A Year in Colors

Once a year, beginning more than a decade ago, we have researched and written an *Annual Market Perspective* for Mill Creek's clients in which we summarize the just-completed year in capital markets and provide our outlook for the year ahead. The discipline of undertaking and writing about this exercise – and the perspectives that a one-year retrospective provide – have made us ever-more deliberate and thoughtful about the investment decisions and portfolio asset allocations that we make for clients across the subsequent 12 months. We hope that you will likewise find this year's annual recap and outlook of interest and valuable.

Capital Markets in 2020: A Rainbow of Colors

Pantone, a US-based company whose extensive color palettes are used worldwide to achieve color consistency in print design usages and to set standards across the graphic, fashion, and product design industries, chooses a *Color of the Year* every December that it thinks best captures anticipated business, lifestyle, and socio-economic trends for the year ahead.[1] For 2020, Pantone selected *Classic Blue* (Pantone 19-4052), a color which it described as both instilling "calm, confidence, and connection" and highlighting "our desire for a dependable and stable foundation on which to build as we cross the threshold into a new era."

In retrospect, perhaps everyone needed a lot more Classic Blue in their lives in 2020 as the entire world crossed the threshold into a new era: a globalized health crisis. Instead, throughout the year we collectively fixated on filling political maps with blue or red, on US and global maps shaded in light orange to deep purple to illustrate COVID-19 cases and deaths, and on red/yellow/green icons indicating the extent to which cities and counties were restricting business activities and social gatherings in their efforts to curtail the global pandemic.

Red and green have, respectively, long been the colors of choice for illustrating losses and gains on investment securities on now ubiquitous investment websites and other sources of financial information. As we discuss in the following detailed review of 2020, the optimism that prevailed as 2020 began soon gave way to a *sea of red ink* in capital markets as the COVID-19 virus spread globally. But much to the collective astonishment of virtually all investors, big gains on most risk assets from late spring through year-end succeeded in coloring nearly all major market indicators green as the months – and the virus – progressed.

[1] Source: www.pantone.com The standardized color used for the font in this and other written Mill Creek communications is Pantone 2151U, an (alas) nameless pastel azure (a hue which Wikipedia describes as "the color of the sky on a clear day")

TOP CAPITAL MARKETS STORIES OF 2020

A year ago, we wrote about *Rota Fortunae* (Latin for "Wheel of Fortune") having spun in favor of investors during 2019, with gains of nearly +30% on global equities and +9% on taxable bonds. And we noted that, although optimism reigned across global capital markets in the face of a record-long economic expansion and very low unemployment as 2020 began, high stock market valuations and low bond market yields provided a strong argument against achieving similarly high investment returns in the year ahead.

COVID-19, to state the obvious, *colored* all the stories that most impacted markets and investor portfolios during 2020. The outbreak of this worst-in-a-century pandemic was an unknown unknown – something not on investors' collective radars – as 2020 began. Given the virus' subsequent unchecked spread, it would not have been unreasonable to anticipate that full year losses on risk assets would more than offset the strong gains of 2019. But as attentive investors have since learned, that was not the case last year.

For perspective, by calendar quarter the top issues affecting clients' portfolios and on which markets focused during 2020 were:

- **1Q 2020**: The world and its capital markets started to take on a new hue in mid-March. Voluntary "work from home" policies and initial rounds of mandatory business closures and travel restrictions started to put the 10+ year economic expansion at risk. Equity market volatility spiked: there were 8 trading days in March when prices moved 5% or more and a massive single day sell-off of -12% (March 16). By late March steps were taken by US and global governments to quickly deploy a variety of policy tools to blunt the pandemic's rising impact on economies and capital markets. In the US, the Federal Reserve stepped in (on a Sunday, no less) with a -100 basis point cut to interest rates and flooded capital markets with liquidity. And bipartisan efforts in Congress resulted in passage of the $2.2 trillion CARES act to reduce the effects of workplace closures on the economy generally and on small businesses and individuals in particular.

