INVESTMENT PARTNERS ASSET MANAGEMENT

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2021 INVESTMENT TRENDS, OPPORTUNITIES, & CHALLENGES

"Most human beings have an almost infinite capacity for taking things for granted."

Aldous Huxley, Brave New World

As we put 2020 in the rear-view mirror, 2021 offers promise, hope and progress.

Seems Like Old Times

When we penned our forecast this time last year, we felt we were already living in a bit of a surreal environment where, perhaps, narrative trumped reality, opinions were too often accepted as truth, and overall sentiment in the Nation was positive (despite several mixed economic indicators). At the beginning of 2020, acceptance and complacency were widely evident in the US securities markets. By comparison to the rest of the world, our equity markets' prior performance led global investors to continue to conclude that the US remained a stand-out exception. It was a bit reminiscent of Aldous Huxley's Brave New World where **"one believes things because one has been conditioned to believe them."**

The feeling of complacency was bolstered by the perception that de-stabilizing events (whether they be heated tensions in the Mid-East, a response to sanctions and restrictive trade policies, the potential for military incursions, or an act of terrorism, etc.) were improbable. The markets were further buoyed by the feeling that a potential slowdown in the economy could be dealt with easily by a dovish Federal Reserve.

Few could see what was yet to come – namely, the Covid-19 coronavirus. A novel virulent virus, born in China, would spread throughout the world, and become a pandemic. As we all now know, Covid-19 became (and remains) a health crisis of monumental proportions that has changed the way we live, work, and interact with one another. While we are confident the world will ultimately recover from this disruption, the ripple effects are likely to be felt for many years to come.

The past year also saw the election of a new US President, anger and divisiveness in Congress, disagreement on stimulus funding, and uncertainty as to the distribution of vaccines to immunize the population. Despite all of the acrimony, in a number of material ways, the government did still manage to keep the economy (and the markets) moving. The accommodative Federal Reserve provided unprecedented amounts of liquidity (particularly through its zero-percent interest rate policy). Similarly, Congress passed two enormous fiscal packages providing trillions of dollars in economic stimulus. The positive outcome? U.S. common stocks traded near all-time highs, and unemployment, while spotty and lagging, gradually improved. The negative outcome: U.S. debt and deficits also hit record highs. The level of publicly held US debt continued to grind closer and closer to $30 trillion, as the US clocked a nearly $3.5 trillion budget deficit in a single year. As our domestic debts mount, the dollar naturally lost some of its luster, falling some 13% against the Euro in 2020.

Internationally, in 2020 global economic growth stagnated in both developed and emerging markets due to the pandemic and stalemate of trade wars between the U.S. and China. Much of the world outside the US is still dealing with the pandemic by strict adherence to lockdowns, testing and tracing. However, there is a silver lining there as well. Foreign central banks have also taken an extremely dovish stance, and the Eurozone has enacted several fiscal-stimulus measures to bridge the gap to economic recovery. Confidence is slowly picking up steam, particularly in Europe, along with optimism of a reopening at some point in 2021.

Forecasting Ability

We have long felt that future direction is embedded in signals. Markets synthesize all available information and display collective perceptions. What the markets seem to be conveying to us today is a message of hope based on the belief that science and technology are the pathways to progress on many fronts (including confronting and conquering Covid-19.) As 2020 fades away, the stage is set for an expected rebound in global economic activity and a return to normalcy at some point this year. While we concur with this interpretation, we also think it is critical that we understand the context of conventional wisdom. As such, we need to consider alternative outcomes so that we can advise our clients how to invest for the potential challenges that lie ahead…and, yes, there are still challenges.

In prior years when we did our annual economic and market forecasts, we could assign probabilities to various events and act accordingly. The process would begin by assembling and collecting lots of data, plotting charts, building a hypothesis, constructing a base case, and weighing the factors likely to impact asset prices as we built our allocation models. We then constructed portfolios and chose investments to achieve an acceptable risk-adjusted return. As the year progressed, we would be either more or less confident based on anticipating the market's reactions to events. With new information we act accordingly. The emergence of a 1 in 100-year event alters this normal discipline. Like a lightning bolt from out of the blue, Covid-19 reminded us that exogenous shocks can and do disrupt even the best laid plans.

