WILKINS
INVESTMENT COUNSEL

2021 INVESTMENT OUTLOOK

The year 2020 was notably different from others and had widely divergent trends, euphoric on one hand and chaotic on the other. The year began normally enough with the longest running growth cycle in modern history (ten years plus from June 2009) and continued through mid-winter with the popular market indices closing at all-time highs on February 19th. Markets then suffered a severe five week sell-off as the pandemic of Covid-19 became a reality. The S&P 500 declined nearly 30% from its February peak, confirming a bear market. First quarter GDP slipped by a modest single digit number while second quarter fell at an historic 31.4% annual rate. Major parts of the economy shut down, travel and hospitality activities were disrupted, up to 20 million Americans lost their jobs, and the unemployment rate peaked at nearly 15%, a depression era level.

Given these conditions, the Federal Reserve stepped in and halted the economic downturn by announcing it would take "extraordinary measures to shore up the economy." Actions included lowering short term interest rates to nearly zero percent (negative in inflation adjusted terms) and providing a variety of accommodative mechanisms to entities in need of liquidity. The Fed subsequently announced it would keep rates at these low levels for several years until inflation comfortably exceed its 2% target for a sustained period. This central bank action was accompanied by the Federal government passing a $2 trillion dollar plus fiscal CARES Act which the Fed essentially monetized on its balance sheet.

These unprecedented measures halted the stock market decline. Investors, encouraged by the liquidity infusions, reversed course and drove the popular market indices higher, exceeding the February peak in August and reaching record levels by year end. Euphoric conditions reigned in large tech companies benefitting from the pandemic while enterprises disrupted by it generally remained on the selling block. The IPO (initial public offering) market boomed in the final quarter of the year and raised a record $167 billion dollars in 2020, exceeding the previous record of $108 billion in the 1999 dot com boom. Approximately half of the IPOs were special purpose acquisition companies (SPACs) or so-called blank check companies which raise funds from investors and then use the SPAC vehicle to purchase an existing private company. This allows the former private company to become public without the detailed disclosures required in a traditional IPO and skirts SEC prohibitions against future projections.

Sectors that fell into disfavor during the pandemic included transportation, travel, hospitality, energy, and broadly defined cyclicals. There was also a notable divergence in real estate valuations with downtown commercial office and retail properties declining in value given the ascent of the virtual workplace. Conversely, suburban and country residential real estate boomed as home dwellers sought refuge from the pandemic in lesser populated areas. New York City rents, as one example, are down some 20% from the prior year with a rising vacancy rate.

While euphoria dominated certain sectors of the stock market, chaos was evident in the economic, political, and social fabric of the country. While the third and fourth quarters of the year regained most of the first half downturn, full year GDP is still estimated to be nearly 3% lower than 2019, roughly 10 million Americans remain unemployed, and deaths continue to mount from the pandemic, stressing health care resources. Full year S&P 500 earnings are estimated to fall some 20% from 2019 as opposed to a modest gain considered likely as the year began. The political fabric of the country was tested by a bitter presidential contest and the unwillingness of the Trump administration to accept defeat at the ballot box and then again in over sixty decisions by an independent judiciary. At the least, this complicates things for the incoming Biden administration as it seeks to move the country forward. On the social front, America wrestled with all too present issues of discrimination, inequality of opportunity, and the widening gap of wealth distribution.

Stock market indices, driven by a handful of mega cap technology companies, surpassed all expectations and enjoyed well above average gains as shown in the table below. It is worth noting that the more diversified S&P 500 Equal Weighted Index advanced a more modest 12.8% while the Value Line Geometric Composite, a measure of the median stock return across nearly 1,700 equities, gained a single digit 3.0% for the year.

Equity Markets – 12/31/20

	Index Price Level	2020 Total Return
Dow 30 Industrials	30,606	9.7%
S&P 500	3,756	18.4%
NASDAQ Composite	12,888	45.1%
MSCI All Country World Index ex-USA	326	11.1%

Outlook

The near and intermediate term outlook will be importantly influenced by the availability and distribution of Covid-19 vaccines. While optimistic about the outcome, leading public health officials warn that social distancing protocols remain critical in limiting disease spread in the near term and that a post-holiday surge in new cases is likely. GDP growth should improve from a modest rate in the first quarter to higher rates later in the year as vaccination coverage expands and herd immunity (70-75% of the population vaccinated) is accomplished.

