2021 YEAR AHEAD
2020 YEAR BEHIND

I am a little wounded, but I am not slain; I will lay me down and bleed a while. Then I'll rise up and fight again.
~ John Dryden

On March 13, 2020, I sat down at the Starbucks on 47th Street right off of Sixth Avenue, across the street from NewsCorp's headquarters (where Fox Business is located). I had two hours to work on my weekly Dividend Café before my scheduled taping of Wall Street Week with Maria Bartiromo (that taping, by the way, was the last "in studio" appearance I did in 2020). I began typing that quote above as the "Quote of the Week" that I do in every issue of the Dividend Café.

It had been a horrid, brutal week in the market (in the 2020 Recap below I will provide meticulous detail of that week and the couple weeks that followed). Conditions in the market felt as bad as anything I had seen or experienced since the Great Financial Crisis, and the ending to the saga we were in felt uncertain, to say the least. I first heard that quote in a speech on September 17, 2008 by a senior leader at Morgan Stanley who was trying to rally the troops as the firm seemed to be circling the drain. That was an emotional day for me for a lot of reasons, and those inspiring lines from the 17th century British poet felt appropriate. I taped it to my desk and read it every day for many months. It proved prescient, then, and in 2020.

2020 was more than just a year of equity market investors seeing a violent plunge and then a violent recovery (though it was surely that, too). It was more than just a year of a global pandemic, of unimaginable government shutdowns, of breakneck-speed economic contraction, of unprecedented vaccine development, of skyrocketing national debt, and of social and political polarization. And while I tirelessly talk of the paradigmatic changes playing out in the U.S. economy due to the entrenchment of Federal Reserve interventions, it was more than just a year of aggressive monetary policy force. Your list of what stands out about 2020 could include a lot of things, and we will cover many of them in this paper.

But for investors, I am quite certain that it was, above all else, a year in which the behavioral habits and traits we have built our business around trumped all else. Investors who resisted human nature won. Discipline was rewarded. Reliable best practices proved meritorious. Through all of the ups and downs and surprises and angsts of 2020, investors who entered the year with a well-constructed plan, who resisted the temptation to capitulate to understandable emotions at various points throughout the year, who either ignored the media or didn't act on the media's tenor, who saw fit to not allow political panic or preference give way to investment policy distortion, won. 2020 provided way too many opportunities for investors to behave badly. But it provided a blessed number of occasions for good behavior to be rewarded.

The ambitions for this paper are simple: *To provide as much* ***recap and summary of 2020*** as could be considered useful, and ***to offer up multiple perspectives on 2021*** expressed in various "themes" that set the stage for our expectations and areas of focus into the new year.

Those themes and expectations are subject to change, because the circumstances and facts that undergird them are subject to change. While I am no fan of the major ideological contributions of John Maynard Keynes to modern economics, I am especially fond of this quote from the deceased economist: "When the facts change, I change my mind. What do you do?" More than any year since I have been doing this annual paper with year-forward projections and themes, 2020 rendered those obsolete in about eight weeks. Ex-COVID, I stand behind my 2020 themes of a year ago, but that is a lot like saying, "other than that, how was the play, Mrs. Lincoln?" I don't offer this up as a qualifier or hedge on my 2021 perspectives herein, but rather as a permanent reminder that markets are inherently unpredictable, because the world is inherently unpredictable. The biggest things that can change expectations are unexpected things (write that down). Ergo, one cannot adjust their expectations for that which is unexpected, because, well, you get the idea.

So we enter 2021 with high convictions about certain themes and economic realities. But we mostly enter 2021 with the most important traits we believe professional investment advisors can ever have – humility and discipline. A lack of conviction is the defining trait of the lazy and unread. But a lack of humility is a sign of the inexperienced.

One I am quite fond of quoting, Edmund Burke, famously said: "Example is the school of mankind, and they will learn at no other." Humility undergirds all that we do because markets provide examples for why it ought to over and over and over again.

And through our convictions and underlying humility, it is discipline that serves as the real governor through all of this - a discipline in one's belief system, a discipline in execution, and a discipline in decision-making that favors the deliberative and the collaborative, not the impulsive or the arbitrary.

We do, indeed, pray that 2021 may be free of global pandemic, and any other unforeseeable macro event that threatens health, well-being, and financial stability. But we also pray for the conviction, humility, and discipline to navigate whatever 2021 may bring.

2020 IN REVIEW

A SEQUENTIAL TRIP DOWN MEMORY LANE

The year began without significant fanfare, amidst a heated contest for the Democratic nomination for the Presidential election and having come off a magnificent year in 2019 for equity investors. The "phase one" China trade deal was signed by both countries, and most discussions of China in late 2019/early 2020 were around the positive vibrations of the trade deal. It would only take a few weeks for "positive vibrations" in the market around China to fully dissipate.

In fact, the Dow would increase another 1,000 points from the beginning of the year until Valentine's Day (on top of the massive Q4 that markets had enjoyed to finish 2019). It didn't happen in a straight line – there was a hiccup in late January over reports of a novel coronavirus impacting the Wuhan region in China, and again after President's Day weekend in February over reports that Apple's manufacturing capacity would be impacted by shutdowns in Chinese factories. But markets took it all in and moved higher, remembering well the false alarms that the last five or six global health scares had proven to be (Zika, Ebola, SARS, Swine Flu, Bird Flu, etc.).

Early state primaries in the Democratic primary pointed to an almost sure nomination for far-left Vermont Senator, Bernie Sanders, after top showings in Iowa, New Hampshire, and Nevada. Former Vice President, Joe Biden, after disastrous finishes in all three of the first states appeared set to drop out of the race, but instead went "all in" on saving his campaign in South Carolina. A February 25 debate among the Democrat candidates included not a single word about the coronavirus, indicating how much of a non-story it remained still at that late date.

By early March, not only had Biden's campaign been resurrected, but he would "clear the field" after Super Tuesday and enjoy a mostly unimpeded path to the nomination after nearly every other candidate backed his nomination. Market distress in late February suddenly looked like it was the fear of a Bernie Sanders nomination as much as rising coronavirus risk, and markets rallied a thousand points on the back of Sanders' Super Tuesday defeat. The tranquility would not last.

In fact, the market would close at just over 27,000 on Wednesday, March 4, and not see 27,000 again until Friday, June 5. But what would happen in those three months would change the country forever and produce one of the strangest and most traumatic market "round trips" in history.

The market was down a couple thousand points on the year by Friday, March 6, but it had rallied off earlier lows, and the fears of a far-left win in the Democrat primary were mostly removed from markets. The virus that had plagued the Wuhan region in China was showing up heavily in Italy as well as South Korea, and significant unknowns remained. On Sunday night, March 8, Saudi Arabia and Russia would effectively announce a commodity war as they failed to secure a deal to curb in excess supply, and oil prices collapsed ~50% in just hours. Monday, March 9, would see markets decline a stunning 2,000 points (-7.8%), making it what was then the 11th worst day in market history. Markets would recover 1,100 of those 2,000 points the next day, one I spent in the White House meeting with the National Economic Council. Policymakers were heavily focused on securing a deal with Congress to provide medical relief and additional support to combating the virus, and possibly aiding the troubled airline and cruise line industries. But as late as Wednesday afternoon, March 11, markets were still not fully sold on what was about to come.

The dam broke Wednesday evening, March 11. The NBA announced it was suspending its season entirely. The NCAA announced the cancellation of its March Madness tournament. Tom Hanks announced he had tested positive for the coronavirus. And President Trump announced he was suspending all travel to and from European countries. All hell had officially broken loose.

The market would drop another 2,300 points on Thursday, March 12 (-10%), making it what was then the fourth worst market drop in history. No states had imposed lockdowns yet, and certainly no national "shelter in place" order was yet in effect, but across the country, especially in big cities, economic life was contracting dramatically. Markets rallied 2,000 points on Friday, March 13, as the White House announced plans for increased testing capacity, an active coronavirus task force, and hope sprung eternal for a quicker resolution to the pandemic.

