Legacy Trust

Investment Perspectives

Recovery Coming in the Year Ahead

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Key Takeaways

- The path of the Covid-19 pandemic continues to be the key driver of economic and stock market growth
- A robust economic recovery should occur this year as more of the population is vaccinated and activity picks up
- Despite 2020's market gains, stocks continue to appear to be the most attractive asset class for investment today
- Heightened volatility is likely, but 2020 showed again the importance of staying invested in spite of near-term uncertainty

2020 proved to be an extraordinary year in more ways than one as the world grappled with a global pandemic for the first time in more than a century. Amidst the initial uncertainty and panic, equity markets sold off more than 30% in just over a month. Rapidly shifting dynamics and extreme volatility throughout the year were challenging to endure but ultimately created opportunity for investors, as global stocks staged a remarkable comeback to finish the year with double-digit gains.

The market rally began in late March as we began to see signs that the first wave of virus cases was peaking. A key driver of the stock market recovery was the massive amount of monetary and fiscal stimulus that was delivered very rapidly and served to quickly calm the initial panic. Forgivable loans to businesses, direct payments to individuals, interest rates slashed to zero and a huge quantitative easing program to push cash into the fixed income markets all played a key role in stabilizing stock prices and, ultimately, driving them higher.

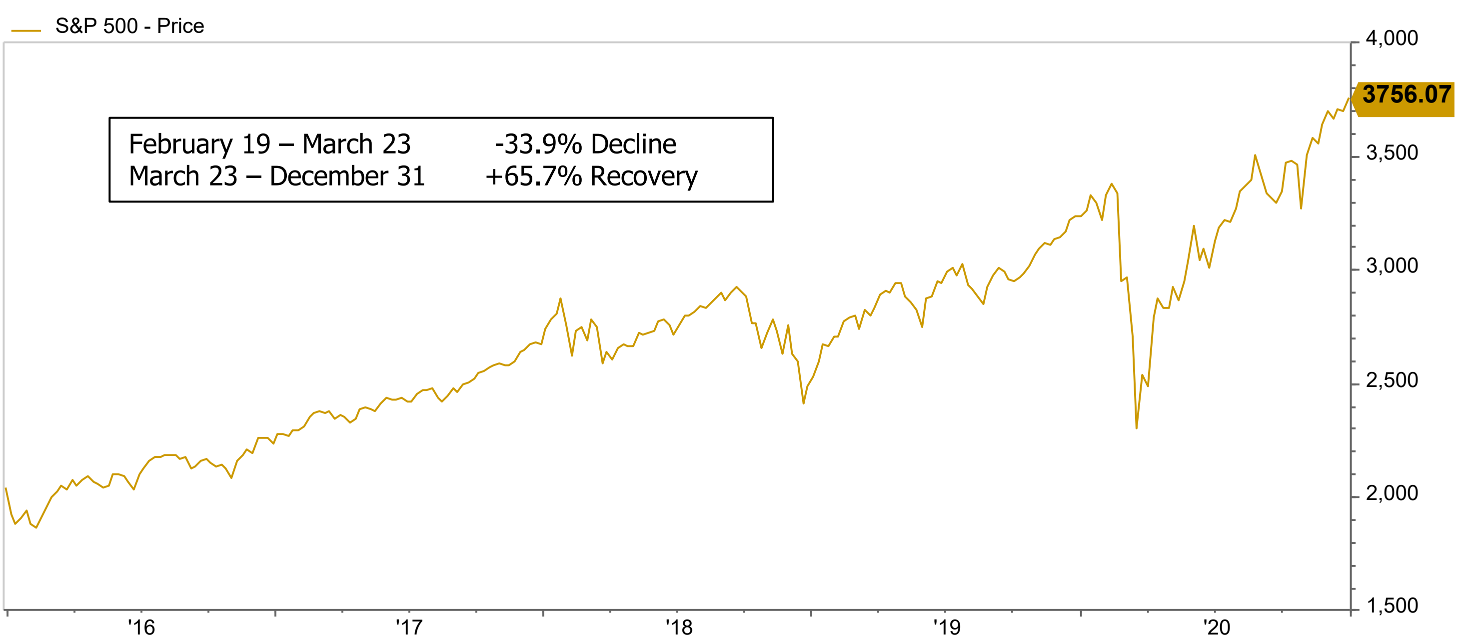
As investors looked for companies that could weather the storm, funds poured in to the largest tech companies that had led the market for the past few years – many of which were beneficiaries of the new stay-at-home environment. The five largest companies in the S&P 500 – Facebook, Apple, Amazon, Microsoft, and Alphabet (Google) – rallied significantly throughout the spring and summer. These gains, on top of 4+ years of market leadership, led these companies to grow to a point that they now comprise a record concentrated weighting in the index not seen since the height of the tech bubble.

