INVESTMENT OUTLOOK

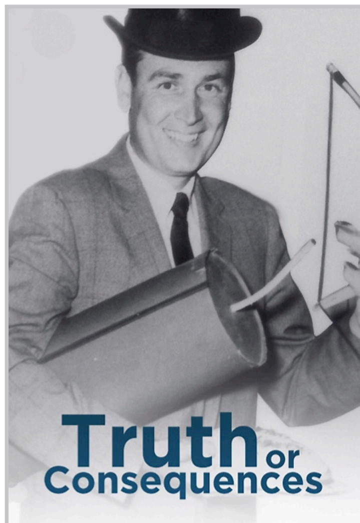
A PEAPACK PRIVATE WEALTH MANAGEMENT PUBLICATION

FOURTH QUARTER 2020: TRUTH OR CONSEQUENCES

The truth does not change according to our ability to stomach it.
–Flannery O'Connor

The first game show to air on broadcast television was a program called *Truth or Consequences*. Originally a radio show, it combined a traditional quiz show format with wacky stunts.

The trivia questions were intentionally obscure, designed for contestants—given a mere two seconds to respond—to give the wrong answer. Failing to complete this "truth" portion meant that the contestant had to face "consequences," typically by performing a zany and embarrassing stunt devised by the show's staff.



The show was intended as light-hearted entertainment. But there was a serious underlying premise: there are consequences to getting it wrong—not being 'truthful.' And it is, at best, awkward and uncomfortable to be in such a situation.

Investors face a number of uncomfortable truths as that most anomalous year 2020 has come to an end and the Year of the Ox begins. For financial markets, these include: interest rates are at multi-generational lows and likely to remain depressed; equities are dear by historical standards, trading at 2 standard deviations above their average multiple for the past 20 years; future investment returns may well be lower in the decade ahead. For the economy, these include: The COVID-19 epidemic is raging even as the first vaccines have been rolled out, and could lead to economic retrenchment in the near term; the US government deficit in 2020 was $3.4 trillion—14.9% of GDP and an astonishing 48% of total government expenditures; robust economic data points mask wide financial health discrepancies among households and businesses; millions of Americans are in need of and receiving unemployment benefits; food insecurity is estimated to affect more than 50 million Americans; according to the Census Bureau, 27 million Americans can't pay their mortgage or rent.

These and other concerns have led to some investment pundits to declare the death of the 60/40 portfolio (60% equities/40% fixed income), and to reject other long-held principles of portfolio management.

As uncomfortable as these truths may be, failing to address them and devise appropriate solutions is unacceptable. There are consequences for not facing the truth, and for accepting as true opinions, and even data, that are false. (Nowhere is this more apparent than in US politics, where *The Washington Post's* tally of over 29,000 false or misleading claims just might have some connection to the outcome of the 2020 election.) Across all facets of life, the promise of the Information Age—a post-industrial economy driven by information technology—has given way to a new disinformation age. Enabled by social media and the discrediting of expertise, we are living in a period of fake news, 'alternative facts,' conspiracy theories, half-truths and outright lies that go viral in the blink of an eye.

In our realm of portfolio management, we are committed to delivering the unvarnished truth as we know it. To identifying what is fact and what is opinion. And to acknowledging and pointing out the many times and places where there may be a wide range of potential outcomes or a high degree of uncertainty. Only by doing so can we provide thoughtful and credible financial advice.

BELIEVE IT OR NOT: THE LAND OF DOUBLE-DIGIT RETURNS

Yet why not say what happened?
Pray for the grace of accuracy
Vermeer gave to the sun's illumination
stealing like the tide across a map
to his girl solid with yearning
–Robert Lowell

2020 was a remarkable year in so many ways. We discovered that the universe is expanding, at a faster pace than we knew. We discovered that Mt. Everest is rising, even as Venice is sinking. And we discovered that the Americas were colonized at least 15,000 years earlier than previously believed.

We also discovered—or re-discovered—the resiliency of financial markets. Markets plummeted in the first quarter, in response to the pandemic-driven lockdowns of economies around the globe. Central banks and sovereign governments swooped in with truly unprecedented—in both speed and magnitude—monetary and fiscal stimulus. Markets responded to massive injections of liquidity and advances in COVID-19 therapeutics and vaccines by rallying to record highs.