- **2Q 2020**: At mid-year, the world was awash in COVID-related data but not in possession of much good information. The Fed, having pledged to "do whatever it takes" to support financial markets, had increased its overall balance sheet by more than 70% since the crisis began. Reactions to consensus estimates of a record -35% annualized one quarter decline in US GDP were tempered by signs of rising spending and economic activity, and an emerging view that a pandemic-induced contraction could be more short-lived than a traditional recession.

- **3Q 2020**: Despite COVID-19's continued global spread and the double-digit GDP contraction reported for most global economies, a sharp rebound in US consumer spending (fueled in part by expanded US unemployment benefits) contributed to consensus views that a V-shaped economic recovery might already be underway. Worst-case fears of 20%+ unemployment were unrealized; by September the rate had declined to (a still high) 7.9% of the workplace. We cautioned clients that elevated levels of market volatility could occur in the weeks preceding and immediately following a US presidential election that we anticipated would be "unlike any other in US history."

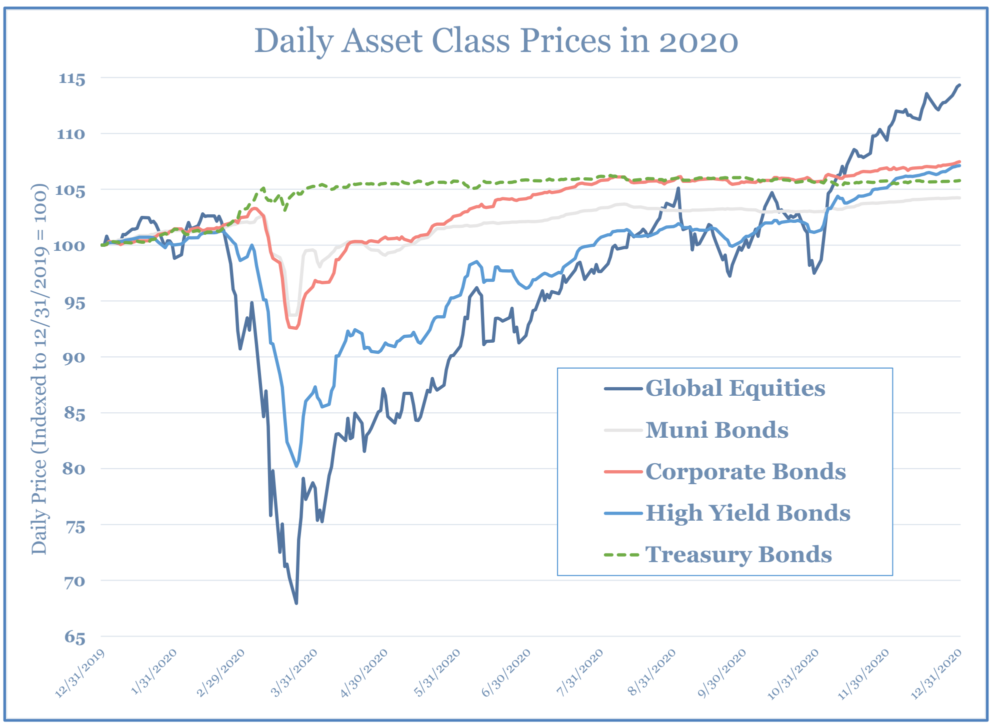
- **4Q 2020**: By early fall, the economic *green shoots* of spring had given way to reports of a robust +33% annual rise in 3rd quarter US GDP fueled by pent-up consumer demand (spending on new cars; on deferred doctor and dentist appointments). Although a pre-election round of fiscal stimulus was not forthcoming from Congress, the Fed announced that it would extend several of its lending facilities into 2021. Despite counting delays and rancor over results of the presidential election, capital markets remained calm. The prospects of one or more efficatious COVID-19 vaccines becoming widely available globally during 2021 provided glimmers of medical and economic hope that the year ahead would bring a more *Classic Blue*-like calm, confidence, and connection.