Megacap tech's market leadership lasted into the fall when we began seeing signs that a sustained economic recovery could be around the corner. Encouraging data from the Phase 3 trials for two leading vaccine candidates sparked a big stock market jump in November and kicked off a rotation from secular growth stocks into cyclical stocks, benefitting financials and industrials among others. Small-cap stocks, which had significantly lagged large caps for much of the year, gained more than 30% in Q4 to finish the year as the top performing equity asset class for 2020.

Ironically, the most contentious U.S. election year in recent memory proved to have little effect on the markets. Investors largely shrugged off developments in Washington throughout the year, beginning with the threat of impeachment for President Trump last January through the contested election results in November, as the trajectory of the Covid-19 virus proved to be the far greater driver of market and business activity.

As we look ahead into 2021, the pandemic remains the key issue that will affect markets going forward. The stock market rally last year has already served to price in the likely path of an economic rebound as vaccines are rolled out, economies reopened, and consumer activity resumes. So far, events have largely been playing out along that expected path. Multiple vaccines have been developed, tested, approved and have begun to be distributed, and we expect that the pace of vaccinations will only increase in the coming weeks and months. While it is still very possible that setbacks will occur along the way, the pandemic should be brought under control this year.

As that happens, the partial recovery that began in April will finally be able to take a firm hold, and we expect that the economy will grow rapidly this year as conditions begin to normalize. Recall that the U.S. economy was in excellent condition prior to the pandemic shock for many reasons but primarily thanks to strong consumer spending. Now, after a year of very limited activity, American household savings and cash deposits stand at record high levels.