Outlook for the Upcoming Year

In 2021, we begin a new decade with different challenges and uncertainties from the previous one. Trying to create forecasts has a different feeling than in prior periods. Not only is there a new President, but there are philosophical policy differences with moral and ethical underpinnings that reach deep into the American psyche. The pandemic and the global response are influencing how we deal with risk. We are used to dealing with uncertainty even though the picture is often hazy. This year, though, has the potential for surprises and outcomes with pronounced consequences for those considering where to invest client assets.

Perhaps the most important question is: Will the newly developed vaccines and therapies be sufficient to arrest the spread of Covid-19? Other important questions are: Will world leaders see this as an opportunity for cooperation in the interest of humanity? Where will the money come from to repair the economic harm done by the disease? In this context, will a new form of capitalism emerge in an interdependent world where income and wealth inequality are real societal problems? Will there be realignments of sovereign relationships, militarily, economically, and societally. And finally, will countries agree that Climate Change is a real and growing risk, and a threat to global economic growth and environmental stability?

This year, there is consensus.

We expect that an economic expansion will develop during 2021, even if it is at a slower pace than we may hope. The consensus is that as long as consumers spend, businesses reopen, and some degree of civility and respect are restored, the economy can recover, and markets can be expected to (continue to) perform. We expect, as time goes on, faith in institutions and the people that manage them will also be required to re-build confidence. With half the country currently conditioned to mistrust the other half of the country, this task may take longer than a year. Beyond simply addressing the market's issues, policy makers will need to focus on how to deal with those who have lost their jobs, face eviction, have no health care, and are suffering in ways that perhaps Wall Street ignores by not taking these issues into account.

Nevertheless, surveys from brokerage houses are by and large bullish about a recovery, and we tend to agree with that assessment. Few, if any, are waving caution flags though, and that may be where we differ.

Set against this backdrop, below are our predictions for 2021:

As in previous years, some of the predictions are of a macro nature and have societal as well as economic and political implications. It is not likely that all our predictions will occur, but when taken as a whole, we have modest positive expectations for overall returns from financial assets for the full year 2021.

<u>First Forecast</u>:

After a chaotic 2020, where almost all domestic investment markets snapped back from the March lows, our base case is for total returns of 6% to 7% from a portfolio of 75% equities and 25% fixed income instruments by year end in 2021 as investors navigate an economy in recovery mode. ***(Bear in mind that such a portfolio may or may not be appropriate for a particular investor based on his or her risk tolerance and objectives).*** **We believe that the gains of the first six months might be hard to achieve because they are predicated on business re-openings, widespread distribution of vaccines, and normalized consumer behavior. We believe that by the second half of 2021, gains in the equity markets could be easier to come by.**

We see the year divided into two different time periods:

The first six months may appear to be a continuation of the type of environment that existed at the end of 2020 when the Federal Reserve remained committed for the foreseeable future to pull forward demand by increasing the money supply and liquidity for as long as it would take to eradicate the economic effects of the pandemic. The optimistic scenario for the first half also assumes that a new Presidential Administration in the White House is prevented from enacting some of the more extreme progressive policies and, at the same time, is able to get the virus under control.

While Covid-19 cases are currently surging, much will depend on the rollout of vaccines and the establishment of so-called *herd immunity*. This, in our view, is a mighty task. More likely, in our opinion, is an *initial period* where bottlenecks in vaccine distribution develop, Congress becomes less willing to provide continued stimulus, businesses continue to shutter, consumers wait to find out whether the two-part vaccine works, and the Senate fails to cooperate with the New Administration.

