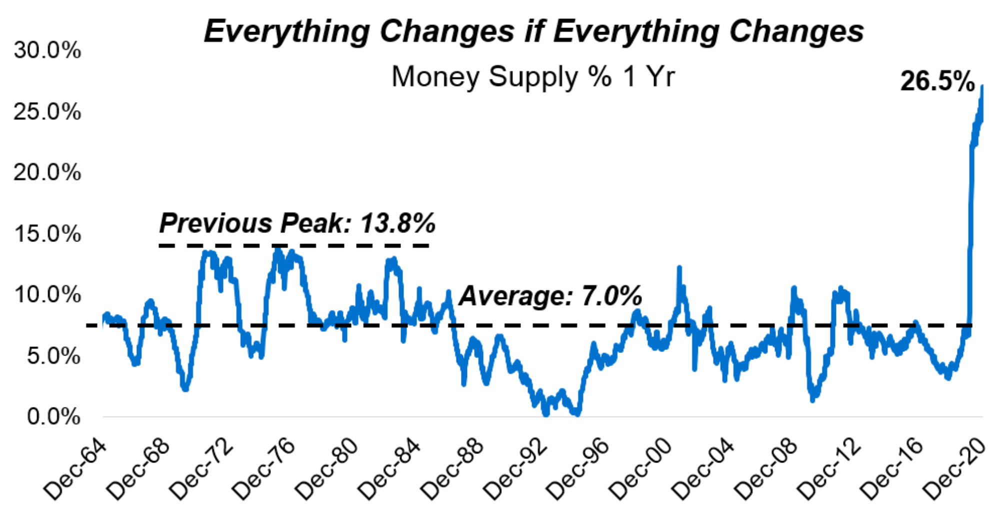
Everything Changes if Everything Changes

"Sooner or later, everything old is new again." – Stephen King –

It's hard to believe that we're already through the first month of 2021. For many of us, having 2020 in the rear view couldn't come fast enough. But has anything changed? I think the answer depends on who you ask and how they've been impacted. Most of us are still operating in an environment that doesn't resemble anything like normal.

But that doesn't mean that nothing has changed. COVID cases remain elevated but vaccines are continuing to rollout assisted by more federal resources going towards the effort. It's still early days on that front and risks remain regarding multiple COVID variants being a byproduct of the spread. Still, estimates of US immunity (vaccinated or antibodies) are progressing and reported to be a quarter to a third of the population, according to the CDC.

The pandemic induced recession certainly took a toll on the US economy last year, but where are we now? One simple metric to track is the jobs gained or lost since the recession began. According to that measure, we're about halfway back – recovering about 56% of the total jobs lost since March. In short, the economic backdrop has improved though there's still lots of work yet to do amid a somewhat uneven recovery with the service industry still feeling the brunt of the pain (travel, leisure, etc.).

