MARQUIS
Wealth Management Group
Personalized Financial Services

Fourth Quarter 2021 Market Review & 2021 Outlook

January 2021

Executive Summary

- Stock markets generated very strong gains in the fourth quarter, leading to above average full-year returns. Bond returns were much lower, as most sectors generated small gains in the fourth quarter. (Pages 1 & 2)
- Action within the stock sectors showed that smaller, riskier, and more cyclical companies generated the strongest gains as investors reacted to news of two vaccine approvals in the US. (Page 2)
- Consensus expectations for 2021 call for a strong rebound in economic growth and corporate earnings that accelerates over the course of the year. But, after the exceedingly strong stock returns to end the year, much of that rebound may already be priced in at current market levels. (Page 3)
- We recommend clients maintain a "neutral" allocation towards stocks relative to their respective target allocations, underweight bonds, and hold additional cash and/or alternatives to offset the underweight towards bonds. (Pages 4 & 5)

Fourth Quarter 2020 Financial Markets Review

Global stock markets reaccelerated in the fourth quarter, led by the small cap US segment, which also finished the year with the largest annual return of the major indices we follow. Amazingly, all stock market segments earned double digit returns for the year after being down 20% or more at the end of the first quarter. Trend-following Managed Futures strategies registered solid gains as well in the fourth quarter, which also brought the full year return positive for these strategies. Commodities were the only market segment to still show a loss for the year, although fourth quarter returns were solidly positive. Below are selected index total returns for the fourth quarter of 2020 and full year time periods:

- Large company US stocks, as measured by the S&P 500 index, gained 12.2%, pushing the full year gain to 18.4%.
- Mid-sized company US stocks, as measured by the Russell Mid Cap Index, gained 19.9%, flipping the full year return to a positive 17.1%.
- Small company US stocks, as measured by the Russell 2000 index, gained 31.4%, reversing the full year return to a positive 20.0%.
- International stocks, as measured by the MSCI All Country World (Excluding US) index, gained 17.0%, and also moved positive on the year to a gain of 10.7%.
- Commodity prices (oil, gold, metals, grains, etc.) gained 13.3% but still finished the year down (8.6%) YTD.

- Managed Futures Strategies, as measured by the Credit Suisse Managed Futures Index, earned 5.9% bringing their return for the year to a positive 1.9%.

The US investment grade taxable bond market, as measured by the Bloomberg Barclay's US Aggregate Bond Index, earned a total return of 0.7% in the fourth quarter, pushing the full year total return up to 7.5%. While shorter term interest rates remained anchored near zero, longer term interest rates crept higher in the fourth quarter. Riskier areas of the credit markets registered the best returns in the quarter, as prices continued to recover from the depressed values seen in the springtime. All areas of the bond market ended the year with positive returns for the year. Below are the sector total returns within the bond market for the fourth quarter and full year time periods:

- Short Term US Treasury Bonds earned 0.03%, inching the annual return higher to 1.0%.
- Long Term US Treasury Bonds declined by (3.0%), reducing the full year return to 17.7%
- US Investment Grade Corporate Bonds earned 2.8%, extending the full year return to 9.4%.
- US High Yield Bonds earned 6.5%, flipping the annual return to a positive 6.2%
- US Floating Rate Bank Loans earned 3.8%, and also moved to a positive full year return of 3.1%
- US Municipal Bonds earned 1.8% and finished the year with a 5.2% total return.
- Developed Market Foreign Government Bonds earned 5.1%, bringing the annual gain up to 10.1%.

Market Commentary

Gains in the stock market were quite pronounced in the final quarter of 2020, providing many of the signs a classic early cycle rebound: smaller, riskier, and more cyclical companies generated the strongest gains as they each bounced off depressed levels. This was a noted contrast with earlier in the spring and summer, when headline index returns were stronger, but the gains were more limited to a handful of the largest technology companies and other so-called "stay at home" companies. All things considered, the market movements in the fourth quarter signal a healthier market environment where gains are broad-based rather than limited.