CAPITAL MARKETS: 2020 TRENDS AND RESULTS

Very little of the foregoing litany of COVID-related medical and economic crises would seem supportive of a year in which most broadly diversified investment portfolios ultimately generated overall total returns in excess of +10%. Investors' years got off to a good start: major US and non-US equity indices built on strong 2019 gains and hit all-time highs in mid-February. But thereafter, prices of risk assets (i.e., equities, high-quality and low-quality corporate bonds, municipal bonds) went into free-fall for nearly six weeks. By March 23, US and global equity prices had fallen roughly -35% from their February peaks. Bonds issued by creditworthy corporations and municipalities likewise sold off. Even the price of gold, a proverbial *safe harbor in a storm*, slipped -12% as financial market illiquidity and the widening COVID pandemic intersected within global capital markets. Treasury bonds, however, performed true-to-form, with their sharply rising prices (e.g., +7%) providing some measure of portfolio stability from mid-February through late-March.

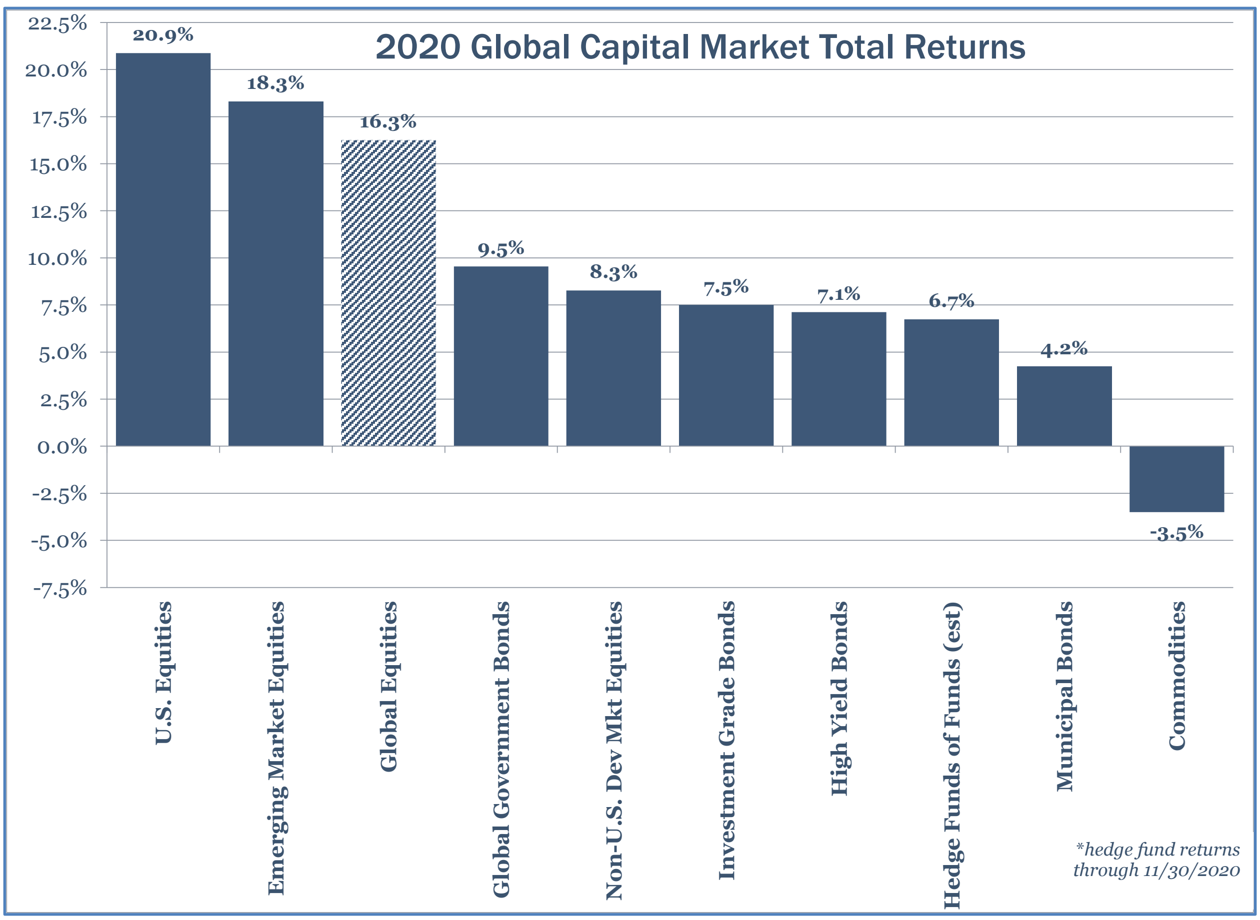
Although it temporarily slowed during the summer months, COVID's spread and the related collateral damage inflicted on global economies did little to dent a rise in risk asset prices from late-March onward. By late summer, most capital market prices had fully recovered their earlier losses; by fall cumulative returns were positive (*green*) across most asset classes. Many broad US equity market benchmarks (the S&P 500 Index, NASDAQ, Russell 3000) pushed higher still, eclipsing their February records to set new all-time records at year-end.

