

Equity Market Summary

U.S. Equity Markets	4Q	YTD	Top/Bottom Sectors	4Q	YTD	Non-US Equity Markets (in USD)	4Q	YTD	Non-US Regions (in USD)	4Q	YTD
S&P 500	12.2%	18.4%	Technology	11.8%	43.9%	MSCI AC World Ex U.S.	17.0%	10.7%	Developed Americas	13.9%	-4.4%
Russell 1000 Growth	11.4%	38.5%	Consumer Discretionary	8.1%	33.4%	MSCI EAFE (Developed)	16.1%	7.8%	Developed Asia	16.6%	12.1%
Russell 1000 Value	16.3%	2.8%	Communication Services	13.9%	23.6%	MSCI Emerging Markets	19.7%	18.3%	Developed Europe	15.6%	6.1%
Russell 2000	31.4%	20.0%	Financials	23.4%	-1.6%	MSCI China	13.2%	31.7%	Emerging Americas	35.3%	-13.2%
Russell 2000 Growth	29.6%	34.6%	Real Estate	4.9%	-2.1%	MSCI France	20.2%	4.8%	Emerging Asia	18.7%	28.1%
Russell 2000 Value	33.4%	4.6%	Energy	27.8%	-33.5%	MSCI Brazil	37.6%	-18.5%	Emerging EMEA	16.9%	-5.4%

Market Review:

The fourth quarter put an exclamation point on a tumultuous year. Stock investors looked through growing infection and hospitalization rates to what the world would look like once vaccine distribution allowed some level of herd immunity to be reached. The S&P 500 returned +12% for the quarter. After leading the charge in the first nine months of 2020, tech giants Facebook (+4%), Amazon (+3%), and Microsoft (+6%) were laggards. Instead, the market was led by Energy (+28%), Financial (+23%), Industrial (+16%), and Materials (+14%) names.

October saw minimal movement as most indices ended little changed. The main action for the quarter began in November with a relief rally after investors' worst electoral fears did not eventuate, and positive vaccine data was released. There was a brief rotation into value in November with the Russell 1000 Value index outpacing its growth peer by a spread of 3.3%, but that paled in comparison to the 32.9% spread that the growth index had notched up in the first ten months of the year. A big winner of the quarter was small cap stocks. The Russell 2000 surged +31%, its biggest one quarter return ever, with most of the rise occurring in November and December. Health Care (+31%), Financial (+35%), and Information Technology (+38%) components were the largest contributors. The Russell 2000 lagged the S&P 500 by almost 10% in the year through October so some of the surge was a catch-up, but the rest is clearly reflecting optimism for a new economic dawn in 2021.

The IPO floodgates opened during 2020. A total of 218 IPOs in 2020 raised a cumulative \$78 billion. Add to that the \$83 billion raised by 248 SPAC's (special purpose acquisition company) and the total capital raised for newly listed equities surged to an all-time high. Secondary offerings of traded companies were also active. The combined total new capital raised this year is reported by Bloomberg to have reached \$438 billion. That is more than 1% of the market capitalization of the Wilshire 5000, used as a proxy for total U.S. traded equities.

One might think that demand might struggle to keep up with all this new supply. But IPO returns have been quite exceptional, with the Renaissance IPO index up +24% for the quarter and +111% for the year. Admittedly, record IPO activity makes us quite nervous since market tops often include a flurry of issuance. But it also could reflect pent-up supply and demand for companies coming public that have remained private much longer than the historic norm. Many of these companies are much more mature than in IPO booms of the past and have a higher probability of survival. Yet some of the names with bid up prices could be vulnerable if speculators find that prices do not always go up.

A year ago, we believed that S&P 500 prices reflected an optimistic projected +9% increase in earnings for 2020 and those expectations would need to be met to justify prices. That was before a global pandemic, accompanied by a deep global recession, coupled with a collapse in corporate profits. Instead, earnings are on track to drop -15%, yet the index total return for the year was +18.4%. Obviously, there was a valuation adjustment. Of course, there also was a trifecta of a 150 basis point drop in Fed Funds rates, a 42% global expansion of central bank balance sheets, and fiscal stimulus that dwarfed the aid doled out during the Great Recession. That magnitude of stimulus creates plenty of room for the valuation event that unfolded.