That was also the day of my aforementioned appearance on Maria Bartiromo's Wall Street.

It was the last time I have been on set for a financial media appearance as of this writing, and that night, Friday the 13th, my family would fly back to Southern California from New York City believing it made sense to get out of the city for a couple weeks while things calmed down. We had no idea what lied in store. Neither did investors.

The following Monday, March 16, would become the second worst day since the Great Depression, down 3,000 points (-13%), rivaled only by Black Monday of 1987 in percentage terms. While there would be a thousand point move higher the next day, that resulted in another thousand point drop Wednesday the 18th, another Friday the 20th, and another intra-day on Monday the 23rd. So many can be excused for not knowing or feeling that Monday the 23rd's intra-day bottom of 18,213 in the Dow Jones Industrial Average would mark the market bottom of this saga. For indeed, there was enough intra-day volatility, daily violence in gyrations up and down, and catastrophic news in the news cycle, the dominant reality for investors was uncertainty.

Somewhere in that horrific week California would shut down, and then New York, and eventually the bulk of the country. Throughout these two weeks of peak pandemic uncertainty, the Fed was active in a profound and unprecedented sense. We will unpack the realities of Fed interventions in a bit, but it cannot be lost from our timeline of 2020 that the Fed was making policy decisions essentially in real time, categorically intervening to rescue capital markets from the horror of what was happening.

10 Worst Daily Losses	
October 19, 1987	-20.5%
October 28, 1929	-12.9%
March 16, 2020	-12.0%
October 29, 1929	-10.2%
November 6, 1929	-9.9%
March 12, 2020	-9.5%
October 18, 1937	-9.1%
October 5, 1931	-9.1%
October 15, 2008	-9.0%
December 1, 2008	-8.9%

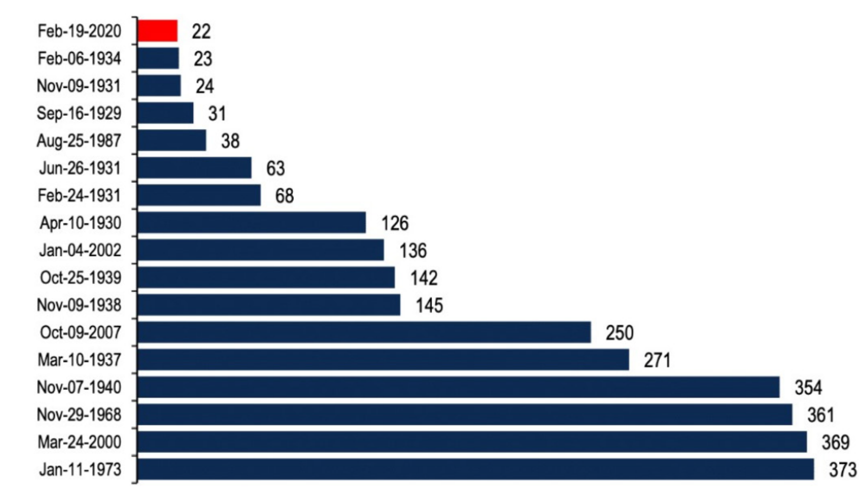
S&P 500: 1928-2020

Source: Wealth of Common Sense, YCharts, April 2020

In the last week of March, after a reasonable amount of political haggling and posturing, Congress passed the $2.2 trillion CARES ACT, a level of fiscal stimulus never before seen in American history, intended to offset the horrific damage being perpetrated upon the American economy by the lockdowns. Restaurant, airline, and retail shopping traffic essentially dropped 100%, and the country suffered through a painful period of not knowing what would come of the virus, the toll on hospital capacity, the availability of needed medical equipment, and more.

The "national margin call" now essentially over (see below), the month of April allowed for more market recovery even as the health challenges

Chart 1: The Feb-Mar 2020 selloff of 30% was the fastest 30% drawdown in history



Source: BofA Global Research, Bloomberg continued to grow. In fact, markets would recover 2,500 points in April, even as death tolls climbed and the national lockdown was extended weeks longer than had been expected. This early market recovery was but the first moment where the headline news trajectory was headed one way, even as market prices were headed the other way.

Investors taking their P's and Q's from the news headlines could not understand why markets were already recovering, and a significant lesson was learned by many in a pivotal reality of markets: *News deals with what just happened in the past; markets price in what they believe will happen in the future.*

That "discounting nature" of markets is a significant part of what happened in 2020, and it is an evergreen lesson for investors that applies to all eras, past and future. However, a huge part of the post-March market performance has to be understood as a by-product of what was happening in credit markets. The Fed cannot, and did not, directly intervene in equity markets. However, by directly intervening in the corporate credit markets (both for investment grade borrowers and even "junk" borrowers), all capital markets were instantly "liquefied." Company's cost of capital collapsed, their current and future earnings streams were therefore higher (as a result of lower debt service cost), and risk appetite was substantially enhanced. Additionally, the Fed's "TALF 2.0" facility provided a back-stop to several realms of asset-backed securities, revealing once again the inter-connectedness of risk assets, and the benefits for equity investors when credit is flowing and other risk holdings on investor balance sheets are unimpaired. (Further unpacking of this below in the Central Banks section).

Markets would advance another thousand points in the month of May, and the country could see light at the end of the tunnel regarding the pandemic. Mortalities substantially flattened, hospital capacity opened up, and several states made plans for re-opening. The country entered the summer in economic disarray, but with hope for the worst of the virus being behind us, and with risk assets substantially better off than they had been just a couple months earlier.

While markets would stay reasonably flat in the month from start to finish, it was the resilience of the markets that generated much attention. The country suffered through substantial social unrest, numerous and rather extreme riots in many parts of the country, and an activation of COVID cases in states that had not been previously infected in large numbers (Florida, Arizona, Texas). By the end of the summer, markets were back to 28,500, right where they started the year, and the American medical system had held up just fine, with fears of overrun hospitals never materializing, and perhaps most importantly, mortalities never coming close to the levels of peak spring COVID activity.

While many states were still limiting economic activity, and large congregations of people were still not being allowed (i.e. concerts, Broadway, football games, churches, etc.), some life began to return to normal in the fall. Positivity rates for the virus collapsed even as testing increased substantially. Multiple pharmaceutical and biotech companies entered late stage trials for vaccine candidates. Some schools re-opened (tragically, many did not). The country felt like it was in a bit of a pause, and markets felt much the same. Markets declined modestly in September, though most of the decline was concentrated in some technology stocks that had performed out-of-this-world throughout the summer. Markets did decline 1,300 points in October, with nearly all of such being at the end of the month, mostly related to election uncertainty.

And just as soon as markets sold off in anticipation of some negative election results, they rallied in the aftermath of the election – substantially. The market seemingly celebrated the concept of divided government, as Joe Biden won a closer-than-expected bid for the Presidency, but the Republicans held on to all the Senate seats they were expected to lose (in Texas, South Carolina, but especially Iowa, Montana, Maine, and North Carolina). Markets would advance another 4,000 points in the next four weeks, and like in the summer rally, this was done even as COVID cases were picking up behind massive increases in testing around the country.

Though I do not elaborate much on this elsewhere in this paper, the market's decoupling from daily COVID news in the late spring or early summer is surely one of the most extraordinary stories of 2020, and provided a useful and objective understanding of the virus that was not always available from a heavily politicized media (on both sides).

Markets held up throughout December, closing the month up another thousand points. Just as the year was coming to an end, President Trump ended up signing into law the $906 billion stimulus-relief bill Congress had passed. In the end, markets ended the year up 2,000 points (+9.6%). The S&P 500 was up 16.2%, and the Nasdaq up 43.6%. It was an ending that no one could have dared predict in the dark days of March.

A National Margin Call

One of the most important takeaways of the market trauma from March is also one of the least covered, least understood, and least appreciated realities of what was happening in that panic sell-off of March 9-23. Though these charts and what they represent may seem too complicated to understand, the basic reality is this: In five days alone, just leveraged hedge funds unwound $400 billion+ of exposure to stocks. This does not count the substantial amount of other forced selling, margin calls, panic selling, and other forced activity that piled on pricing pressure in the apex of the March trauma.