In one sense, the rebound in stock market prices (particularly in the US) exhibited much of the same *disconnect* from earnings as was the case in 2019. A year ago, we remarked that US stocks' price advance (e.g., the Russell 3000 Index's +29%) was achieved independent of modestly lower (-2%) actual earnings. By December 2019, investors had pushed valuations to a multiple of 20.7x estimated 2020 earnings. The pandemic, however, caused a wholesale re-assessment of prospective annual earnings. By late June, consensus estimates had been lowered -35% from where they were as the year began. Bearish 2020 earnings estimates were later revised upward (+14% above their June nadir), and investors' enthusiasm about a post-COVID profit recovery pushed overall market valuations higher still, to a multiple of 23.3x (Russell 3000 Index) estimated 2021 earnings as of December 31, 2020.



Price performance in portions of the bond market followed the same path as equities. Prices of corporate and municipal bonds rose at the start of 2020 as interest rates continued the downtrend begun in late 2018. But rising credit concerns as COVID-19 challenged economic growth, coupled with market illiquidity as investors actively looked to move money into safer investments (i.e., Treasury securities), pushed prices down -9% (municipal bonds) to -20% (high yield corporate bonds) in March. Credit spreads on the latter briefly topped 1100 basis points (11%), their widest since the global financial crisis of 2008-2009. Thereafter – particularly after the Fed assured capital markets that it would facilitate market liquidity and the economy began to trace a V-shaped recovery – these segments of the bond market gradually yet fully recovered earlier price declines and finished the year with total returns that exceeded most investors' expectations.

