The Colony Group

MARKET PERSPECTIVES

QUARTER FOUR 2020

Most investment markets posted strong returns for 2020 despite grappling with a pandemic and one of the worst global economic crises since the Great Depression. While counterintuitive to many, it highlights that markets are forward-looking, discounting mechanisms, reflecting expectations about the future. Policymakers also played a role as they responded quickly and forcefully to offset the effects of virus-related lockdowns that at their worst slowed economic activity to a fraction of what it was pre-pandemic.

Following a historically sharp decline during the first quarter, equity markets eventually found their footing, rising each of the final three quarters of the year. The S&P 500 Index returned +12.2% during the fourth quarter, propelled by news that two coronavirus vaccines were more effective than expected. Stocks outside the U.S. generally performed better, with the MSCI ACWI ex-US Index returning +17.0%. News of the vaccines encouraged investors to look past the pandemic and consider how a reopening economy may impact corporate earnings growth. Indeed, we witnessed early signs of leadership change within equity markets near the end of the year as work-from-home beneficiaries took a backseat to the stocks of companies that will likely prosper as virus containment measures are relaxed. Segments of the equity markets, such as small-cap, value, and international stocks, outperformed during the fourth quarter after several years of lagging. Broadening market participation would be a positive sign if sustained in 2021.

Interest rates gradually moved higher last quarter due to rising economic growth expectations. While recovering growth served to depress the returns of government bonds (-0.8% return for the fourth quarter), it provided a tailwind for credit instruments, such as investment-grade corporate (+2.1%) and high-yield (+6.5%) bonds. The Federal Reserve has repeatedly communicated its desire to keep rates low until such time as the burgeoning economic recovery is on solid footing.

As we transition into 2021, the investment backdrop is one of hope and optimism. This is well supported by expected growth rates and the policy backdrop. In the remainder of this quarter's Market Perspectives, we outline our market outlook and identify some risks to avoid.

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Great Expectations

We are borrowing the name of our upcoming market outlook webinar, as it appropriately depicts sentiment heading into 2021. After spending most of last year suffering through a pandemic that has killed millions worldwide and caused economic activity to grind to a halt in many sectors, it is no wonder that as we transition to the new year, individuals prefer to be hopeful. These feelings were galvanized by the recent approval of two COVID-19 vaccines in the U.S., which are currently in the early phases of being distributed, with several more potentially on the way during the first quarter.

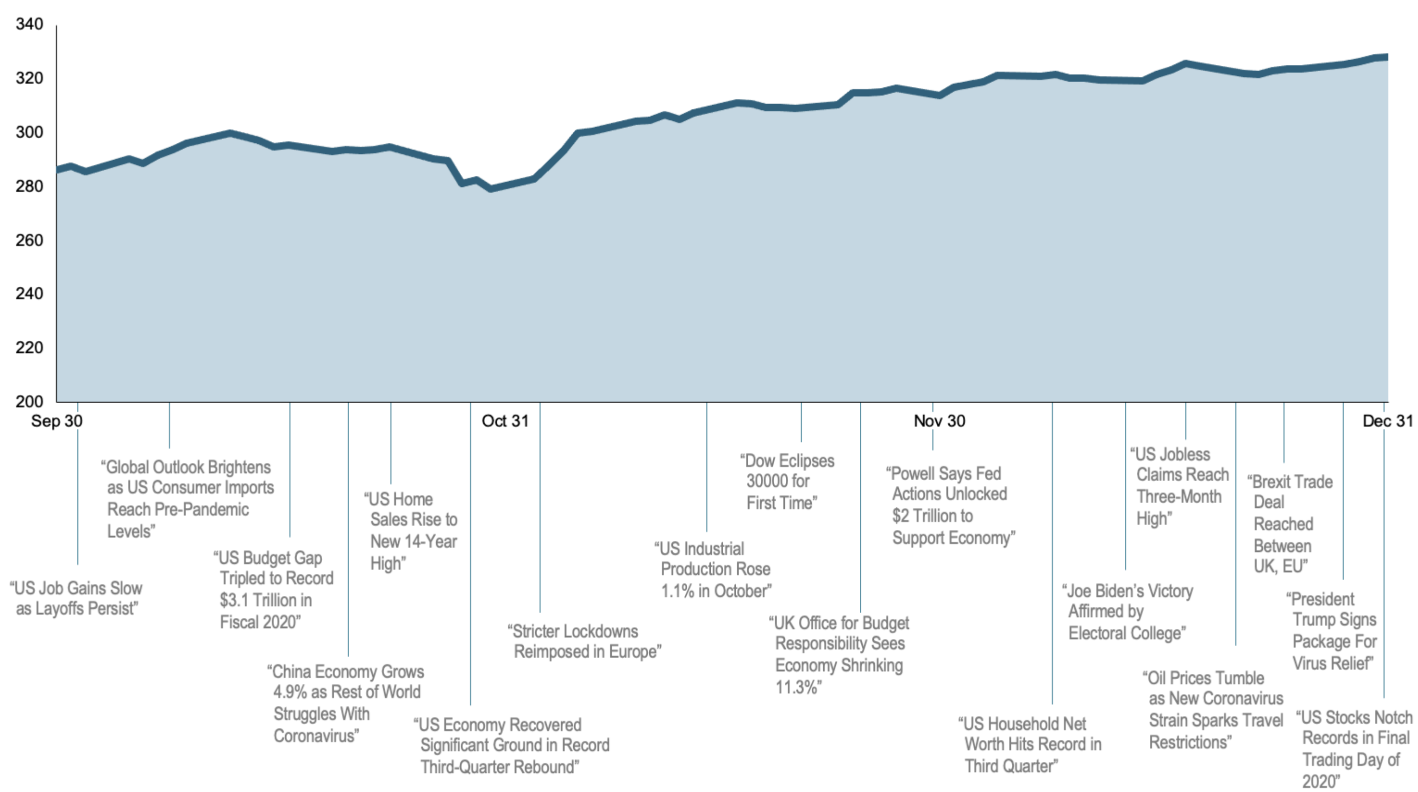
The vaccines and improving treatments have given investors hope that lockdowns and social distancing measures will no longer be required. As the economy reopens, we expect to see a wave of pent-up demand unleashed. Consumers are eager to return to pre-pandemic activities, such as traveling for vacation, dining in a restaurant without fear of infection, attending concerts or sporting events, or watching a movie in a theater. As fears regarding the virus fade, we expect a resurgence in these types of activities.