Pent-up demand is likely to produce a surge in economic activity as Covid-19 abates and normality begins to return. Current estimates call for real GDP to expand more than 4% in 2021 and get close to 2019's $19.1 trillion achievement on an inflation-adjusted basis. Consensus Wall Street profit estimates forecast another positive year for the stock market with S&P 500 earnings growth of more than 20% to $165 per share, which will approximate the 2019 level. A meaningful profit recovery will occur, but the current valuation comes to a nearly 22.8x P/E ratio using forward estimates, a number well above last year's 18.4x valuation at this time and amongst the highest levels of the past 50 years excluding the late '90s bubble. Interest rates remain trapped at historic lows and the Federal Reserve seems fully committed to keeping them there for several years, which is the primary force driving stock valuations higher in the short run. Such valuations could eventually prove challenging for the stock market down the road as economic growth reaccelerates, inflation picks up, and the central bank decides to temper its current policy.

The incoming administration is inheriting a very challenging series of issues. Fiscal stimulus applied last year resulted in a $3.1 trillion federal deficit, amounting to 15% of GDP and a level not seen since WWII. Additional stimulus in the trillion dollar plus category is likely to be passed in the New Year and could be accompanied by tax increases in order to keep the deficit from becoming an even greater burden on future generations. The outcome of these push-pull forces is difficult to project but basic economics does limit the ability for any entity to borrow at a never-ending amount. The Federal Reserve balance sheet currently stands at nearly $8 trillion, up from $4 trillion plus this time last year, and the Fed's current plans of buying $120 billion of government and mortgage securities each month does leave it room for further expansion.

Inflation will play a meaningful role in future government spending and borrowing policies. Government officials are hopeful that given an aging population and excess global capacity, inflation will remain within a 2% or so range for a few years, allowing the loose monetary conditions to continue until the economy fully recovers from the pandemic. Pent up demand, higher imported goods prices from a declining dollar, and the large trade imbalance could change the calculus and result in market forces requiring higher interest rates on government borrowing sooner than expected. This would have a dampening effect on today's lofty market valuations and very negative consequences for lower quality and longer-term bonds.

Several other factors exist which investors should consider when setting their longer run investment strategy. A key issue is the very crowded trade and bullish sentiment in a handful of large technology companies. Six tech issues (Apple, Microsoft, Amazon, Google, Facebook, Tesla) currently account for $8.2 trillion dollars of market value, or 23.4% of the S&P 500 index, a level of concentration which has historically ended unfavorably for some names at the very top of the index. Their collective valuation is also double the size of the $4 trillion municipal bond market. Several recent IPOs also carry extremely high valuations and, in some cases, have zero current earnings to value. Margin debt has also risen to a record level of $722 billion in November. While not a record as a percentage of overall market capitalization, the trend continues to move higher.

Other issues to reflect upon include the surge in activity by novice retail investors using platforms such as Robinhood. Jason Zweig, a seasoned professional who writes a column entitled *The Intelligent Investor* for the *Wall Street Journal* had this to say when his editor asked him to use the system and become part of the momentum-investing crowd:

> *"With a few moments of exposure, the ever-changing numbers and colors put me into a kind of trance. Robinhood showed me a list of top movers. They were bright lime green. They were beautiful and I had no idea what most of them were. My plan flew out the window and I bought a fistful of top movers."*

The SEC has since fined Robinhood $65 million for alleging commission free trading for investors when in fact failing to disclose that it was being paid for order flow. A class action suit by investors is pending.

Challenges posed by ever present geo-political issues and cyberattacks such as the recent breach of the SolarWinds platform into numerous government agencies and private enterprises also warrant attention.

Investment Conclusion

While there are good reasons for investors to approach 2021 with caution, there will also be opportunities for new investment and success. Central to the latter is this firm's view that the distinction between investment and speculation should be kept firmly in mind. Webster defines the former as being an asset or other item acquired with the goal of generating income or appreciation in the future. Speculation on the other hand is a financial transaction that has the risk of losing substantial value but carries the expectation of a significant gain.

The digital era has arrived and there remain opportunities in medium sized software companies benefitting from this global transformation. In addition, as the economy returns to a more normal footing and notwithstanding the changes inherent in a more virtual world, cyclical sectors which have suffered during the recession will recover and enjoy leveraged profit growth due to cost reductions made during the recession period. Finally, the falling dollar will give a substantial boost to firms with significant international operations and companies with exposure to this trend should have an important place in client portfolios.

Bond investments are only advised for use to enhance cash equivalent earnings when the bonds in question are of solid investment quality and short maturity. A return to a more normal yield curve and higher interest rates would make longer term bond holdings of interest once again but such a backdrop could be several years into the future.

January 4, 2021

The firm is pleased to announce that Tom Terracinno has been promoted to Director of Equity Strategy and will work closely with the portfolio managers and research team to identify emerging companies across the broad investment landscape. Tom, a graduate of Carnegie Mellon, is in his 13th year with the firm and has historically specialized in the technology sector.