1919 INVESTMENT COUNSEL
Complexity to Clarity

January 2021

Investment Review and Outlook

SUMMARY

- The vaccine rollout will fuel the pace and magnitude of the economic recovery in 2021.
- Government stimulus will help support struggling consumers, businesses, and state and local governments.
- With no foreseeable change in the existing low interest rate environment, equities remain poised to provide growth for investors.

KEY TAKEAWAYS

- It is important to note that the impact of the pandemic on the market may be more akin to a natural disaster than an economic crisis. Before the pandemic, the US was experiencing high employment and positive economic growth.
- Innovation will help drive future economic growth and productivity. New businesses will be launched, and advances in the healthcare, financial, technology, and energy sectors can provide growth opportunities.
- Rich equity valuations and sustained low interest rates may result in modest equity and fixed income returns over the next several years. However, over the longer term, equities still provide meaningful growth potential.

Total Returns & Values As Of 12/31/20

	QTD Return	YTD Return	Price/ Value
Dow Jones Industrial Average	10.7%	9.7%	30,606
S&P 500 Index	12.1	18.4	3,756
Russell 2000 Index	31.4	20.0	1,975
MSCI EAFE Index	16.1	8.3	2,148
MSCI EM (Emerging Markets)	19.8	18.7	1,291
Bloomberg Barclays U.S. Aggregate	0.7	7.5	110
Bloomberg Barclays Municipal Bond	1.8	5.2	115
Gold (NYM $/ozt) Continuous	0.0	24.4	$1,895.10
Crude Oil WTI (NYM $/bbl) Continuous	20.6	-20.5	$48.52

Source: FactSet

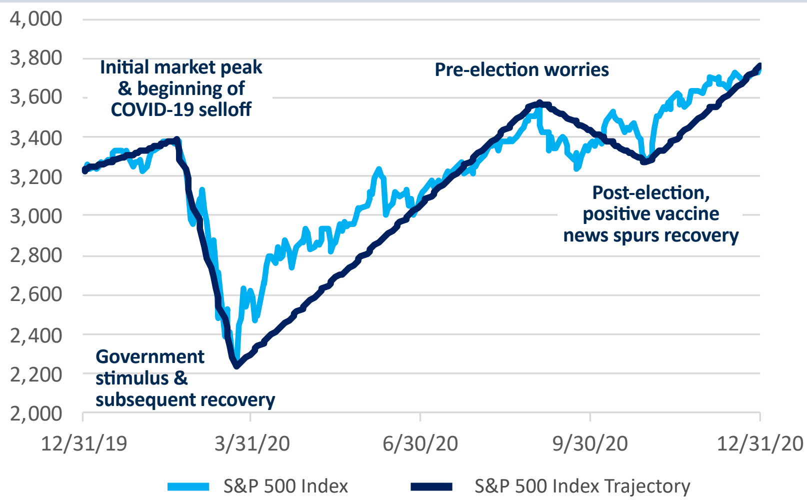
THE ECONOMY

A Year Of Unprecedented Challenges

As the new year begins, we breathe a collective sigh of relief and reflect on the many challenges wrought by the COVID-19 pandemic:

- The death of more than 350,000 Americans and infection of 20 million plus, as of this writing.
- Unemployment at historic levels with the rapid decimation of many service-based industries (restaurants, travel, and other hospitality-related businesses) due to pandemic-related shutdowns.
- Virus protocol as a political issue, heightening an already contentious election season, and civil unrest as the spotlight shone on systemic social issues.
- The dramatic market reaction to headline news.

2020 Market Reaction To News - S&P 500



Source: FactSet

The Welcome Promise Of Vaccines

There is light at the end of the tunnel for the US economy with multiple vaccines coming to market. However, in the near term, economic activity will face headwinds due to the severity of the current second wave of the COVID-19 outbreak. As a result, we may see the economy lag for a quarter or two.

However, as we have previously written, the market impact of the pandemic appears to be more akin to a natural disaster than a financial crisis. Before the pandemic began, the US was in a period of historically high employment and modest, but steady, economic growth. At this time, many Americans remain unemployed or underemployed, particularly in the service and hospitality industries, and difficult days still lie ahead. The development, approval, and distribution of multiple vaccines will boost investor, consumer, and business confidence, setting the stage for an economic rebound.

