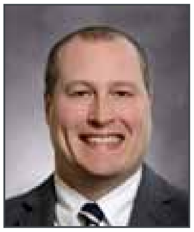
Asset Strategy Consultants

MARKET REVIEW

Fourth Quarter 2020



We are pleased to present *Market Review,* featuring a discussion of the Capital Markets during the Fourth Quarter 2020 and a summary of historical performance for the major asset style passive indices for the period ending December 31, 2020. We hope you find the information useful and helpful in your investment considerations.

We welcome your comments.

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ASSET STRATEGY CONSULTANTS

Founded in 1991, Asset Strategy Consultants provides investment consulting services to institutional clients representing $11.4 billion under advisement. Headquartered in Baltimore, Asset Strategy Consultants has offices throughout the East Coast.

THE MACROECONOMIC ENVIRONMENT

2020—Good Riddance

Most of us are happy to say good-bye to 2020. And, there are reasons for optimism as we head into 2021. These include a roll-out of vaccinations, probable fiscal stimulus on top of the recently passed package, and pent-up demand from consumers in addition to lean inventories that will need to be rebuilt. Further, a last-minute Brexit deal thwarted uncertainty on that front (though it will take time to iron out the details) and a contentious U.S. election is nearly behind us.

That said, for those of you who would self-categorize as “glass half empty” folks, there is plenty of fodder to support that sentiment. A new super-contagious coronavirus strain has emerged, hospitals are struggling with capacity, important pockets of the economy remain depressed, and the inequality gap continues to worsen.

Markets seemingly defied much of the anguish imposed on society during the year, leaving some to question whether they are “priced to perfection.” After the precipitous sell-off in the spring, risk assets have rallied with some U.S. stock indices hitting record highs going into year-end and yields on high yield bonds reaching record lows. As a result, investment return projections leave little room for enthusiasm.

Third quarter real GDP rose 33.4%, a record quarterly increase, following the 2Q20 record drop of 31.4% (both annualized). As of Sept. 30, the year-over-year decline was 2.8%. Fourth quarter and 2021 GDP projections vary and are dependent on the degree to which lockdowns are reinstated, the timeline for broad distribution of a vaccine, and the nature and timing of additional fiscal and/or monetary stimulus. The Conference Board estimate for 4Q real GDP is 2.8% (annualized), bringing its full-year estimate to -3.6%. Broadly, projections for 2021 growth generally fall between 3.5% and 4.0%. The recent passage of the aptly titled Coronavirus Response and Relief Supplemental Appropriations Act provides a needed boost, but many economists feel that more is needed. The roughly $900 billion package includes more aid for small businesses, an 11-week extension of federal unemployment benefit programs with an additional $300 per week, and a $600 stimulus payment for

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qualified individuals. Notably, aid for states and municipalities was not included.

The unemployment rate, which peaked at 14.7% in April, fell to 6.7% in November. However, 22 million jobs were lost from February to April, while only 12 million have been added since. Lower-income, less-skilled, and tourism-related jobs have been the hardest hit, increasing concerns about the widest income inequality gap in history, further fueled by climbing stock prices. On the hopeful front, the need to replenish low inventory and a positive outlook for capital spending may support employment growth in coming months.

The Federal Reserve Board left its Fed funds target rate unchanged (0.00% to 0.25%) at the December meeting and reiterated its belief that the course of the economy depends on the pandemic, which continues to “pose considerable risks to the economic outlook over the near term.” It further committed to continue monthly purchases of both U.S. Treasuries ($80 billion per month) and mortgages ($40 billion per month) for the foreseeable future. Current projections remain for no hikes until 2023.

Concerns over the Fed’s ballooning balance sheet, approaching $8 trillion, as well as expectations for increased stimulus, have fueled worries over future inflation.

While year-over-year inflation remained low (CPI: +1.2%; Core: +1.7% as of November), the breakeven spread for 10-year Treasury Inflation Protected Securities widened to 2% at year-end, the highest since 2018 and sharply higher than the 0.5% level hit in March 2020. Concerns over the Fed’s ballooning balance sheet, approaching $8 trillion, as well as expectations for increased stimulus, have fueled worries over future inflation. The Congressional Budget Office projects that the 2020 U.S. fiscal deficit will be roughly 15% of GDP, the largest since 1945.

