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Where do we go from here? Fourth Quarter 2020 Review and 2021 Outlook

Happy New Year! As no surprise to anyone, writing a comprehensive review of the news and events of the fourth quarter of 2020 would more than consume this quarterly letter.

Our goal here instead is simply to describe what moved markets and why. Up until the fourth quarter, the equity markets had been dominated by very few stocks (for example, in the S&P 500, six technology stocks, making up more than 25% of the index, had largely been driving performance in 2020). More recently, the market rally finally broadened to include emerging markets as well as small capitalization, cyclical, financial and energy stocks. As noted in previous quarterly market updates and calls, we have been expecting this to happen but, as always, timing is difficult to pinpoint. The broadening out of market opportunity during the quarter meant that active portfolio management started, and should continue, outperforming passive indexes.

Gries Financial Partners started moving our portfolios further in the direction of active management over the last several months. Theoretically, the current economic situation seems favorable for further growth. Negative real interest rates (interest rates adjusted for inflation), fiscal stimulus with more to come, and GDP growth for the next 12 months that could be the highest in recent history are all positives. Clearly this is predicated on the continued success of the vaccines. It was a quarter for the ages on a myriad of fronts, and one unlikely to be repeated anytime soon.

2021 Outlook

The outlook for 2021 first depends upon vaccine distribution and success in preventing future COVID-19 cases. Yes, the rollout to this point has been disappointing; however, the market is anticipating more supply than demand of vaccines as early as May. With that as a starting point, we view 2021 outcomes based on the following issues:

1. The viability of the economy. Inventories are at record lows, consumers have cash and there is pent- up demand for goods and services. Thus, we expect significantly above-trend earnings and Gross Domestic Product (GDP) growth this year.

2. The stimulus from the federal government. With the Democratic Senate runoff victories in Georgia, it appears Congress may pass additional stimulus into the economy that goes higher than recent expectations. That being said, the Senate majority is tight, so a meaningful increase in stimulus is unlikely to be acceptable to some more moderate Democrats.

3. The implications of low interest rates. The importance of this issue cannot be overstated. As we have noted in the past, as long as real interest rates remain negative, and the absolute level of rates stays this low, it is hard to see a major correction in the equity markets in the near future. While rates are likely to go higher, we do not expect a significant increase over the next several months, although we continue to watch inflation carefully, as highlighted below.

4. Productivity. We have seen significant increases in productivity led by companies utilizing technology better and becoming more efficient. As horrible as COVID-19 has been on a personal and business level, one bright spot is that many publicly traded companies have figured out ways to become more productive, which increases earnings and multiples.

Risk Factors

The biggest near-term risk we see is a dramatic increase in inflation based on significant money from the public sector being introduced into the system alongside pent-up demand. Our view is that this will not be a secular, long-term issue, but there could be pockets of higher, worrisome inflation numbers along the way. The current political situation as we write this is messy with the slimmest majorities in Congress (particularly the Senate) until the next election cycle in two years. We do not expect a hugely productive Congress although that is difficult to forecast in the current backdrop.

Balancing these potential risks are the expectation of more stimulus benefiting the economy as a whole, including some sort of infrastructure bill and general economic support. From the perspective of tax increases and concerns around related market impact, a thin Democratic majority may reduce the likelihood of any meaningful changes which would mitigate a potential risk factor. We also expect a fixed income default cycle (an increase in bond defaults) based on certain industries' questionable long-term viability post-pandemic. While we don't expect defaults on company debt to disrupt the banking system or the markets, we will continue to monitor this factor carefully.

Asset Class Outlook

Equities

Clearly equities have become significantly more expensive over the last several months. We are not of the view that prices can't go higher from here, but we do think if that happens it will be led by new market leaders, for example value (over growth) investing. That does not mean we are less bullish long term on technology or parts of the healthcare sector, we just believe that they may experience a relative breather compared to stocks that have underperformed for a decade. Also, we believe emerging markets and other parts of the developed world beyond the U.S. can do well as the global GDP recovery progresses in an uneven manner. To take advantage of this view, we continue to have broad diversification in equities exposure, inclusive of geography, style and strategy, with an increase in active management.

Fixed Income

Traditional bond interest rate exposure is dangerous right now. If the Ten-year Treasury Note were to go up by 100 basis points from here, which is entirely possible, the average bond fund could lose close to 8% or more. We are still favorable on credit (as opposed to bond duration) exposure due to the resilience and growth potential of the economy. As a result, we have increased allocations to strategic income funds and other fixed income exposure that is more credit (rather than interest rate) based, largely avoiding more traditional bond strategies.

Alternatives

We believe, particularly at this point in the cycle, alternative strategies with low correlations to the stock and bond markets remain a necessary part of a long-term portfolio. In select cases, this includes being compensated (through returns) for well-defined illiquidity. As the universe of alternative strategies expands, we are finding, through intensive sourcing efforts, many investments that lower risk and provide steady total returns for our portfolio. Look for us to continue expanding the use of these tools in the future.

Conclusion

We do not expect 2021 to be as volatile as 2020, a welcome change for everyone. With additional stimulus and low rates, we think any selloffs will be contained for now. Prices are high, so we need to be vigilant in constructing risk-managed portfolios utilizing the full continuum of asset classes. We are pleased with client risk-return outcomes during a difficult 2020, and we look forward to providing similar guidance in 2021.

Wishing you a happy and healthy New Year.

Gries Financial Partners

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