An acceleration of economic activity heading into the second half of 2021 is likely as the vaccine rollout gains momentum. However, it will not be an equal recovery for everyone. While more-affluent Americans have benefited from appreciating portfolios in a rising stock market and the ability to work remotely, many workers in industries impacted by pandemic-related shutdowns are struggling financially.

Additional Stimulus Is Needed

While the Federal Reserve uses the monetary tools at its disposal, additional fiscal stimulus is needed to provide funding to struggling businesses, extend unemployment benefits, and supply much-needed income to unemployed or underemployed Americans. As of this writing, a $900 billion stimulus package was passed by Congress and signed into law by President Trump.

While more stimulus may be forthcoming, consumption is declining as consumers focus on meeting current expenses against an uncertain timeline for recovery. Likewise, state and local governments have significantly drained their rainy day funds due to pandemic expenses and also would benefit from additional stimulus.

The Pace Of Recovery

The timing of the vaccine rollout will impact the pace of recovery. While healthcare professionals, long-term care facility residents, the immunocompromised, and essential workers will receive the vaccine first (receiving two doses over several weeks), the remainder of Americans may not receive vaccinations until late Spring or Summer 2021. The rate of vaccination adoption will be a crucial variable as a significant portion of the US population will need to be inoculated and some Americans seem to resist the idea of a vaccine altogether.

Globally, the vaccination process is a tremendous logistical effort that will take some time. Overall, the US economic recovery should strengthen after the first quarter of 2021, which the equity and fixed income markets appear to have priced in already. We estimate real GDP growth will exceed 4% in 2021, compared with -3.5% in 2020 and +2.2% in 2019.

Opportunities & Challenges For The Biden Administration

As President-elect Biden assumes office, the pandemic will be his priority. Boosting the vaccine adoption rate, distribution, and usage will be his greatest near-term challenge. From a leadership perspective, Biden's cabinet choices have been well communicated and include individuals with diverse expertise, backgrounds, and experience. His appointment of former Fed Chair Janet Yellen as Treasury Secretary bodes well, and we expect her to be confirmed by the Senate. She and current Fed Chair Jerome Powell should collaborate successfully on economic issues.

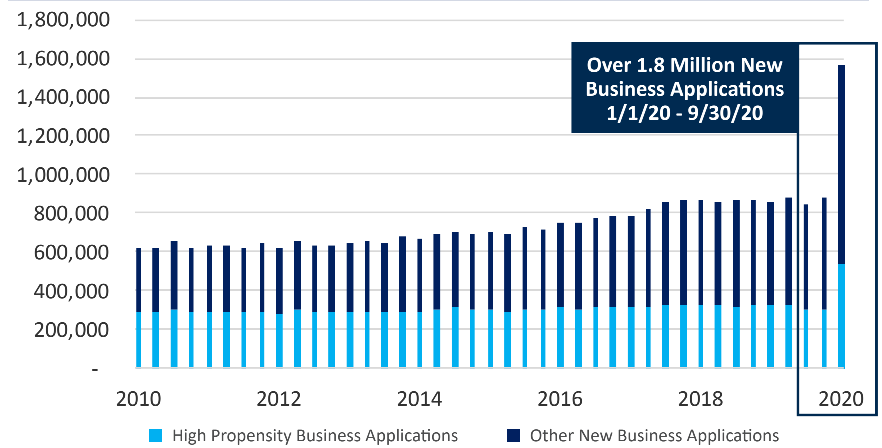
The Biden Administration will be focused on environmental and social issues as well, including climate change, diversity, and inclusion. This should lead to a more conducive environment for ESG (environmental, social, and corporate governance) investment considerations and for the US rejoining the Paris Agreement (a global initiative focused on mitigating the economic and environmental impact of climate change).

Innovation Nation

From healthcare to climate change to renewable energy and financial services, American innovation is the spark that fuels economic growth. Disruptive innovation is a theme we consider when evaluating companies. These may include investments in financial services companies that are reengineering methods of payment processing, industrial companies that are implementing smart water and environmental technologies, and companies across many industries that are facilitating renewable energy initiatives.