Source: FactSet Research Systems

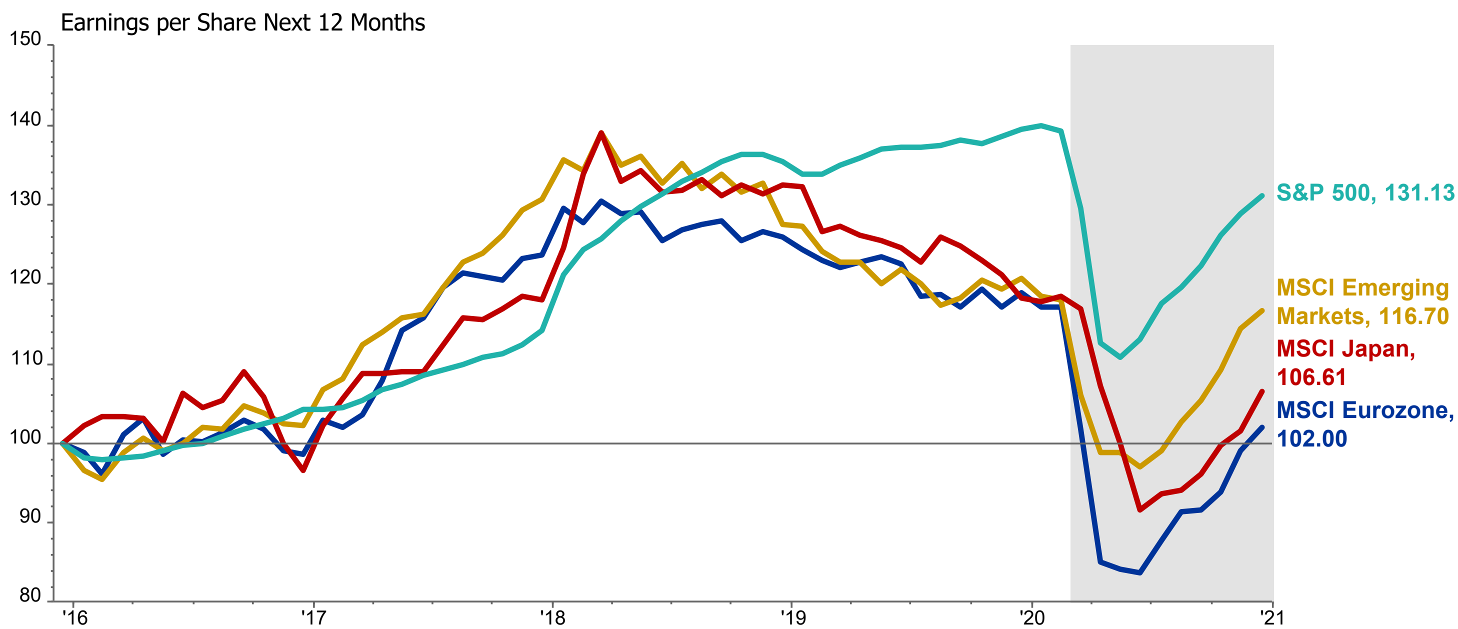
Consumers have money to spend, and as the lockdowns end and pent-up spending demand can be released, we expect to see significant company earnings growth this year which will drive additional stock market gains. While our outlook for equity market performance is positive, remember that this year's market gains are likely to be lower than last year's, since the market is forward looking and 2021's improvements were already accounted for last year.

We also believe that the stock market rotation toward cyclicals and small-caps that started in November – December is likely to persist for the foreseeable future. These are market segments that tend to do well in a period of fundamental economic growth, which we see as the most likely environment this year for the reasons noted previously. Active management, which added tremendous value in 2020 during the market disruption, should also be poised to do well this year as the post-Covid recovery favors certain market segments and companies more than others.

We expect international equities will also benefit from the global recovery in 2021 but we continue to favor the U.S. over other developed markets, to which we maintain a significant underweight. The Eurozone and Japan have lagged the U.S. in the initial economic recovery that has been underway since April, and we have no reason to think this leadership will change going forward. Further, recall that Europe and Japan were saddled with a number of structural headwinds prior to the pandemic – including Brexit, debt issues, and demographic challenges – and none of those factors have gone away. Meanwhile, Emerging market equities should do well this year as they benefit from a weaker U.S. dollar and declining global trade tensions.

With the outcome of the Senate races having just been decided last week, investor attention is turning toward the potential impact of Democratic control over the White House and both houses of Congress. Markets have already taken action to price in the likelihood of additional fiscal stimulus in the near-term, and interest rates have backed up. Tax increases and other initiatives are no doubt on the table for the Biden administration, but the extremely narrow margin of Democratic leadership in both the House and Senate make the passage of sweeping progressive policy packages unlikely as compromise will be necessary. Further, we do not believe it would be in the best interest of the Biden administration to enact policies that could damage the Covid recovery in its early, fragile days.

In conclusion, we believe the current environment favors investors position themselves overweight equities relative to the neutral weightings laid out in their Investment Policy Statements, at the expense of core fixed income. While complications surrounding the Covid-19 pandemic could certainly cause disruption in the near-term, we believe we are on a path to its eventual decline and equities stand to benefit most. Core bond holdings will continue to serve their purpose as a diversifier but are in for a period of very low total returns and are unlikely to overcome inflation in the near term. The roller-coaster path of the stock market in 2020 showed again the importance of staying invested through market volatility, and we believe the same will be true going forward. We remain confident in the ability of the economy to adapt and thrive even in through this unique set of circumstances.



Source: FactSet Research Systems