ECONOMIC COMMENTARY
2020 Year in Review; 2021 Outlook

2020 YEAR IN REVIEW

The year of 2020 was definitely one to remember, but also one that many of us wish to forget and put behind us. The global pandemic swept across the world with millions becoming infected and sadly, hundreds of thousands losing their lives to this virus. COVID-19 has impacted everyone’s lives, as most people wear masks in public, many people are afraid to leave their house, children are required to learn outside of the classroom, millions of Americans have either lost their jobs or their employment has been severely disrupted, and thousands of small businesses have been shut down, many forever.

From an economic standpoint, America entered the quickest, but also shortest recession in its history. In just a matter of weeks beginning in March, millions of jobs were lost and many Americans were scared for both their lives and their livelihood. From its peak on February 19, the US stock markets lost about 35% in a matter of only 5 weeks, and in rare form, bonds followed suit by losing about 15% as well. Fear was running rampant in the US, as we were witnessing a stock market crash along with the loss of lives and jobs - not just in the US, but around the world.

In late March, the US government came to the rescue with a series of stimulus packages designed to help Americans, the unemployed, and small businesses. While many can debate the effectiveness or fairness of the stimulus package, it certainly caused the stock markets to bounce off their...
March 23 lows. At a minimum, it saved many small businesses and helped to turn the unemployment around.

At that time in late March, I only wished for the bleeding to stop, and if the markets ended the year back where they started, I would have been pleased. No, I would have been relieved. Boy, was I wrong! See the table below showing the beginning of the year, the market peak on February 19, the market low on March 23, and how the markets ended the year. Now that was a pleasant surprise.

<table>
<thead>
<tr>
<th></th>
<th>12/31/19</th>
<th>2/19/20 Peak</th>
<th>3/23/20 Bottom</th>
<th>Drop From Peak</th>
<th>12/31/20</th>
<th>2020 Return*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dow</td>
<td>28,538</td>
<td>29,551</td>
<td>18,592</td>
<td>-37%</td>
<td>30,606</td>
<td>9.7%</td>
</tr>
<tr>
<td>NASDAQ</td>
<td>8,973</td>
<td>9,817</td>
<td>6,861</td>
<td>-30%</td>
<td>12,888</td>
<td>45.0%</td>
</tr>
<tr>
<td>S&amp;P</td>
<td>3,231</td>
<td>3,386</td>
<td>2,237</td>
<td>-34%</td>
<td>3,756</td>
<td>18.4%</td>
</tr>
</tbody>
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* Note that an individual cannot invest in these indices directly, and that the return represents the total return of the index which also includes dividends of the underlying companies.

Before being enamored by those lofty numbers, it is important to pare down deeper into them. As I have noted in prior correspondence throughout the year, the 2020 market rally was essentially led by a small number of technology stocks, often referred to as the “FANG” stocks, but more accurately as FAAANM, which is Facebook, Apple, Amazon, Alphabet (Google), Netflix, and Microsoft. These six stocks represent 48% of the NASDAQ, 23% of the S&P 500, and 8% of the Dow, and they gained between 28% and 75% for the year. At one point in the year (August), the S&P 500 was up about 3%, yet those six stocks were up about 35% and the remaining 494 stocks were down 5%. In fact, just Apple, Amazon, and Microsoft represented 53% of the S&P 500 gain for 2020, and technology stocks represented 69% of that index’s total return. That is why I consider the Dow to be more representative of the economy than the other two indices, despite the Dow representing only 30 stocks.
Bonds also rallied off their pandemic March 23 lows, as they reacted to a liquidity crunch, similar to what happened in the 2008 global financial crisis. Once the Federal government announced that it would help the liquidity crisis by buying bonds on the open market, bond prices also rallied. In the end, diversified bond funds were up about 7% to 9% for the year.

For those of you who have investment portfolios managed by Menninger & Associates, let’s recap what we did for the year.

Feb 26 One week after the market peak, we were concerned about news of how this pandemic was catastrophically impacting China, while not being reported much yet in the US. We de-risked all of the investment portfolios by significantly reducing exposure to international investments, and eliminating exposure to small cap investments, and over weighted large, stable, US companies. In a historically large portfolio movement, we sold about 25% of the stock portfolio, and purchased bonds with the proceeds. (In hind sight, we would have been better putting the proceeds into cash, as bonds also dropped.)

Mar 27 Four days after the bottom, but more notably after the government announced the massive stimulus packages, we bought back about half of the stocks we sold, but continued to remain in the high quality, large US companies.

May 8 We made minor adjustments to the portfolio to transfer some of the stock investments weighted more heavily to bank stocks to those more heavily weighted in technology stocks.

