

Market Commentary Fourth Quarter, 2020

We hope all is well and everyone is staying safe and healthy.

When writing the Market Commentary, we go to great lengths to provide facts that explain our perspectives on the economy and markets. We generally avoid commenting on political or other current events because they seldom have a long term impact on the markets or economy, but recent events warrant a few comments.

It is difficult to comprehend something so unthinkable as a mob carrying weapons, invading the Capitol and causing death and destruction, with the sole purpose of challenging the peaceful transfer of power.

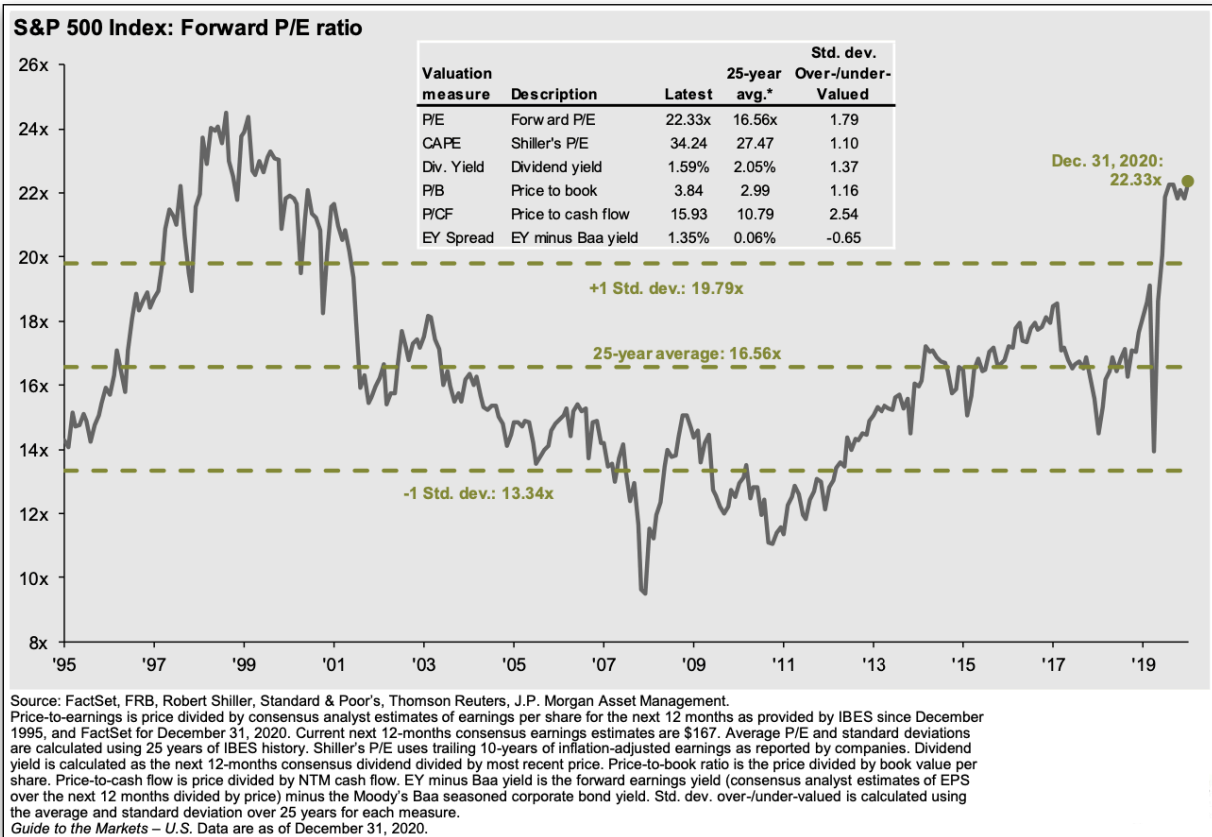
Although the markets seem indifferent, we believe the Capitol assault, the subsequent impeachment of the President and extreme partisan divisiveness have tarnished our global reputation, will adversely impact consumer and business confidence, and delay our economic recovery.

Just as we cannot ignore the events in Washington, we must comment on the coronavirus and how it is impacting the economy. After surging and retreating in the spring and the summer, the pandemic has worsened in recent months, with the hardest hit regions again struggling with hospital capacity limitations and extremely fatigued health care workers.

