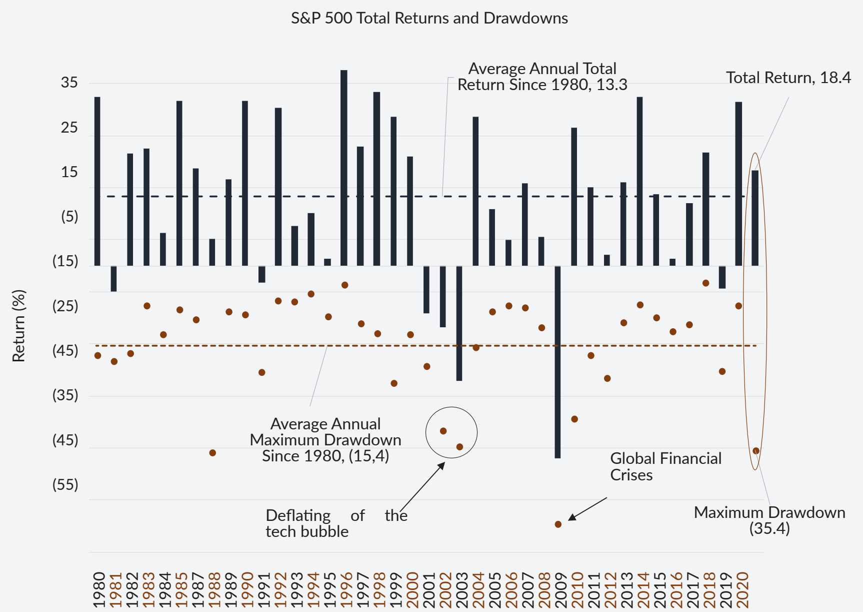
# Stembrook Market Review — Fourth Quarter 2020

In the previous year we all faced unprecedented challenges from not just an economic standpoint but also from a public health and social well-being perspective. We hope that you, your family members and friends are safe and healthy. The global economy faced enormous stress as businesses were forced to shutter to help control the virus. Total economic output for 2020 is forecasted to fall by -3.8% on a year-over-year basis,[1] but forecasters expect economies to regain momentum in 2021, with continued support from central banks and as countries deploy vaccines to their citizens. The recent event in our nations capitol has been on the minds of many over the past weeks. Thankfully, the system that was set in place by the genius of our founding fathers held and the meeting to certify the electoral college votes resumed only hours after the disruption. The change in government will lead to changes in legislation, but it is important to keep in mind that candidates do not tend to get everything they campaign for, and we don't think this time will be different. We will keep a close eye on the expected changes to regulatory and tax policy.

Global equity markets faced a significant selloff in March. The U.S. stock market was down over -35%, but finished the year on a positive note, up over 18%.[2] There have been few years when markets have seen such a dramatic drawdown followed with such a strong recovery (see History of Market Corrections chart below). This quick recovery reinforces the importance of staying invested, because markets often react before the overall economy does. With vaccines being administered and an end in sight to this pandemic, markets are clearly looking ahead to economies reopening and corporate earnings increasing.

Our proprietary models forecast long-term, pre-tax returns ranging from 0% to 1% for fixed income-like asset classes and 7% to 9% for equity-like asset classes (see Expected Market Returns and Risks chart below). We maintain target weight allocations for equities and fixed income. Our more detailed observations and current portfolio positioning are outlined in the following comments.

### History of Market Corrections




*Drawdowns measure the price change of the S&P 500 index from its highest point (peak) to its lowest point (trough) over each calendar year beginning in 1980.*