Market Outlook:

Once again, we find ourselves talking about companies needing to meet optimistic earnings expectations to justify stock prices. S&P 500 earnings are currently expected to rise 38% in 2021, which seems like quite a high hurdle and many pundits believe it is unattainable. However, as seen in Exhibit #1 (page 2), a large earnings increase after a recession is not all that uncommon and expectations, once they bottom, tend to rise for an extended period. For instance, expectations for 2010 earnings bot-

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tomed in May 2009 and maintained an upward trajectory until the final report after the end of 2010, ultimately delivering 16% better than anticipated at the trough. Since expectations for 2021 S&P 500 earnings bottomed in July, they have risen 4% in about five months and continue to climb. It would not be unprecedented for this trend to continue for months to come. If history repeats that high hurdle for 2021 earnings growth might just be achievable.

Many are pointing to rising earnings optimism as a sign of a bull market top. But looking at past bull market tops (see Exhibit #2) there has not been a top in the last 40 years while expectations were rising. What is the chance that earnings expectations are about to peak? As previously noted, history would suggest expectations should continue to rise. S&P 500 2021 expectations are still 14% below their peak and 2022 are 9% below. Barring a negative surprise in the pandemic fight it is very possible that history will repeat in this case.

High levels of optimism could be a reason for concern. The headlines certainly are focused on the flood of new investors, specifically the ten million new individual online brokerage accounts. Individual investors on the Robinhood trading platform have been accused of being divorced from reality in their trading decisions. But that is a small group relative to the broad field of investors. Looking at a more traditional group of individual investors, the portion of American Institute of Individual Investor survey respondents that are bullish is at 44%, which is in the 75th percentile of historic readings - high but not excessively high.

Interestingly, the most optimistic readings we follow are for some of the more “sophisticated” investors. The Institutional Investor Bull/Bear ratio is in the 98th historic percentile and the Put/Call ratio was in the 99th, but it had been moving lower as the year closed. A recent survey of some of the top market strategists revealed 2021 S&P 500 targets between 3800 and 4400. Considering the year-end index level at 3756 that translates into a price move of between +1% to +17%, with the average being about +8%. Positive, but not overly bullish. However, it is notable that strategists are loathe to predict lower stock prices. Investors seem to be focused on what can go right rather than go wrong. We believe the range of outcomes is quite wide in both directions. There is still plenty that can go wrong, but also potential for positive results.

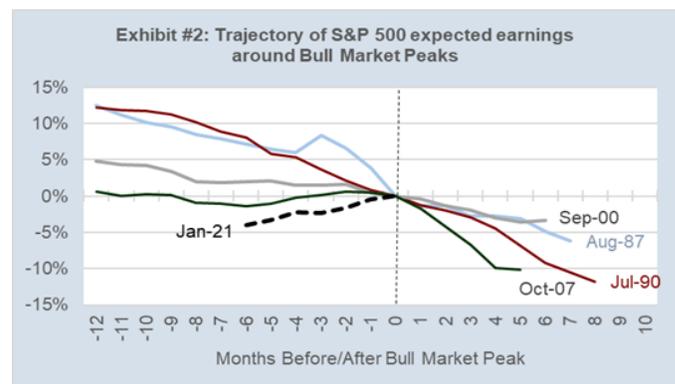
Commodity prices are giving the green light to a global economic recovery. During the quarter Brent crude oil notched up a 26% increase, copper added another 22% (a seven-year high), iron ore extended its rise by 32%, establishing a new all-time high on the way, and corn rose 32% to a six-year high. Some of this rise is linked to an already recovering Chinese economy, some to a weaker U.S. Dollar, and some to excess liquidity in the system. But it is difficult to justify these multi-year highs without a broad global expansion. If confidence in that global recovery catches hold with excess liquidity in the system that confidence could make its way into consumption, investment, and hiring. Those are ingredients for a sustained feedback loop and a longer-term economic expansion.

