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The 3 R's – Reflation, Recovery and Rotation

Todd Asset Management Q4 2020 US Market Commentary

	4Q 2020	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
S&P 500	12.2%	18.4%	14.2%	15.2%	12.9%	13.9%
Russell 1000 Value	16.3%	2.8%	6.1%	9.7%	8.2%	10.5%

* *Annualized Total Returns.*

The concerns we noted in our last quarterly letter seem to have evaporated (like we thought they would) to give way to an optimism for reflation, economic recovery and allow for a rotation into new leadership for the market. Worries about elections, stimulus, pandemics and Brexit were on the top of investors' minds, despite a robust rally in stocks and recovery in the economy. We wrapped up the election, a stimulus bill got passed, vaccines were developed and a trade agreement for post Brexit Europe was agreed to, alleviating those concerns. The relief rally showed up in a hurry, and the market advanced nearly 15% during the last two months of the year. Value stocks and small caps (the prior laggards) were the securities that rallied the most as investors started believing the reflation/recovery/rotation thesis.

Following a fierce pandemic recession the combination of government spending, extraordinarily low interest rates and pent up demand should lead to a reflation and recovery of the economy to start a new economic cycle. All of these elements are in place now and investors are waking up to the fact that economic cycles usually last years. What should investors look for in the current environment?

- The forces driving the recovery and market rally remain in place. Stimulus is increasing, earnings are recovering and vaccine optimism is growing. These should combine for an economic reopening later this year that exceeds most estimates.
- The new economic cycle has led to new market leadership as investors' confidence of accelerating growth improved. During the fourth quarter of 2020 the Energy, Financials, Industrials and Materials sectors rotated to become the leaders, a significant change from earlier in the year. Since their blow-off in August, the "sure fire" FANGMA stocks have been lagging the market.
- The Democratic Sweep resulting from the January Senate runoff ensures that the government is going to pursue more fiscal spending programs. This should provide long lasting support to the economy and amplify the economic recovery that is already expected.
- Long term rates should rise (not to troublesome levels), though short term rates are likely to remain pegged at zero while the Fed tries to promote positive economic surprises.
- Many pandemic impacted businesses should see a surge in profitability as productivity enhancements drive margin improvements and pent up demand drives sales. This pandemic

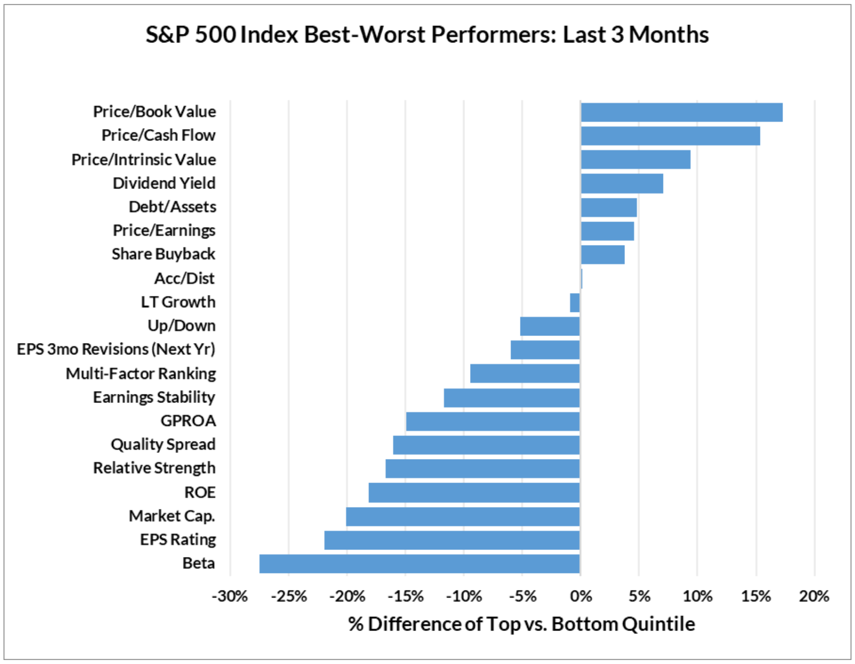
did not feature a financial crisis, so consumers and businesses are not overextended and have the ability to spend.