Asset Class	Index	4th Quarter Results	Full Year Results
US Large Cap Stocks	S&P 500 Total Return	12.2%	18.4%
US Small Cap Stocks	Russell 2000	31.4%	20.0%
International Developed Markets Stocks	MSCI EAFE	16.1%	7.8%
Emerging Markets Stocks	MSCI EM	19.7%	18.3%
Real Estate Securities	MSCI US Real Estate	11.5%	-7.6%
Commodities	Bloomberg Commodities Futures	10.2%	-3.5%
Bonds	Bloomberg Barclays US Aggregate	0.7%	7.5%
Cash	FTSE 3-month UST Bill	0.2%	0.6%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

Across all risk assets, returns in the fourth quarter soared. After years of dominance by US large cap stocks, smaller stocks and international markets were the star performers. They were driven higher by signs of progress in the fight against the coronavirus, and the conclusion of a fractious US presidential election.

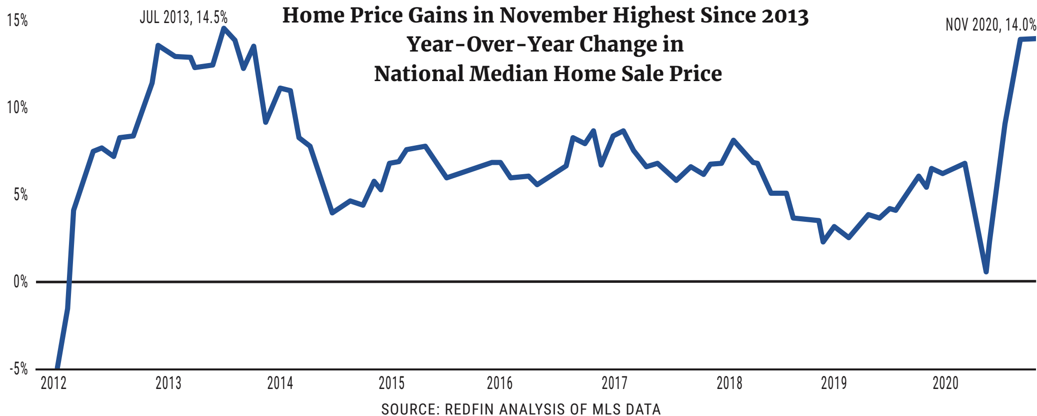
For the year as a whole, returns were robust for most asset classes, with many markets ending the year at all-time highs. Stocks rallied strongly on excellent clinical trial results from vaccine developers, offering the promise that global economies can re-open earlier than anticipated this year, accelerating economic growth. Real estate securities posted negative returns, as concerns about the decline of brick-and-mortar retail sales and the uncertainty over future office space needs dragged down stocks in the sector. Commodities also posted modestly negative returns, driven by excess supply and tepid demand growth. Bonds generated solid returns, as prices rose after the Fed cut rates in response to the recession. Cash? A mere place-holder.

A TALE OF TWO ECONOMIES

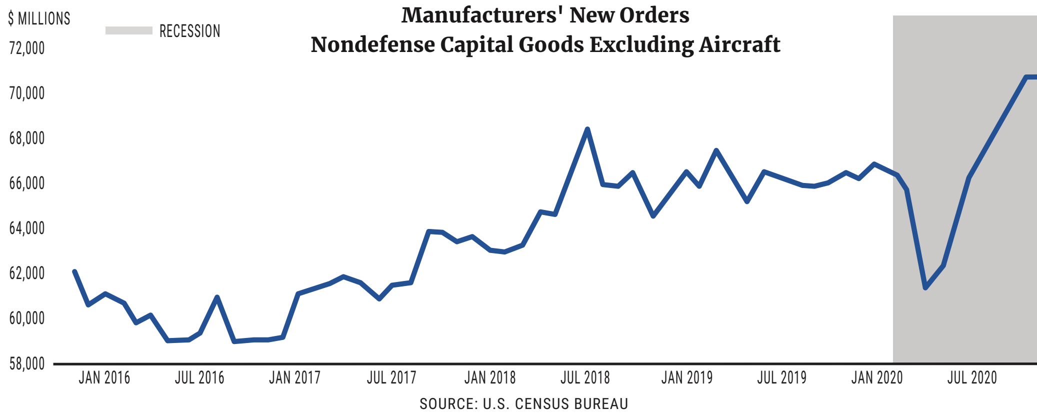
You're entitled to your own opinions, but not your own facts.
–Daniel Patrick Moynihan

