2021 - A New Beginning?

Executive Summary

2020 Review

2020 was a year unlike any other. With COVID-19 dominating world events, a global recession shook markets. Our investment themes, modified in March, were mostly accurate, as a strong recovery followed the worst recession since the Great Depression. Equity markets proved to be more resilient than expected after bouts of extreme volatility, and interest rates declined to historic lows.

2021 Outlook

With vaccine distribution underway, 2021 should mark a return to more normal life. Our investment themes center around economic recovery, with cyclical stocks benefitting from a reopening, a new economic cycle beginning, and looking for permanent changes in the way that we work and live in a post-pandemic world.

Portfolio Positioning

We remain slightly overweight US equities relative to both international and emerging markets and fixed income, with the expectation that interest rates remain low through 2021. Liquid alternatives continue to play an important role in well-balanced portfolios.

Q4 Review and 2020 Recap

The fourth quarter of 2020 saw strong performance across all equity markets. The S&P 500 continued its advance, returning 12.2% during the quarter, while small caps soared 31.4%, eclipsing large caps as the top performing asset class for the full year. International markets also turned positive for the year, advancing 16% and 19.7% for developed and emerging markets, respectively. For the full year 2020, equity markets proved to be astonishingly resilient in the face of the pandemic.

After leading the charge for the first three quarters of the year, investment grade bonds flattened out in Q4, returning 0.67% to bring the full year return to 7.5%. Despite a lack of inflation, treasury inflation-protected bonds returned 11% in 2020. High yield bonds continued the sharp recovery that began in Q3, finishing the year up 7.1%

Asset Class Returns

	Index	December 2020	Q4 Oct–Dec.	YTD
US Large Cap	S&P 500	3.84	12.15	18.40
US Small Cap	Russell 2000	8.65	31.37	19.96
International Developed	MSCI EAFE	4.65	16.05	7.82
Emerging Markets	MSCI EM	7.35	19.70	18.31
US Investment Grade	Barclays US Agg	0.14	0.67	7.51
US Inflation-Indexed	Barclays US Tips	1.15	1.62	10.99
US High Yield	BBgBarc US Corp High Yield	1.88	6.45	7.11
EM US$ Debt	JPM EMBI Global	1.90	5.80	5.26
Absolute Return	HFRX Global Hedge Fund	2.45	5.11	6.80

Source: Morningstar

Technology Finishes on Top

Technology finished 2020 as the top performing sector within the S&P 500, but the fourth quarter saw the Value sectors recover sharply with Industrials, Energy, Materials and Financials delivering strong performance.

Sector Returns: Q4 and 2020

Equities	Index	Qtr 4 2020	2020
Information Technology	S&P 500 Sec/Information Technology	11.81	43.89
Real Estate	S&P 500 Sec/Real Estate	4.94	-2.17
Industrials	S&P 500 Sec/Industrials	15.68	11.06
Energy	S&P 500 Sec/Energy	27.77	-33.68
Consumer Disc	S&P 500 Sec/Cons Disc	8.04	33.30
Communication Services	S&P 500 Sec/Commun Services	13.82	23.61
Consumer Staples	S&P 500 Sec/Cons Staples	6.35	10.75
Utilities	S&P 500 Sec/Utilities	6.54	0.48
Materials	S&P 500 Sec/Materials	14.47	20.73
Financials	S&P 500 Sec/Financials	23.22	-1.69
Health Care	S&P 500 Sec/Health Care	8.03	13.45

Source: Morningstar

2020 Look Back: Investment Themes

Before we look ahead to the themes that we believe will influence investment decisions in 2021, we look back at the themes that we identified in 2020:

THEME 1: RECESSION THEN RECOVERY

The unemployment rate had fallen to 3.6% at the end of 2019 (the lowest level since 1969). As the lockdown began in March, the economy ground to a halt and the unemployment rate rose to 14.7% by April (the highest level in the history of the data being tracked which began in 1948). Then as the recovery accelerated, the unemployment rate fell to 6.7% by the end of November. (According to the Bureau of Labor and Statistics)

We saw a similar pattern with GDP. First quarter GDP was down 5.0% on an annualized basis, and was down 31.4% in the second quarter. The 2020 recession was the worst since the Great Depression. The third quarter, however, recorded 33.4% annualized GDP growth and set a quarterly record. Many economists believe that GDP will rise over 5% in 2021. This would be the highest year over year GDP growth since 1984 (According to the World Bank).