U.S. consumers have accumulated more than $2.2 trillion of savings as of November, nearly twice the level before the pandemic, thanks to the CARES Act and other fiscal stimulus programs. Federal Reserve Vice Chairman Richard Clarida explained, "This was the only downturn in my professional career in which disposable income actually went up in a deep recession, and a lot of that has been saved." There should be little doubt that, at least on a collective basis, consumers have the means to spend.

We also expect spending to re-emerge from the corporate sector. Corporations have deferred capital spending plans due to uncertainty over the timing of an economic recovery. As these uncertainties subside, we expect spending to accelerate. Moreover, both corporations and politicians from both sides of the aisle have discussed onshoring critical components of supply chains. Whether this is originating from rising nationalism, a recognition of current supply network vulnerabilities, or the need for redundancies, supply chains will likely undergo significant change requiring enormous investments in infrastructure and manufacturing.

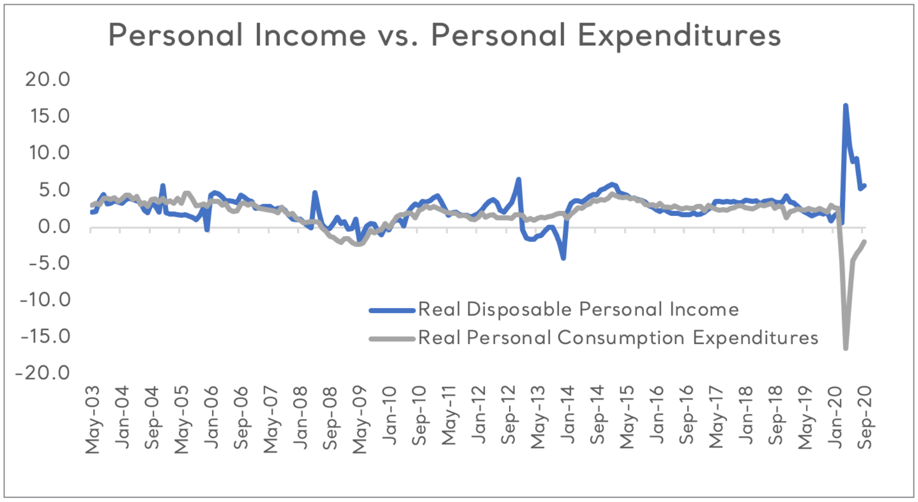
Consumers and corporations both have money to spend – and soon a reason to spend it now that we have visibility into a post-COVID world. Based on current production schedules from vaccine makers, the U.S. should have enough vaccines to inoculate most of the U.S. population by the end of the first quarter. Spending, however, may be slower during the first quarter due to the recent rise in new cases and deaths. Nevertheless, we expect economic growth to accelerate throughout the remainder of the year, with the final three quarters of the year likely to experience above-average growth rates.