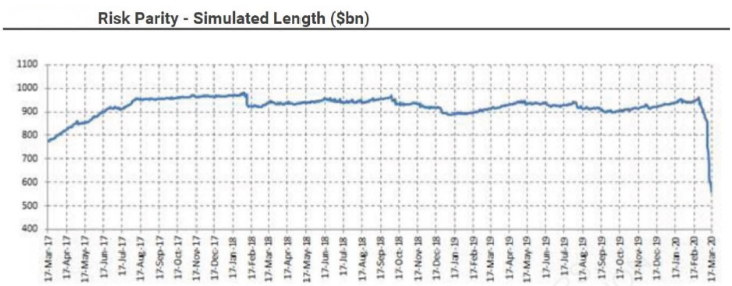


Exhibit 3. *Risk Parity – Simulated Length, source Goldman Sachs, March 2020.*

Similarly, using Prime Services data, Credit Suisse estimated that the week of March 16th saw the fastest and deepest unwind of quant and market-neutral strategies on record, as cross-asset correlation hit a record high, forcing several strategies to almost fully unwind.

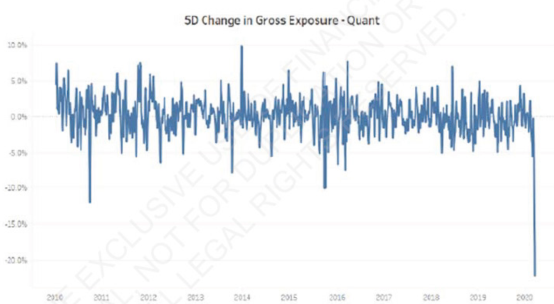


Exhibit 4. *Five Day Rolling Change in Gross Equity Exposure for Quant Funds Globally on CS Prime Services Platform (2010 to March 17, 2020), source CS Prime Services Portfolio & Risk Advisory.*

This is the reason we pleaded with clients to not try and time their way out of and back in the tensions of the moment. Our nation's financial system has significant leverage in it – borrowed funds that represent fixed amounts of debt, tied to assets that have a variable valuable. When those asset values decline and the debt does not, you get forced sellers at certain levels. Forced sellers do not want to sell equities down in price so they start off selling anything else not nailed to the floor (assuming they have anything else). You sell what you can, not what you want to, when you are a forced seller. The fundamentals of the moment, the impact to corporate earnings from the shutdown, the scope of health risk COVID represented – none of these things were driving markets in that fateful two-week period of March. Indeed, no one would have known the answer to any of those things if they had been! What was happening was a true fundamental impairment to the national economy and a true re-pricing of risk assets (like stocks) was going to have to play out. But at some point in these moments, several of which I have now lived through as a professional investment manager, everything goes out the window except one thing: Sellers have to sell, period.

I would love to tell you we will never experience another national margin call again. My earnest advice to investors is to do one of two things: (1) Do nothing and let it play out. It ends when it ends and the last forced seller wipes away his last tear to hit his final sell button. Or, (2) Be the person on the other end of that computer line who is buying from the forced seller. Of course, one can't know the bottom is at hand until after it has been reached, so this is not for the faint of heart. #1 is a perfect solution for most investors. Some can stomach #2. But never forget the national margin call of March 2020, and never sell into a forced selling panic when you are not a forced seller, ever.

Central Banks to the Rescue

One cannot understand 2020 (nor 2021, as you will soon see) without appreciating the aggressiveness of central bank interventions into financial markets. We start with the easiest policy tool at central bank disposal, the cost of money. With the fed funds rate moved to 0% just as the pandemic was beginning, and key borrowing reference rates across the developed globe also at 0%, central banks used their easiest policy tool immediately. There may be room to debate if it will be 2023 or 2024 (or later?) before the Fed moves off the zero-bound, but what is understood across the globe is that at least a few years of a 0% fed funds rate awaits capital markets.

But the major policy tool in a post-GFC world available to central banks already at the zero-bound is asset purchases, also known as bond-buying, also known as quantitative easing. In 2020 we saw our own Fed add $2.5 trillion to their balance sheet – this time in two months, not the four years it last took them to do such.

Total central bank balance sheets grew 42% in 2020, a staggering number that doubles the percentage increase out of the Great Financial Crisis.

Y/Y Pct. Chg. of
Total Assets on Central Bank Balance Sheets
(FED, BOJ, ECB, PBOC)

Source: Strategas Research, Daily Macro Brief, Dec.23, 2020

But as mentioned earlier, even this unfathomable bond-buying does not capture the full spirit of Fed interventions into capital markets in 2020. Out of the Cares Act and in a very carefully constructed accord with the Treasury Department, the Fed created an alphabet soup of different facilities to support corporate credit (primary and secondary), asset-backed securities (car loans, credit card loans, student loans, commercial mortgages, etc.), commercial paper, money markets, swap lines with foreign banks, and even municipal bonds. By merely announcing their presence and capacity for support, the Fed created credit spreads, reaffirmed liquidity in financial markets, enabled more borrowing, encouraged cash build-up on balance sheets, enhanced safety buffers, and provided the catalyst for change in risk assets in 2020.

The Fed has her share of critics, and I am frequently one of them. There was much about what they did in 2020 I support, and much I would criticize. But the investment takeaway has to be this, regardless of what one thinks is right or wrong in the Fed's post-GFC aggressive monetary approach, put on full display in the COVID moment:

1 Risk investors have every logical reason to believe the Fed is there to backstop them.

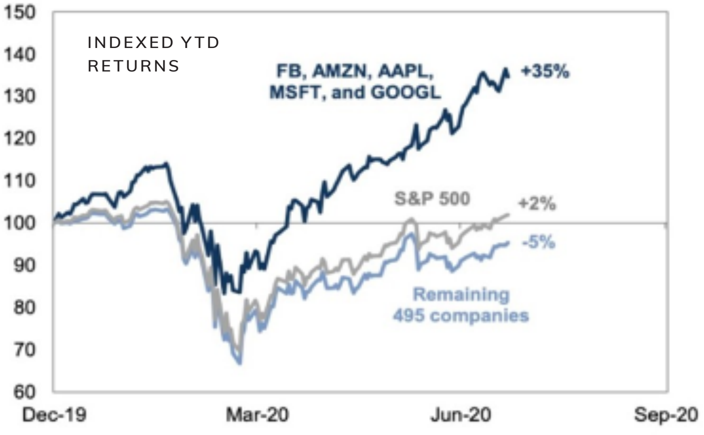
2 But that backstop does not come without a price. The price will always be paid. There is no free lunch – Economics 101 (someone should write a book).

3 Even as investors grow accustomed to the Fed's support for capital markets, through time, there exists a clear and unavoidable diminished return to such interventions. Economics 201.

The S&P 5 vs. the S&P 495

For much of the market recovery post-COVID, the S&P 500 seemed to be doing fine, yet the average stock in the S&P 500 was doing anything but. This seemingly contradictory state of affairs was a result of the "market cap weighted" nature of the S&P index, whereby large companies had a much larger price impact to the index than smaller companies. As a very small handful of mega-cap tech companies rallied post-March, the disparity in market returns increased in distortion (this chart shows how things were for the five largest S&P 500 companies vs. the whole index in mid-summer 2020).