### Expected Market Returns and Risks
### 7-10 Year Horizon

As of 31-Dec-20
Expected Risk and Return – 7-10 Year Horizon

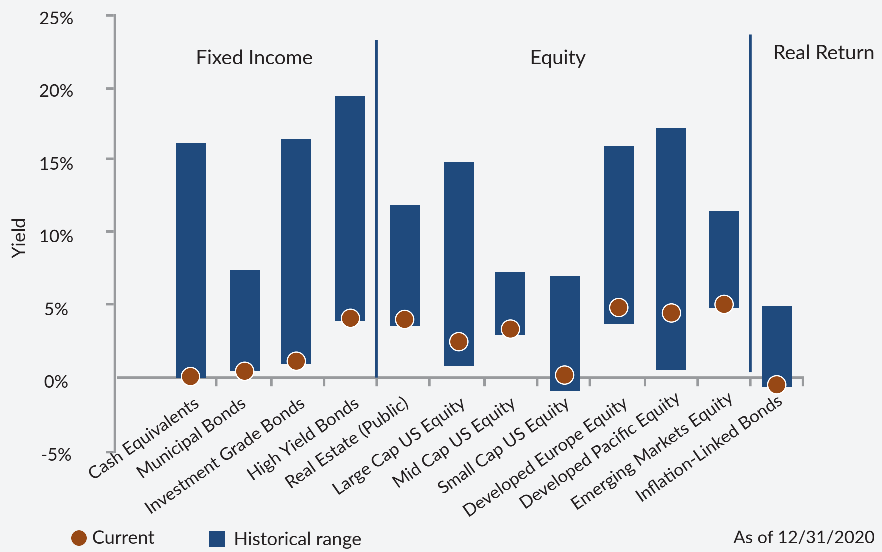
| | | Pre-Tax Annualized Return | After-Tax Annualized Return | Volatility[1] |
|---|---|---|---|---|
| | Inflation | 2.0% | 2.0% | 3.1% |
| Fixed Income | Municipal Bonds | 0.5% | 0.5% | 4.4% |
| Fixed Income | Inflation-Linked Bonds | 0.8% | 0.4% | 5.6% |
| Fixed Income | Investment Grade bonds | 0.9% | 0.4% | 6.7% |
| Fixed Income | High Yield Bonds | 1.0% | 0.2% | 13.2% |
| Equity | Broad Market US Equity | 7.2% | 5.6% | 16.9% |
| Equity | Developed Non-US Equity | 7.9% | 6.1% | 21.4% |
| Equity | Emerging Markets Equity | 9.4% | 6.0% | 29.6% |

*A sampling of return expectations produced by our models. Expected returns are projections and are not guaranteed.*

## Economic Backdrop

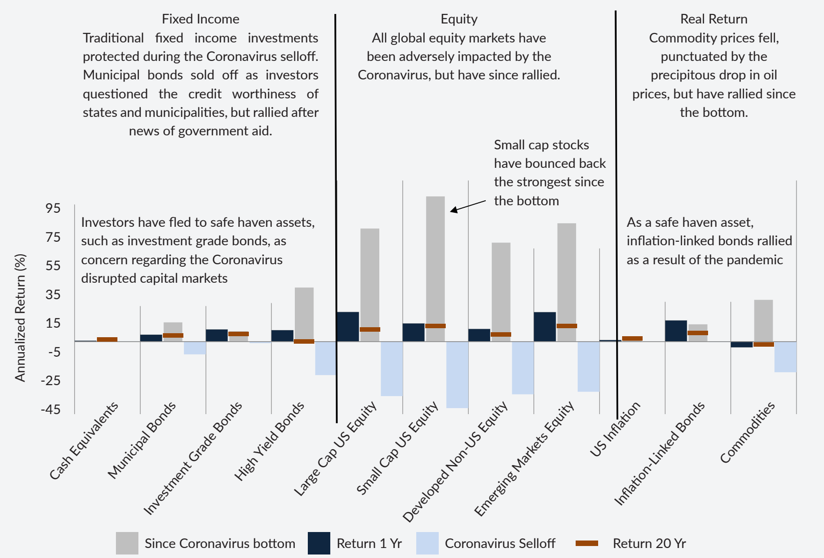
- **After a recovery in the third quarter, global economic growth in the fourth quarter was slowed by a second wave of Covid-19. The global economy is expected to contract by –0.1% in the fourth quarter.[3]**
- Accommodative monetary policy hasn't yet led to higher inflation. Inflation for G-20 countries is expected to remain subdued at 1.2% in the fourth quarter. [4]
- Notable weakness was seen in the Eurozone. GDP for the country group is expected to fall by –6.8%. On the other end of the spectrum, U.S. economic growth is expected to increase by 4.6% in the fourth quarter.[3]
- Emerging Markets' economic growth improved in the fourth quarter and is expected to grow at a below trend level of 1.6%. Quite a bit of dispersion can be seen amongst the constituents as China is expected to grow at a 6% annualized pace, while GDP growth in the Czech Republic is expected to fall by –9.5%.[3]
- Despite the pandemic, global business confidence remains at an elevated level, as managers look through to a rebounding economy, post pandemic. Both services and manufacturing purchasing manager's indices are, once again, above 50. A level above 50 indicates expansion, while a level below 50 indicates contraction.[5]
- Fueled by record low financing rates and households relocating out of cities and into suburbs, the U.S. housing market has continued to build strength. On a national level, the year-over-year change in home prices has increased by over 8.4%, this is the largest price increase since 2013.[6]