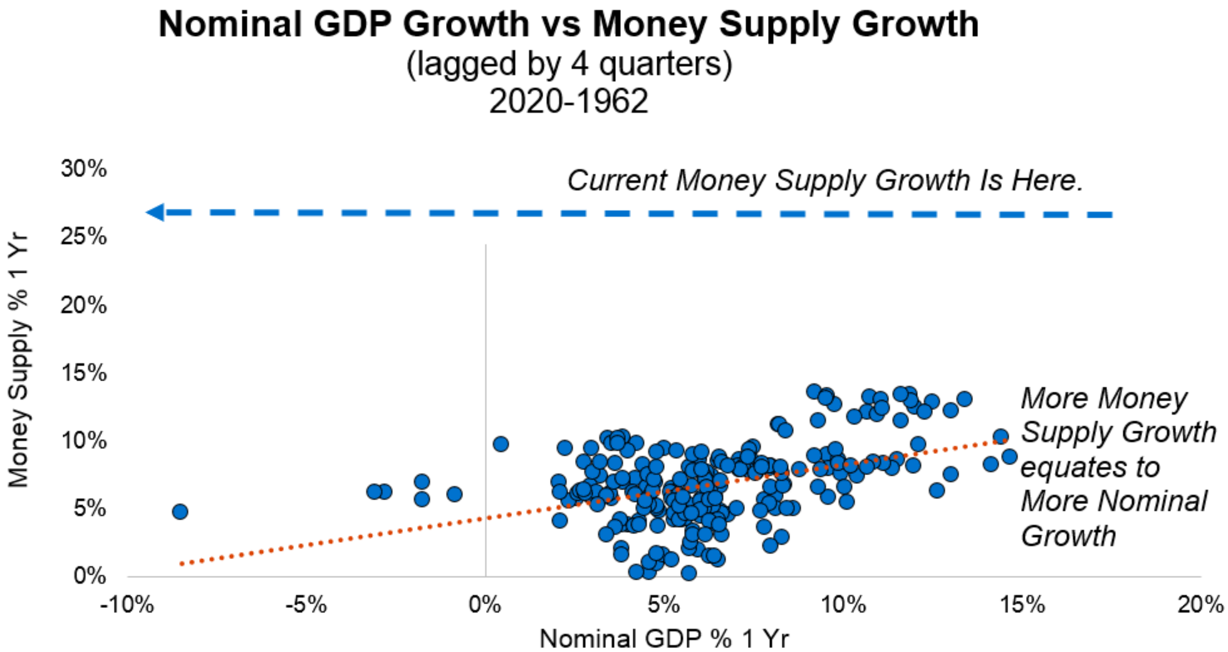


Source: Factset

Without a doubt, the most change has come on the policy side. Early in the pandemic, the Fed led a full-on assault against the virus by lowering rates back near zero and launching a massive bond buying program. Additionally, Washington got in on the act by passing multiple aid packages including the $2 trillion CARES Act – representing about 10% of US GDP. <u>As can be seen in the chart above, the change in the money supply has surged to unprecedented levels</u>. Today, the amount of cash, inclusive of checking account, savings account, and money market fund balances, is growing at almost <u>four times the historical average and almost two times the previous record pace</u> set back in the '70's.

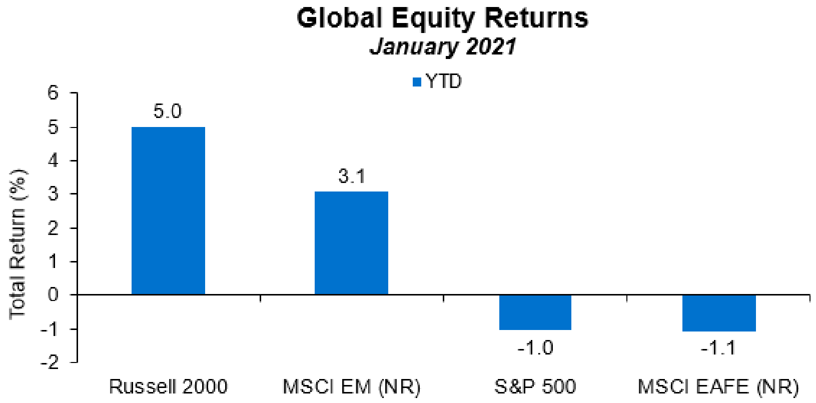
So, what do all of these policy changes mean? As can be seen in the chart below, there's a historical relationship between nominal GDP growth and money supply growth (with about a year lag). ***To put it simply, more money in the economy means more money gets spent. As a result, increases in the money supply tend to be very stimulative to nominal growth which manifests in the form of either an improving real growth backdrop, higher inflation, or some combination of the two.*** When you consider how fast money supply has been growing for the better part of the last 8 months – well above anything we've come close to seeing historically – it certainly implies the potential for a significant change in nominal GDP growth should the economic environment approach some sense of normality through the course of 2021-2022.

Of course, higher growth also tends to come along with a new set of challenges – namely higher interest rates and inflation – an environment that could be very different than what we've experienced in quite some time. For now, we think its important to recognize that we may be on the front end of this notion that ***"everything changes if everything changes".***