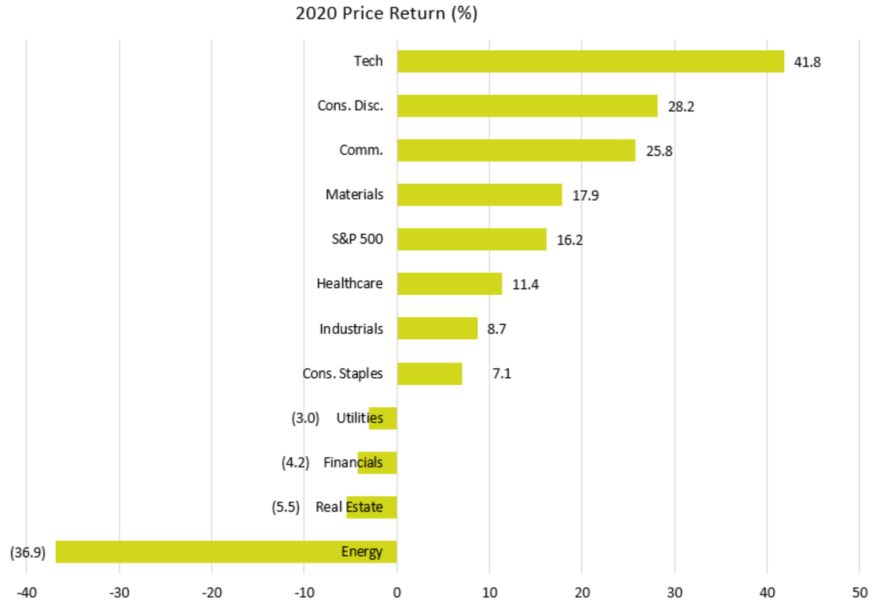
But that dynamic re-adjusted a great deal by the end of the year. In fact, the Russell 2000 (small cap index) has now passed the S&P 500 in total return on the year, and while the "top five" have still produced a highly disproportionate impact in market index returns this year, fully half of the companies in the index have reached +10% returns on the year, democratizing the contribution to return substantially.



Source: FactSet, Goldman Sachs Global Investment Research

Sector Attribution

Technology clearly led the way in 2020, with Energy the biggest laggard despite a significant Q4 rally. The transitory damage to Energy, Financials, and Real Estate was quite particular to COVID events, and in a lot of ways some of the boost to Technology, Consumer Discretionary, and Communications was as well.



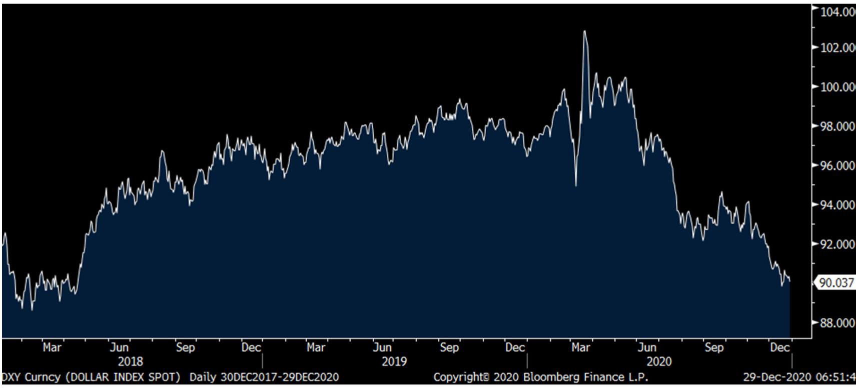
FactSet, Dec. 31, 2020

Dollar weakness

The dollar experienced a monstrous spike during the COVID moment of March, as has become quite predictable during moments of global crisis. It gave up that spike level rather quickly (as expected) when the initial panic subsided but has since retreated in four different legs down all the way to its early 2018 level.

The weaker U.S. dollar has, so far, not so much created new advantages for U.S. exporters and emerging markets countries, as much as it has removed older disadvantages for U.S. exporters and emerging markets countries that had been in place since the big dollar rally of 2014-2017.

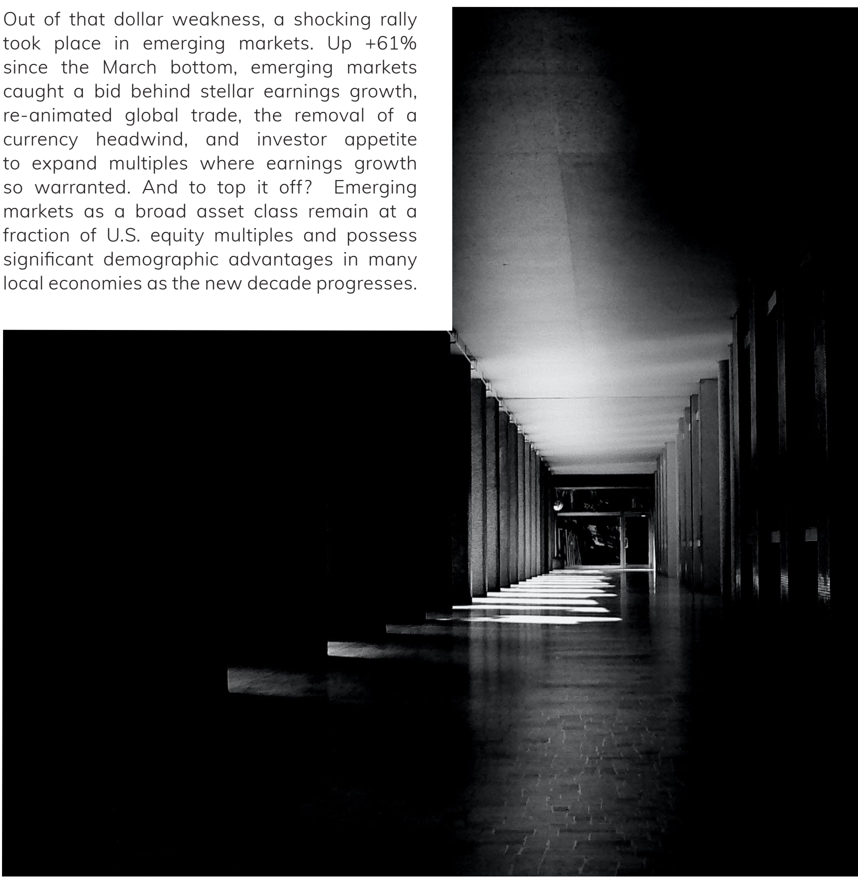
Additional softness in the dollar, and that remains our outlook for the foreseeable future, will likely serve as a boost to the earnings power of multi-nationals and integrated energy companies. The main beneficiary would be emerging markets investments where earnings power and achievement has been offset by currency adjustment for several years.



Source: Bloomberg Finance, Dec. 29, 2020

A Re-Emerging

Out of that dollar weakness, a shocking rally took place in emerging markets. Up +61% since the March bottom, emerging markets caught a bid behind stellar earnings growth, re-animated global trade, the removal of a currency headwind, and investor appetite to expand multiples where earnings growth so warranted. And to top it off? Emerging markets as a broad asset class remain at a fraction of U.S. equity multiples and possess significant demographic advantages in many local economies as the new decade progresses.



Housing Deja Vu:

THE GOOD, THE BAD, AND THE SURPRISING

As the economic damage from COVID was more and more revealed to be concentrated in the lower tiers of income generation, it made more and more sense why housing prices and housing activity behaved so well in the aftermath of the COVID lockdowns. That, combined with all-time record lows in mortgage borrowing costs provided ample support to an already-strong housing market.

Multi-family renters found 2020 to be an optimal time to pursue their first suburban single family residence. Low rates drove prices higher without impacting monthly payments. Many homeowners took advantage of their spring "sheltering in place" to focus on all they didn't like about their current homes.

From the vantage point of people who care what the sale price may be of the place they live in and have no intention of selling, 2020 was a strong year for housing. From the vantage point of those trying to buy a home, affordability even with unprecedented low borrowing rates is being pressured substantially. Ultimately, the under-supply of housing stock provides a floor for housing prices, yet the percentage of disposable income being devoted to a house payment is uncomfortably high.

The dynamic I have to watch carefully is if equity extraction becomes a growing phenomena. The significant equity build-up in home equity is why housing behaved resiliently in 2020; the complete absence of equity is why housing was ground zero for 2008.

The moral of this story is – have equity, and you will be anti-fragile; have no equity, and the entire game changes. And did I mention what happens in a leveraged financial system?