The approval of several very effective vaccines should allow for the inoculation of about half of the U.S. population in the first half of 2021. In spite of significant challenges with the rollout of the vaccines, we are optimistic and expect accelerating progress in fighting the pandemic, with the domestic economy recovering close to pre-pandemic levels in the second half of 2021. Globally, the economic recovery will be in direct proportion to each country's success in vaccinating its citizens, which will be determined in part by the wealth and healthcare system capacity of each nation. Further, we do not know if there will be a "scarring effect" that delays a full rebound to pre-pandemic spending and consumption habits, or if we will experience something similar to the "Roaring 20s" following the defeat of the Spanish Flu, due to pent-up consumer demand.

Economic growth in the U.S. stalled during the fourth quarter and remains far below its pre-pandemic level. We recovered 12.3 million of the 22.8 million jobs lost earlier this year, but the unemployment rate remains stubbornly high at 6.7%. Likewise, consumer spending on services was \$10.3 trillion on a seasonally adjusted annual rate pre-pandemic, before declining \$2.1 trillion in April and subsequently rebounding to \$9.7 trillion in November, the most recent month data is available. The current surge in Covid cases, a corresponding tightening of restrictions and delays in extending unemployment and other benefits, have hindered the recovery. However, with the Democratic party controlling Congress, the likelihood of additional economic stimulus to support individuals and businesses adversely impacted by the pandemic is very high, and will provide much needed support to the economy while we roll out the vaccinations.

Meanwhile, 2020 reminded us again that financial markets often ignore the harsh reality of current economic conditions and political issues. The domestic equity market was very strong, with the S&P 500 returning 12.2% and 18.4%, respectively, during the fourth quarter and calendar year, including reinvested dividends. Valuations have recovered rapidly from the March lows and are considerably above the pre-pandemic levels. After adjusting for higher earnings in a normalized post-pandemic economy, valuations are still far above their historical averages.



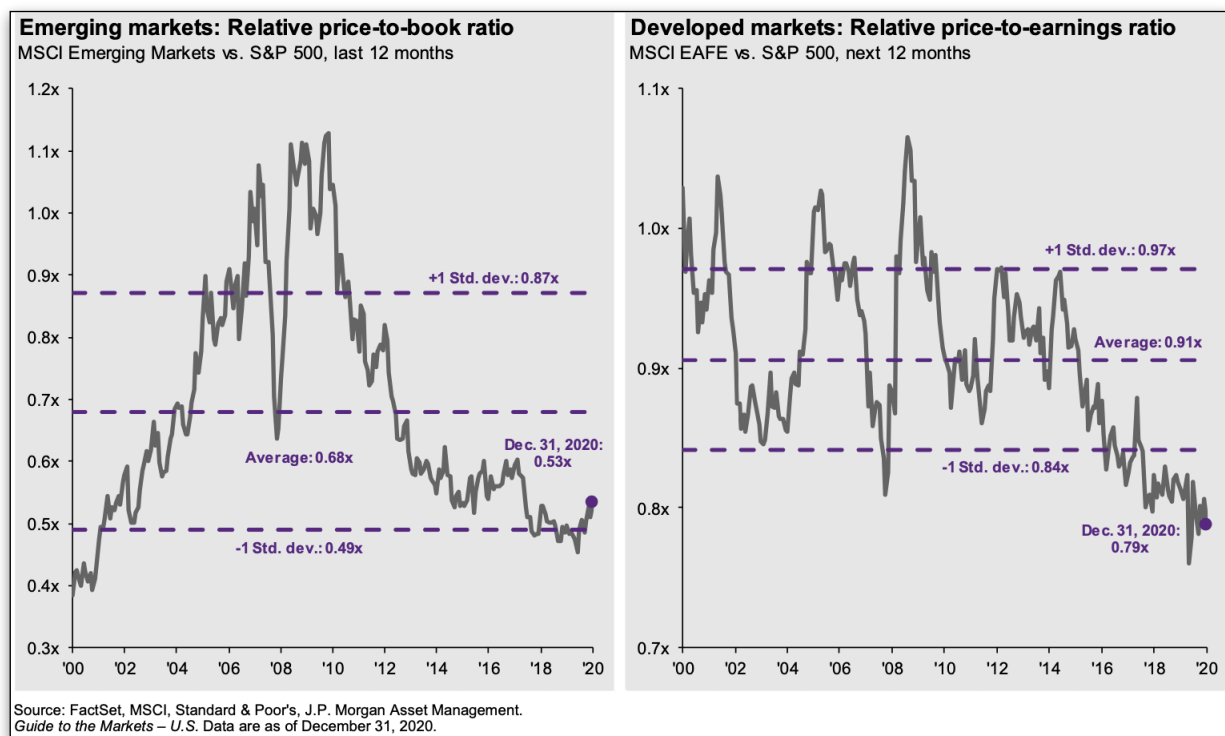
Technology was the strongest sector, its second consecutive year with a 40%+ gain, for a cumulative gain of 210% during the last two years. The last time the technology sector had similar back to back gains was 1998 and 1999, when it was up 75%+ both years and gained a cumulative 317% during that two year period before declining dramatically during the dot com market crash.