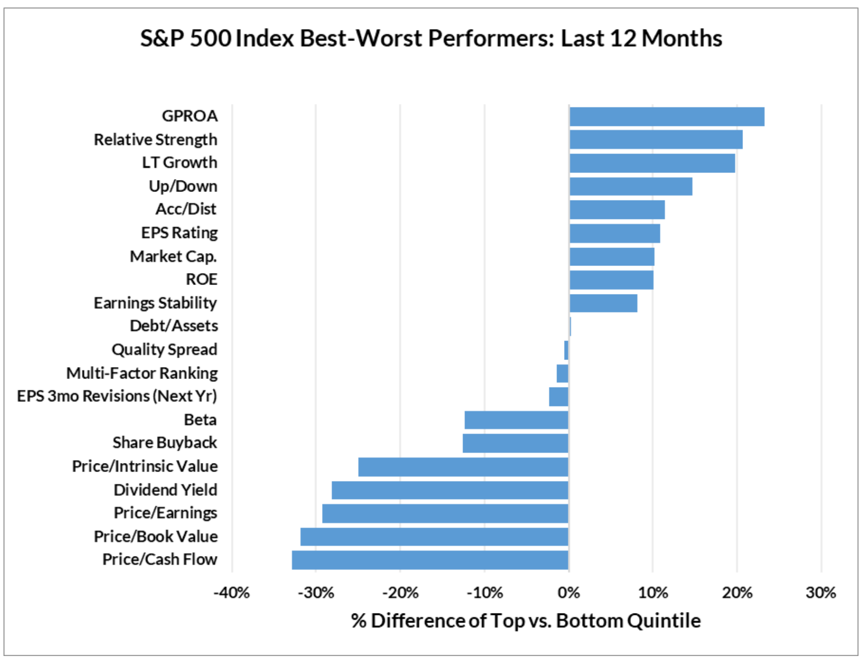
Not everything will go according to plan. Some concerns that are notable include:

- Taxes are likely to rise with the new administration.
- Stock markets have rallied dramatically and may see consolidation after a strong run.
- The pandemic continues to rage on. Vaccine distribution seems slow. Europe may see a double dip on shutdowns.
- Worldwide stimulus programs are likely to taper somewhat next year. A "taper tantrum" is likely later on this year.
- Longer interest rates are rising (a headwind to activity), though they still are very negative on real inflation adjusted basis. This occurred despite the Fed pegging short rates near zero.
- Inflation expectations are rising. Current market expectations just crossed above 2% and seem to be heading higher. The Fed has indicated they expect an overshoot of inflation above their 2% longer term target.

We continue to believe stocks are in a secular bull market. Historically, secular bull markets mark the midpoint with a dramatic market selloff followed by a recovery to new highs. Covid 19 has provided the midpoint cyclical bear market this time, much like 1987's Black Monday and the 1957 Recession did for prior secular bull markets. If you couple this thought with our prior point that economic expansions last for years, we believe the second half of this bull probably has years to run.