Municipal Mayhem

In March during the peak COVID distress municipal bonds became the opposite of a "safe haven." As I wrote in the March 27 Dividend Café:

> "Heavy flows into retail mutual funds are the best predictor of future turmoil in the muni bond space. The market becomes dependent on those inflows, and prices are driven higher by the heavy money entering the space (forced buyers). But then, heavy "fast money" in municipal bond funds mean a one-second button to hit for a brutally inefficient exit, punishing all other holders of the asset class.
>
> Last week there was $2.15 billion of redemptions on Monday, $2.19 billion on Tuesday, $1.72 billion on Wednesday, $2.57 billion on Thursday, and $1.34 billion on Friday – just from mutual funds. These insufferable periods have repeated themselves multiple times (financial crisis, Meredith Whitney, taper tantrum, and rate fears post-2016 election) – the value of the bonds drops a bit, which forces people who have no business owning municipal bonds to sell their funds, which forces values down a lot more. Rinse and repeat.
>
> Do these dislocations matter? Well, yes, in the moment. They disrupt the fundamental benefit of asset allocation which is to see zigs and zags, not universal correlation. But they also present inefficiencies that are buy-able. So there is a half-full and half-empty glass here, and the direction we take this depends on individual client liquidity needs. None of this is easy, but all of it is manageable."

Municipals did, indeed, recover (and then some) in the months that followed, yet now face the same interest rate reality that Treasuries and High-grade corporate bonds face: Investors are paid a paltry yield to part with that money.

IPO's, SPAC's, and the Alphabet Soup of ~~1999~~ 2020

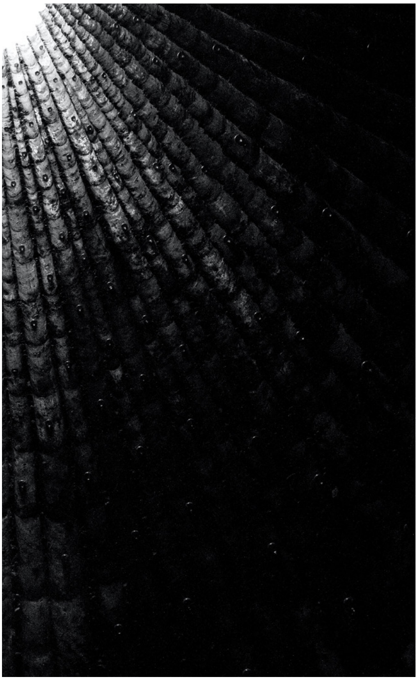
Entering 2020, it had been a really difficult ten years for the IPO marketplace. Broad access to private equity capital and venture capital, not to mention an explosive secondary market for pre-IPO securities, gave companies plenty of reason to delay or defer going public, often into a point where excessive valuations had already been achieved. High-profile "unicorn" IPO's for various office-sharing companies, cloud messaging companies, home exercise equipment, or ride-sharing platforms either spectacularly failed in 2019 or were canceled all together.

2020 saw a reversal of this trend, with high demand for several brand name companies that went public, from the food delivery app industry to home vacation rentals to cloud data. Renewed appetite for growth-speculation explains much of the reversal. $170 billion was raised in IPO's in 2020, beating the $116 billion of the year 2000 (though adjusted for inflation, the year 2000 brought in right around $180 billion). Extremely high valuations have not been an impediment to investors in public equities, and high valuations for companies that often lose significant amount of money have not been an impediment to investing in companies entering public markets, either.

The IPO world should, in theory, be judged by the merits of the individual companies involved, but in practice, it is often a bellwether for the state of risk appetite in public markets. Companies pursuing an IPO often are looking for liquidity for early investors, but that need is far less prominent now with ample evolutions in capital markets making pre-IPO monetization possible for founders and early investors. Companies may very well need the primary equity an IPO is intended to raise, but even that objective is a fraction of what it used to be as significant company funding can be found in private markets without venturing into public equity. There certainly exists plenty of benefits for companies to pursue public markets, but a lot has changed in corporate finance and investors are wise to be discerning.

One major change in corporate finance has been the skyrocketing popularity of SPAC's (i.e. Special Purpose Acquisition Companies). Here, a company is formed for the sole purpose of raising money in an IPO, the proceeds of which will be used to buy a company without making that company go through the traditional IPO process. Some SPAC's have identified their target purchase ahead of time, but many have not. Once the SPAC's IPO is complete, the SPAC sponsor has 18-24 months to complete an acquisition or funds are returned to investors. This vehicle has been in existence for many years, but have only recently become wildly popular, largely as big-name underwriters and sponsors have migrated to the space. Nearly half of 2020's IPO's were SPAC's, and big name companies finding public markets through this vehicle has created an avalanche of interest in the space.

The IPO world and the SPAC world are not immune from the laws of the investing universe, laws we take seriously at The Bahnsen Group. Capable and experienced management teams matter. The quality of the business matters. The economics of a deal matter. There is no "lottery ticket" in investing. The specific navigation of optimal corporate finance vehicles is fine, and even laudable in many cases. 2020 has merely teed up the question as to whether or not Wall Street has found a new innovative funding solution, or a structure ripe for abuse. The answer is surely going to be, "both."

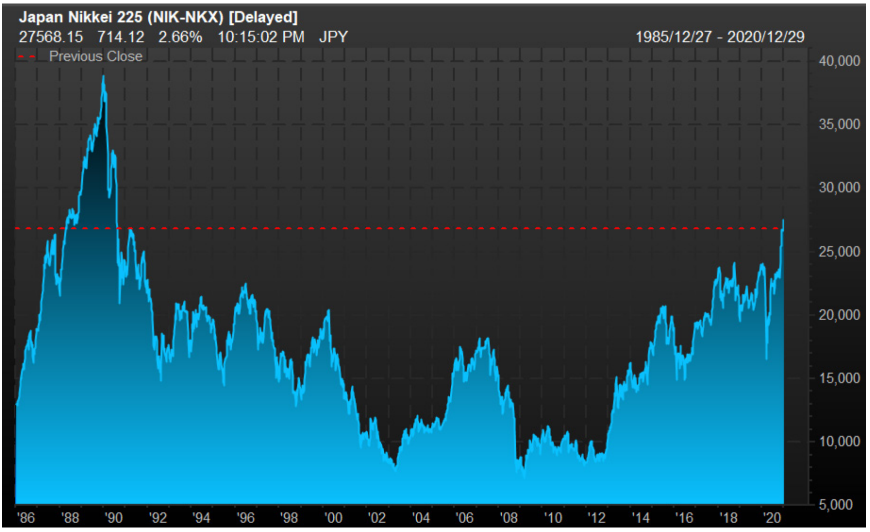


Japan Rallies

The Nikkei in Japan started the year at 23,300, and after a 28% March COVID decline found itself at 16,725. Now at 27,500, this is not only a +66% return from its March bottom, but a +18% gain since the beginning of the year. Historically, this brings Japan back to levels not seen since 1990 (as it was declining from the mother of all bubble-bursts).

On one hand, the COVID moment was particularly benign for Japan (it's total of 3,252 mortalities in a population of 126 million gave it a per capita fatality rate that was #138 in the world). But central bank support in Japan's capital markets continues to be the most aggressive of any developed nation in history.

Real GDP growth has been a pitiful ~1% per annum for the last decade (fluctuating between just below 0% and just above 2%), but the bazooka of monetary policy may have finally stemmed the tide of the debt-deflation spiral. The result? A no-growth economy with a rising stock market. America: take note.