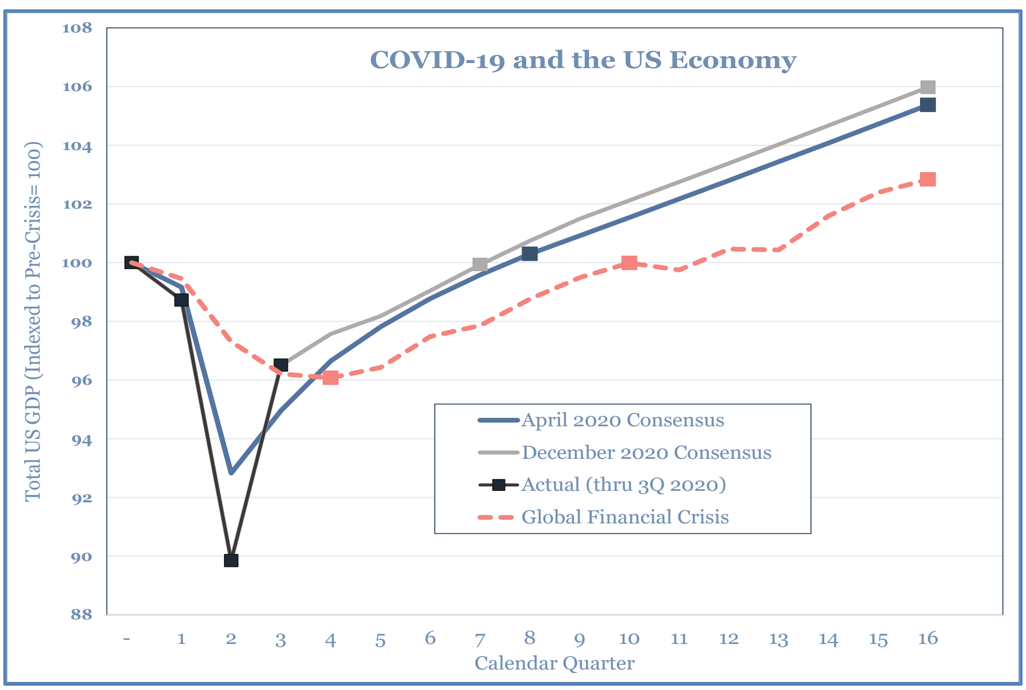
Comparatively, in 2020 the US Treasury bond market provided less drama than all manner of risk assets. Declining yields across the entire universe of Treasuries, the source of very strong (+6.9%) total returns in 2019, continued as the US economy was weakened by the pandemic, the Fed vowed to keep interest rates low, and global investor demand for these securities surged. The consequence: an all-time low yield for the aggregate US Treasury market (0.40% at mid-year; 0.60% at year-end) and even richer (+8.0%) total return in 2020. Only one major asset class – commodities – finished 2020 "in the red" with oil prices in particular (-21%) a notable capital markets victim of COVID-19 and its adverse impact on global economic growth.



The Outlook for Capital Markets in 2021

It all depends. On COVID-19. Returning to theme, performance of global capital markets in 2021 will very much depend on the *colors* that are applied to US and world COVID-19 maps, and how broadly and quickly they change from the (mostly) current shades of deep red to more uniformly pale yellow or even uncolored. Arguably, forward-looking capital markets have already incorporated optimistic virus and economic outcomes for the year ahead into prices. For example, economists' median consensus estimates are for very strong US and worldwide annual GDP growth of +3.9% and +5.2%, respectively. And full year earnings for US companies overall in 2021 are currently projected to increase +20 to +25%, in the process more than retracing their projected 2020 net declines.