Outside of the U.S., recoveries have been mixed with Asian countries being the furthest along. Purchasing Manager Composites, which gauge activity in both manufacturing and services, remain at or below 50 (signaling contraction) in many areas (Japan, the U.K., and the euro zone). According to projections from the Organization for Economic Cooperation and Development (OECD), several countries are expected to experience real GDP declines for 2020 of roughly 10% (U.K., Argentina, France, Italy, Mexico, and India); China is an outlier at +1.8%. At its December meeting, the OECD released its new predictions: -4.2% in 2020 and +4.2% for 2021. While the 2020 forecast is slightly improved from the -4.5% September projection, the 2021 outlook has worsened (from 5.0%). China (+8.0%) and India (+7.9%) have the brightest prospects for 2021, according to the OECD.

Renewed lockdowns were announced throughout Europe and the U.K. as post-Thanksgiving cases rose. Exacerbating the situation, a new super-contagious variant of the virus emerged in the U.K. and has since spread to more than 30 countries. Plans for distributing vaccines were in the works as the year ended, but timing remains uncertain. In recognition of the continued pandemic toll on economies, the European Central Bank announced that it will increase the size of its asset purchases by €500 billion to a total of €1.85 trillion ($2.21 trillion) and will continue asset purchases at least through March 2022. With respect to Brexit, the last minute “EU-UK Trade and Cooperation Agreement”—passed on Christmas Eve—paves the way forward but leaves much uncertainty. While hotly debated issues around fishing and the border in Northern Ireland were resolved, the agreement does not cover the financial services sector, an industry with one of the largest trade surpluses in the U.K. Further, implementation is likely to cause some disruptive snags given new customs and regulatory checks, and many details still need to be worked out—including a trade deal with the U.S. ■

EQUITY MARKETS

U.S. stocks continued their upward trajectory in 4Q20, and the S&P 500 Index hit a record high going into year-end. The Index was up 12.1% for the quarter, bringing its 2020 gain to 18.4%. Since the market low in March, the benchmark is up over 70%, with all sectors posting increases greater than 40%. The quarter's winner, Energy (+28%), however, remains down 34% for the year. Technology (+12% in 4Q) was the best-performing 2020 sector with a 44% gain. Laggards for the quarter and the year were Utilities (+7%; +1%) and Real Estate (+5%; -2%). The pandemic has cast a pall over certain sectors while rewarding others; online retail stocks soared 69% in 2020, but hotels/cruise lines, airlines, and retail REITs dropped roughly 30%. Megacaps continue to account for a disproportionate amount of the index and returns; the five largest stocks (Apple, Microsoft, Amazon, Facebook, Alphabet) made up 22% of the S&P 500 Index as of 12/31, and for 2020, this group accounted for 12.1% of the 18.4% Index return. In 4Q, value outperformed growth across the capitalization spectrum but trails by a significant margin for the full year. Small cap value (R2000 Value: +33.4%) was the best-performing style group for the quarter but its 2020 gain is a mere 4.6%. Small cap outperformed large for the quarter (R2000: +31.4%; R1000: +13.7%) but 2020 performance was roughly even (+20.0%; +21.0%).

Developed ex-U.S. and emerging market indices (MSCI ACWI ex-USA: +17.0%; MSCI Emerging Markets: +19.7%) also posted robust returns for the quarter and the year (+10.7%; +18.3%). Double-digit returns were broad-based across both developed and emerging market countries for the quarter.

The U.S. dollar continued to weaken versus developed and emerging market currencies. Relative to a basket of developed market currencies, the greenback lost just over 4% for the quarter and more than 7% for the year. While emerging market currencies broadly rallied in 4Q, some have not recovered from poor performance earlier in the year. ■