The final months of the year brought additional good news in the form of the first two COVID-19 vaccine candidate approvals in the US. While early supply limitations have been personally frustrating, we think it is important not to lose sight of the bigger picture: the global village researched, tested, and brought to market a safe, effective vaccine in a little over 10 months – a truly extraordinary feat previously unheard of in vaccine development, and one that will save countless lives over the course of the coming year. We hope that additional vaccine candidates will prove safe, effective, and receive approval over the first few months of the year. Perhaps the most important trial to keep an eye on is that of Johnson & Johnson's candidate, which is the only single-dose candidate currently under development and has the possibility of delivering an additional billion doses in the first year once approved.

The election of Joe Biden to be the 46th President and subsequent election of both Democratic candidates in the Georgia Senate runoffs means the Democratic Party will control the Legislative and Executive action in Washington DC for the next two years. But the electoral victories were far from the predicted “blue wave”: The Senate is deadlocked with the Vice President holding a tie-breaker vote if needed, and the House has the slimmest Democratic majority in nearly a Century (the Republican party had a similarly slim majority about twenty years ago). We think this has two likely effects on the legislative agenda: it likely curtails the possibility of the most partisan portions of the Democratic platform becoming law; and it also likely means additional federal deficit spending is coming beyond what would have been approved with a split government or Republican majority. Time will tell what exact proposals will get enacted into law, and what their impact on markets might be. Thus far in 2021, action has been sanguine in the stock market while longer term interest rates have started creeping higher in the bond market.

<u>**When we boil down our expectations for 2021 to a sentence, we think it is likely to be a year where economic and/or business fundamentals outpace stock market returns.**</u> We fully expect this year to be one of cyclical recovery, likely gaining steam as the year progresses and the world can return closer to normal as a higher percentage of the population becomes vaccinated. <u>Consensus expectations are for economic growth in the US to be in the mid-single digits – the highest growth rate in a decade</u>. The outlook for Europe is slightly softer, while the outlook for the Emerging Markets, and in particular, China, is notably stronger. Additionally, the rebound in corporate profits has already been stronger than initially anticipated mid-year, and is on pace to reach new all-time highs in late 2021 or early 2022. These are all unmitigated positive factors. <u>Unfortunately, much of this rebound may already be priced into the stock market.</u> The other downside risk that bears close monitoring is the spread of the more-infectious “UK variant” of COVID-19, which if unchecked, could lead to new rounds of economic shutdowns if the spread outpaces vaccine distribution capacity.

We feel the stock market rebound that began in April reasonably tracked the recovery in fundamentals through the end of September. However, the fourth quarter saw a noticeable slowdown in the pace of the recovery as the number of COVID-19 cases started to rebound in November. Although Florida was not one of them, many states reimposed various levels of business restrictions to combat rising infection rates, leading to an uptick in unemployment rates and a reversal in consumer spending that is just starting to appear in the economic data. Nevertheless, the stock market reaccelerated as investors cheered the vaccine news. <u>The stock market is most-assuredly forward looking, but sometimes it gets ahead of itself.</u> In the past we have used the analogy of a rubber band to describe this situation. When a rubber band gets stretched, one of four things occurs next: first the left side can push to the right to relieve the stress. In our analogy this would be akin to economic fundamentals moving higher while the stock market stays relatively constant. Second, the right side can push to the left. This would equate to the stock market contracting while economic fundamentals stay relatively constant. Third, and usually most likely, both sides push back towards the middle but in smaller amounts than if only one side or the other moved. Finally, if the rubber band gets stretched too far, it can snap. In our analogy, this equates to a bubble forming in the markets that eventually pops, leading to significant declines in the market irrespective of economic fundamentals. Fortunately, this rarely happens, but when it does, the experience can be painful, just like a rubber band snapping. While we do think expectations for stock returns should be curtailed in the near term because the “rubber band” is currently stretched in our opinion, we are not yet to an extreme where a “snapping” seems like something that should be a major concern.