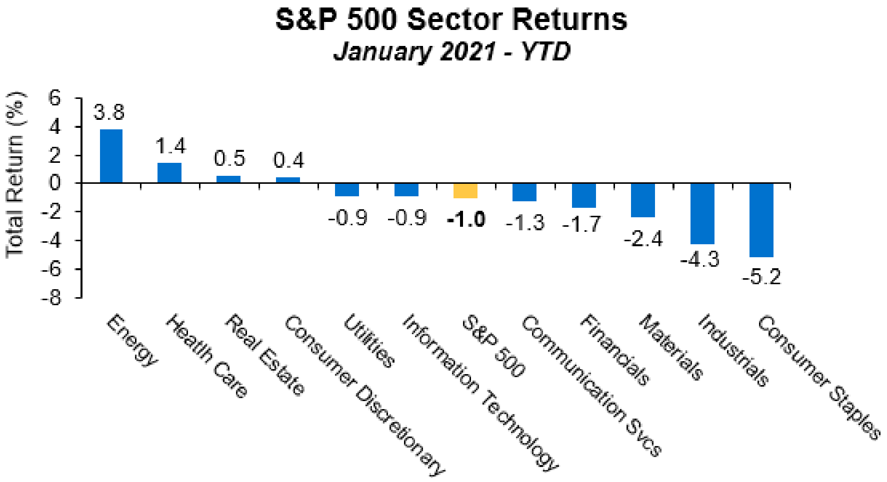
Source: Factset

The S&P 500 had a decent January up until the final week of the month when increased volatility amid heavily shorted stocks drove a shift in sentiment despite a 4Q earnings season that was generally better than expected. Still, there were pockets of the market that did quite well like Small Caps, Energy and Agriculture prices while other areas were pressured like long duration Treasury Bonds and Consumer Staples. ***While headlines centered around retail day traders winning against hedge fund short sellers, we think the more important market message suggests budding cost pressures.***



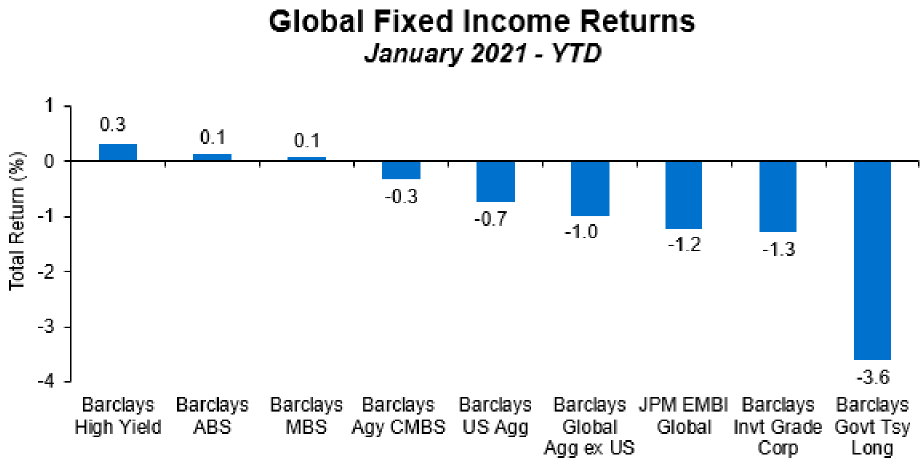
Stocks

Certain pockets of global equities cooled in January including US Large Caps (S&P 500) and International Developed Markets (MSCI EAFE) while other areas remained quite well bid. We think investor preference for both US Small Caps (Russell 2000) and Emerging Markets (MSCI EM) may suggest a desire for more pro-reflation assets in portfolios in an environment where inflation could surprise to the upside. By S&P 500 sector, performance was more mixed as is often the case amid an earnings season where idiosyncratic impacts can muddy macroeconomic themes. As such, a mix of different sectors were at the top and bottom of the list though we think the bookends are notable. The unloved Energy sector outpeformed to begin the year – an area very positively correlated to changes in real assets like oil prices. Conversely, Consumer Staples underperformed – an area that historically has had trouble pushing through immediate cost increases in real assets like Agriculture prices.



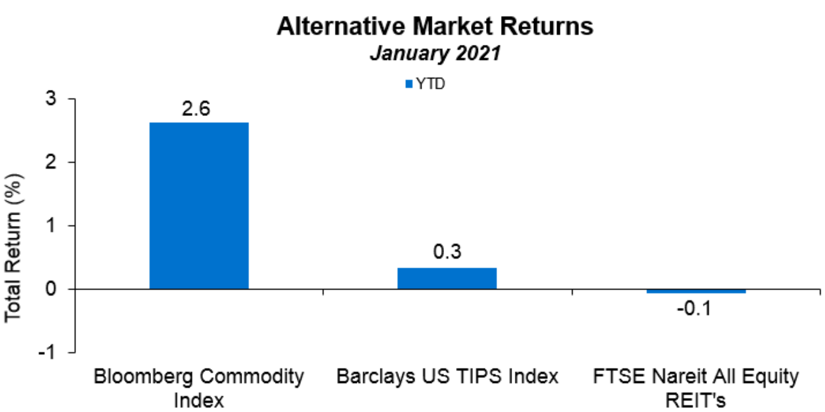
Bonds

Long-term interest rates started to trend higher last August which continued through this month. Meanwhile, short-term rates remained anchored by the Fed – resulting in a 10-2 Year Yield Curve that has steepened to its highest level since May 2017. This is also consistent with a breakout in inflation expectations to levels we haven't seen since 2013. As a result, the more interest rate sensitive areas of the bond market were held back, including long-duration Treasuries (Govt Tsy Long), Investment Grade Corporates (Invt Grade Corp) and Emerging Market Debt (EMBI Global). Securities with shorter durations and more sensitivity to equities outperformed, including Securitized Assets (ABS, MBS, CMBS) and High Yield.