FactSet, Nikkei 225, Dec. 29, 2020

Concluding Takeaways

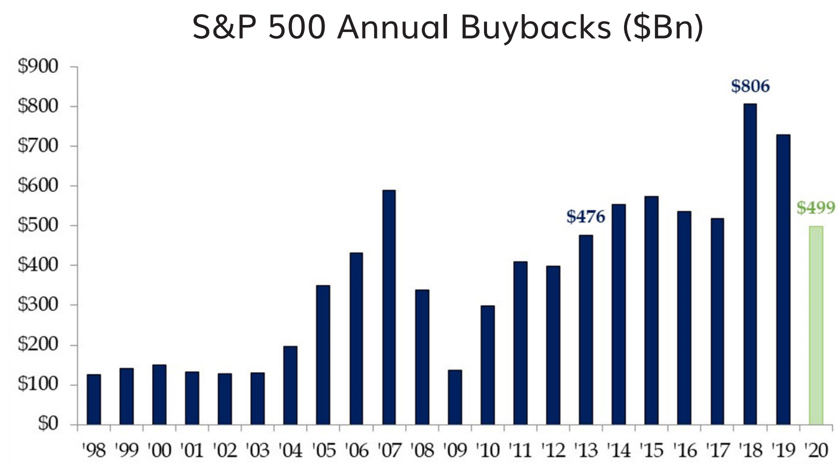
1 Investor behavior dictated investor outcomes in 2020, as it always does. All newsworthy realities aside, the great takeaway for investors is to formulate a portfolio that accounts for a plethora of outcomes, and to hold fast to the discipline needed to execute that plan.

2 The descent to zero percent interest rates has re-priced risk assets favorably, but also left a totally new paradigm for savers and bond investors. How to respond to this new reality is a necessary action for all investors.

3 COVID proved to be mostly an accelerator of trends and events already in place, more than a disruptor.

2021 AT-A-GLANCE

One of our "key themes" for 2021 is not a rebound in stock buybacks, and yet we certainly believe you will see such. However, while many "year ahead" forecasts from consensus Wall Street thinking are sure to focus their optimistic outlook around the resurgence of stock buybacks, we see them as more incidental to healthy market activity than we do a cause of healthy market activity. In a perfect world, stock buybacks, dividends, M&A, debt payback, capex, and cash hoarding are all discussed as "options after good results" – not as a cause of good results. It is no secret from that list that we favor growing dividends as a lead priority for optimized capital return to shareholders, but even that presupposes favorable operating results. Dividends flow out of favorable results; they do not create favorable results. The same is true of stock buybacks, yet one would be hard-pressed to find that logic in the various arguments for stock buybacks as a reason to be bullish in 2021.

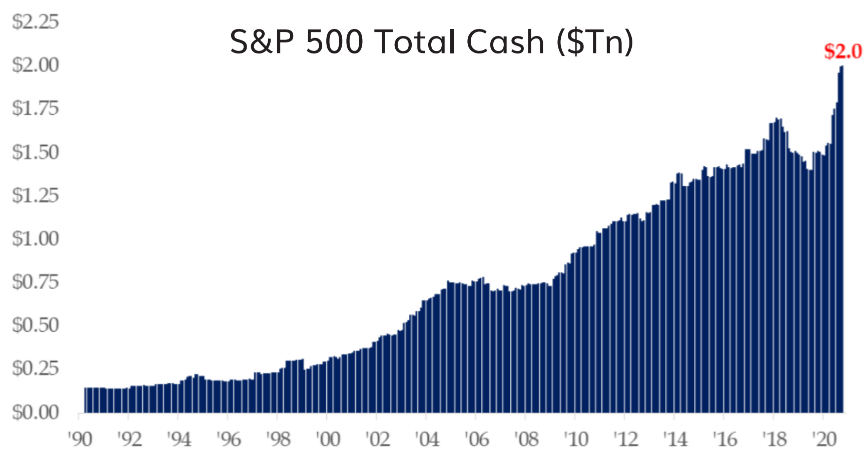


Strategas Research, Daily Macro Brief, Nov. 25, 2020

Nevertheless, the low level of buybacks in 2020 in this post-Trump tax reform era is likely to reverse in 2021, and while it is not an "investible theme" for us, that doesn't mean it won't be a heavy media theme. Truth be told, what ought to be a big theme for the media and punditry class is not stock buybacks, per se, but more broadly, the incredible story of cash on corporate balance sheets in corporate America. How that cash ends up being deployed will be a significant wildcard story for markets in 2021.

Might companies simply reduce debt levels, especially because much of this cash comes from newly-acquired debt in the aftermath of the pandemic? It is unlikely, given that the cost of the debt is so likely beneath the Return on Equity most of these companies generate. Will they pay higher dividends? Many will (and we'll be smiling). Stock buybacks? Sure. M&A? Count on it. Increased capex? We are praying. The various deployments of corporate cash will be a more significant story to the fate of markets in 2021 than any of the major stories sure to get media coverage.

To qualify as one of our 2021 themes, it had to be a reasonably actionable perspective, or possess some sort of takeaway that defied vanilla media conventions. We do not set year-end price targets, and we do not take seriously anyone who does. We do, however, strongly encourage our clients to ignore the finger-in-the-wind number setting that often passes for Wall Street research. Nobody on earth has any idea where markets will be in one month, let alone one year. What we have tried to do with our 2021 themes is focus on that which can actually be analyzed, that which is empirical, that which is relevant, and that which commands accountability. *We will not be right in everything, but we will be on the record, in writing.*



Strategas Research, Daily Macro Brief, Nov. 30, 2020, p. 1

2021 Themes

1 DON'T FIGHT THE FED

The biggest mistake I see in the community of Fed critics I often congregate with is the non-sequitur conclusions they derive from their generally cogent premises. So many Fed critics note the mistakes the Fed is making here, or could be making there, and then land on a bearish square that doesn't follow at all what they have said. Saying, "markets are only up because of the Fed" may be right and it may be wrong, but it certainly is not a reason to be out of the market (unless one believes three decades of a Fed put is going to be pulled away). My view in this paper is that the Fed is on a policy path – deep into it, as a matter of fact – that carries plenty of risks and negative ramifications, and yet is extremely difficult to ignore when formulating an asset allocation and portfolio strategy.

The risks and negative ramifications current Fed policy present are:

A **Mal-investment** – if anything I posit in this paper is non-controversial, it is this... Artificially accommodative monetary policy incentivizes bad investments, mis-allocated capital, improper risk/reward trade-offs, and speculative leveraged investing.

B **Punishment of Savers** – perhaps as much a moral problem as an economic one, Fed policy punishes savers of capital, often senior citizens wishing to de-risk their money, and instead favors those wishing to borrow and spend.

C **Excess Consumption** – I understand there is a school of thought that there is no such thing – that driving animal spirits and seeing more Americans buy more things is the essence of a successful economic program. I will save you from the moral high horse I want to summon as to what is wrong with this thinking, and instead focus on the economic logic behind it. Shunning saving because there is no incentive to do so (i.e. due to zero percent yields) inevitably leads to additional spending (which yes, some would celebrate). But inadequate savings "risks up" the entire society, as future bad events are not met with adequate cushions, and the pain of a bad event becomes more severe than it otherwise would be if a savings cushion was in place. Therefore, the benefit of excess consumption today becomes the enhanced downside of inadequate savings later. The two are inextricably linked. A healthier monetary policy that better balances consumption and savings resets the risk/reward trade-offs we want in the economy.

These are real considerations, they are important, and they will eventually be reckoned with in ways no one can fully predict or time. But they do not contradict the fundamental thesis that the Fed has a monopoly on the creation of money and has more power in how they manipulate capital markets than any of us can possibly imagine, and more than has ever been really tested. The Fed's governing philosophy is to drive economic growth with the expansion of credit. A continual aid and abetting of risk assets is the cousin to this sincerely held belief.

You can bet they will fail on certain policy objectives (I do). Their inability to wave a wand and create inflation is a by-product of the impropriety of that goal, and the deflationary forces they are fighting. But betting against one of the things they can most easily do (i.e. favor risk assets over risk-free assets) is a tough bet to rationalize.

What would be really nice is to see the U.S. government also understand this "don't fight the Fed" mantra with their own portfolio – mainly, the debt securities that exist on their balance sheet as liabilities. Should the U.S. treasury take advantage of this monumental moment in U.S. history of a compressed yield curve across the term structure to issue ultra-long term debt (50-year and/or 100-year maturities) they not only would lock rates for many decades for their own borrowings, and provide investors an incredible asset to buy to hedge deflationary risk, but they would eliminate a certain tail risk in the markets. That elimination would be highly stabilizing to capital markets and would fortify our nation's financial position at the same time. But I digress...