There is no lack of very smart investors wringing their hands about market valuations these days. However, valuation has historically been a poor market timing tool. Allan Greenspan’s “Irrational Exuberance” speech was on Dec. 5, 1996 but the return for the S&P 500 in 1997 was +33%. Warren Buffett described the market as expensive and noted in his 1997 annual letter “we get relatively little in prospective earnings when we commit fresh money.” The market continued to surge for another two years. In total the S&P 500 returned another +115% after the Greenspan speech.

We too fret about high valuations, but we also acknowledge that a risk-free rate at 0% creates all kinds of problems for traditional valuation metrics. It’s a challenge to argue the market is cheap on any basis, except relative to interest rates. But fortunes of companies this year have been widely disparate. Yes, there have been some phenomenal stock stories this year. But more than a fifth of the constituents in the S&P 500 are still more than 20% below their pre-pandemic high and of those the median price-per-peak earnings is only 11 times. Some of those companies will take years to achieve their previous peak earnings. Some will snap back in a timely fashion. Some will not survive. But many of those that do survive and revive will someday look reasonably priced at current levels. Our tendency is to lump index constituents into the same basket. But indexes are made of individual companies. Today some are early in a growth cycle and some are closer to peak earnings momentum.

There is no shortage of comparisons to past market peaks. But one argument that has remained silent is the role that rising interest rates play in popping bubbles. The DotCom bubble persisted for at least four years until the Fed increased Fed Funds from 4.63% to 6.5% over a 1 ½ year period to June 2000. The popping of the housing bubble that led to the Great Recession was preceded by a 425 basis point increase in Fed Funds between June 2004 and July 2006. Bubbles tend to survive for years

	Year 1	Year 2	Year 3
2020 Recession	+38% est.	?	?
2009 Recession	+47%	+15%	0%
2001 Recession	+19%	+19%	+24%
1991 Recession	+8%	+29%	+18%



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and often take a concerted effort by monetary policy to halt them when the Fed is fighting inflation. The Fed has indicated they expect interest rates to remain near zero at least through 2023 given their outlook for low inflation. There is a chance that liquidity in the system could lead to a pick-up in inflation, forcing the Fed's hand. But even if inflation begins to pick up, driving the Fed to begin raising rates, bear markets rarely are triggered by the first rate rise.

Part of the argument that stocks are due for a correction is the magnitude of the snapback from March. In the first nine months off the March 23rd low the S&P 500 returned +65%. No question a powerful move, but was it unusual? The rebound from bear market lows is almost always significant. Many are like the 2020 recovery. Exhibit #3 is a sample of bull markets that started with a similarly powerful first move. We certainly would not downplay the powerful recovery experienced in 2020. But it is not as unprecedented as some would have you believe, and it is not a forgone conclusion that a market that has run this far this fast is destined to suffer a dramatic selloff. Yes, it adds to the uncertainty always inherent in the stock market, but in of itself does not foretell doom.

Exhibit #3: S&P 500 Returns from Bear Market Bottom			
	First 9 Months	Next 12 Months	Full Bull Market
March 2020	+65%	?	?
March 2009	+62%	+15%	+529%
August 1982	+60%	+1%	+302%
October 1974	+51%	+15%	+203%

A reasonable base case would be for earnings to continue to improve, but with valuations high not to expect much appreciation in overall stock prices. But last year has put an exclamation point on the difficulty in predicting market moving events and how dramatically those events can impact the direction of the market. This early in the economic cycle there is a wide range of outcomes, especially when dealing with a medical condition that has wide ranging impacts and no historic precedent that can be modelled. The virus could mutate into a form that is not protected by current vaccines with significant economic implications.

On the other hand, herd immunity could give consumers and companies the confidence to spend some of the cash hoard they have been accumulating. There is no doubt there is considerable suffering in the world. Small businesses are closing and there are still many workers in stress from the employment picture. But from an economic standpoint those are idle resources that can be put to productive use with little cost to the overall economy. Inflation could raise its head sooner than the Fed expects forcing their hand. A "taper tantrum" at some point is likely when the Fed starts to take the punchbowl away. We believe we are in the early stages of an economic expansion and the risks are elevated. But that is generally the case early in an economic expansion and those that are willing to ride through the volatility are ultimately rewarded.

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