Following the recession in late winter, the economy, broadly measured, has exhibited remarkable resilience. The Bureau of Economic Analysis reports that the US economy grew at an astonishing annual rate of 33.4% (granted, following the second quarter's 31.4% drop). Many areas of the economy have more than recovered from the recession.

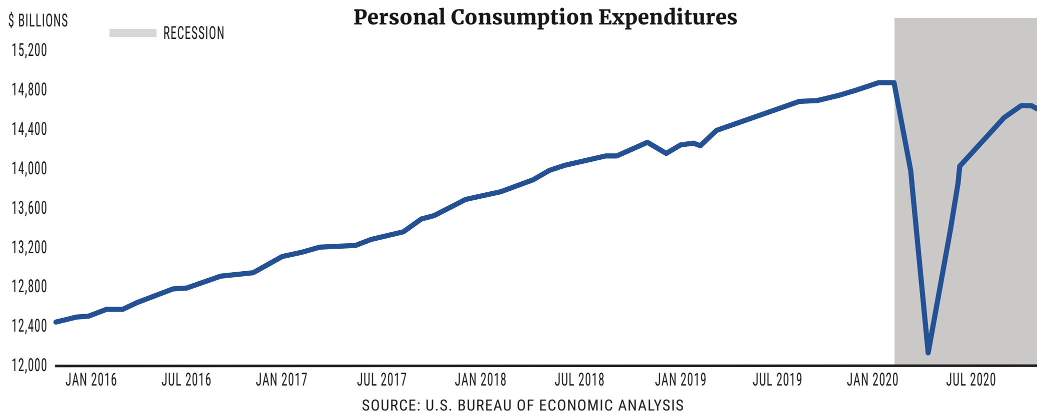
Among them, the residential real estate market has been on fire. Home prices have risen 14% in the past year, driven by record-low mortgage rates and families seeking more space as they work/school from home.



The goods economy reflects muscular strength—manufacturers' new orders are significantly higher than pre-pandemic levels.

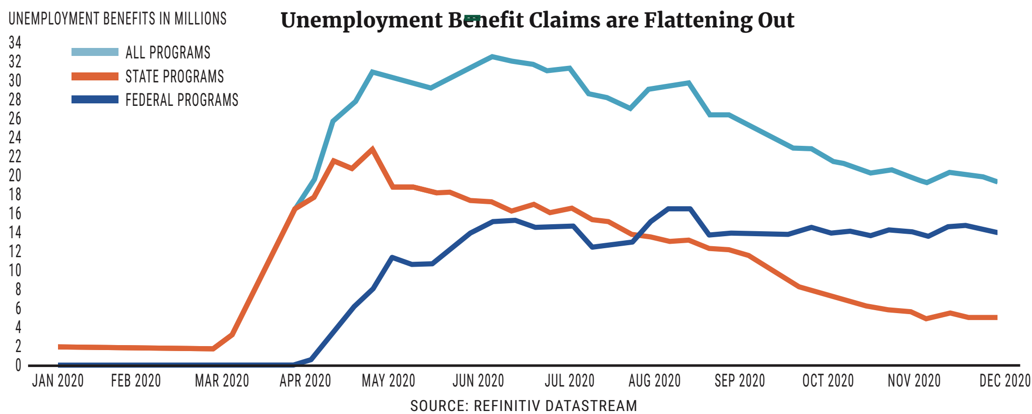


Consumer spending, also, has recovered substantially, although not to prior levels:



These data points suggest a successful 're-opening' of the economy. The Atlanta Fed's GDPNow estimate of fourth quarter growth is an astonishing (and, truth be told, not very credible) 10.4%. The New York Fed's Nowcast model estimates that the US economy grew by 2.1% in the fourth quarter. Wherever the growth rate finally lands, it represents good economic progress.