### Yields Across Assets Classes




*Yields are an indicator of future returns. Orange dots show current yields, blue bars show historical ranges. Bond yields are generally low versus historical range.*

### Historical Market Returns




*Historical market returns as of December 31st, 2020. Note that looking backwards at recent returns is not a reliable method for predicting future returns.*

## Equities

- **Equity markets continued to build on the strength of the third quarter in the final quarter of 2020. Small cap stocks led the way, up over 28%,[7] followed by Emerging Markets equities, up 19.6%.[8]**
- The technology-driven and growth oriented NASDAQ index outperformed nearly all other aggregate markets. The index was up nearly 49% in 2020, as “COVID winners” — stocks that benefited from the shutdown and remote work, rallied earlier in the year, while other stocks sank.[9]
- Value stocks began to show strength in the fourth quarter after lagging growth stocks for the year, up 14.3% versus 11.6%.[10] The valuation gap between the two segments of the market indicates that value stocks remain significantly more attractive than growth.

## Fixed Income

- **Fixed income returns were tempered in the fourth quarter after a strong year. High yield bonds continued to outperform, up 6.3% in the quarter.[11]**
- As noted last quarter, with yields at record lows, it is difficult to find attractive opportunities in the fixed income market.

### Global Asset Class Returns

| Asset Class Name | Last 10 Years | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Large Cap US Equity | S&P 500 11.4% | Infl-Indx Bnd 14.0% | EM Eq 18.2% | Small Cap 41.3% | Real Estate 31.8% | Real Estate 2.8% | Small Cap 26.5% | EM Eq 37.3% | CPI 2.0% | S&P 500 31.5% | EM Eq 18.5% |
| Small Cap US Equity | Small Cap 9.8% | Real Estate 9.2% | Real Estate 17% | S&P 500 32.4% | S&P 500 13.7% | S&P 500 1.4% | HY Bnd 17.5% | Intl Eq 25.0% | Inv Grd Bnd 0.0% | Real Estate 28.7% | S&P 500 18.4% |
| Real Estate (Public) | Real Estate 7.8% | Inv Grd Bnd 7.8% | Intl Eq 17.3% | Intl Eq 22.8% | Inv Grd Bnd 6.0% | CPI 0.8% | S&P 500 12.0% | S&P 500 21.8% | Infl-Indx Bnd -1.8% | Intl Eq 22.8% | Infl-Indx Bnd 13.1% |
| High Yield Bonds | HY Bnd 5.6% | HY Bnd 4.5% | Small Cap 16.3% | HY Bnd 7.4% | Small Cap 5.8% | Inv Grd Bnd 0.5% | Commod 11.4% | Small Cap 13.2% | HY Bnd -2.1% | Small Cap 22.7% | Small Cap 11.2% |
| Developed Non-US Equity | Intl Eq 4.9% | CPI 3.0% | S&P 500 16.0% | Real Estate 1.9% | Infl-Indx Bnd 4.6% | Intl Eq -0.2% | EM Eq 11.3% | Real Estate 8.7% | Real Estate -4.0% | EM Eq 18.6% | Intl Eq 8.4% |
| Emerging Markets Equity | EM Eq 3.1% | S&P 500 2.1% | HY Bnd 15.4% | CPI 1.5% | HY Bnd 2.5% | Infl-Indx Bnd -1.4% | Real Estate 8.6% | HY Bnd 7.5% | S&P 500 -4.4% | HY Bnd 14.3% | Inv Grd Bnd 7.5% |
| Inflation-Linked Bonds | Infl-Indx Bnd 3.4% | Small Cap 1.0% | Infl-Indx Bnd 7.2% | Inv Grd Bnd -2.0% | CPI 1.3% | Small Cap -2.0% | Infl-Indx Bnd 3.6% | Inv Grd Bnd 3.5% | Small Cap -8.5% | Infl-Indx Bnd 10.6% | HY Bnd 7.1% |
| Investment Grade Bonds | Inv Grd Bnd 3.2% | Intl Eq -12.1% | Inv Grd Bnd 4.2% | EM Eq -2.6% | EM Eq -1.8% | HY Bnd -4.6% | Inv Grd Bnd 2.6% | Infl-Indx Bnd 3.0% | Commod -13.0% | Inv Grd Bnd 8.7% | CPI 1.3% |
| Inflation | CPI 1.5% | Commod -13.3% | CPI 2.0% | Infl-Indx Bnd -9.4% | Intl Eq -4.5% | EM Eq -14.8% | CPI 2.8% | CPI 2.1% | Intl Eq -13.3% | Commod 5.4% | Commod -3.5% |
| Commodities | Commod -5.9% | EM Eq -18.4% | Commod -1.1% | Commod -9.5% | Commod -17.0% | Commod -24.7% | Intl Eq 1.6% | Commod 0.7% | EM Eq -14.5% | CPI 2.1% | Real Estate -5.1% |