In 2020, investors were willing to accept the narrative that massive injections in liquidity and stimulus were required. The increase in liquidity was meant to make consumers feel the urge to spend and investors to take on more risk. The latter certainly occurred in 2020, inflating equity valuations. So now companies have the daunting challenge of showing that they can and will grow into their new earnings and revenue multiples. With stock prices at high valuations on a historical basis, this may make future equity returns tougher to achieve until that expected growth materializes.

Further, it seems that market participants may, again, be too complacent to face certain realities. Since everyone appears to be benefitting from the oddity of the markets, there doesn't appear to be much motivation to seek a different "truth". As a prime example, no one is currently asking how we expect to pay down the trillions of dollars in debt created in the past year while Government receipts continue to remain low. Nor is anyone focusing on what happens when our national debt eventually soars to 200% of GDP within 10 years. The inattention to the deficit and the lack of attention to the possible buildup of inflationary biases will become debate points by late summer if not sooner.

Once the end of the Covid-19 crisis is clearly in sight, we believe that the time for answering those questions will develop in the second half of 2021. We also believe that the year promises to be volatile and likely will experience a pull back at some point, giving up some portion of the gains markets experienced in 2020, before recovering.

Second Forecast:

Interest rates and growth in GDP will require continual vigilance, because they could shock to the upside.

As we begin 2021, the accepted meme is that central banks around the world will remain dovish, with yields rising ever so slightly on the back of a recovery in global growth. Investors are accepting as a given that the yield on the ten-year US Treasury will be only slightly upwardly biased and range-bound between 0.75% and 1.50% for the first six months of 2021. It is also expected that inflation will remain low (under 2%). However, rates could move outside of the expected band if it is *perceived* that the recovery may take hold quicker than anticipated, (i.e. the consumer can sustain the economy until businesses reopen, the job market improves, wage gains pick up, capital remains plentiful, productivity gains are adequate, and liquidity is abundant). A favorable economic outcome would, of course be welcomed, but upward pressure on long dated interest rates (and downward pressure on long-dated fixed income) could cause a re-pricing of risk assets. Simply put, interest rates on the 10-year US Treasury bond trending closer to 2% (rather than 0.75% to 1.50%) during 2021, could stymie the rapid ascent of US equities and real estate.

Third Forecast:

Related to the previous forecast, there is a consensus view that domestic inflation will remain muted (sub 2%), for all of 2021 because of downgrades to global GDP growth forecasts and continued low interest rates. We believe that inflation risks are, perhaps, under appreciated. If the economy were to boom, there would likely be a rise in inflation expectations. Fewer trade tariffs and restrictions in developed and emerging markets also support higher inflation dynamics abroad.

Our base case assumes that the Federal Reserve has pursued a more liberal stance when setting its inflation targets and is committed now to support overshooting its 2% aim for years to come. We have entered a new era where assistance from Government is the norm. The issue that is unfolding in 2021 is: Who gets the bill for all the stimulus created in the past two years?

When we layer on the ambitious liberal spending plans of the newly elected Administration on top of fiscal deficits for years to come, there is a growing realization that without revenue sources such as taxes, the US runs the risk that its financial standing could be diminished.

Infrastructure spending, likely to occur in 2021, would go a long way toward spurring employment and growth – but also tends to be inflationary. We therefore are suggesting exposure to a global risk-premium through investments in inflation-oriented securities and/or certain commodities such as gold or silver.

Fourth Forecast:

One of the great uncertainties in 2021 is how the Biden Presidency will govern with a divided Congress. We predict that each party will feel each other out, with Republican boundaries and Democratic policies colliding initially. Surprisingly, though, we believe Congress will ultimately agree on certain big-picture initiatives by the end of 2021.

While Conservative Republicans continue to carry the mantle of the previous Presidential Administration, Progressive Democrats expect to change the political landscape over the next four years with extreme stances on taxation and regulation. In the end, we believe that Democratic control of the White House and the House of Representatives, and Republican control of the Senate will, at some point, be less contentious in a Biden Administration as common-ground issues are debated. (As we write this, a run-off election is being held in Georgia which would determine whether Republicans do indeed maintain control of the Senate).