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FIXED INCOME MARKETS

U.S. Treasury yields rose steadily over the course of 4Q; the 10-year U.S. Treasury yield closed the quarter at 0.93%, up 24 basis points from Sept. 30, but off sharply from the year-end level of 1.92%. TIPS (Bloomberg Barclays US TIPS: +1.6%) strongly outperformed nominal U.S. Treasuries for the quarter as 10-year breakeven spreads widened from 163 bps to 199 bps. The Bloomberg Barclays US Aggregate Bond Index gained 0.7%, bringing its 2020 gain to 7.5%. Corporates strongly outperformed U.S. Treasuries for the quarter and the year (Bloomberg Barclays US Treasury: -0.8%; +8.0%; Bloomberg Barclays US Corporate: +3.0%; +9.9%) in spite of record 2020 issuance. High yield corporates (Bloomberg Barclays High Yield: +6.5%; +7.1%) outperformed investment grade for the quarter but trailed for the year. High yield default rates (6.2% y-o-y as of December) continued to trend higher but are expected to peak far below levels reached in the Global Financial Crisis. Separately, municipal bonds (Bloomberg Barclays Muni Bond Index: +1.8%; +5.2%) outperformed U.S. Treasuries for the quarter but trailed for the year.

Outside of the U.S., broad-based U.S. dollar weakness dampened hedged returns for the quarter. The Bloomberg Barclays Global Aggregate Bond Index rose 3.3% (unhedged) and 0.9% (hedged). Emerging market debt indices posted solid results in the risk-on environment (EMBI Global Div: +5.8%; GBI-EM Gl Div: +9.6%) with emerging market currencies doing especially well; full-year returns are now in positive territory (+5.3%; +2.7%). ■

REAL ASSETS

Real assets posted strong returns in 4Q though most indices remain in the red for the full year. The Bloomberg Commodity Index gained 10.2% and the more energy-heavy S&P GSCI Index rose 14.5%. Full-year returns for these indices are -3.1% and -23.7%, respectively. Gold took a breather and was roughly flat for the quarter but is up over 20% for the year. Oil prices continued to recover from the spring plunge; Brent Crude closed the year at over $50, a sharp increase from the $20 level hit in April. The Alerian MLP Index benefited, gaining 32.4%, but it is down nearly 30% for 2020. REITs also did well during the quarter but fell over the year (FTSE Nareit: +11.6%; -8.0%). TIPS (Bloomberg Barclays TIPS: +1.6%; +11.0%) outperformed nominal Treasuries for the quarter and the year. ■

CLOSING THOUGHTS

Few are wistful over the end of 2020 as we hope for a more “normal” 2021 with respect to both personal and work lives. At the same time, markets seem fully priced and return expectations across asset classes are muted. Yields in U.S. fixed income remain unquestionably meager, with some questioning whether the asset class can play the role it has traditionally served. Negative-yielding debt has reached epic levels—the market value of the Bloomberg Barclays Global Negative Yielding Debt Index hit $18 trillion in December with just under 30% of the world’s investment grade debt yielding less than 0%. Real yields on cash are the lowest since 1830 (according to data from JP Morgan). Stock valuations are also lofty, and market leadership, especially in the U.S., has been unquestionably narrow with momentum being a key driver of relative results. This paints a challenging backdrop for our clients, yet ASC’s advice remains to adhere to a disciplined investment process that includes a well-defined long-term asset allocation policy and, if applicable, to understand the risks undertaken to improve expected investment returns. ■