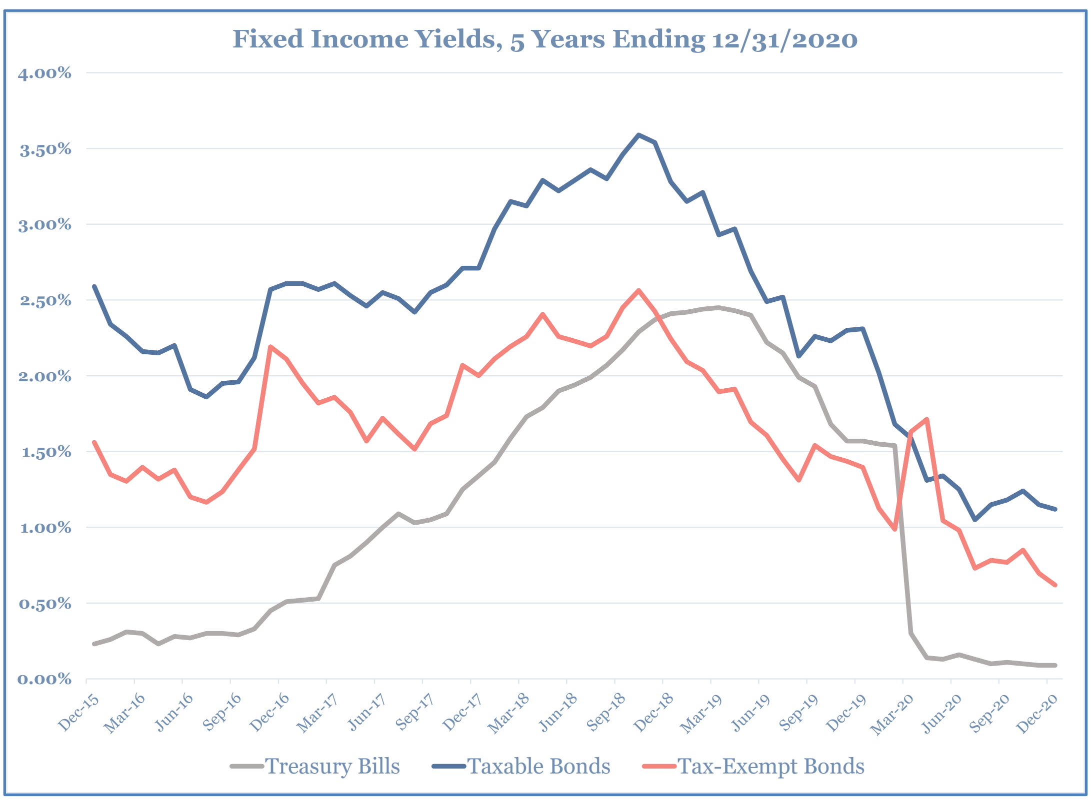
As shown in the accompanying chart – one that we first developed as the pandemic began and which we have since reprised as time has passed and more data has become available – strong quarterly gains in US economic activity are now projected to return the overall economy (though, we wager, not all its constituent parts) to 4Q 2019 levels by 3Q 2021. Were it to do so, GDP would trace the V-shaped economic recovery that was first theorized as a possible outcome in April. The economy would also be exhibiting greater resilience than it did following the global financial crisis of 2008-2009. The obvious risks of such a view: the virus' continued, unpredictable unfolding and/or a slow roll-out and uptake of one or more efficacious vaccines that causes economic growth to fall short of these expectations.



US Bond Markets and Fixed Income Portfolios

The US Federal Reserve (and to be fair, other world central bankers) will go down in financial history as global capital markets' savior in 2020. It is also anticipated that the Fed will play a significant – though hopefully less dramatic – role in 2021 and beyond. In mid-December, Fed Chairman Jerome Powell expressed confidence that the US economy would rebound strongly in 2H 2021 even as the bank announced that it would continue its bond purchases to keep interest rates (hence, borrowing costs) low. The Federal Reserve expects to maintain its benchmark Fed Funds Rate at its current level (0.25%) through 2023.

Interest rates that are both low and expected to remain low will remain a burden for savers and fixed income portfolios in 2021 and beyond. For savers, the resulting low yields on Treasury Bills (currently 0.09%) virtually ensures that money market accounts will produce little or no income for years. Bond portfolios will continue to bear the burden of rock-bottom yields: currently 1.12% in the taxable bond market and 1.07% in the tax-exempt bond market. Short of a further decline in these yields (which would be an unfortunate byproduct of a worsening economy and attendant, more aggressively stimulative Fed policies**), the annualized returns that investors can expect from their bond portfolio allocations across the next several years will differ little from these record-low yields.**



Corporate Profits, Valuations, and Equity Returns

Equity analysts and stock markets broadly tend to look beyond current profits (i.e., the most recent quarter's earnings) to anticipate outcomes of the next several quarters or year ahead. With a strong economic rebound already taking shape, consensus full year US earnings estimates for 2020 were lifted to a less catastrophic -9% year-over-year decline by December. Similar forecast trends also occurred for non-US companies. And, given rising prospects of widespread COVID-19 immunizations occurring in 2021, consensus estimates for the year ahead similarly bottomed-out in mid-2020 and were bumped higher (to the +20% to 25% growth rate referenced earlier). If past is prologue, we expect these projections to undergo further revisions throughout 2021. Given recent second (or third) surges of COVID-19 cases and deaths, **the greatest risk to these optimistic earnings estimates is that the virus is not curtailed** as rapidly as is hoped and that economies remain moribund for longer than is now anticipated.