In our opinion, neither party will want to engage in encouraging more divisiveness, and they will come to the realization that extremism is not good for the country, for the citizenry, or the common good. Areas of agreement could be reached in infrastructure development, trade policies, and labor initiatives, to name a few. From a market perspective, it is generally viewed that political gridlock is a favorable outcome because no major policy changes can take place. In our opinion, *cooperation* from both parties centered around common-sense economic policies, without recrimination and divisiveness, is an even better result – although it depends upon *forced collaboration* in a split Congress.

The wild card, currently, is whether the Georgia run-off election puts control of the Senate in the hands of the Republicans or the Democrats. It should be noted that in the event the Democrats control the Presidency and both houses of Congress, markets may react negatively, at least initially, due to the potential for increases in taxation and regulation without checks and balances by the Republican Party. On the other side of the coin, a Democratic dominated government might be more inclined to continue stimulus initiatives, which perhaps could have the short-term effect of economic stability during the recovery from a Covid-19 recession.

Speaking more broadly, however, the outcome of this Senate race is of critical importance because it will define the direction of the country, and government's societal role, in the short-to-intermediate term.

Fifth Forecast:

While China remains focused and committed to its strategic goal of technological domination and adoption of its "Made in China 2025" policy, the US needs to determine how to deal with the next phase of Chinese growth. In 2021 we believe that China will recognize that they need to attract foreign capital and provide access to their consumer society. We therefore expect a willingness to consider some minor concessions in return for tariff relief.

China is a controlled economy - a capitalist autocracy, not a democracy. Perhaps the central geopolitical question facing the US is whether we are willing to share, and in certain instances cede, political and economic power in the short run to China in exchange for more normalized behavior and greater reliance on international rule of law.

We have always believed that democracies have been the friendliest environment for trade and commerce. It is in our DNA that political freedom aligns with personal economic freedom. As an example, look no further than the success of Hong Kong. Markets with fewer restrictions and intelligently applied regulations have thrived. China does not yet appear to know how to manage its economy without the onerous imposition of arbitrary and capricious taxes and regulations. As China tries to replace its reliance on overseas consumers to fuel and sustain growth with its own population's consumerism, there appears to be a need to relax some controls over its citizens. To fund this transition, it has decided to financially leverage the economy while restricting, or in some cases forbidding, foreign access to their capital markets. Now there is a growing realization that a dramatic slow-down in global trade will affect China and impede it from reaching its strategic ambitions in the near-term.

This setback produces a blow to their national pride and is a source that could lead to political uncertainty for their leaders. As important, China is not quite ready militarily, to exert its will, particularly in the South China Sea. So, it will be interesting to watch throughout the year whether trade negotiations result in meaningful concessions and reforms or a continuation of an economic cold war. The Biden Administration will take on the challenge of how to deal with China while the World watches for signs of either hostility or cooperation.

Sixth Forecast:

There will be an attempt to restore some form of globalism and the "New World Era." A globally integrated world economy was assumed to work in the best interests of all the participants. The focus was on the economic aspects of geopolitics. The theory held that competition could be replaced or supplemented by cooperation. National Security was inseparable from economic security. Each country could prosper, if the US and other superpowers could focus less on geographic control, maintain détente militarily, and permit and promote trade.

Ian Bremmer of the Eurasia Group has defined globalization as one of the most important features of the post-world-war landscape - with people, ideas, goods and capital moving faster across borders around the planet. This acceleration has created extraordinary wealth and opportunity, fostered global equality, reduced poverty, extended lifespans, and supported peace and prosperity.

