

Three Things to Watch in 2021

By: Henry Pizzutello, Chief Investment Officer

As we open the curtain on a new year, it always seems to be a favorite pastime to start with predictions of what will happen. Hindsight being 2020 (see what I did there?), nobody could have predicted the events that transpired, and as has been repeatedly stated, we don't do predictions. Nevertheless, these are three things that bear watching in the coming twelve months:



Value versus Growth

When it comes to the debate between value and growth stocks, Beckett's classic play *Waiting for Godot* comes to mind. In the play, the title character never arrives, much in the way value investors have been waiting for their version of Godot. However, in the second half of 2020, value started to close the gap in returns versus growth that had widened to historic levels. The expectation of a much stronger global economy this year, and the recent strong performance of the financial and energy sectors, make for a combination with historically good correlation for value outperformance. This correlation also suggests that international and emerging markets will do better than domestic, given the relative value discount overseas. Lastly, small caps have also greatly outperformed large caps during periods of high government budget deficits.

Cold War 2.0

Notwithstanding the recent political turmoil regarding President Trump, there is little doubt that the President's dealing with China has fundamentally changed the way they are viewed, both by the United States and the global community. This view goes beyond the trade implications between nations, as China's initial handling of the COVID crisis has caused many to be skeptical of the Chinese Communist Party's long-term motives, especially as many countries have not enjoyed the economic rebound that China is seeing. As new trade agreements are signed with Europe, China is no longer seen as a necessary trading partner, and their global standing and reputation have suffered. While it is expected that the Biden administration will be more agreeable to Eurozone trade, the same cannot be said for China. The net result may be somewhat slower economic growth and potentially higher inflation over the long-term, as well as a period in which both Washington and Beijing will compete globally in economic and geopolitical influence.



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The Bubble Doesn't POP

While there have been numerous warnings regarding the “bubble” valuation levels of the market, there usually needs to be a catalyst for the bubble to pop. More often than not, it is not an exogenous event like COVID but something more ordinary in the form of interest rates. While much has been made of the lofty P/E levels of the S&P and NASDAQ being as high as they were during the periods before the 2000 and 2008 crashes, those valuations fail to take into account the real culprit that stopped the party — rising interest rates. More importantly, the absolute level of rates was significantly higher than what we have today.

In 1987, the S&P 500 went up roughly 40% January through August as 10-year Treasury yields increased from 7% at the start of the year to 10%. The market finally violently corrected on October 19, although it finished slightly higher on the year. Similarly, in 1999, the NASDAQ increased by 75% as long rates rose almost 2%, and the Fed raised the funds rate three times from 4.75% to 5.5% — we know how that turned out, as well. In both cases, the yields rose to a level that was sufficient to draw money away from risk assets. With the Fed funds rate likely to be pegged near zero until 2023, the party punch bowl still looks appealing.

Feeling Blue About The Blue Wave?

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As we start the new year with what will be a Democratic controlled House and Senate, there are a number of takeaways to consider — both from an investment perspective and an economic/political landscape.

Our previous thesis prior to the November elections was that a divided government would be the best of both worlds — a continuation of policy to foster economic growth without an increase in taxes. What we have seen since the election prior to the Georgia run-off was less stimulus from a fiscal standpoint, but a focus on renewed growth as the effects of COVID continue to run its course. That dynamic will likely change with Democrats winning control of the Senate. It is very possible that there will be more fiscal stimulus, which will help as a short-term panacea. More fiscal stimulus, however, will be coupled with tax increases, which will have longer-term effects.

While the Senate is ostensibly even at 50-50 (Vice President-Elect Harris would cast deciding votes), Democrats will probably view this as a mandate for bold action in terms of stimulus and fiscal spending. This looks very similar to 2001, when George W. Bush entered the presidency with a 50-50 Senate and a razor-thin majority in the House. In six months, Bush was able to get a large tax cut, boost defense spending, and pass landmark education reform.

The hope is that the moderate Democrats will seek a balance to level down spending and tax increases. The switch from a Republican to Democratic Senate means more fiscal stimulus but also tax increases. From a market perspective, this will help growth in 2021, but creates a longer-term headwind for late 2022 and 2023.

