Market Note

Integra Capital ADVISORS

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So Long to 2020!

As we bid farewell to tumultuous 2020, I couldn't help but conjure the image of the parting scene from Disney's ride It's a Small World. To anyone who has experienced hardship or loss during the global pandemic, our sincere sympathies go out to you and those affected. I think we all look forward to a day of "maskless" excursions, jam packed sporting events, concerts and normal family gatherings. This is certainly my prayer for all of us as we move toward another calendar year.

In terms of the financial markets, I think many individual investors and professionals alike were surprised at the market's reaction after the initial selloff into bear market territory earlier this year. It was only natural. Financial markets faced a wholly uncertain and uncharted near-term future when the pandemic arrived at our shores. As we've communicated through 2020, there were no right or wrong answers, only personal comfort decisions.

They say hindsight is 20/20, so let's take a look back and see what can be learned from market behavior this year. An initial observation is that the U.S. stock market is comprised of just over four thousand publicly traded companies. Local restaurants and bars, your favorite boutiques and other small businesses are not publicly listed companies. While it's certainly true that what impacts individuals can also adversely impact publicly traded stocks in our interconnected economy of transactions, it is also true that in today's technology powered world truly disruptive events must impact greater swaths of the economy than we have seen during the pandemic. This is the reason the top 5 largest companies by market cap significantly outperformed the other 495 stocks in the S&P 500 by the end of August.

However, since then, we've finally experienced greater participation by other than the "big 5" as can be seen in the chart above. Since the beginning of September, the "other 495" stocks have outpaced the "big 5". The "other 495" were even less negative than the "big 5" during the pullback in early November.

Since September 2nd, we've experienced "a recovery rotation". The "big 5" are down 8%, while the "other 495" are up 6% (as of December 14th). We view this as a positive sign and in technical parlance we call this greater "breadth" in the market. This greater participation by other than the "big 5" has been disorderly and messy, with no obvious consistent pattern. Some days or weeks it was the growth to value rotation, at other times its been a shift from large caps to small caps, defensive stocks to more cyclical stocks, "stay at home" stocks to "go out and live" stocks, and COVID winners to COVID losers. Some of these rotations took place before vaccines became a reality and some took place because vaccines became a reality. Some took place

because investors were pushed to riskier stocks over risk-free treasury bonds, given the current yield environment and risk-reward setup. I'm sure this haphazard, day to day response to new news will continue as vaccines are rolled out, their effectiveness is assessed, and most importantly, we begin to gather information on people's willingness to return to normal.

What to Expect in 2021

Well, this is certainly the mother of all questions! Let's begin by understanding that the stock market is built to go up, not down. The natural gravitational pull is up, not down. It makes sense if you think it through. The stock market is comprised of large companies with highly educated, experienced management teams who are financially incentivized to grow their respective businesses. Do company managers and boards fall short in their duties and in this pursuit? You bet some do at times but those who do aren't around for long. That's what makes investing interesting; using information to sort out which companies and management teams are up to the task.

These managers answer to their board of directors and shareholders who are constantly picking and prodding at these companies to identify their failures and successes. No one in business convenes the troops to encourage them to produce and sell less. It's all about growth. In fact, that's why so many companies have been willing to give away some of their intellectual property to China in return for access to China's humungous population of consumers. Once a company has tapped growth at home, they naturally look for future growth opportunities. For these reasons it's not healthy for investors to live in constant fear of market declines. It leads to flawed decision making. It takes a lot of direct and lasting financial impact to cause a pro-longed market decline. The most recent example would of course be the Great Financial Crisis of 2008 - 2009. 2020 has been a serious health and economic event, but not a structural problem in the financial system.

One measure we use to determine when to invest new client capital in stocks is market sentiment, among the so-labeled "smart money" (institutional investors) and "dumb money" (average retail investors). I've included a graph of the indicator below but understand that the indicator is difficult to analyze and use in practice because it is only informative at the extremes. The idea here is that when we have new cash to invest, we prefer to do so when prices are more attractive and when the "dumb" money is a bit pessimistic, because they are usually proven wrong. We're not talking about "market timing" where an attempt is made to identify the top and bottom, but rather just having a reasonable discipline when initially putting new cash to work or increasing exposure to stocks within a portfolio.

As you can see in the sentiment chart below, the "dumb money" is at an extreme optimistic high and the "smart money" is at an extreme pessimistic low, although both have come off these extremes a bit recently. The interpretation here is that patience is warranted increasing risk and putting fresh cash to work in stocks. If these extremes do not continue to narrow as they have the last few days, and instead grow wider still, that could indicate a possible normal, healthy market correction. Remember, we are in the recovery phase of the business cycle coming out of recession, so I am referring to a bull market correction, not a lasting or deep selloff.

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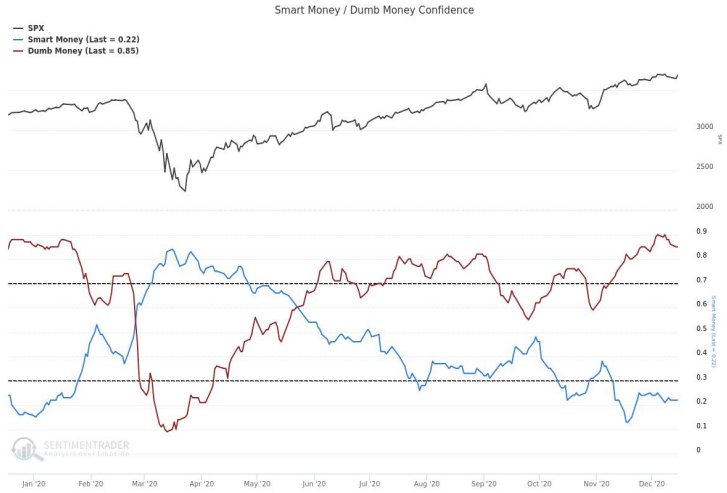

We also interpret the sentiment indicator as a cautionary indicator. Cautionary in a sense that when extreme levels of positive or negative sentiment are reached the market becomes more vulnerable when some sort of negative news or event occurs. Negative events could include problems with the vaccines, lack of additional stimulus package from Congress, government shutdown, widespread local government economic shutdowns and host of others.

I feel like a broken record pointing out the next market dynamic, low yields. However, in today's ultra-low yield environment, the single biggest driver of stock prices remains low yields. Professional investors get up every day and compare investing in risk-free U.S. treasury bonds versus riskier stocks. Even at today's elevated stock prices, stocks remain more attractive on a risk-reward basis, so the gravitational pull remains to the upside.

On the flip side of low yields as positive stock market catalyst, there is the dark side as well. Low yields for a long time may be creating asset price bubbles in some pockets. Perhaps residential real estate in Florida and other areas desirable for those looking to evacuate more densely populated large cities or those looking to move from higher to lower tax states "desirable COVID locations" where people have shifted in the pandemic. The supply of real estate in these areas has reached very low levels, driving the current seller's market. What about the stock market? Are stocks at bubble levels? Some certainly are trading at levels wholly unjustified by their underlying financial results, but others are not. Stocks that are trading at bubbly levels will be more sensitive to market selloffs, faring far worse than others trading at reasonable prices to their underlying fundamental results.

As advisors and managers of your hard-earned resources, as opposed to "speculators", we will continue to seek opportunities where the risk versus reward setup is attractive and structure your portfolio with the objective of positioning you to achieve your personal financial objectives and goals within your desired risk tolerance.

We wish you much joy and peace during the remainder of 2020 and the upcoming holidays and all the best for a great 2021. As always, please reach out to your Integra Capital advisor with any questions or concerns.