With the US encouraging a decoupling and withdrawal from the world stage we are now at an inflection point. Our Military withdrawal from the Mideast, destabilizing Europe by diminished support of NATO, and the tearing down of institutions have produced a deteriorating environment and created a vacuum for China and Russia to fill. The result, predictably, is less trade and greater challenges. In our opinion, unilateralism, and a feeling that our allies need to figure out how to get along without our support, makes the US more vulnerable militarily and economically. The 2021-2030 decade is fraught with geo-political risk unless we restore international diplomacy. **The major issue in 2021 is whether the US can restore confidence in its leadership once more.**

<u>Seventh Forecast:</u>

Related to the previous prediction, as in previous years, we believe more than ever that Destabilization remains a risk.

Even before the worldwide pandemic, the world was a fractious and dangerous place. Nothing has changed in that regard. So much attention was devoted on how to deal with risks to health that it is easy to forget that there are destabilizing forces particularly in national security. The risks of mistakes in foreign policy or missteps in judgment, militarily and financially, are even more substantial in the aftermath of broken alliances over the past four years. We believe that there are just too many hotbeds globally for there to not have an incident or two that tests the new Administration's resolve. The effect on markets from destabilizing events of high impact is difficult if not impossible to predict. Virtually every new President faces a test in his first few months of his or her Administration.

Having said that, certain economic events are, in and of themselves, destabilizing. For one, restrictive trade and tariff policies have proven to have negative consequences for businesses everywhere. While China-U.S. relations remain front and center, there are numerous alliances affected by bilateral negotiations. During a time when there are still signs of a global economic slowdown, countries are forced to choose sides. One thing is for sure - the need to act in their own self-interest will be more noticeable in 2021. **Growth in Protectionism, therefore, remains a central theme again this year.**

As an example, certain *big picture* issues cry out for global solutions. One obvious issue is the need for enactment of measures that address climate change. Disruptive policies and denial of scientific facts make solutions harder to attain. There are also issues surrounding immigration policies which must simultaneously address complicated matters of human rights and national security.

These topics will require attention and represent challenges.

Without dealing with these types of issues, the feeling that the global economy could enjoy synchronized growth over the long term has been diminished. Europe will require diplomatic attention and assurances on the part of the US that we will stand behind our promises and commitments particularly to NATO. Of significant focus will be on Asia's growth because of its overall linkage to China. Investors will pay close attention to how the US manages the delicate China relationship.

<u>Eighth Forecast:</u>

Cybersecurity threats are likely to impact institutions, individuals, and governments creating the potential for a possible crisis environment in 2021 and beyond.

When we made this forecast in 2020, we were amid dealing with the claim of election interference by Foreign powers. With the revelations about Russia's involvement in the 2016 election and the promise of retaliation by Iran for the killing of its military leader, there is little doubt that the Government, corporations, financial institutions, and individuals are more vulnerable to attack than we were a year ago. Threats to national security from any source will require retaliation. We believe that the world is increasingly at risk of continued major cybersecurity disruption, and hence we are repeating our forecast.

Because the digital world has made us more connected and reliant on technology solutions in our every-day lives, the risk of denying access to services we take for granted is amplified by cybercriminal behavior. Breaches in security that safeguard data or identity, even data supplied by government or large institutions, likely will accelerate in 2021.

The likely response will be the creation of new technologies to counteract the potential for future threats - but are they enough? It is one thing for cyber-criminals to be motivated by political, social or economic gain; it is another if their motivation is military in nature. The Mueller probe concluded that there was a degree of complicity that foreign powers have had on elections, the democratic process, and our way of life.

In 2021 we are again likely to find out something we already know. Bad people are capable of bad things.

The likelihood of some form of geopolitical attack, hitting the US where we are most vulnerable, is real. It falls in the area of *unknown unknowns*. Whatever economic forecasts we may rely on, in the event of an attack on this country, its internet, its power grid, or other important infrastructure, these forecasts understandably go out the window.

<u>Ninth Forecast:</u>

Valuations did not matter much in 2019 or in 2020. They might matter a lot more during 2021.

Just as markets often overshoot during periods of complacency, they are apt to underperform during periods of heightened uncertainty. At inflection points, markets tend to accelerate away from their former direction, gathering momentum. Trend followers and momentum theorists tend to exacerbate the trend, taking particular notice of the lack of liquidity in certain markets and sectors.