*Returns are arranged in columns, by year. Each color represents a different asset class. Each year, the leaders and laggards tend to shift. Diversification across a range of asset classes can smooth returns and enhance growth.*

## Current Positioning

In late April, **we increased our allocation to high yield bonds** for both taxable and tax-deferred portfolios as yields became more attractive during the selloff. We maintain this position.

We maintain our **overweight to developed non-U.S. and emerging market equities,** where valuations and long-term return potential remain attractive.

We also maintain our **underweight to large cap U.S. equities.**

We favor **lower priced, value-oriented equities, both in the U.S. and abroad,** which tend to outperform the broad market over time, with less volatility. These investments outperformed in the fourth quarter.

We remain **overweight municipal bonds** for taxable investors.

As a reminder, you have until your tax filing deadline to make contributions to retirement accounts. If you would like to discuss this, please let us know and we can schedule a time to speak. If you or your tax advisor have any questions regarding the upcoming tax season, please feel to reach out.

We continue to focus our efforts on helping you meet your financial objectives by following our disciplined investment approach. Our approach uses return and risk models, incorporating fundamental valuations and tax-efficient strategies. This investment discipline is tailored to your individual situation in our continuing effort to craft and implement your customized investment solution.

As always, we thank you for placing your trust in our investment management and advice and welcome your questions and comments at any time.

Peter D. D'Agati, CFA

Thomas Kosinski

### Endnotes and Sources:

**Text:**

(1) Bloomberg: World GDP Economic Forecast (Annual YoY %) Survey Median. As of 12/31/20.

(2) Bloomberg: S&P 500 Total Return. 2/19/20-3/23/20, 12/31/19-12/31/20.

(3) Bloomberg, Stembrook Research: GDP measures are based on the most recent annualized quarterly, seasonally-adjusted data. Statistics are stated in inflation-adjusted terms. Aggregate Statistics are weighted by each country's GDP translated into USD. Where available, official estimates are used. Where official estimates are not available, GDP data is based on Bloomberg Contributor Forecasted GDP. Emerging Markets measures are based solely on Bloomberg Contributor Forecasted GDP. As of 12/31/20.

(4) Bloomberg, Stembrook Research: Aggregate inflation statistics are weighted by each country's GDP translated in to USD. As of 12/31/20.

(5) Bloomberg: Markit Global Purchasing Managers Index for Manufacturing and Service. As of 12/31/20.

(6) Bloomberg: S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index YOY% . As of 10/31/20.

(7) Bloomberg: S&P 600 Total Return. 9/30/20-12/31/20.

(8) Bloomberg: MSCI Emerging Markets Total Return. 9/30/20-12/31/20.

(9) Bloomberg: NASDAQ 100 Total Return. 12/31/19-12/31/20.