THEME 2: GLOBAL PANDEMICS MAKE FOR VOLATILE MARKETS

The US stock market took investors on a wild ride in 2020. After experiencing a violent 32.8% decline from February 19 to March 23 the S&P 500 proved to be more resilient than many expected. The S&P 500 recovered strongly and swiftly to end the year up 18.4%. Investors that stuck to their investment plans were rewarded generously.

THEME 3: RANGE-BOUND RATES

The spike in interest rates that some investors expected in 2020 did not occur. The 10-year US Treasury rate was 1.91% at the end of 2019. The rate declined to 0.5% on March 9th, 2020 as the Federal Reserve (the Fed) aggressively cut the fed funds rate to zero in order to provide support for the economy and ease borrowing costs. The Fed also pledged support through bond buying activity, which soothed a nervous bond market.

The 10-year US Treasury rate finished the year at 0.91% and the Fed has pledged to keep rates low for 2021.

2021 Look Ahead: Investment Themes

As we do each year, we begin by identifying those broad themes that are likely to affect our investment decisions over the coming year and beyond.

THEME 1: INNOVATION ACROSS SECTORS

Embracing Technology

Life changed drastically in early 2020 as office buildings emptied and working from home became the socially distant norm. Computers and smart phones quickly became our new offices, supermarkets, and classrooms. Video chats and conference lines became the world's new meeting place for conducting business, teaching students, and visiting with family. Amazon and UPS trucks were frequent visitors to our doorsteps. Zoom, the video conferencing company, saw its daily active user base increase from about 10 million users in December 2019 to over 300 Million daily users just four months later (Source: Zoom 90-Day Security Plan Progress Report: April 22, Zoom Blog). While Neiman Marcus, JCPenney, Brooks Brothers, Lord & Taylor, Pier 1 and over 25 other retailers added to a growing list of bankruptcies, online retailers like Amazon exploded, with net income up 197% year-over year Q3 2020 (Source: FactSet).

Continued Innovation Key to Growth

While the technology trend is nothing new, innovation in the employment of technological advancements across sectors ranging from Consumer Staples to Financials will result in a widening gap between those companies that effectively innovate and those that can't. Industry-specific technological advancements will continue to be rewarded with more robust earnings and higher stock prices in 2021 and beyond. While we will continue to manage well-diversified portfolios, **technological innovation is the key theme that will enable companies across all sectors to thrive in the digital age.**

THEME 2: CYCLICAL RECOVERY FAVORS NEW TYPE OF VALUE STOCKS

We begin 2021 with the roll out of COVID-19 vaccines slowly underway, while new cases continue to accelerate. As a result, mobility will continue to be limited and an economic recovery delayed until vaccine distribution efforts ramp up significantly. This may take significantly longer than initial estimates. While markets are likely to advance in anticipation of successful vaccine distribution and the related economic reopening, a full-fledged economic recovery will be delayed in 2021 until vaccine distribution is near completion.

Eventually, a cyclical recovery will positively impact some of the laggard sectors from 2020, including financials, industrials, healthcare, energy and real estate. While some of these sectors are traditionally included in the definition of “value stocks”, we would differentiate between cyclical stocks and classic value stocks, selectively favoring those which will benefit from a reopening of the economy.

Innovation will be Rewarded

As discussed in our first theme above, those **firms that innovate to gain greater efficiencies will likely succeed and see better price appreciation in 2021 and beyond.** Financial institutions that embrace more of an online presence at the expense of brick and mortar branch networks will likely be favored as will healthcare companies focused on next generation medical technologies that improve patient outcomes. The energy sector should see solid price appreciation in the year ahead as increased mobility results in higher demand for their products and services. However, energy firms will need to innovate in order to incorporate renewable sources of energy.

