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~OUR CHIEF INVESTMENT OFFICER'S COMMENTARY~

Happy New Year! Each year end, investment professionals are compelled to offer a forecast for the coming year. After last year, you must be thinking that it takes an inordinate amount of hubris to attempt such predictions. After all, this time last year, how many of us would have thought that the entire global economy would be held for ransom by a microbe; or the economy would be shut by government mandate; or the speed with which monetary and fiscal policy would respond to the ensuing crisis would be sufficient to prevent a global depression? **Further, who could have anticipated that the stock market, embroiled in such chaos, could reward investors with such positive investment returns?**

As we begin the new year, a consensus is building that 2021 will be another good year for equities. This consensus is premised on the notion that the vast amount of liquidity created by central banks, combined with ongoing robust fiscal spending, will support continued economic recovery. Until now, much of this money has been hoarded; stashed in bank accounts and excess reserves, or invested in financial assets. Growth of the money supply is going first into assets, producing a low velocity of money. By the second half of 2021, with widespread distribution of a vaccine, we expect money will begin to flow into the economy, increasing the velocity of money, and begin to be reflected in slightly higher inflation. **We agree with the consensus that although inflation will continue to accelerate, it won't be a concern to be addressed until 2022.**

It is a shame there was not a second round of fiscal support approved before the election, when the spread of virus infections was relatively subdued. **This delay, due to nothing more than pre-election political posturing, has produced slower economic growth in the fourth quarter, which will carry over into the first quarter of 2021; it probably also resulted in the loss of an opportunity to slow the surge in the new cases we are experiencing now.** Although we are very confident that the rollout of a vaccine will produce robust economic growth in the second half of 2021, we also acknowledge that the availability of the vaccine will disappoint until late in the second quarter. Stay safe! It seems likely the most dangerous time for contagion will be in the weeks ahead.

We have spoken in past newsletters about changes brought about by the pandemic. **In essence, the pandemic accelerated trends already in place and forced established behavior to adapt new patterns.** We have mentioned a decline in traditional retail, replaced by online shopping. Banking and payments have shifted toward electronic formats. The ease with which white collar workers have transitioned to working from home is causing us to rethink office space requirements and the amount of time and mode of transportation people need to spend commuting. We expect business travel to remain depressed for an extended period, replaced by a plethora of video conference tools. Leisure travel will most likely return quickly. Restaurants will come back, maybe under new ownership, while efficient takeout and home delivery of prepared food will continue. **These macro trends, and others, will continue to provide investment opportunities through and beyond a COVID-19 world.**

The next six months will bring much uncertainty to the economy. We are still in a pandemic and will endure a multitude of risks until a majority of the population is vaccinated. In the U.S., this isn't likely until mid-year, at the earliest. The runoff election for two Senate seats in early January adds additional uncertainty to the political agenda of a new administration. Even if the Democrats win both seats in the Georgia Senate race, the conservative Democratic senators and moderate administration should restrain the implementation of a radical agenda funded with much higher taxes. **Still, with large and growing fiscal deficits, and ever greater income inequality exacerbated by the pandemic, we are likely to see higher taxes in the coming years.**

Since the beginning of the pandemic, last March, combined monetary and fiscal policy has produced the largest increase in the money supply since World War II. Until now, this money has been circulating at a slower than normal pace. **As the velocity of money starts to increase, we can expect much higher inflation, 3%-5% each year, than we have experienced over the past couple of decades.** Although this will be well above the Fed's target of 2%, we expect the Fed will be slow to respond because unemployment will stay relatively high. Since the dollar is a reserve currency, it seems unlikely we will see double digit, or even high single digit inflation. Still, it has been a long time since we have experienced secular inflation of this magnitude.

With the economy recovering in the coming year, we expect the US will grow faster than its potential sustainable rate; maybe 4.5%-6% GDP growth, next year, depending on timing of the rollout of a vaccine. We expect 2021, and beyond, to be defined by recovery and a return toward normalcy. Earnings growth for the S&P 500 should be 20% and 13% in 2021 and 2022, respectively. With interest rates and inflation on the rise, and higher earnings growth, we expect to see lower price to earnings multiples, even though we expect higher stock prices as well as higher earnings. Looking beyond the coming year, we see the virus a fading memory, the economy robust but growth decelerating, the yield curve steeper, volatility lower, and the rotation into cyclical stocks largely behind us.

In spite of such a positive outlook, it is important to remember how easily a forecast based on known data can be turned upside down by bad, unexpected events; events we sometimes can't even imagine.

Fixed Income

The pandemic created deep cracks in the U.S. economy, but monetary and fiscal policy were able to build a bridge across them to prevent worst-case scenarios from happening. The legacy of the pandemic will be higher debt levels and a strong incentive for the Federal Reserve to keep interest rates very low. In our previous newsletters, we've addressed how public debt has risen to record levels in response to the pandemic. Although government debt has not increased without risks, these risks continue to be largely contained. The combination of economic growth, low interest rates, and the passage of time should be enough to reduce debt burdens gradually.