June 8 Immediately following the June 5th announcement of the May jobs report (expected loss of 2 million jobs, which surprisingly reported a gain of 5 million jobs), the Dow rocketed about 1,000 points. At that time, we felt the markets were overpriced (as stated in a series of weekly commentaries noting that PE ratios were climbing too high, evidencing the markets may be over-priced). At that time, we reduced our stock exposure again to about 15% below their corresponding target weightings.
With the exception of minor adjustments, we held steady with our portfolios the remainder of the year, but also commented that the fundamentals of the economy were finally catching up to the market prices in October. All things being equal, we would have returned the portfolios to equal weighting, but we felt there were still two main risks facing the economy and the markets. These risks were the potential second wave of COVID with subsequent economic lockdowns, and the forthcoming presidential election, where concerns of a “blue wave” (Democratic Party winning the White House and both chambers of Congress) could result in policy changes that could have adverse effects on the markets. Specifically, the policy changes included possibly raising the corporate tax rate, and also raising the tax rate on stock dividends and capital gains. Either of those policy changes could have significant adverse effects on the stock markets, so we continued to remain cautious on behalf of our clients’ accounts, particularly when dealing with their retirement nest eggs.

In the end, the stock and bond markets finished 2020 in a favorable manner. Further, despite missing some of the late year rally with our actively managed portfolios, our strategic allocation moves during the year have led us to outperform the benchmarks we use to measure our performance.

2021 OUTLOOK

As a direct result of the pandemic, we are witnessing the beginning of tectonic shifts in our economy. Some of these shifts may be temporary, while others could begin a series of unintended consequences. One of the major changes that will likely stay with us are people working more from home, which begins the tectonic shift. Here are some of the repercussions:

- The need for technology at home, such as computer equipment, technology, and increased bandwidth
- The need for additional (private?) space at home to work
- A reduction in demand for corporate real estate
- A reduction in demand for living in cities, while increasing the demand for suburban real estate
• The increased use of online shopping, and the corresponding
decrease in shopping in retail stores.

This list could go on and on.

From an economic perspective, there continues to remain weakness in certain areas of our economy, particularly in the leisure and entertainment industries. After all, personal and corporate travel has come to a near stand still, as the fear of travelling and the pandemic will persist for quite some time. Conversely, the pandemic has demonstrated the need for and expanded use of technology, so one can expect that industry to continue to flourish in this environment.

Economic fundamentals have strengthened, and the consensus of economists are predicting a market growth of about 10% for 2021. These predictions are based on corporate earnings to overcome the drop in 2020, and surpass 2019 while certain industries are expected to continue to lag, as noted above. More importantly, the consensus of earnings forecast are an additional 15.2% from 2021 to 2022.

According to leading economists at JP Morgan, there are a number of reasons to be bullish for 2021.

• The current interest rate environment is expected to remain low (near zero) for three more years.
• A low interest rate environment supports the higher PE ratio in the market that we are currently experiencing,
• Earnings forecasts for 2021 and 2022 are strong.
• Stocks are “cheap”, when compared to the interest rate of the 10-year Treasury, which is currently about 0.9%.
• There is about $4.4 trillion of uninvested cash on the sidelines.
• The amount of cash on corporate balance sheets (as a percentage of total assets) is the highest since the 1950’s. Now that uncertainty is dissipating, that cash can be used for mergers and acquisitions, stock buybacks, and increasing dividends, all of which are favorable to stock prices.
• The consumer balance sheet continues to improve, and the consumer represents almost 70% of our economy.

In our opinion, these forecasts represent the “goldilocks” viewpoint, in that everything must go well in order for this to happen. Clearly, the introduction of the vaccines are critical to these forecasts, as it will be imperative for our society to mentally put this pandemic behind us. Americans need to see the number of cases and the number of deaths show a continuous drop for an extended period of time before they feel comfortable with coming out of their shell and getting back to “normal”, whatever that may be in the future. Economists believe we may begin to see herd immunity by July, which should help the economy in many ways.

Just remember that the stock markets are a leading indicator, as they “forecast” the economy in about 3 – 6 months. The fact that we’ve seen such a rally in the past few months is indicative that the markets are forecasting the US to emerge from this pandemic and forge ahead with strength.

As far as the portfolios we manage for our clients, we have been waiting for certainty with the elections, as we believed the biggest remaining risk is the potential for policy change regarding the tax code, its impact on business profits, and the corresponding demand for stocks. As of the time of writing this document, it appears that the Georgia Senate races will both be won by the Democratic party, giving the Democratic Party control of all three branches of legislature in Washington. Many pundits believe there are enough centrist Democrats in Congress to inhibit some of the more progressive policy changes. The pundits also believe this will open the door to additional government spending that could further increase our country’s budget deficit and debt. Under these circumstances, it can also be expected that the dollar will show more weakness.

We intend to provide a measured approach to returning back to “fully invested” in the markets, depending on the portfolio’s risk objective. In doing so, we will be increasing our exposure to international investments, as well as adding back to emerging markets equities. In both
cases, we have significantly reduced or eliminated our exposure to these asset classes over the past few years. However, they have each already demonstrated a bounce off their bottom, which is supported by a falling dollar and a potential ease in trade tensions between the US and China with the new US President. While adjusting our portfolios, we will continue to be cautious about adding some small cap exposure until the policy changes are more clear.