While businesses have closed due to the pandemic, the prevalence of the American entrepreneurial spirit has resulted in the completion of over 1.8 million IRS new business applications as of September 30, 2020.

Total New Business Applications (Quarterly)



Source: Federal Reserve Bank of St. Louis as of 9/30/20.

Our Interest Rate Perspective

As we stated last quarter, the Fed has committed to an ongoing low interest rate environment by virtue of its average inflation targeting policy change (the Fed will wait to see evidence that inflation has reached its 2% target, on an average basis over time, before making any adjustments to the Fed Funds rate). Throughout 2021, longer-term interest rates should move gradually higher but remain low by historical measures, as illustrated by the following chart.

10-Year Treasury Yields Over Time

Source: Federal Reserve Bank of St. Louis as of 12/29/20.

By year-end 2021, as the economy reopens, we expect the 10-year Treasury yield to rise from the 0.90% current level to a range of 1.25% to 1.50%. Yields on short-term debt will stay low as the Fed maintains its accommodative policy in order to stimulate economic growth and employment.

Confidence in the Fed should enable it to pursue its employment target while managing inflation expectations as rates slowly rise. To bolster the economy, the Fed continues to buy bonds, purchasing $80 billion Treasury bonds and $40 billion mortgage-backed securities monthly, until it sees "substantial progress" in achieving economic growth and maintaining a stable 2% inflation rate.

A Heated Housing Market

The housing market has proven to be a significant economic driver in the US, gaining increased momentum in 2020, as historically low interest rates supported pandemic-spurred relocations. While prices for both new construction and existing houses have soared, we are starting to note a troubling rise in mortgage delinquency rates, now at 7.7% (versus 4.0% in 2019). Even more concerning is the 15.6% delinquency rate for FHA mortgages, which is reflective of the struggles of lower-income borrowers to make mortgage payments.

THE EQUITY MARKET

Ample Opportunity Emerges In Growth & Value

The Dow Jones Industrial Average, S&P 500, and NASDAQ Composite all reached record high levels in December, spurred by hopes for effective vaccines, a return to normalcy, low rates, and additional stimulus. In 2020, investors were understandably willing to pay premium prices for companies that delivered strong revenue growth.

The technology and communications services sectors drew much investor attention. These two sectors boast the FAANG (Facebook, Amazon, Apple, Netflix, and Google) stocks among other high-profile growth companies, including work-from-home beneficiaries, such as Zoom, and vaccine-related innovators such as Moderna.

The demand for stocks of faster-growing companies resulted in a significant performance and valuation difference between those stocks and ones that are more cyclical or interest rate-sensitive. Looking towards a new post-virus business cycle, investors have started to consider companies that should benefit from a resurgence in economic activity. Attractively valued companies in the financial services and industrial industries, for example, offer ample opportunity. As always, our approach to equity investing entails comprehensive, fundamental analysis, and a long-term perspective.

LOOKING TOWARDS A NEW POST-VIRUS BUSINESS CYCLE, INVESTORS HAVE STARTED TO CONSIDER COMPANIES THAT SHOULD BENEFIT FROM A RESURGENCE IN ECONOMIC ACTIVITY.

Thoughts On Valuations

Given lofty valuations, we still believe that stocks can outperform bonds and cash, primarily because bond yields are extremely low and, in many cases, do not offer a return above inflation.

Stocks Offer Compelling Dividend Yields

	% of S&P 500 Stocks Above 10-Year Treasury	10-Year Treasury Yield	S&P 500 Dividend Yield
12/31/18	35.8%	2.68	2.13
12/31/19	45.1%	1.92	1.80
12/31/20	66.7%	0.92	1.54

Source: FactSet

The hurdle is quite low for equities to outperform fixed income, assuming a reasonable time horizon. While stocks are richly priced on an absolute basis, which increases risk and the potential for sharp corrections, relative to bonds, they look attractive:

- As the chart above illustrates, currently, more than 60% of stocks in the S&P 500 have dividend yields higher than the 10-year Treasury, a level significantly above the long-term average of 17% since 1972.
- Successful vaccination programs will have a positive impact on growth of employment, income, consumption, and profits.
- Equities have delivered superior returns over most periods. The cost of timing using an “all in” or “all out” strategy is quite high, with the odds of winning very low. As the table below shows, missing just the five best days over the last 25 years would have lowered annualized returns from 8.3% to 6.4%.