That said, data points around the labor economy indicate considerable economic pain. The hard truth is that in this "K"-shaped recovery, white collar knowledge workers with a fast broadband connection are generally doing well, while lower-paid workers in industries such as hospitality, travel, restaurants, and the arts are severely impacted. 20 million Americans lost their jobs in the pandemic-induced lockdowns, and only half of them are back at work. New weekly unemployment claims average more than 800,000 and continuing unemployment claims clock in at 5.4 million people. If we include people receiving pandemic unemployment assistance and pandemic emergency unemployment compensation, the total number of claims for some form of relief has fallen from a peak of 33.6 million to 19.6 million. A big decline, but still a huge number, and further improvements in the labor market appear to have stalled.

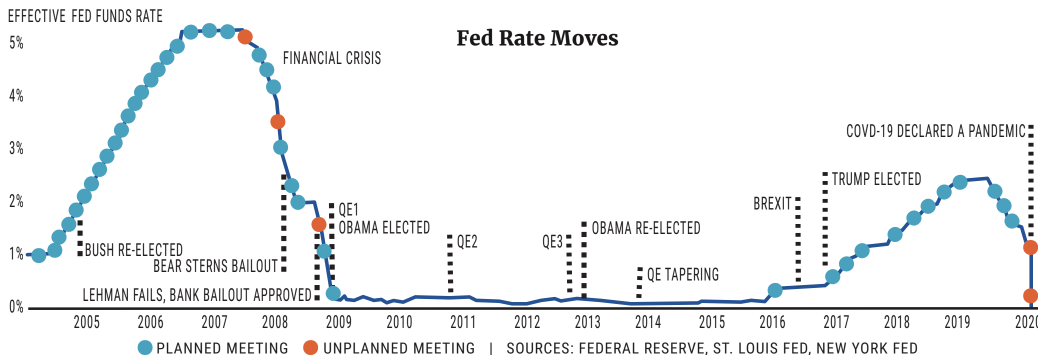


It's a valid point, from a macroeconomic perspective, that employment is a lagging indicator. But that's scant comfort to millions of Americans who are experiencing food insecurity, eviction or foreclosure, and other severe economic hardships.

FIXED INCOME: WHERE'S THE INCOME?

Truth is like the sun. You can shut it out for a time, but it ain't goin' away.
–Elvis Presley

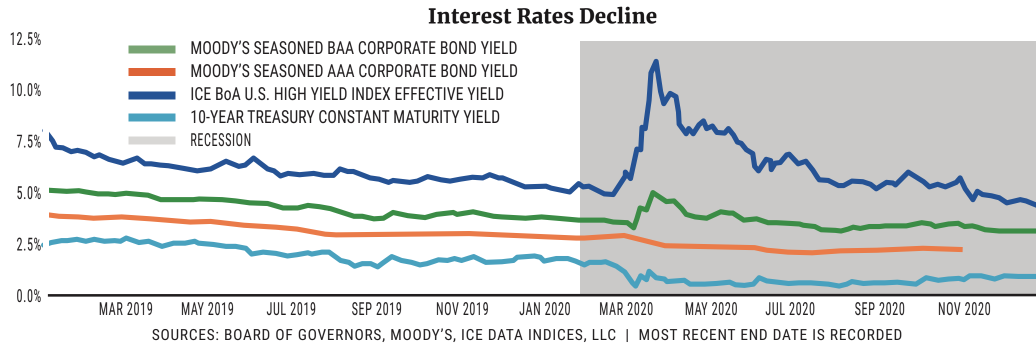
The Federal Open Market Committee (FOMC) responded with alacrity to the recession this winter, dropping the Fed funds target to 0.00% - 0.25% and revving up quantitative easing (the purchase of bonds to drive down interest rates). In doing so, the FOMC lowered the cost of borrowing and maintained market liquidity. Further, the Fed has pledged to sustain these low rates for at least the next two years.



