DANN ASSET ADVISORS, LLC

Fourth Quarter 2020 Update

January 13, 2021

4Q20 Highlights

- Vaccine approvals, monetary and fiscal policy and election results boost the market
- Stocks rise broadly and strongly for the quarter, capping a volatile but positive year
- Economic growth remains uneven with Covid-19 impacts but should rebound later in 2021

The table below summarizes the performance of some key indices during the fourth quarter and for the full year:

Market Performance		
Index	% Ch. 4Q20	% Ch. YTD
S&P 500	12.2	18.4
MSCI All Country World ex US	17.0	10.7
MSCI Dev. Markets (ex US)	16.1	7.8
MSCI Emerging Markets	19.7	18.3
US Aggregate Bond	0.7	7.5
Liquid High Yield	5.9	4.7

Source: Morningstar, iShares

Equities. Positive vaccine developments, additional fiscal stimulus, continued Fed support and favorably perceived election results combined for a flood of good news for the market during the quarter. These factors should enable strong economic growth by the second half of 2021, assuming no surprises with the vaccines and that rollouts accelerate as expected. In our opinion, anticipation of these better times fueled the market's gains even though Covid-19 cases spiked during the quarter and virus-caused partial shutdowns are likely to continue through the winter.

The prospect of a stronger economy led to a significant shift in market leadership. The five large technology stocks (Alphabet, Amazon, Apple, Facebook and Microsoft) that had led the S&P 500 higher over the first three quarters, on average trailed the market in the fourth. Value stocks outperformed growth for the first time since the fourth quarter of 2018, with the Russell 1000 Value index up 16.3% vs. 11.4% for the Russell 1000 Growth index. Even with the stronger fourth quarter, Value still trailed Growth by nearly 36 percentage points for the full year – an extremely wide margin.

Small company stocks – often considered beneficiaries of a strong economy – rose a remarkable 31.4% (as measured by the Russell 2000 index), bringing their full year return to 20.0% and better than the S&P 500 for the first time since 2016. International stocks also had a strong quarter, likely propelled by the same factors that helped U.S. stocks, plus the removal of uncertainties associated with Brexit.

Fixed income. Ten-year treasury yields rose from 0.68% on September 30 to 0.92% at year-end (compared with 1.92% at year-end 2019 prior to Covid-19 impacts on the markets). The fourth quarter increase likely reflects the prospect for improved growth in 2021; however, 10-year rates remain very low by historical standards. Two-year treasury yields dipped slightly from 0.13% to 0.12%, reflecting the Fed's commitment to keeping rates low in the portion of the treasury market they can most closely control.

With the decline in rates, investment grade bonds as measured by the Barclays U.S. Aggregate Bond index generated a strong 7.5% return for the year. Although more speculative sectors of the bond market did well over the second half of 2020, full year returns were held back by the steepness of the decline in the first quarter and continuing credit concerns facing industries most negatively impacted by Covid-19.

Market sectors. As mentioned above, the prospect of an improving economy led to a significant rotation and broadening in what worked in the market during the quarter. The two best performing sectors were energy (+30%) and financials (+25%) – these economically sensitive sectors had been the worst performing groups through the third quarter. Further reflecting the market's shift to more cyclical stocks, the communications, industrial, materials and consumer discretionary sectors each rose more than 17% during the quarter. Utilities, real estate and consumer staples stocks lagged with gains ranging from 7% to 9%.

Even with the fourth quarter reversal, technology and related sectors led for the year, with the consumer discretionary (Amazon and Tesla together account for more than 30% of the sector) and technology sectors up 45%-plus. Communications (Alphabet and Facebook more than 35% in aggregate) was the third best performer for the year. Generalizing, the pandemic's impact on the economy significantly accelerated demand for technology products and services enabling many companies in the sector (especially the larger ones) to generate strong results and stock market performance even as the economy sank. Energy, financials and real estate all fell for the year, with energy down 33% despite the strong fourth quarter.

Portfolio Positioning

As stocks continued climbing, for many clients owning both fixed income and equities we trimmed equity exposures and added to fixed income to keep allocations in line with targets. We also initiated a position for some clients in a high yield bond mutual fund to pick up some additional yield. We're very comfortable with this fund managers' approach to high yield investing but have sized this as a small holding for now given current relatively tight credit spreads.

For many equity-only clients, we purchased a position in a financials sector indexed exchange traded fund (ETF) in early October. Financials had badly trailed the market through the third quarter, as investors had been concerned about the potential for large loan write-offs and the negative impact of low interest rates. We believed these issues were more than fully reflected in the prices of many of the bank stocks included in the financials ETF, and that any signs of an economic recovery would lead to more enthusiasm for the sector.

2021 stock market outlook. In our 2020 outlook we wrote:

"Putting the foregoing together, our best guess is that the market is flat to up modestly in 2020. Regardless of whether that proves accurate, we feel confident that at some point during the year there will be a decline of 10%-20%, if for no reason other than that the market currently seems to be priced for perfection and something negative almost always comes up (even if it proves to be irrelevant beyond the short term)."

Although our prediction relative to actual results was directionally correct, the most accurate part of our forecast was that "something negative almost always comes up" and certainly that proved true with Covid-19. From the February 19, 2020 peak to the low on March 23, the S&P 500 fell 34%. The 71% recovery from then to December 31 was extremely strong and, beginning in the fall, broad based. The full year return of 18.4% comes on top of 31.5% in 2019, making for two very strong back-to- back years.

Among the factors that we believe will be key to the market's performance in 2021 are:

- A continuation of low inflation expectations and supportive Fed policies – the Fed has committed to keeping rates low into 2023.
- The pace of vaccine rollouts and the public's willingness to be vaccinated – the initial rollout has been significantly slower than expected.
- Fiscal policy – whether Congress continues to provide support for individuals and businesses that will be negatively impacted by the virus until widespread vaccination occurs.
- The pace of economic recovery in other important economies – China, which controlled the virus early, has been leading the way.

If each of these factors resolves positively, U.S. economic growth should be strong by the second half of 2021. And with the economy expanding strongly, robust earnings growth should follow. Assuming this occurs (and that interest rates remain low), the market could continue to move higher in 2021. From what we've read, this seems to be the consensus outlook for the year.

Our concern is that the market's 21.2% advance over the second half of 2020 may already have discounted much of the anticipated improvement in the economy and earnings for 2021. Per a recent Yardeni Research report, consensus earnings estimates for the S&P 500 for 2021 and 2022 are $167 and $195, implying multiples of 22.5x and 19.3x on current and next year's earnings, respectively (based on the index's year-end 2020 closing price). We appreciate that multiples often expand when interest rates are low, but these multiples are high by historical standards and to us imply an expensive market.

Our best guess is that the market ends 2021 close to unchanged. We believe there's a good chance the market declines modestly if the economy hasn't begun recovering by the end of the year. However, with the Fed committed to supporting a recovery and the Democrats controlling both houses of Congress (additional fiscal stimulus more likely), a substantial and prolonged downturn seems unlikely. We believe the least likely outcome for 2021 is another big gain – to us the market already reflects the significant economic and earnings improvement expected for later this year and into 2022. As occurs in most years, unexpected events are likely to cause volatility along the way. This could be especially true on the downside in 2021 given current high valuations.

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