Alternatives

Alternatives posted mixed returns. Publicly traded real estate was flat and remained held back by concern regarding real estate demand in a "work from home" world. Treasury inflation protected securities (TIPS) were slightly positive though outperformed nominal Treasuries given increasing inflation expectations. Commodities posted among the best returns in the month led by notable increases in both Energy and Agriculture prices – consistent with the market's message of budding cost pressures on the rise.



Market Outlook

Coming into this year, we used the phrase "from Red Lights to Green Lights" to describe our view for what we expect. Last year, the world both figuratively and literally hit lots of red lights with global economies shutting down seemingly overnight. This year, the emergence of green lights stems from the notion of having a medical solution to the medical problem. That's not meant to suggest that there aren't risks to the backdrop including variant strains that are more resistant. <u>Things won't be easy and may not even be "normal" but we think things will be better.</u> And importantly markets care more about the relatives of better or worse than they do about the absolutes of good or bad.

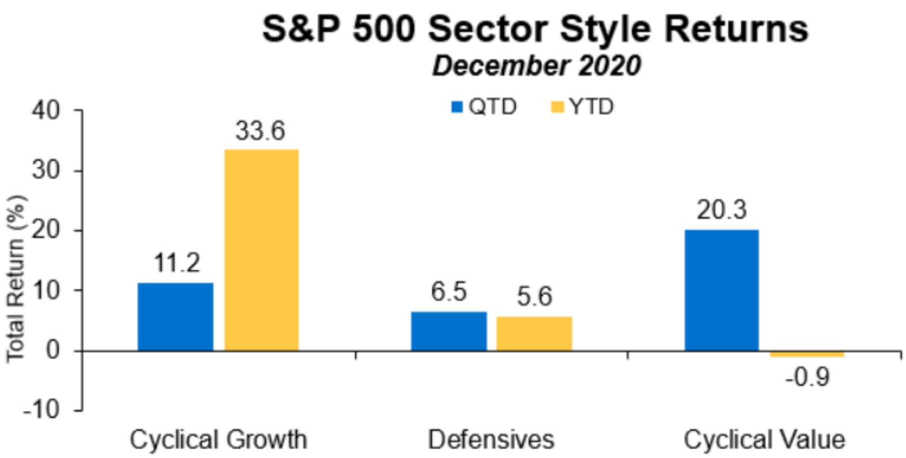
	Red Lights		Green Lights
Indicator	**2019**	**2020**	**2021 e**
GDP (yoy)	2.3%	-2.5%	4.2%
Unemployment Rate	3.5%	6.7%	5.0%
S&P 500 EPS (yoy)	3%	-20%	38%
COVID Cases	N/A	19.1m	?

Source: Factset; 2020 readings and 2021 S&P 500 EPS growth estimate are as of 1/1/21. 2021 GDP and Unemployment Rate estimates are projections produced by the Federal Reserve as of December 2020. COVID case count from www.coronavirus.jhu.edu as of 12/28/20.

As can be seen in the table above, forecasts suggest we are on the eve of an economic and corporate profits recovery. Easy compares are certainly one reason, but we think vaccinations will allow for more economic reopening which is also key to these forecasts. As we mentioned earlier, the unprecedented surge in the money supply will add even more consumption demand to the equation and suggests that despite these robust forecasts, growth may surprise to the upside.

The market, being a forward discounting mechanism, has moved in advance of these expectations. After declining rapidly in February-March of last year, the S&P 500 was back to new record highs as early as late August and continued to move higher through year end. However, <u>we think that's only half of the story</u>.