The FOMC's action was extremely favorable to borrowers, who could more easily meet their debt obligations, given lower interest expense. But it's worth remembering Newton's third law of physics (you recall it…for every action, there is an equal and opposite reaction).

So, a reprieve for borrowers is also a punishment for savers. For bond investors, this is the worst of times: the 10-year US Treasury bond yields a mere 0.92%. The highest savings rates for online accounts, according to Bankrate, are 0.50%. The highest 5-year CD rates are 1.00%-1.05%. These extraordinarily low interest rates, below the rate of inflation, are a form of financial repression. And this is hardly a US concern only; worldwide, over $18 trillion of government debt bears *negative* interest rates!

Interest Rates Decline



SOURCES: BOARD OF GOVERNORS, MOODY'S, ICE DATA INDICES, LLC | MOST RECENT END DATE IS RECORDED

There are several critical consequences to this policy. Some economists believe that financial repression inhibits growth and leads to inefficient allocation of capital. Perhaps more importantly, in the near term, is the loss of interest income to savers and bond investors. The need for more income forces fixed income investors to take higher incremental risks. As yields drop, investors shift from safe sovereign debt and high quality corporate and municipal bonds to junk bonds, emerging market debt, preferred stock, and dividend paying stocks, among other alternatives. They also purchase longer-dated instruments.

This is a point worth pausing over. Sure, fixed income investors purchase bonds for income. But they also purchase bonds for their downside volatility-reducing role in portfolio construction—in short, for their relative safety. After all, bond interest payments are contractually obligated, as dividends are not. Strong debtors are likely to be able to meet their obligations. But in an economic downturn, weaker debtors may not be in a position to do so, and the value of their bonds will fall. And holders of dividend paying stocks will find that the high yielders will exhibit volatility in line with equities, not with high quality fixed income. That is to say, they'll lose value in a stock market decline.

In short, fixed income investors chasing yield by moving further out on the risk spectrum had best determine whether their risk tolerance truly supports such a shift to higher risk instruments. And that assessment is best made ahead of the next downturn.

EQUITIES: TREES GROW TO THE SKIES...OR DO THEY?

Truth isn't truth.
–Rudy Giuliani

The truth is still the truth even if no one believes it.
A lie is still a lie, even if everyone believes it.
–David Stevens

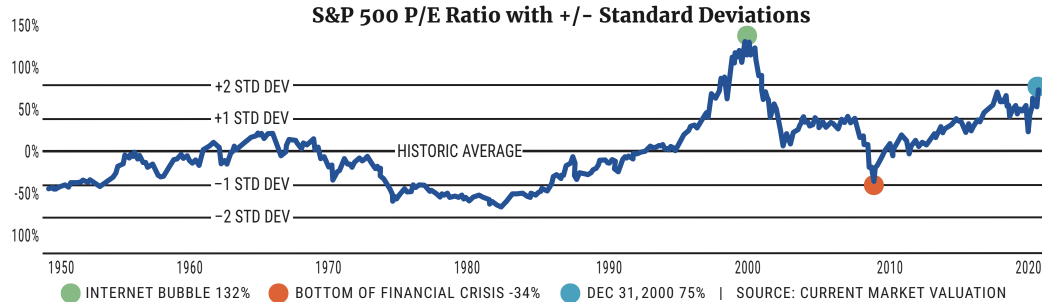
Both professionals and casual observers of markets have been surprised by the resilience exhibited by equity markets. This is particularly true in light of an economy still bearing considerable scars from the recession. There are several credible narratives to explain lofty stock prices.

As noted above, low interest rates have consequences, including unintended consequences. Lower interest rates increase the value of stocks, other things being equal. It's a simple corporate finance exercise—lower discount rates equal higher valuations. Of course, there's the simpler-still explanation that in a very low interest rate environment There Is No Alternative (TINA) to stocks. TINA has been our near-constant companion ever since the Fed cut rates in 2008 in response to the global financial crisis.