MSCI ALL COUNTRY WORLD INDEX WITH SELECTED HEADLINES FROM Q4 2020



These headlines are not offered to explain marketplace returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

Graph Source: MSCIACWI Index [net div.]. MSCI data © MSCI 2021, all rights reserved.
It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. **Past performance is not a guarantee of future results.**



SOURCE: Bureau of Economic Analysis

Nevertheless, we must remind readers that investment markets are forward-looking. The strong returns from last year prove this out. Certainly, markets did not reflect last year's economic realities. Instead, they were discounting a 2021 economic recovery. Arguably the easy part of the market recovery is over. The economy seems well poised to exceed the most pessimistic sentiments from early 2020, and optimistic investors have been well rewarded. Beating 2021's expectations will be more difficult.

Fortunately, we believe that this is possible. Analysts are notoriously bad at forecasting around economic inflection points. History shows that they become overly optimistic near expansionary peaks and too pessimistic during recessionary nadirs. As a result, they frequently overestimate earnings near the end of an expansion and underestimate them when a recession ends.

Financial conditions are also supportive of further gains this year. Global central banks have kept interest rates accommodative and continue to grow their balance sheets through asset purchase programs (a/k/a quantitative easing). There are some concerns that interest rates may move higher alongside accelerating growth, but the Federal Reserve is committed to keeping interest rates low until inflation rises sustainably above its 2% target, which is unlikely to happen this year.

Lastly, government spending should remain supportive of growth. Indeed, the levels of fiscal stimulus applied across the world has not been this high since World War II. Following the Democrats' victory in the two Georgia Senate runoffs in early January, U.S. fiscal spending is expected to expand from current levels. We note, however, that with Democrats having the thinnest of margins in Congress, it is unlikely that some of the more liberal policy initiatives, such as The Green New Deal or a full repeal of the Tax Cuts and Jobs Act of 2017, can be enacted. The constraints on legislative action are perceived positively by many investors.

WHAT THIS MEANS

We believe there are many reasons to be optimistic about the investment markets in 2021. Growth may exceed expectations, and financial conditions are conducive to further gains in risk assets. We are especially encouraged that several material sources of uncertainty have been resolved, including the U.S. elections, Brexit, and the development of effective vaccines. Nevertheless, the strong market returns during the last three quarters of 2020 have stretched valuations, setting up a more challenging year for investors. This combination creates the conditions for a rising, albeit volatile year for risk assets.

DeFAANGed

In July, we wrote about the narrow leadership of the U.S. equity markets. We explained that the five largest stocks, four of which are included in the acronym FAANG (which stands for Facebook, Amazon, Apple, Netflix, and Google parent Alphabet) had grown to comprise over 20% of the S&P 500 Index. We warned readers not to chase these names, as history shows that such high levels of concentration are rarely sustained.

While this warning may have seemed premature at the time, something we acknowledged could be the case in the "2020 2Q Colony Market Perspectives," we may now have better idea of what might ultimately trip up these high-flying companies: increasing regulatory scrutiny. The Department of Justice and Federal Trade Commission have investigated, and in some cases launched lawsuits against, several Big Tech companies for antitrust violations. The European Union also has started investigations and lawsuits. Lastly, several countries in Europe and the Biden administration are considering or have already implemented changes to their tax regimes that would result in higher taxes for internet companies.

WHAT THIS MEANS

We do not expect these investigations to result in the breakup of mega-cap technology companies, although, for some of them, it is not out of the question. Rather, we expect smaller changes to the way they conduct business. While this would hardly cause the end of Big Tech as we know it today, we are reminded of Microsoft's experience after it settled its suit with the Department of Justice back in 2002. Microsoft's stock price flatlined for nearly ten years following its settlement. For those investors considering putting new money into concentrated positions in technology stocks, caveat emptor.

Conclusion

It has become trite to wish good riddance to 2020. The year was unkind (to say the least) from a humanitarian perspective, marred by a global health crisis, social injustice, political polarization, and economic inequality. Investment markets were not oblivious to these issues, as evidenced by the historically high level of volatility, but seemed willing to overlook them.

There are many reasons for investors to be optimistic as we head into the new year. It is this optimism that gives us reason to pause, as high expectations have the potential for greater disappointments. While we take great pride in always being careful stewards of our clients' hard-earned capital, this year may require even more attentiveness.

COLONY INSIGHTS & EVENTS

In lieu of the Colony Spotlight section, we invite you to read our latest **Our Perspectives, Your Possibilities** newsletter dedicated to helping you stay up to date with the latest news about the markets, upcoming webinars, and how we strive to make an impact in the communities we serve. For more insights, visit our **News & Insights**. We look forward to staying more connected and sharing our collective knowledge to give you the tools to move towards your vision of a wealthy life.

The Colony Group

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