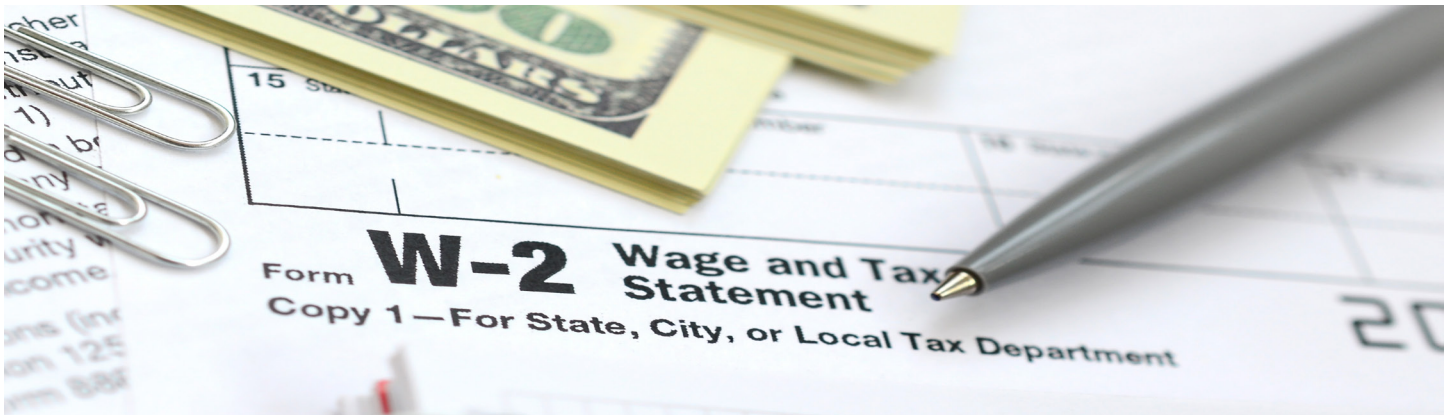
Tax

Increases in taxes will most likely be the first area that will be affected by the Democratic stronghold.

- Higher top income tax rate
- Corporate rate around 25% for 2022
- 25% cap gains/dividends
- State and local tax deduction reinstated

From a market perspective, the capital gains increase could be the most troublesome. Historically, higher capital gains tax rates have not been above 30% since 1978. In fact, when the capital gains tax rate was cut in 1978 and then again in 1981, it started one of the longest bull markets in history. On the corporate front, this is less of a surprise as many corporations started to factor this into future guidance last year, even before the November election, although the Senate flip may accelerate the process.

There will likely be a tax increase at the highest marginal rates, which is probably more political than revenue-based, but will not have much effect on most taxpayers. More Americans may benefit if the SALT deductions are reinstated (State and Local Taxes), which will also have a positive effect on new construction housing.



Feeling Blue About The Blue Wave?

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Fiscal Spending

It is estimated that another \$1.5 trillion of fiscal spending is possible with climate, infrastructure, states, education, and healthcare the prime targets. The most immediate target may be an inclusion of \$2,000 stimulus checks to help keep the economy moving in the right direction.

An infrastructure spending deal is likely to help highway and other forms of infrastructure. This is one area where Republicans may compromise with Democrats, as it will also likely boost employment. Similarly, there is likely to be a large increase in climate spending for solar, wind, EVs, power charging stations, and biofuels.

One area that will definitely be affected is healthcare. Healthcare costs were identified as the biggest concern for middle-income Americans and there is broad voter support for positive changes. There will be a focus on expanding the ACA to include Medicaid to residents in states that have not done so. There will also be support for more price controls on prescription drugs, and a more effective national health care plan.

Market Effect

1. Long-term: dollar should head lower, yields higher as stimulus deficit grows
2. Longer-term: growth may be compromised without sustained growth

While most Americans don't pay attention to the value of the U.S. dollar relative to other currencies, it has far reaching effects across a number of asset classes. The expected fiscal stimulus will be positive for near term growth, but the resultant debt may present a headwind over the longer-term if growth is not sustained. Rates should move higher in response, but this is not a given. We have seen globally that rates remain significantly lower in other countries with worse demographics and economics.

From a trade perspective, the "America First" platform will also be decreased. Although President Trump made significant strides in dealing with China, it would be expected that a Biden administration would be more accommodating in dealing with our traditional trading partners. This could have an effect on stocks, as well. Under the Trump trade policies, which highlighted corporate tax cuts and foreign tariffs, U.S. stock has gained more than 40%, while non-U.S. stocks are up only 8%. This trend has started to reverse over the past few months since the election, as international stocks have rallied as the dollar fell.

A falling dollar will also be good for the energy industry, as energy price outperformance is very much correlated with a weaker dollar. This also bodes well for emerging markets and reinforces our philosophy on global diversification.

As we move forward, we will have to price in these factors, as well as many others which have not been discussed. The effect of a specific political party on market performance, regardless of preference, is inconsequential over the long-term, as markets follow the economy. Historically, since 1950, when we have had a Democratic president and unified Congress (22 years), the average market return has been 9.8%. Interestingly, market performance under Democratic presidents actually performed better with a Republican Congress (13.0%). The reality is that it is extremely difficult to accurately predict market performance based upon a single factor. What drives successful long-term investment performance is consistent philosophy and focus on the overall risk of many factors tied together.