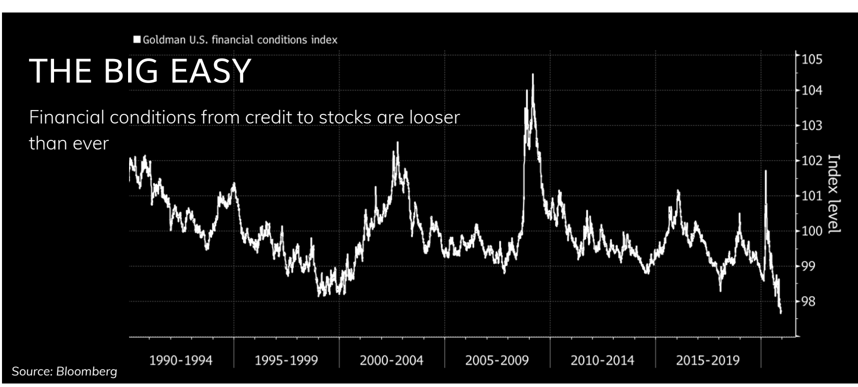
2021 will not be a walk in the park just because the Fed wants to stimulate financial markets. The areas the Fed cannot control still matter. But "fighting the Fed" means ignoring or circumventing in your own portfolio decisions the clear and present reality that (a) The Fed is leaving financial conditions easy, and (b) They are telling you they will do so for a long time. You show me a stronger correlation to equity markets than easy conditions for credit, and I'll have something else to lead next year's white paper with...

2 THE M&A TRAIN IS COMING

One could argue theme #2 is part of a logical extension out of theme #1. Easy credit, heavy appetite for leverage, low cost of debt service, and all sorts of financial conditions serve as the sine qua non for heavy transactions in corporate America. If all sorts of strategic and operational synergies exist, yet financial conditions hamper the efficiency of a transaction, you can bet that financial conditions will win out almost every time.

But financial conditions are as ripe for M&A right now as they have ever been in the history of corporate America. Borrowing costs are dirt cheap. Access to debt and equity capital is abundant. Covenants and restrictions for borrowers are as light as they have ever been. Yield spreads are tight. Capital markets are quick to fund debt and equity projects across a multitude of sectors and capitalization levels.

But appropriate financial conditions are a necessary but not sufficient condition for a healthy M&A environment. Indeed, there also must be interested buyers, eager sellers, advantages



towards consolidation, and the need to create scale in a given sector. In other words, the present conditions all keep piling up! The COVID economy has created the need for more efficiency, more scale, and more competitive advantages.

From pharma to financials, technology to industrials, and every sector in between, we believe conditions are ripe for heavy M&A activity in 2021.

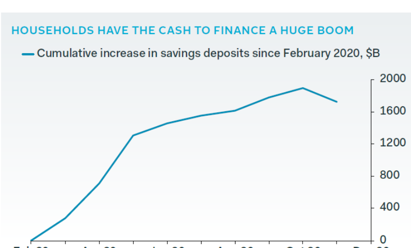
The investible thesis here is not to target companies that can be a suitor or a target in an acquisition, but rather companies in the supply chain of that process that will benefit – investment banks, private equity, non-bank lenders, advisors, etc. Too much attention has been given to "net interest margin" and not enough to the real ways financial services companies can make money post-GFC.

3 ECONOMIC RECOVERY IN THREE STAGES

1. Wait it out
2. Pent up demand
3. A bittersweet "true-up"

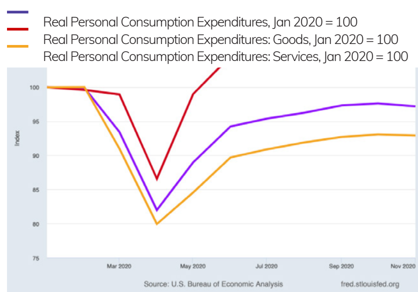
It is not just tough to forecast what the economy will look like in Q1, it is unnecessary. We know there is a push-pull between the anticipation of a vaccine and the present reality of continued state and local partial lockdowns in select pockets of the economy. The economy is "waiting it out" for now, and that stage is immaterial right now for investors.

I remain somewhat confused why the post-vaccine "melt-up" thesis (as it pertains to economic activity) is not receiving more attention. While some of my suspicions are merely anecdotal (i.e. high number of people talking about a vacation they are waiting to take, the human nature of people splurging when they feel free to do so, Americans love of binge-spending when they feel they deserve such etc.), there is ample economic support to at least the theory. For one thing, cash has been saved to support such a spending release out of this pent-up demand. This does not include any impact from the recently passed stimulus/relief bill.



Pantheon Macroeconomics, The United States in 1H 2021, December 2020

I see increased savings balances as a positive for the U.S. economy, yet also fully anticipate available liquidity serving the needs of this pent-up demand. I do not consider the satisfying of pent-up demand to be inflationary but do expect there will be hand-wringing over whether or not this consumption boom means a return of inflation.



Source: U.S. Bureau of Economic Analysis Bloomberg

When the "pent-up demand" phase is over, I anticipate a "true-up" in the state of the U.S. economy. The debacle of Q2 2020 gave way to the instant recovery of Q3 2020, and the "wait and see" of Q4 2020 into Q1 2021. The pent-up demand explosion will, I believe last for Q2 and perhaps into Q3 as well, but it will not be enough to tell us if we are on a steady, dependable, reliable economic path. Going into Q4 2021, and possibly beginning sooner, we will have to re-evaluate after the distortions of outlier contraction (2020) and outlier expansion (mid-2021). That "true-up" will very likely:

A. Depend on business investment so as to restore and enhance productivity, and

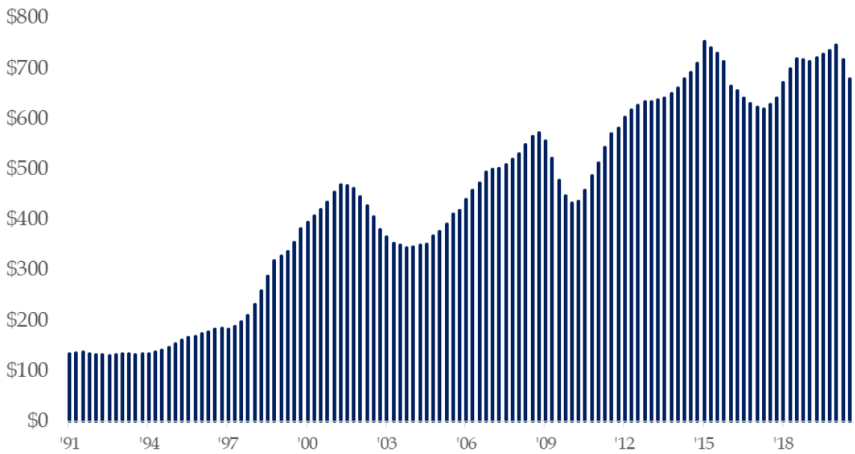
B. Leave in its wake both winners and losers

I believe a significant amount of jobs are coming back throughout the economic recovery process, even in the most afflicted industries of hospitality, travel, leisure, retail, and fitness. However, the process of spending stimulus money, lobbying for more stimulus money, deferring evictions, granting

PPP money to troubled businesses, and all sorts of other interventionist activity (some of which has been perfectly legitimate, some of which may not have been so fruitful) has kicked out into the future the ability to assess with clarity the real economic damage of this era. The labor data has clearly revealed a painful impact on lower-wage, lower-skill employees, but how that converts into more structural unemployment in white-collar positions (if at all) remains to be seen.