THEME 3: FIXED INCOME AND ALTERNATIVE STRATEGIES FOR DOWNSIDE PROTECTION

Fixed Income typically plays two roles in a well-diversified portfolio: a source of income and a hedge against equity volatility. As the pandemic unfolded in February, the S&P 500 lost 33.8% (Source: Morningstar. Total Return 2/19/2020 – 03/23/20). Bonds, as measured by the Bloomberg Barclays US Aggregate Bond Index, lost just 1.2%. Bonds served as an effective hedge against volatility in 2020 as investors sold stocks and bought bonds.

As a result of the Fed’s actions in 2020, we now have a yield curve that is at historically low levels. As a result, bonds are not very attractive for a yield-oriented investor and have limited value as an equity hedge. Our third and final theme for 2021 is essentially a continuation of the “Lower for Longer” theme in 2020, combined with the liquid alternative portfolio positioning that we have used for the past two years or so.

Lower Credit Quality, Shorter Duration and Liquidity

With interest rates now at historic lows the likelihood of them providing the same level of downside protection in a stock market sell off has been reduced due to their attractiveness relative to cash becoming diminished. Furthermore, the risk they pose to loss due to a spike or gradual rise in interest rates is heightened. As a result, **we are underweight fixed income, preferring a combination of lower credit quality and shorter duration entering 2021.**

In addition to our bond allocation, liquid alternative strategies served as an effective cushion against volatility in 2020, sustaining an approximate -11% decline during the February – March selloff. In the current environment of ultra-low interest rates, **liquid alternative investment strategies should prove to complement both our equity and fixed income holdings in 2021.**

Portfolio Positioning for 2021

Bullish with Bouts of Volatility

We came into 2020 with a moderately bullish stance on equities, favoring U.S. large cap with an emphasis on growth stocks. We also expected volatility to remain high throughout the year. Without a crystal ball, it would have been impossible to foresee the shocking and unprecedented events of 2020, but our positioning throughout the year provided very strong performance for our clients.

As we begin 2021, we remain bullish on equities as the economy regains its footing, thanks in large part to the Fed’s decisive monetary policy and pledge to support a regime of low interest rates well into 2022. However, as in 2020, we would expect numerous bouts of short-term volatility throughout the year as the vaccine rollout has its fits and starts.

Corporate earnings should recover strongly in 2021, albeit off very low comparisons from the corresponding quarters of 2020. In fact, consensus estimates for 2021 S&P earnings stand at around $166 per share, which implies 38% earnings growth for the year (Source: JP Morgan).