But the macro picture, too, provides a viable story line to justify higher stock prices. Two major overhangs on equity markets in 2020 were the presidential election and the course of the pandemic. In the fourth quarter, these uncertainties were eliminated or significantly reduced. The election outcome has been determined, notwithstanding the reluctance of some to accept that outcome. And the Emergency Use Authorization of two vaccines has provided optimism that widespread immunity may be feasible in the spring or summer of 2021. With that, consumers are likely to respond with pent-up demand for travel and other pandemic-constrained activities, and businesses are like to respond with increased hiring and capital investment.

Insofar as markets are forward looking, this prospective good news propelled equity markets to all-time highs.

As a result of the market's rise, valuations have become stretched. Investor behavior is frothy. We can see that in the record number of initial public offerings. In the unprecedented fund-raising in SPACs (Special Purpose Acquisition Companies), known colloquially as blank check companies because they have no pre-existing business operations, and investors don't know what target firm the SPAC will be acquiring. In the fast-finger trading done by novice investors on the Robinhood app. And in the astronomical rise of speculative vehicles like cryptocurrency Bitcoin, up 419% last year, and Tesla stock, up 720%.



And we see it in the S&P 500, which trades today at 22 times next year's estimated earnings. That is 2 standard deviations above its average valuation over the past 70 years. For those of you who blotted out your statistics class, that means that stocks have been this expensive only 2.5% of the time. The only other time stocks bore such rich valuations was in the dot com bubble of the late 1990s. And we know how that story ended.

We also know that market valuations are a good predictor of future returns. A beginning point of high valuations suggests lower future returns. A record worth remembering as pundits roll out ever loftier market forecasts.

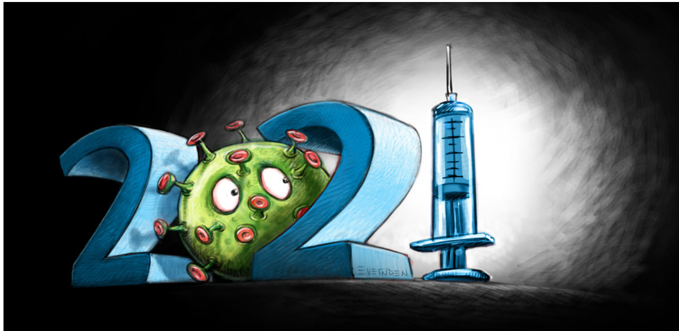
INVESTMENT TRUTHS REVISITED

In the long run, the most unpleasant truth is a safer companion than a pleasant falsehood.
—Theodore Roosevelt

The show *Truth or Consequences* had a long run. No show runs forever, of course. But the message of this one lives on. It lives on, in part, because the town of Hot Springs, New Mexico agreed in 1949 to change its name to Truth or Consequences in exchange for hosting an episode. But it also lives on because it captures, succinctly, the need to get it right, knowing there's a price to be paid for being wrong.

The tag line at the end of each episode of *Truth or Consequences* was, "Hoping all your consequences are happy ones." But for investors, that's just not good enough. If we are successful truth seekers, we can anticipate, rather than merely hope for, 'favorable consequences.'

As we gaze into the new year—the Year of the Ox, according to the Chinese zodiac—it's all about COVID-19. In the short term, the outlook is worrisome. We are seeing record cases and hospitalizations, as the predicted second wave plays out. The numbers are grim, and they're not just numbers—they're people. As of this writing, the US has recorded more than 20 million cases and 350,000 deaths. 125,000 people are in the hospital with COVID.

