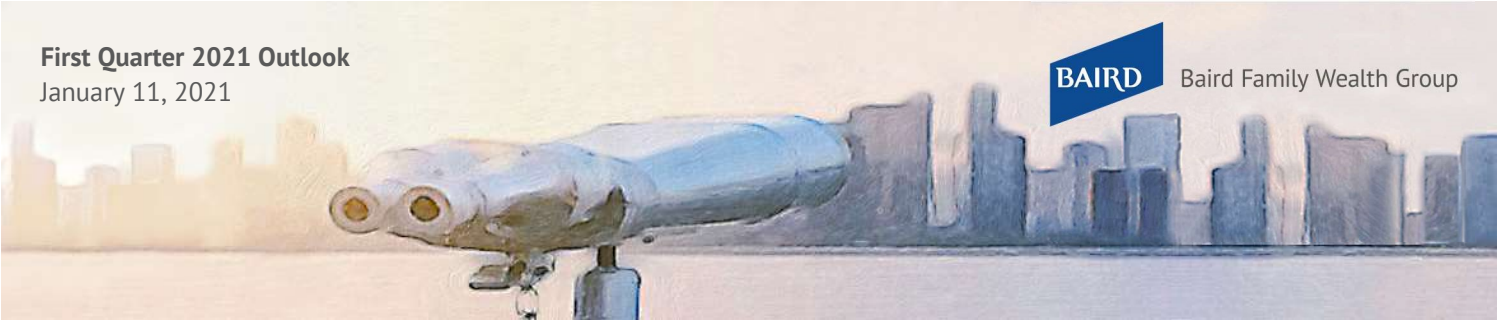

Summary: The stock market ended the year in a mood approaching euphoria, which is typically associated with a top in the cycle. Since March of last year, the market has largely been driven by the enormous amounts of liquidity and stimulus provided by the Federal Reserve and Congress. Fundamentals, such as corporate earnings, have been an after-thought. Instead, the potential of disruptive ideas represented by Tesla – up 800%, Bitcoin – up 300%, and initial public offerings – the most since 1999, caught the imagination of the market. A resurgence in COVID during the fourth quarter was largely ignored, as investors remained confident that any new economic weakness would be met with additional liquidity and stimulus. Also largely ignored, was the potential for higher corporate taxes, as investors instead bet that the democratic election sweep would also lead to additional stimulus. There are signs that the underlying economy is improving. Increased disposable income, strong retail sales and an uptick in travel are all positives. The Industrial Production index is also signaling some improvement, but a complete recovery will take some time. Increasing economic demand and liquidity, in the form of a larger supply of dollars, may lead to inflation. While supporting corporate earnings, economic growth and inflation would likely be accompanied by higher interest rates. Unfortunately, the more positive the economic news becomes, the less likely the need for additional liquidity required to keep the market aloft. The CAPE ratio, another measure of valuation, is suggesting that the expected return for a new $1 of investment is now unattractive. As market fundamentals come back into focus, valuations will start to matter, and market multiples will likely return to more attractive levels. Therefore, clients may consider reducing exposure to More Risky asset classes, favoring value sectors and asset classes that historically out-perform with a weakening dollar.

- With the exceptions of real estate and energy, most asset classes performed well in 2020. More Risky asset classes were led by Gold, up 20.9%, U.S. Small Cap, up 20%, Emerging Markets, up 18.7% and U.S. Large Cap, up 18.4%. Less Risky asset classes were led by intermediate taxable bonds, up 7.4%.
- The market cycle has been driven ahead of the economy by the tremendous increase in liquidity and stimulus provided by the Federal Reserve and Congress. Instead of focusing on fundamentals, such as earnings, investors are watching for signs that additional liquidity and stimulus will be forthcoming. The excitement around disruptive ideas represented by Tesla and Bitcoin, while excessive, would not be alarming in isolation. However, the incredibly strong market for initial public offerings is a different story as it is often a sign of market tops. New issues in 2020 were the most since the dot.com bubble in 1999.
- Like today, growth stock investing outperformed in the period preceding and including 1999. That changed in the years that followed. An increase in interest rates would be a positive for bank earnings which would be supportive of the value side of the stock market.
- There are signs that the broader economy is improving and will continue to do so over the next year. COVID wreaked havoc on confidence in travel and the manufacturing supply chain causing these sectors to lag the consumer driven sectors of the economy. Indicators such as TSA year-over-year travel and Industrial production are showing sign of improvement.
- Given the huge increase in dollar supply, an increase in economic demand will likely cause inflation. While some inflation would be positive for corporate earnings, as it would allow companies to raise prices, it would also, more than likely, be accompanied by an increase in interest rates.
- With the dollar already in a cyclical decline, the Federal Reserve may be forced to reduce the amount of liquidity in the markets sooner rather than later and investors would refocus on market valuations. During periods when the dollar is rising, asset classes such as domestic equities out-perform while assets classes such as emerging markets and precious metals under-perform. The opposite has been true during periods of a declining dollar.
- Even with the prospect for improved earnings in 2021, the S&P 500 has a forward PE of 22.6, which is above the 5-year average of 17.5 and the 10-year average of 15.7. Another measure of valuation, the CAPE ratio is suggesting that the expected return for a new $1 of investment is now unattractive.
- **Clients should reduce exposure to More Risky asset classes, tilting their allocation toward value stocks and asset classes that historically out-perform with a weakening dollar.**