Despite the positive impact from a vaccine in the near future, monetary policy will remain very loose for several years to come. Ultra low interest rates are likely to stay in order to ease the burden of servicing debt while the U.S. economy continues to grow its way out of the downturn. **In spite of a strong economic recovery, we expect bond yields to remain low in the near future.** The Fed's asset purchase programs (i.e. increasing balance sheet) will persist for several more years continuing to exert downward pressure on long-term interest rates. Short-term interest rates will likely remain on hold for the foreseeable future in order to ease the burden from the cost of higher debt. This is a much more palatable solution than the alternative to "inflate away" the debt (i.e. a higher level of inflation would erode the real value of debt); since higher inflation would lead to higher interest rates and increase the government's borrowing costs.

It remains unlikely that policy stimulus, which has fueled a rise in the money supply, will generate inflation in the next couple of years. The risk of excess money causing inflation to spike is outweighed by lower consumer demand which keeps the velocity of money, its inflationary potential, in check. Even if consumers spend large amounts of their accumulated savings, as the vaccine restores demand next year, the increase in inflation will be constrained by a simultaneous recovery in the economy's production of goods and services. Elevated bank lending, which has largely supported the survival of businesses through the lockdowns, rather than fund increased investment in productivity, will also start to shift, as the lending criteria for less credit worthy businesses tightens. Further, despite the Fed's policy change to allow inflation to average 2% over time, the odds that inflation will eventually rise will be pushed further into the future and dependent on a continued evolution in monetary policy.

International Market

"The deal is done." British Prime Minister Boris Johnson tweeted this on Christmas Eve, marking the final episode of the "Brexit" soap opera. The journey towards the United Kingdom leaving the European Union was never short of drama since the EU Referendum was passed on June 23, 2016. News headlines continuously projected each scenario for an outcome agreement; in addition, multiple delays and extensions of the deadline, as well as the resignations of two Prime Ministers, triggered wildly fluctuating global markets from time to time. As the closing chapter of this initially described "Black Swan" event comes to an end, major global markets are trading near historical highs and the economic consequences are not as devastating as once feared. **This once again reinforces our position that event-driven market fluctuations will not last long before the market, once again, focuses on fundamentals. It is never prudent to base significant investment decisions purely on news headlines.**

A more recent example would be the 2020 U.S. election. Prior to the election, reacting to worst case election scenarios, some investors grew increasingly concerned and global markets started to decline. Interestingly, the worst case scenario, with no clear winner for the Presidency prevailed on election night, and control of the Senate was also left undecided. As of this writing, President Trump has still not conceded the election to President-elect Biden, and the Georgia runoff election in January will determine which political party will control the Senate. **However, markets did not decline as predicted; indeed, the global market registered one of its best months in November as the MSCI World index surged 12.66%.**

The current event that continues to dominate our daily life, and overshadow the market, is the pandemic. **We want to emphasize that although the restrictions being enforced to stop the spread of a new, highly infectious, variant of the coronavirus continues to impact economic activity globally, we would like to remind readers of our previous guidance that "event-driven slowing of economic activity usually results in a much shorter time period for economies to regain traction."** Again, we continue to urge clients to not overreact to news headlines. Although it is widely expected for global GDP to decline 3.8% in 2020—which is larger than any annual decline since World War II— data on world trade volume, as a proxy for economic activity, paints a less gruesome picture. Based on the past relationship between GDP and world trade volume, a 3.8% decline in world GDP this year implies an estimated 30% plunge in world trade. **However, data available thus far suggests the decline is far smaller at an estimated 5.4%. This suggests there is something missing from looking at GDP in isolation.**

Global GDP data alone fails to recognize the elevated consumer savings rate and the significant amount of cash that consumers have been hoarding, during the lockdown periods. This might lead to a potential upside surprise when households have the opportunity, once again, to spend the extra savings they have accumulated. Further, the data on personal savings as a percentage of disposable income, indicates the household saving ratios in major economies have soared compared to the historical average. Using history as a guide, major events are not likely to result in a permanent change to spending, as there is no evidence to suggest a sustainable rise in the savings rate after past major events. **Therefore, once the vaccine has been widely distributed and life starts to return to normal, households will likely spend at least some of the cash they have accumulated which would potentially supercharge the economic recovery currently underway.**

Policy stimulus is expected to continue to ease financial market dislocation and drive the price of risky assets higher. Further, with higher inflation not likely to be an issue within the foreseeable future, we expect monetary policy to remain loose. For example, the European Central Bank has clearly signaled that it plans to extend net asset purchases until at least the end of 2022. With tighter monetary policy very unlikely in the near term, we expect the rally in risk assets to continue. However, with markets at near historical highs, it is important for investors to maintain discipline and adhere to their comfort level to manage their exposure to market risk. By maintaining the proper asset allocation between stocks and bonds, investors are less likely to feel undue stress at market downturns and hence, less likely to make irrational decisions under pressure.

Year 2020 has been a blunt reminder that uncertainty is the only certain thing within the world of economics. Throughout the year, investors may have felt quite anxious trying to comprehend the ever changing news headlines. **However, as the year winds down, it is very obvious that only those investors who adhere to a long-term outlook, instead of trying to dance with the market, will end up reaping the fruit of decent returns.** This perhaps is the most valuable lesson one can take away from the rollercoaster year of 2020.