The Challenges Of Market Timing
January 1, 1995 - November 30, 2020

Investment Timing	S&P 500 Annualized Return
Fully Invested	8.3%
Missed 5 Best Days	6.4%
Missed 10 Best Days	5.1%
Missed 20 Best Days	3.0%

Source: Strategas

Follow The Innovation

We closely follow innovative companies that are disrupting established markets or pioneering new industries. For example, we are following developments in blockchain (technology that allows transactional data to be stored, unaltered, and distributed to multiple global servers providing real-time information). These advances now are being driven by technology investments from large financial companies. For example, JP Morgan recently created the first cryptocurrency backed by a major US bank to facilitate blockchain-related payments, and it boasts cryptocurrency exchanges Gemini and Coinbase as banking clients. Bank of America has applied for over 80 blockchain-related patents in order to capitalize on this emerging financial technology. These innovations will dramatically change the payment processing system. Although there are numerous compliance and security issues to be addressed cryptocurrency acceptance should continue to gain traction.

WE CLOSELY FOLLOW INNOVATIVE COMPANIES THAT ARE DISRUPTING ESTABLISHED MARKETS OR PIONEERING NEW INDUSTRIES.

New & Shiny

The robust appetite for several blockbuster IPOs (initial public offerings) that have come to market, including DoorDash and Airbnb, is symptomatic of a degree of excess stock market enthusiasm that feels like an echo of the late 1990s. Excitement on the part of individual investors has played out in the use of day trading apps. While not necessarily driving the market, given the small size of trades placed on these platforms, it is somewhat troubling as retail investors seek to “gamify” the stock market. This behavior, combined with high absolute valuations, warrants attention and increases the risk of significant volatility.

A Word About Financial Stocks & REITs

The financial sector underperformed the broader market in 2020 as the economy shut down almost overnight. With progress made on vaccine approvals and an upcoming new business cycle, the sector has the potential to outperform in 2021. Valuations are attractive, and we expect earnings acceleration as loan growth improves once the economy opens and companies start to reinvest. This faster revenue growth trajectory, coupled with banks' expense control, should provide the catalyst for meaningful earnings acceleration. Share buybacks likely will occur in 2021, as will increased dividend payouts. In the same sector, property and casualty insurance companies offer attractive valuations as revenue growth accelerates, driven by higher pricing offsetting higher insurance claims.

In the REIT sector, beneficiaries of the work-from-home economy have outperformed. These include the data centers and tower companies poised to benefit from businesses' need to manage data and higher cellphone usage as 5G rolls out. Industrial REITs, with warehouses and distribution centers in their portfolios, continue to benefit from record levels of e-commerce. Conversely, REITs that hold hotels, office buildings, and retail malls were severely impacted and broadly underperformed in 2020 until the recent cyclical rally. However, as vaccine distribution gains traction and re-openings occur, there may be attractive opportunities in this segment for well-run REITs with tenants in growth industries, such as life science and technology.

The Continued Case For Equities

Earnings growth should rebound significantly this year after a 20% decline in 2020. We anticipate operating earnings growth for the S&P 500 to reach 25% or more, driven by the economic recovery and new business cycle. Likewise, investing in small-cap stocks, which historically have led the charge out of a recessionary cycle into a more robust period, becomes more compelling.

THE FIXED INCOME MARKET

Finding Opportunity In Intermediate Bonds

Corporate bond prices initially collapsed when the pandemic took hold in March but ended up generating attractive positive returns for the year due to ongoing support from the Fed. With rates stuck at historically low levels, we believe high-quality bonds in the intermediate part of the yield curve are attractive, enabling investors to increase yield while managing duration risk.

What The 10-Year Treasury Tells Us

The slow upward trend of the 10-year Treasury yield signifies that the economy is recovering, with optimism fueled by the availability of vaccines and additional fiscal stimulus. Inflation expectations have drifted higher, as measured by the yield on TIPS' (Treasury Inflation-Protected Securities).