Source: Asset Strategy Consultants and Callan Associates

PRELIMINARY RETURNS FOR VARIOUS PERIODS: 4Q20

		October	November	December	Last Quarter	Year to Date	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
EQUITY	1 Russell:3000 Index	(2.16)	12.17	4.50	14.68	20.89	20.89	14.49	15.43	13.79	9.98
	2 Russell:1000 Index	(2.41)	11.78	4.23	13.69	20.96	20.96	14.82	15.60	14.01	10.07
	3 Russell:1000 Growth	(3.40)	10.24	4.60	11.39	38.49	38.49	22.99	21.00	17.21	12.54
	4 Russell:1000 Value	(1.31)	13.45	3.83	16.25	2.80	2.80	6.07	9.74	10.50	7.34
	5 Russell:Midcap Index	0.64	13.82	4.68	19.91	17.10	17.10	11.61	13.40	12.41	9.77
	6 Russell:Midcap Growth	0.12	13.43	4.80	19.02	35.59	35.59	20.50	18.66	15.04	11.55
	7 Russell:Midcap Value	0.93	14.04	4.63	20.43	4.96	4.96	5.37	9.73	10.49	8.31
	8 Russell:2500 Index	1.81	16.29	7.61	27.41	19.99	19.99	11.33	13.64	11.97	9.55
	9 Russell:2500 Growth	1.18	14.56	8.60	25.89	40.47	40.47	19.91	18.68	15.00	11.79
	10 Russell:2500 Value	2.26	17.50	6.95	28.51	4.88	4.88	4.34	9.43	9.33	7.47
	11 Russell:2000 Index	2.09	18.43	8.65	31.37	19.96	19.96	10.25	13.26	11.20	8.91
	12 Russell:2000 Growth	0.76	17.63	9.35	29.61	34.63	34.63	16.20	16.36	13.48	10.69
	13 Russell:2000 Value	3.58	19.31	7.92	33.36	4.63	4.63	3.72	9.65	8.66	6.92
	14 S&P:500	(2.66)	10.95	3.84	12.15	18.40	18.40	14.18	15.22	13.88	9.88
	15 S&P:400 Mid Cap	2.17	14.28	6.52	24.37	13.66	13.66	8.45	12.35	11.51	9.55
	16 S&P:600 Small Cap	2.58	18.17	8.32	31.31	11.29	11.29	7.74	12.37	11.92	9.44
	17 MSCI:ACWI ex US	(2.15)	13.45	5.41	17.01	10.65	10.65	4.88	8.93	4.92	4.89
	18 MSCI:EAFE	(3.99)	15.50	4.65	16.05	7.82	7.82	4.28	7.45	5.51	4.48
	19 MSCI:EM	2.06	9.25	7.35	19.70	18.31	18.31	6.18	12.81	3.63	6.59
	20 MSCI:ACWI	(2.43)	12.33	4.64	14.68	16.25	16.25	10.06	12.26	9.13	7.20
FIXED INCOME	21 Blmbg:Aggregate	(0.45)	0.98	0.14	0.67	7.51	7.51	5.34	4.44	3.84	4.49
	22 Blmbg:Gov/Credit	(0.60)	1.34	0.09	0.82	8.93	8.93	5.97	4.98	4.19	4.64
	23 Blmbg:Credit	(0.22)	2.55	0.46	2.79	9.35	9.35	6.80	6.44	5.40	5.60
	24 Blmbg:Corporate High Yld	0.51	3.96	1.88	6.45	7.11	7.11	6.24	8.59	6.80	7.50
	25 Blmbg:Municipal Bond	(0.30)	1.51	0.61	1.82	5.21	5.21	4.64	3.91	4.63	4.45
	26 Blmbg:US TIPS	(0.65)	1.12	1.15	1.62	10.99	10.99	5.92	5.08	3.81	4.31
	27 Blmbg:Glob Agg ex USD	0.46	2.38	2.17	5.09	10.11	10.11	4.23	4.89	1.99	3.69
	28 S&P:LSTA Levg Loan	0.20	2.23	1.35	3.81	3.12	3.12	4.01	5.24	4.31	4.61
	29 ML:US Treasuries 1-3 Yrs	(0.04)	0.05	0.05	0.05	3.10	3.10	2.74	1.90	1.30	2.25
	30 LIBOR - 3 Month	0.02	0.02	0.02	0.06	0.64	0.64	1.78	1.47	0.89	1.59
	31 3 Month T-Bill	0.01	0.01	0.01	0.03	0.67	0.67	1.60	1.20	0.64	1.23
REAL ASSETS	32 Blmbg:Commodity TR Idx	1.41	3.51	4.97	10.19	(3.12)	(3.12)	(2.53)	1.03	(6.50)	(4.01)
	33 GS Commodity Index	(3.57)	12.04	5.97	14.49	(23.72)	(23.72)	(8.21)	(1.85)	(8.76)	(7.75)
	34 MSCI:US REIT Index	(2.59)	10.77	3.35	11.52	(7.57)	(7.57)	3.54	4.84	8.30	6.50
	35 Alerian:MLP Index	4.38	23.78	2.51	32.45	(28.69)	(28.69)	(12.69)	(5.95)	(2.31)	3.60
	36 DJB:Glbl Infrastructure	(1.59)	9.24	(0.22)	7.27	(6.97)	(6.97)	3.33	7.53	8.15	8.38
	37 US DOL:CPI All Urban Cons	0.04	(0.06)	--	--	--	--	--	--	--	--

Source: Callan Associates