Portfolio Positioning

All things considered, we are reasonably positive in our outlook for this year. We think there are some hurdles to clear, particularly in the first half of the year. But assuming those can be cleared, we expect economic momentum to accelerate over the course of the next twelve months. We also expect stock markets to produce reasonable, if somewhat constrained returns in 2021 as much of the "easy gains" from an early cycle rebound may have occurred in 2020. **With that in mind, we recommend clients maintain stock allocations near the midpoint of their long-term ranges, positioning for a "neutral" outlook. We also recommend holding bond allocations near the bottom end of their ranges, as we have for many years. Correspondingly, we continue to recommend filling the gap from our bond underweight with a combination of alternatives and cash.** Further thoughts on each component are offered in the next few paragraphs.

Using information compiled by JP Morgan Asset Management, the valuation of the US stock market is currently near the top of the historical range using just about any metric aside from valuing stocks relative to bonds.[1] As we wrote earlier, this high-valuation dynamic is balanced against an expected environment of accelerating economic growth, so there are certainly counterbalancing forces at work, leading us to our "neutral" positioning recommendation. This "overvalued" dynamic is less prevalent in smaller-cap US stocks, international stocks, and emerging markets stocks – as has been the case for much of the past 5 years. On a client-by-client basis, we may recommend tilting towards these areas where current valuations are more reasonable. We also think the stock markets may be an increasingly important source of investment income in the coming years with bond yields near historic lows. Stocks from relatively lower risk companies with a stable financial profile and a history of increasing dividends – like publicly traded infrastructure companies – are another area where we will consider recommending increasing our allocations.

Turning to the bond market, we don't find a lot to be excited about these days. To restate the valuation concern we noted above, the only area more overvalued than the US stock market is the bond market. One big mitigating factor in favor of bond prices remaining fairly stable in the coming year is the Federal Reserve, which has pledged to maintain short term interest rates near zero for the foreseeable future. With this in mind, investors can reasonably expect short term bonds will generate returns close to their stated yields in the coming year. Longer term bonds might still experience some price fluctuation based on inflation expectations – and the risk here is definitely skewed to longer term bond prices falling rather than rising. **While we firmly believe high quality bonds will always have an important role to play in a diversified portfolio, we do think the current environment calls for an underweight position.**

With bonds generating income at near the lowest yields in history, the opportunity cost of holding cash or owning small amounts of gold as an alternative has never been lower. We think both could have important roles in client portfolios over the coming year, and with the stock market currently reaching new all-time highs, now is a good time to re-evaluate near-term cash needs and reserve for them prospectively. We also continue to recommend

[1] JP Morgan Asset Management "Eye on the Market 2021 Outlook" Page 8, https://am.jpmorgan.com/us/en/asset-management/institutional/insights/market-insights/eye-on-the-market/annual-outlook/

investments in selected publicly traded REIT stocks and/or private real estate as another alternative source of investment income and as a sort of hybrid investment that sits between stocks and bonds on the risk and return spectrum. We continue to evaluate other alternative sources of income, and expect to have recommendations to share at some point in 2021.

2020 was unprecedented in many ways: the fastest bear market in history, followed by one of the strongest and shortest recoveries – all caused by the first global pandemic in a century. Concerns about protracted market declines and permanent asset impairments in the Spring gave way to near record levels of investor speculation and "fear of missing out". Through it all we tried to be a voice of reason while the markets fluctuated wildly, trying always to keep our focus on the long-term financial health of our clients. We hope you appreciated our perspectives along the way. As we turn the calendar again to a new year, we are grateful for the trust each of our clients have placed in us, and dedicate ourselves each day to continually earn that trust. We wish each of you a healthy and prosperous new year! If you would like to schedule a meeting to review your portfolio in detail, or discuss any other financial matter, please give us a call.

Best Regards,

Rick

Richard Krichbaum, CFP®, MBA
President

Trevor

Trevor Whitley, CFA, CFP®, AIF®
Partner, Financial Advisor

Brian

Brian O'Connell, CFP®
Partner, Financial Advisor

Kim

Kim Sands, MSM, AIF®
Client Services Manager

<u>DISCLOSURE</u>

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Marquis Wealth Management Group), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Marquis Wealth Management Group. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. Marquis Wealth Management Group is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. A copy of the Marquis Wealth Management Group's current written disclosure statement discussing our advisory services and fees is available upon request<u>. If you are a Marquis Wealth Management Group client, please remember to contact Marquis Wealth Management Group, **in writing**, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services.</u>