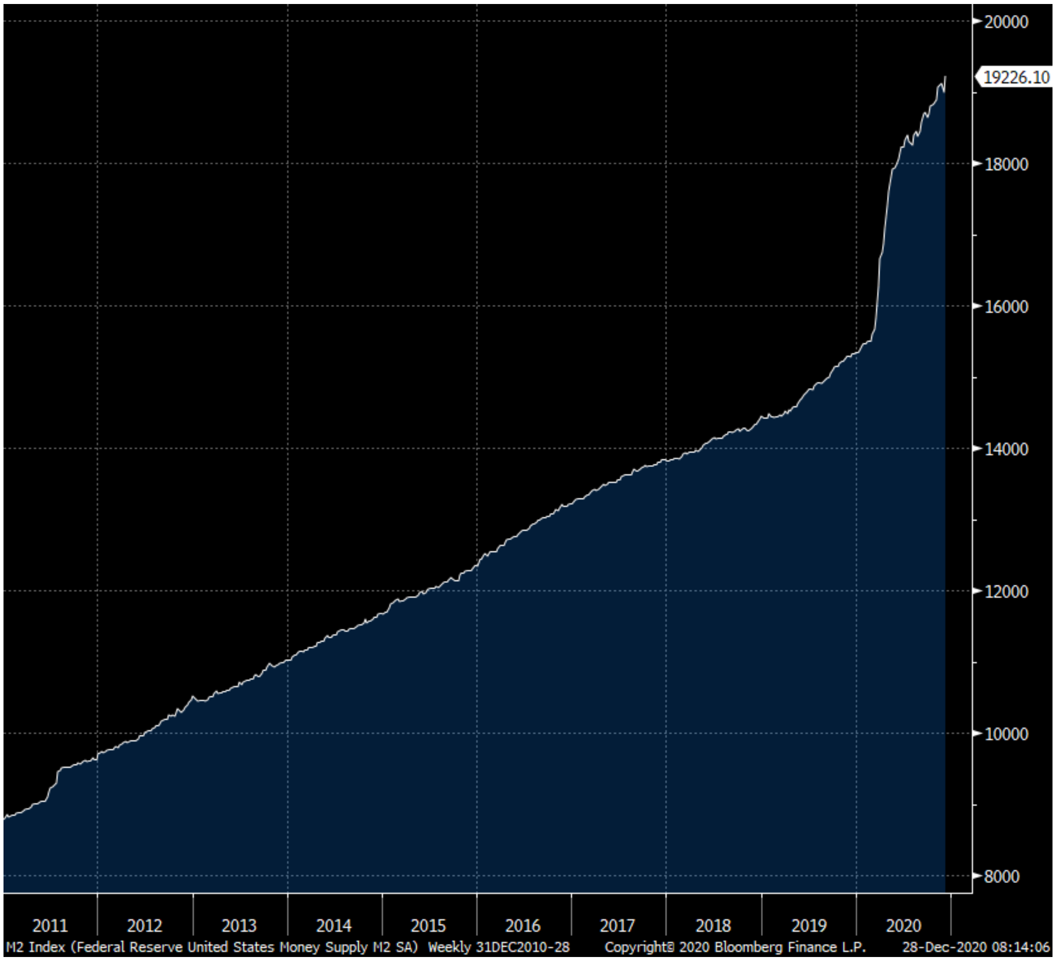
While quantitative easing and the exceptionally accommodative monetary policy measures enacted by central banks have resulted in pronounced appreciation in financial assets, consumer and producer price inflation have remained elusive even as economic growth has returned. Closely monitoring inflation in 2021 will be critical as it is likely to drive the Fed's actions in the coming year. At its current pace of $120bn per month, the Federal Reserve remains committed to continuing to drive forward monetary accommodation. Even with a new mandate announced this summer at Jackson Hole where the Fed shifted its policy framework to allow inflation to "overshoot," any indication that the central bank may begin to reduce its accommodation would be very poorly received by markets. It is important to remember that it was the "Taper-Tantrum" of 2013, rather than the eventual lifting of the Federal Funds rates.

US M2 Money Supply



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The decision for the Federal Reserve to inevitably remove accommodation presents investors with unique challenges. Fixed income investments, particularly treasuries, have traditionally served as a hedge to investor portfolios in times of volatility. If in fact, rates were to move higher because the Fed's hand has been forced by inflation, this scenario likely would result in both equities and fixed income investments performing poorly at the same time. As such, our focus in our allocation models has been to reduce both duration and credit risk in fixed income portfolios, while at the same time focusing equity allocations on those sectors and factors that benefit most from economic growth rather than lower rates. The ability to act tactically in such an environment is as important as ever, and we remain focused on identifying such opportunities for our clients.

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