Factor Analysis



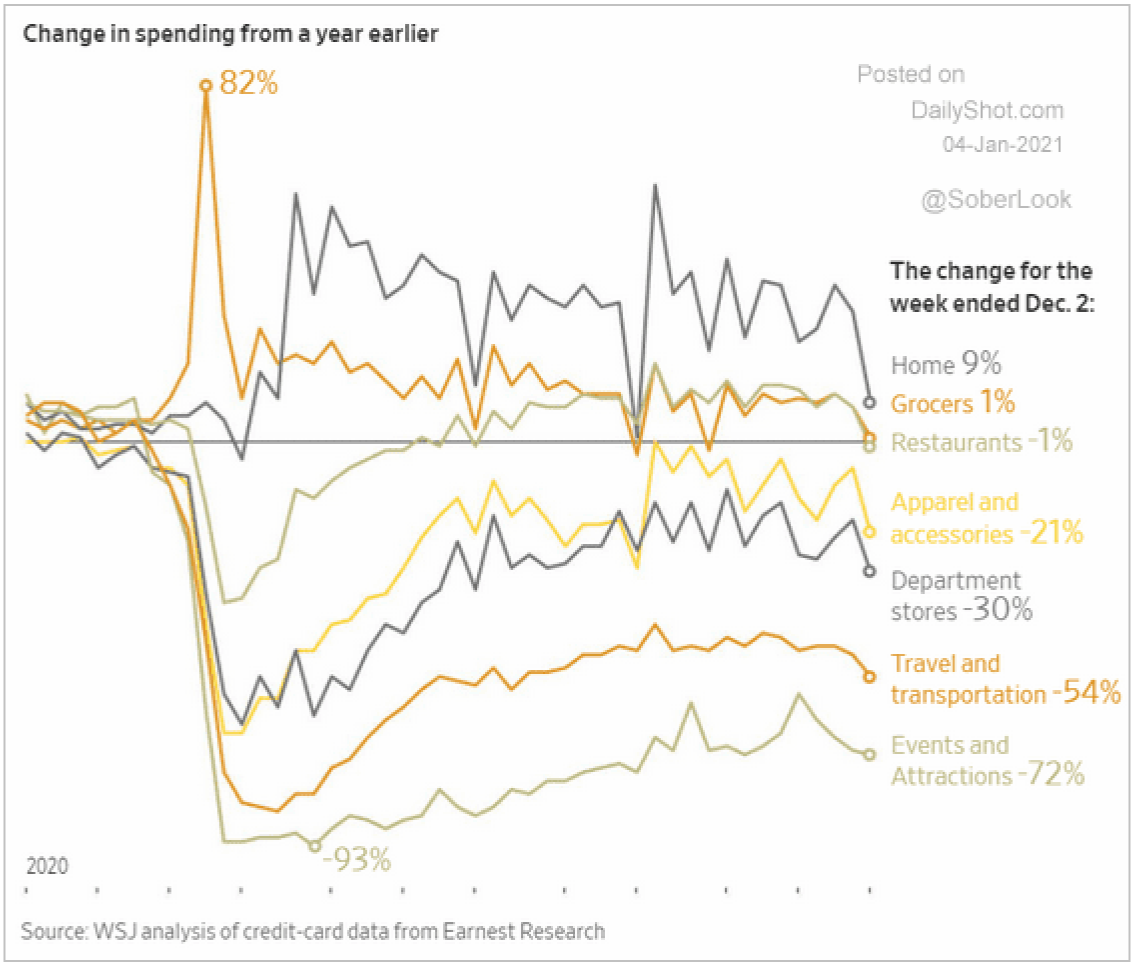


Source: Bloomberg, William O'Neill + Co. and Todd Asset Management

The rotation we highlighted above was most evident in the factors leading during the fourth quarter (chart left, top). All valuation metrics were rewarded during Q4, while growth and momentum measures were not. Comparing that with the year to date period (chart left, bottom) you can see that this was a dramatic shift. With the improved visibility surrounding economic growth, we believe this shift is going to have some legs to it and should last some time.

Interesting Charts we saw this quarter.