Portfolio Positioning for 2021 *continued*

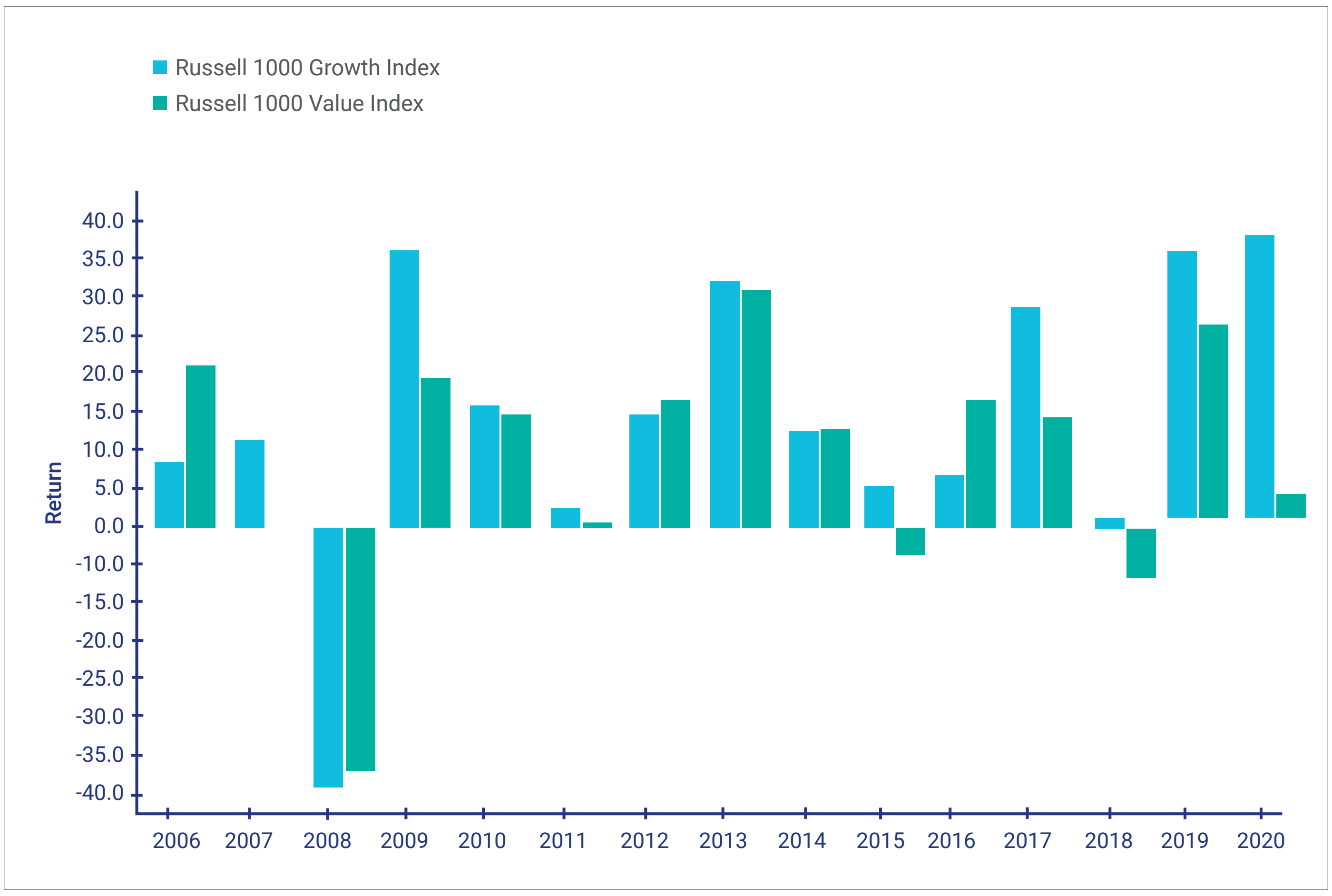
Growth Sectors Over Cyclical Value Sectors

Going deeper within equities, our more nuanced positioning remains the same despite recent outperformance by the laggards of 2020. That means **we continue to prefer growth sectors (e.g., Technology, Health Care and Communication Services) over cyclical/value sectors (e.g., Financials, Industrials, Materials).** Growth sectors are highly levered to the "stay at home"/"work from home" environment and traditionally feature stronger balance sheets and larger cash positions. In a low growth/low interest rate environment these growth companies can stay strong without a ton of help from the overall economy.

With growth outpacing value by the largest margin on record in 2020, it is natural to ask the question: "When will we get a rotation into value"? This is a constant point of discussion among our team, as well as one that our clients are interested in.

As a brief refresher, portfolio managers typically divide the equity markets into **Growth and Value** stocks. Growth stocks (e.g., Technology, Communication Services), tend to exhibit faster earnings growth rates, along with higher price/earnings ratios. Value stocks (e.g. Financials, Industrials), tend to grow more slowly and steadily, and come with lower price/earnings ratios. When growth stocks are doing well, value stocks typically lag. Growth stocks trounced value stocks, 38.3% to 2.7%, in 2020, prompting many to believe that we will see a rotation back to value leading markets in 2021.

GROWTH & VALUE STOCKS: DOING WELL AT DIFFERENT TIMES



To complicate matters, value stocks are often associated with the term "cyclical". Cyclical sectors, those that benefit from an improving economy, are likely to lead the way as the world returns to normal in 2021. However, cyclical stocks come from both growth and value sectors. Our focus is on "cyclical" rather than "value" investments.

U.S. Equities over International

Finally, we still prefer US companies over their international counterparts for many of the same reasons. While there is a case to be made for international stocks to do well (particularly perhaps those in the "emerging markets") as the global economy recovers and the US dollar stays fairly weak- we are "staying close to home" for now. The US is home to many of the top growth companies in the world, so this position is also tied to the growth / value / cyclicals debate. That said, some international exposure is a crucial diversifier in client portfolios.

As always, please don't hesitate to reach out to your contacts at Webster Private Bank if you have any questions. It is a pleasure to serve you during these difficult times and we appreciate the trust you have placed in us.

A Very Happy New Year to All!

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