We started this piece with a quote from Aldous Huxley, so it is fitting that we have one more. **"Great is Truth but still greater, from a practical point of view, is Silence about the Truth."**

Over a long period of time studies have proven that security prices fluctuate from pockets of enthusiasm to outright despair. For the most part, when prices are at extremes they eventually regress towards the statistical average, or the mean. One style of investing that has gathered devotees in recent years is determining which *factors* market participants favor at any time. Initially, *factor* investing was confined to the growth vs. value debate. Now characteristics such as momentum, investor sentiment, and earnings are measured in the same breath. At the heart of the matter is valuation; what one should pay for taking risk. For over seventy-five years security analysis has focused on the price to earnings multiple as a substantial measure of confidence. Higher multiples are associated with a belief that, all things considered, future performance will be better than the past. So, in times of lowered expectations, earnings-based valuations suffer.

For value and GARP investors, lowered expectations and lower stock prices can be viewed as opportunities. For that reason, we believe the start of 2021 may offer some valuations in certain corners of the market that may be attractive on both an absolute and relative basis. For growth minded investors, looking for attractive entry points on a relative basis, 2021 may also prove rewarding if the measure for assuming risk is believing that increased revenues can be sustained in the current economic environment. That is particularly relevant in the technology sector where growth-minded managers see innovation being rewarded before profit making financial success can be observed.

Within the technology sector, for some *unicorn* stocks it seems as if each acorn is expected to grow into a sapling, each sapling to grow into an oak tree, and each oak tree to grow to the sky. We all know nature doesn't work that way. On Wall Street circa early 2021 the belief is that all oaks are sturdy and will be of unlimited height. It needs to be said: if history is a guide, today's valuations are extended, and we believe a catalyst of some kind will emerge to pull the more overvalued stocks back to earth.

<u>Tenth Forecast:</u>

Investor behavior will be greatly influenced by headline risk, perhaps created for political purposes. The use of analytical techniques, data trends and algorithms to predict human responses to fast moving events will become necessary tools for investors and traders to gain a competitive advantage.

In 2021 active managers with an "edge" will gain more prominence in the active-passive debate. Those not equipped with intellectual curiosity, disciplined processes, analytical tools, and conviction may underperform. Human interpretation of the data will be a challenge but can prove rewarding to those that become contrarian by taking the longer view… but that, in our view, is not enough.

One thing is near certain in 2021. The way financial services are delivered to clients will continue to change rapidly.

To meet client expectations investment managers are going to need to understand and build client relationships based on competence but, more importantly, on developing partnerships based on trust and results. Beyond asset management, though, clients increasingly expect advisors to understand their needs for advice on things most important to them personally:

Health care issues because health often brings wealth;

Financial viability of social safety nets;

Milestone objectives and how to fund them;

Lifestyle choices, particularly in retirement; and

Management of disruptions from health reversals, employment issues, failed relationships and tragedies.

Every life or business, it would appear, is confronted, at times, with events of an unpredictable nature that create risks and opportunities. No one can predict what will happen with accuracy, but it is important to emphasize preparedness as part of the way we advise and manage client affairs in the exercise of our fiduciary responsibility.

CONCLUSION

We recognize that certain clients may have multiple (sometimes competing) objectives, such as the need to distribute income for current expenses or grow capital for future milestone events. All of the items above highlight, in our opinion, the particular importance of diversification and balance in an attempt to create an investment portfolio whose goals may include a number of combined elements. We expect to manage portfolios purposely by owning a blend of fixed income securities, individual equities (many with income components) with potential for growth in principal, actively-managed mutual funds, closed-end funds, and actively and passively managed ETFs.

We invite you to reach out to us to discuss your own circumstances as we endeavor to build a personalized allocation to meet your specific goals and objectives. Thank you, as always, for valuing our relationship and allowing us to advise you.