Maintaining A Corporate Bond Overweight

While corporate bond issuance was record-breaking in 2020, we expect it to be down significantly in 2021. Many companies issued debt to build up cash reserves in order to ride out the shutdown or take advantage of the ultra-low rates that ensued. As a result, balance sheets are flush with cash, diminishing the need to raise more. With over $18 trillion of negative-yielding debt globally, demand for corporates, which offer positive yields, should remain strong. While US corporate bonds appear attractive on a relative basis, rates remain extremely low, which means low-coupon bonds will be sensitive to any rise in interest rates.

WITH OVER $18 TRILLION OF NEGATIVE-YIELDING DEBT GLOBALLY, DEMAND FOR CORPORATES, WHICH OFFER POSITIVE YIELDS, SHOULD REMAIN STRONG IN 2021.

Municipalities Spend Down Rainy Day Funds

The Fed has not been as supportive of the municipal bond market as we would have liked; instead providing an expensive lending facility only accessed so far by the state of Illinois and New York City's MTA. Encouraging municipalities to borrow in this way to relieve budgetary issues is not positive from a credit perspective. We would prefer direct federal subsidies to make local governments whole until tax revenues revive and COVID-19-related expenses subside, similar to the CARES Act crafted early in the pandemic.

Thankfully, in most instances, revenue shortfalls have not materialized to the degree anticipated last spring. However, state and local expenses have risen as the federal government has delegated the pandemic response to local governments. In the absence of further stimulus, rainy day funds have borne the brunt of the fiscal challenges, and in many cases, have been severely diminished. Fortunately, as a legacy of the financial crisis, states had increased their rainy day funds to the highest levels in decades. Additional government stimulus for states would prove helpful to offset the pandemic's negative financial impact until the vaccine is widely distributed.

Muni Yields Remain Low

Despite yields residing near all-time record lows, municipal bonds were not part of the modest Treasury market sell-off that occurred in late 2020. While taxable municipal issuance surged as a tool to refund older, higher-yielding debt, traditional tax-free municipal bond issuance for capital projects is at a relative standstill as issuers ponder why they should borrow money to fund infrastructure projects when long-awaited federal stimulus may provide the funding. As a result of constrained supply, tax-free municipal bond prices have moved little.

Refunding issuance, traditionally a meaningful percentage, has been redirected to the taxable municipal market due to recent tax code changes. The Biden administration may try to reverse this recent change which would create new issuance, which would be particularly welcomed if marginal tax rates rise as well, resulting in increased demand for tax-free bonds. The $10,000 limitation on the SALT (state and local tax) deduction also may be revisited, which would be positive for credit since it will stem the outflow of residents from high-tax states.

FINAL THOUGHTS

As we welcome 2021, putting an extremely challenging year behind us, we anticipate what has been characterized as a K-shaped recovery. Certain industries that have adapted well during the pandemic will thrive, while others with less flexible business models will struggle. This bifurcated recovery is reflected in the stark financial disparity between those who have been fortunate enough to continue working throughout the pandemic and those financially impacted by pandemic-related shutdowns. For people who are unemployed or underemployed, the fiscal stimulus package cannot come soon enough.

Following the presidential inauguration, the Biden Administration likely will focus, initially, on alleviating the pain and prevalence of the COVID-19 pandemic. The Fed will remain responsive to stimulus needs or inflationary concerns as the recovery unfolds, their current view being that risks remain to the downside.

Equity market valuations are high, a near-term concern that may contribute to heightened volatility and pullbacks over the next year or so. At the same time, low interest rates (high bond prices) do not provide investors with much in the way of an alternative. Therefore, the returns of most asset classes during this period are expected to remain fairly modest. However, over a longer time horizon, equities still offer the greatest growth potential, while high-quality bonds and cash equivalents will play an important role in mitigating portfolio volatility and funding cash flow needs.

As always, we remain focused on your long-term goals and encourage you to keep the same perspective. We will keep you informed of any new developments and remain hopeful that a post-pandemic 2021 is a brighter one for all.