Equity market price increases of +8% (non-US markets) to +18% (US) in 2020 were achieved in the face of this challenging earnings environment. Consequently, price-to-earnings valuations at year-end were appreciably higher than a year earlier. Likewise, P/E ratios ended the year materially higher than long-term (in this table, the last 25 years) averages. Although it is not unusual for strong stock market price advances to precede earnings growth, **starting the year from a point of elevated valuations introduces much higher investment risks in 2021** than is characteristic of this point in an economic cycle.

US Equity Market Valuations

Price/Earnings Ratio	As of 12/31/2019	As of 12/31/2020	Long-Term Average^
Based on Current Year EPS Estimates	20.7	29.5	17.3
Based on Next Year EPS Estimates	18.6	23.3	15.2

^ for period 12/1994 to 12/2020

Quite possibly, the market's current valuations are sustainable across a period of expected low returns on risk-free assets (i.e., Treasury Bill yields near 0%; 10-year Treasury yields of 0.9%). But at some point, the calculus of a decline in valuations toward the mid-point of historical norms implies some combination of above-average earnings growth and slower advances in (or falling) share prices ahead. Certainly, investors prefer the comfortable ride of the former. After bottoming in June 2009, for example, actual and estimated EPS grew at +21% and +18% annualized rates, respectively through 2012.[2] Prices advanced at a slower but still generous +14% annualized rate, allowing the market to *grow into* its elevated starting valuation. But

[2] Data based on the *Russell 3000 Index* of the total US equity market

investors' post-Dot Com experience (coming on the heels of valuations peaking at 25.1x estimated earnings in mid-2000) resulted in a more painful re-valuation process: prices declined at a -13% annualized rate through December 2002 even as earnings shrank at a more modest -3% rate, producing a 34% lower (16.5x) P/E by the end of 2002. Whether equity markets track one of these courses – or an altogether different trend – across the next several years is impossible to predict. Nevertheless, we do think that it is reasonable to project that – even if valuations become less ebullient at some point – **growing earnings and still-generous cash dividends will likely combine to produce mid-single digit total returns on equities across the next several years.**

Summary and Conclusions

In many of our past discourses discussing what *could* occur within capital markets in the short run, we have drawn comparisons between *known unknowns* and *unknown unknowns*. Capital markets, by definition, cannot anticipate the latter. Prior to 2020, selected scientists, futurists, moviemakers, and others had predicted the *possibility* of a pandemic, and the 1918 pandemic was a well-known if dated historical precedent. But to our knowledge, scenarios detailing how to position investment portfolios for a rapidly and broadly spreading virus had not been contemplated immediately prior to the COVID-19 crisis. Any prediction that stocks worldwide would return +16% in such an eventuality – especially given the resulting economic shocks – would have been considered laughable.

The COVID-19 pandemic has, across the last nine months, become a *known unknown*. We cannot predict the crisis' endpoint. But we now know that a widespread and effective global immunization to control the pandemic is required to successfully re-open wide swaths of the economy, put people back to work, and generate the strong cash flows and profits presently anticipated by capital markets.

The aforementioned Pantone company broke with past precedents in December by choosing two *Colors of the Year* for 2021: Ultimate Gray (Pantone 17-5104) and Illuminating (Pantone 13-0647), a warm yellow. Their rationale for selecting these two very different hues: in combination, they are "a marriage of color conveying a message of strength and hopefulness that is both enduring and uplifting". As investment professionals – who tend to see things more in black and white (or, simplistically, just as green for positive returns and red for negative returns) – we defer to Pantone's creative interpretation of its selected color duo. But immunizing ourselves with doses of strength and hopefulness seems, to us, an appropriate approach to facing (or, coloring) uncertainties as 2021 begins.

INVESTMENT STRATEGY TEAM
JANUARY 4, 2021

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