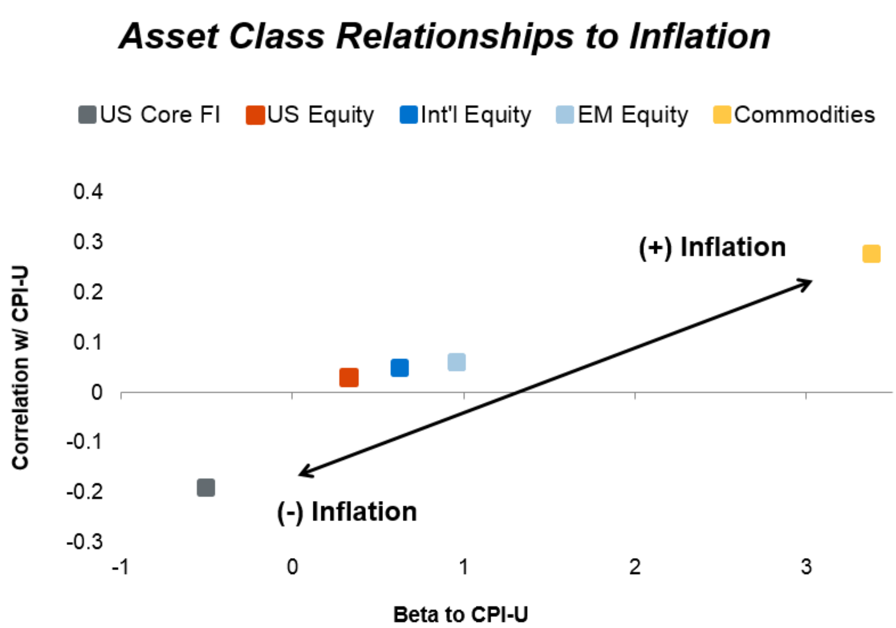
It's also critically important to recognize that there were massive pockets of outperformance and massive pockets of underperformance last year. As can be seen in the chart on the next page, cyclical growth sectors including Tech, Discretionary and Communication Services were not only the secular winners over the past decade, but were also the major pandemic beneficiaries. As growth became even more scarce in 2020, invesors bid up an even more select group of stocks. Curiously, however, the final quarter of the year led to a modest reversal in favor of a much more inexpensive grouping – the cyclical value sectors, including Industrials, Materials, Financials and Energy.



Source: Factset; Cyclical Value: Financials, Industrials, Materials, Energy; Cyclical Growth: IT, Discretionary, Comm Svcs; Defensives: Health Care, Staples, Utilities, Real Estate

We think that may be the key storyline in 2021 – less about what happens to the market in aggregate and more about what happens within the market itself. As we noted in our piece last month, this year may give renewed credence to the notion that it's not a "stock market" but a "market of stocks".

From an investment theme perspective, we see the pieces in place for a "Reflation Reset". The surge in the money supply is a key facet that plays into that view and, as a result, new leadership may emerge. It's pretty easy to make an argument that there are signs of froth in the market. However, its seems that that froth is very bifurcated in areas that have been secular winners further exacerbated by the pandemic. As growth becomes more prevalent in 2021, ***investors may uncover the opportunity to pick up stocks with substantially faster earnings growth rates trading at substantially cheaper valuations.*** That may trigger a rotation as perhaps <u>"old becomes new" again</u>. As such, leadership may shift towards areas that have traditionally been more positively disposed to an accelerating nominal growth environment



Source: Factset, Data November 2001 - January 2021 (i.e. combination of real growth and inflation) – something we've not seen in quite some time. Thus, the chart above and the table below dictates our tactical views in terms of areas that we are more or less constructive on.

Reflation Reset

Advantaged	Disadvantaged
International Markets	Domestic Markets
Commodities	Fixed Assets
Economically Sensitive Sectors	Defensively Oriented Sectors
High Operating Leverage	Low Operating Leverage

Source: FFWM Research

As such, our positioning reflects a desire for more cyclicality consistent with the thesis above. Market rotation has started to reflect this positioning over the past several months. While we think this could lead to a cooling off period in the near term – we trimmed our OW to risk assets earlier this month – we view this price action as confirmation over the intermediate term. ***Strength often begets strength in favor of the trend*** (especially during early recoveries) ***and historical analysis of bull markets suggests that we're still likely in the early innings*** (first and second quintile) ***when looking at both duration and magnitude.***

Within equities, our OW's favor a pro-reflation bias. Previously, we've increased our exposure to International Developed Markets to complement our OW to Emerging Markets. We've also increased our US Small Cap exposure and have shifted toward more of a cyclical value sector tilt within our US Large Cap exposure.

Within fixed income, to mitigate some portfolio risk, we remain UW the most cyclical parts of the bond market (High Yield and Emerging Market Debt) but our US Core managers are OW investment grade credit and UW (defensive) treasuries. We also continue to carry a shorter duration bias (less interest rate sensitivity). Our US Core Fixed Income exposure remains a large OW though we've previously trimmed this position and lessened the UW to International Fixed Income which has benefited from a weaker dollar trend.

Within alternatives, we remain UW to REIT's given our concerns about commercial real estate demand in a "work from home" world as well as to mitigate some of the portfolio risk stemming from the OW to equities per the above. We are equal weight to both a broad basket of Commodities (an inflation beneficiary) as well as to Diversified Alternative's which provide some hedge against market volatility.

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