During the last few years, a small group of mega-cap stocks have represented an increasingly disproportionate share of the market capitalization of the S&P 500. Five companies-Apple, Microsoft, Amazon, Alphabet (parent company of Google) and Facebook represent about 22% of the index and contributed a very large portion of the market gains last year. Apple's price increased 81%; Microsoft, 41%; Amazon, 76%; Alphabet, 31%; and Facebook, 33%. For additional context, Apple, the largest company by market capitalization, added \$1 trillion to its value in 21 weeks and ended the year with a market value of \$2.3 trillion.

These gains have contributed to one of the widest valuation gaps ever, with the largest companies valued at 40x (Apple), 36x (Microsoft), 95x (Amazon), 34x (Alphabet) and 32x (Facebook) earnings, respectively. Tesla now the sixth largest company, is in a valuation league of its own, valued at 1,220x earnings or \$1.6 million per car sold in 2020. For comparison purposes, the median S&P 500 stock is valued at 21x earnings and value stocks at 18x earnings.

In 14 of the last 14 economic recoveries, value stocks outperformed growth stocks across all sectors, and we expect the same to occur during the current recovery. No two economic recoveries are the same, and this one will have some peculiarities due to the coronavirus. However, we expect the current recovery will be more similar than different to past recoveries, and we are tilting our domestic equity allocation towards value and smaller cap stocks and away from the mega-cap growth stocks. We believe the largest risk in domestic equity is a sharp reversal of the stocks that have exploded higher.

Emerging markets and developed international equities returned 19.7% and 16.1%, respectively, in the fourth quarter, and 18.3% and 7.8%, respectively, year to date. In spite of these gains, current valuations relative to historical averages are compelling, as noted in the following charts.



Both U.S. and international stocks declined significantly at the height of the Covid crisis, and the valuation gaps that persisted during the years prior to the pandemic continue today. We think this will shift during the economic recovery, especially for emerging markets, due to more favorable growth prospects for their economies.

Since current valuations impact future returns, we expect international equity returns will be better than domestic during the next few years.

The amount of global debt with a negative interest rate increased from \$8 trillion in March, 2020 to \$18 trillion in December, 2020, and might increase further. This is not normal, despite the fact it has been on-going for many years. The central banks of the world have created this bizarre upside down debt market and at some point in time, there will be serious consideration for normalizing interest rates. In the meantime, it is a delightful time for governments, corporations and individuals to borrow money.

Ultra low interest rates may be here for a long time, and if so, bonds will not provide much income or opportunity for compounding interest. Yields are at or near all time lows and reinvestment yields for maturing bonds are not very appealing. With yields so low, the risk is interest rates will rise and the price of bonds will decline. Although we do not pretend to know if or when interest rates will rise, we believe they are more likely to be higher than lower five years from now. Despite unattractive yields, high quality fixed income can provide some downside protection and diversification in our multiple asset class portfolios.

So what are our market expectations for 2021? We have never provided forecasts for markets and certainly would not venture a guess today about the year ahead. The only forecast we are willing to make is 2021 will be hard to predict. There are too many conceivable (and inconceivable) events and factors that may and will impact the markets.

It is remarkable how resilient financial markets have proven to be. We recognize that the blessing of strong performance brings with it the challenge of higher valuations and lower expected future returns. We believe it is wise to maintain a diversified investment portfolio to manage risk and market volatility, and rely on financial planning to ensure each client's portfolio asset allocations are consistent with their goals and risk tolerance.

Thanks for reading our market commentary. We are available to answer any questions you may have regarding our views on the markets in general or your specific investment portfolio and financial plan. Please do not hesitate to reach out to us at any time.

We are grateful for your trust and confidence.

The JRM Investment Counsel Team

Jack, Phil and Lauren