The economic story of 2021 will largely prove to be a very positive story. The drag on economic growth in 2020 was a transitory event caused by external circumstances that could not have been foreseen. The policy response to the pandemic has suffocated a great deal of economic activity – maybe not automobile purchases or house purchases (those things which benefit from low interest rates) – but certainly dining, events, entertainment, and travel. Those activities will increase in 2021 substantially, especially as the vaccine impact works its way through society. The pent-up demand will then be acted upon, and we expect strong quarterly GDP prints in Q2 and Q3. By late 2021, sending a true "post COVID" economic condition, the state of affairs will not be "out of the woods," but rather "where do we go from here." And as was the case pre-COVID, the answer to that question will depend on business investment geared towards driving increased productivity.

S&P 500 Trailing 12 Month Capex Spending ($Bn)



Strategas Research, Daily Macro Brief, Dec. 8, 2020, p. 2

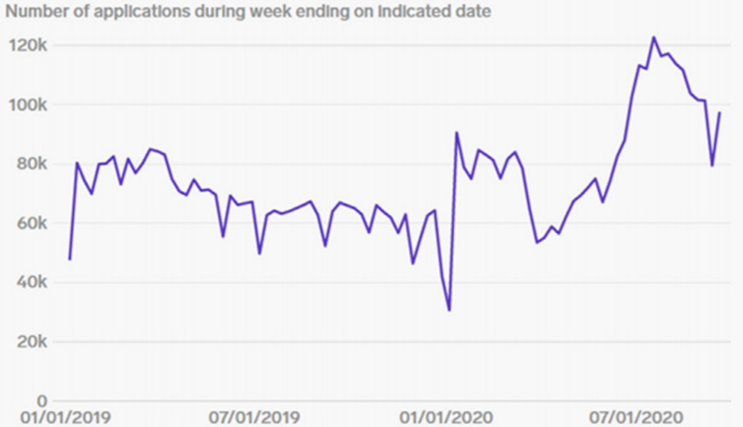
4 MARKET ROTATION IS REAL AND INEVITABLE

We enter 2021 big believers in an "equity rotation" of sorts. This is not a call in and of itself for a good market or a bad market. In fact, it is not a call for one sector doing well or another sector doing poorly. It is, however, a belief that the primary leadership in the market will rotate from the previous leadership group (very large capitalization technology names) to new leadership that has previously lagged (what so many are fond of calling "value" stocks). While our bottom-up, company-driven investing methodology results in certain sector overweights, we are not so much calling for a "sector rotation" as we are a category rotation. That is, the predominant driver of markets for some time has been momentum, popularity, and size combined with a consumer-friendly technology appeal. And while we could not time what we expect in re-pricing of that group, we do believe equity investors will see a new leadership group take hold as reversion-to-the-mean processes play out.

5 ENTREPRENEURIALISM IS IN THE AMERICAN DNA

Bet against small business in the United States all you wish. Look out your window and recognize the painful conditions for so many gym owners, hotels, retail stores, neighborhood bars, and restaurants. But understand this... the U.S. does not possess a policy prescription for overcoming these challenges; it possesses a DNA that is unique in the annals of history.

Businesses will fail in 2021, but new businesses will start and take their place. Any macroeconomic analysis that attempts to discount the former without pricing in the latter is going to be drastically wrong.



Note: Data is not season adjusted - Chart: Madison Hoff/Business Insider
Source: US Census Bureau, "Business Formation Statistics

6 CHINA COMMOTION IS IN THE FUTURE, NOT THE PAST

The temptation to believe drama with China is a thing of the Trumpian past will prove to be wishful if not partisan thinking. Poorly conceived tariffs may very well roll off, but there are a plethora of challenges that exist in the relationship between the U.S. and China, and markets are highly vulnerable to these tensions.

What the exact posture of the incoming Biden administration will be is somewhat unpredictable, but from technology regulation to national security to regulatory listing issues to diplomatic tensions to trade particulars to China's highly vulnerable economy, American impatience for China excesses is not going away.

7 PRIVATE EQUITY, SURE. PRIVATE DEBT, ABSOLUTELY

Illiquidity remains at a premium. It provides significant benefits to investors that are sacrificed at the altar of mark-to-market investing.

But the Fed theme of #1 and M&A theme of #2 are also married to theme #7 in our appetite for private market investing. Dry powder is at record levels in both private equity and private debt. The default rate on such debt of just 4.2% in Q3, actually lower than pre-COVID default rates, reaffirmed the resilience of the asset class. The cooperation of private equity sponsors with private debt lenders throughout the COVID-distress period to avoid tripping covenants and loan defaults provided a needed boost of confidence to this rapidly growing asset class.

There are tactical and structural merits in this asset class we believe in entering 2021. The caveat is that there is no such thing as private markets beta – in other words, we are not trying to capture the return of a generic investment in general non-public companies, or generic non-public debt. Underwriting matters. Selection matters. Manager talent matters. Manager process matters. This is an area we believe will be very opportunistic in 2021 for investors, but it is an area that depends on a deliberative process of due diligence. Best-of-breed managers are out there, and specific decisions around capital structure are of paramount importance. The great lessons of Michael Milken live on, and they make up theme #7 for our 2021 perspective.

8 SENTIMENT IS NOT YOUR FRIEND

One of the things we will hear a lot about in 2021 is whether or not bond yields are going higher, and if they are, what will it mean for equities. Higher yields do not mean that equities suffer, in and of themselves. A steeper yield curve can help equities, and higher rates at the longer end of the curve when they reflect organic, healthy economic growth are a good thing. It is higher rates that reflect real inflationary pressures that hurt stock (multiples) and bonds. So the reason rates move matter. My fear is not higher rates; it is the inability to get higher rates because of compressed growth caused by the debt-deflation cycle.

The biggest risk entering 2021 is not higher bond yields, but excessively positive sentiment. We can see a blow-off top as one potential ending, or we could see buyable dips coming. What we do not see is 2021 being a year of straight-line, low-volatility, upward-sloping markets.

Sentiment is perhaps getting overheated, though in several categories it is not yet in the danger zone. Should sentiment overheat we expect it to add volatility to markets at various points of 2021, and in particular arenas, even drive a correction.

Sentiment Dashboard

Sentiment Study	Current Percentile	90th Percentile?	95th Percentile?
SPY / QQQ / IWM Flows	29th		
S&P 500 Futures Positioning	31st		
I.I. Bull/Bear Ratio	97th	●	●
Consensus Inc. % Bullish	87th		
AAII Bull/Bear Ratio	70th		
10-Day Put/Call Ratio	97th	●	●
20-Day Put/Call Ratio	99th	●	●

Source: Strategas Research, Technical Strategy Report, Dec.29, 2020

CONCLUSION

I re-read my conclusion from last year's white paper as part of my preparation for this writing, and I was taken by this line:

> "We enter 2020 with a sense of cautious optimism, aware of the diminished effect of trade relief and monetary stimulus that assisted risk assets in 2019, yet encouraged by the possibilities of a resurgence in business investment, and committed to the 'no recession' story of 2020. Risk and uncertainty are permanent conditions for investors, and this is no less true as we enter the new year."

Well, that "no recession" story didn't play out, but the reiteration of risk and uncertainty as permanent conditions certainly did. We do hope (and believe) that a very different reality is coming as we prepare for a post-vaccine dynamic. And unlike in 2020, there is no pending election that represents a "known unknown" for investors to deal with. In other words, we think the economic environment should prove more stable and the macro environment more conducive to low-anxiety investing in 2021.

But it is not, and will not be, that simple. Bond yields enter 2021 sub-1% and market multiples enter 2021 > 20. These are expensive starting points for investors. Where yields are attractive and valuations reasonable, popularity and sentiment have not been present, meaning that until those sectors and asset classes draw attention prices may stay subdued.

That is okay for a goals-based investment manager like us, but quick and hot returns seem easy when market multiples get this high. Our job is not going to become finding those; it is going to be resisting the temptation to try. Our clients deserve our best care, and it is outside our duty of care to chase what cannot be chased and time what cannot be timed.

We enter 2021 smarter investors than we were in 2020, if for no other reason than we now have yet another year of experience, observation, demonstration, example, and education. We also enter it with the same traits we sought to demonstrate throughout 2020:

Conviction, humility, discipline.

To that end we work, in 2021 and beyond.

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