(10) Bloomberg: S&P 500 Value Total Return, S&P 500 Growth Total Return. 9/30/20-12/31/20.

(11) Bloomberg: Bloomberg Barclays U.S. Corporate High Yield Index Total Return. 9/30/20-12/31/20.

**Charts:**

**Expected Market Returns and Risks, 7-10 Year Horizon: As of 12/31/20.**

Source: Stembrook Research.

(1) Volatility is measured in terms of Standard Deviation. Standard deviation is the statistical measurement of dispersion about an average, which depicts how widely a stock or portfolio's returns varied over a certain period of time. Investors use the standard deviation of historical performance to try to predict the range of returns that is most likely for a given investment. When an investment has a high standard deviation, the predicted range of performance is wide, implying greater volatility. If an investment's returns follow a normal distribution, then approximately 68 percent of the time they will fall within one standard deviation of the mean return of the investment, and 95 percent of the time within two standard deviations. For example, for a portfolio with a mean annual return of 10 percent and a standard deviation of two percent, you would expect the return to be between 8 and 12 percent about 68 percent of the time, and between 6 and 14 percent about 95 percent of the time. Source: Morningstar.

**Yields Across Asset Classes: As of 12/31/20.**

Sources: Cash Equivalents Yields since March 1976. Ibbotson, Federal Reserve Bank, Thomson Reuters, Municipal Bond Yields since March 1988. Barclays Capital, Charles Schwab, BofA Merrill Lynch, Standard & Poor's/Investortools Municipal Bond Indices, Investment Grade Bond Yields since March 1976. Barclays Capital, High Yield since December 1984. BofA Merrill Lynch, Barclays Capital, Real Estate (Public) Earnings Yield since March 1976. NAREIT all Equity, Large Cap U.S. Equity Earnings Yield since March 1976. Standard & Poor's, BARRA, Mid Cap U.S. Equity Earnings Yield since June 1991. Standard & Poor's, BARRA, Small Cap U.S. Equity Earnings Yield since December 1993. Standard & Poor's, BARRA, Developed Europe Equity Earnings Yield since March 1976. MSCI Europe, Standard & Poor's Europe 350, Developed Pacific Equity Earnings Yield since March 1976. MSCI Pacific, S&P/Citi PMI Asia Pacific, S&P Asia 50, Emerging Market Equity Earnings Yield since December 1998, Inflation-Linked Bond Real Yield to Maturity since March 1997. Citi Yield Book, Federal Reserve Bank. Note: Yields are not perfect predictors of future returns and should not be used in isolation.

**History of Market Corrections: As of 12/31/20.**

Source: Bloomberg. S&P 500. Drawdowns measure the price change of the S&P 500 index from its highest point (peak) to its lowest point (trough) over each calendar year beginning in 1980. Total returns are calculated on a calendar year basis every year from 1980-2020.
Historical Market Returns: As 12/31/20.
Coronavirus selloff: 2/19/20-3/23/20 Since Coronavirus Bottom: 3/23/20-6/30/20.
Source: Bloomberg, Stembrook Research.
Indices: Bloomberg Barclays U.S Treasury Bills 1-3 Month Total Return, Bloomberg Barclays Municipal Bond 5 Year (4-6) Total Return, Bloomberg Barclays U.S. Aggregate Bond Total Return, Bloomberg Barclays U.S. Corporate High Yield Total Return, FTSE All Equity REIT Total Return, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Total Return, MSCI EM (Emerging Markets) Total Return, Consumer Price **Index** – U.S., S&P 10 Year U.S. TIPS Total Return, Bloomberg Commodity (Total Return) Index.

**Global Asset Class Returns: As of 12/31/20.**

Source: Thomson Reuters, Bloomberg, Stembrook Research.

Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Bloomberg Barclays U.S. Treasury Bills: 1-3 Month Index, Citigroup Inflation-Linked Index, S&P 10 Year US TIPS Index, Bloomberg Barclays U.S. Aggregate Bond Index, BofA Merrill Lynch U.S. High Yield Cash Pay, Bloomberg Barclays U.S. Corporate High Yield Index, Dow Jones Wilshire REIT Index, FTSE All Equity REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones AIG Commodity (Totl Ret) Index, Bloomberg Commodity Index.

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