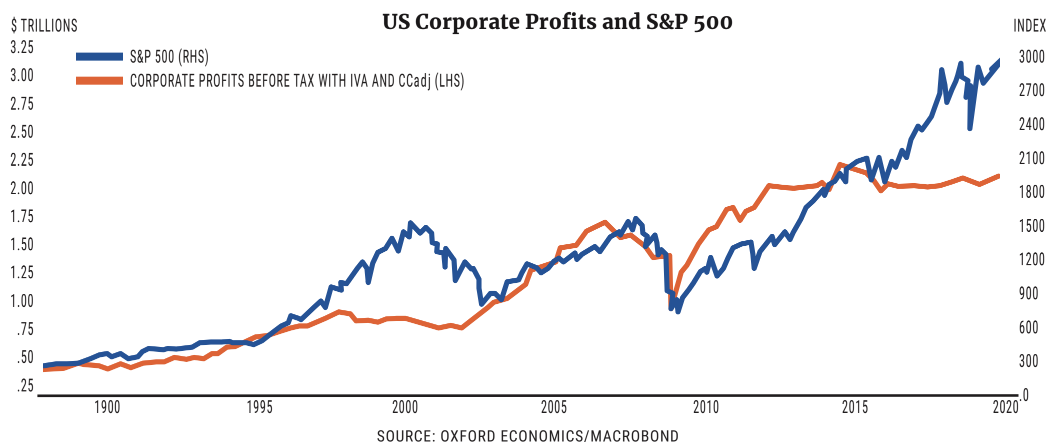


As bad as these numbers are, Dr. Fauci makes a credible argument to expect the health care crisis to deepen in the next two months. Cases will rise following Christmas and New Year's Eve celebrations. While therapeutics have improved, hospitalizations and deaths are virtually sure to rise. The news flow, and cautious consumer behavior in response to higher case counts, could well cause first quarter GDP to come in softer than expected.

But looking further out over the course of 2021, it seems reasonable to posit that vaccinations will be fairly widely available by next summer, bringing us closer to herd immunity. And if that is the case, an economic rebound of considerable magnitude appears to be credible. Further, this is likely to play out around the world, in a synchronized global economic expansion.

As the pandemic becomes less of a health concern and, therefore, less of an economic concern, investors will refocus on fundamentals. To wit, corporate earnings. At this time, S&P 500 revenues are estimated to rise 7.9% and profits are estimated to rise 22% in 2021, according to FactSet. The stock market at current levels reflects that upside expectation—as previously noted, stock valuations are at historically elevated levels. That said, the monetary and fiscal policy backdrop is constructive. The Fed is likely to remain highly accommodative, and Congress has just, finally, passed a new stimulus act.

Perhaps most importantly, corporate profits may well rise more than analysts currently anticipate. As the chart below illustrates, the stock market direction is usually highly correlated with corporate profits. (Put another way, the most solid basis for higher stock prices is higher corporate profits.) Note that stock prices look to have gotten ahead of earnings, as they did in the late 1990s. Investors appear to anticipate that actual future earnings will exceed expectations.



Should this favorable backdrop play out as anticipated, international markets—especially emerging markets—may well have the greatest upside potential. Domestically, this scenario may be particularly favorable to smaller companies and to more cyclical value stocks.

The outlook for bonds is less upbeat. Absolute low rates may limit interest income, even if the Fed protects bond investors with its commitment to maintaining rock bottom rates and buying $120 billion of bonds monthly. The potential for inflation to tick up this year, as the economy reaccelerates, creates some downside risk for bond investors.

What should investors do, in such an environment? We hold these investment truths to be, if not self-evident, time-tested and still valid:

- Sound portfolio construction consists of combining asset classes with varying correlations, volatility, and expected returns. The ground-breaking work of Harry Markowitz and those who came after him remains a solid foundation for building robust portfolios.
- Investors vary in their utility curves for returns and risk. This is economist-speak for saying that risk tolerance is a highly personal matter, and asset allocation should be customized for each individual's preferences—and their time horizons.
- Investors should temper their stock market expectations for returns in the future. US large cap stocks returned 55.9% and international stocks returned 34.5% over the past two years. Such appreciation is unlikely to be repeated.
- Investors should also temper their bond market expectations for returns in the future. Record low interest rates may be sustained for several years.
- Retirement plans may need to be modified to reflect reduced return expectations. Some investors may need to consider deferring retirement or reducing living expenses to compensate.

As noted, 2021 is the year of the Ox. In the Chinese zodiac, the Ox is a symbol of diligence, persistence, and honesty—hardworking and methodical. Our horoscope says we will fully feel the weight of our responsibilities, that it will be a year when it is necessary to double our efforts to accomplish anything at all. We are up for the challenge, buoyed by a willingness to face tough investment truths and to acknowledge changed expectations.

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