This Is What Pent-Up Demand Looks Like

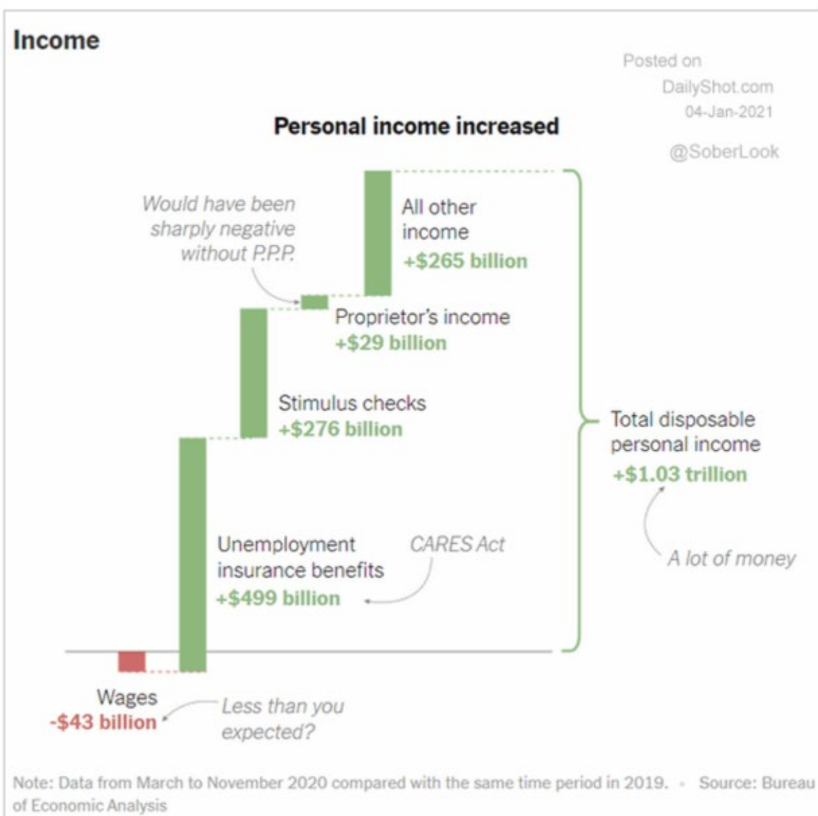


Is anyone else tired of sitting at home, or is it just us? The pandemic upended spending patterns as can be seen in the chart above. While some areas saw increased spending, like home upgrades and grocery stores, most leisure and apparel categories got killed.

Consumers are probably tired of staying home and painting the spare bedroom for their zoom calls. We expect a sharp recovery during the second half of this year as consumer spending plays some catch up in the laggard categories.

This Is What "Dry Powder" Looks Like

"Dry Powder" Seen Differently

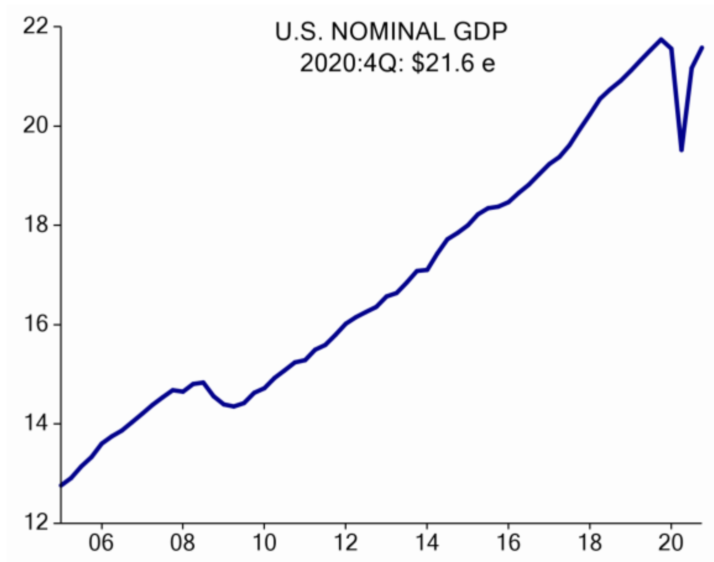


"Dry powder" is a phrase investment people use to describe buying power. The consumer has lots of buying power. Government income substitution has driven saving rates up to 14%, from about 7% prior to the pandemic (chart left, top, from Evercore ISI). Money market funds hold over $4.3 trillion dollars, up substantially from pre-pandemic levels. Disposable personal income ***ROSE*** $1.03 Trillion between March and November (chart left, bottom) despite the pandemic recession.

Our point is that consumers are in better shape than some headlines would have you think. Some consumers in service industries are suffering terribly, but most are OK. If the savings rate declines from 14% to 8% next year, consumer spending would increase 4% more than income growth. This should provide a tailwind to US growth next year as consumers fuel a post pandemic boom.

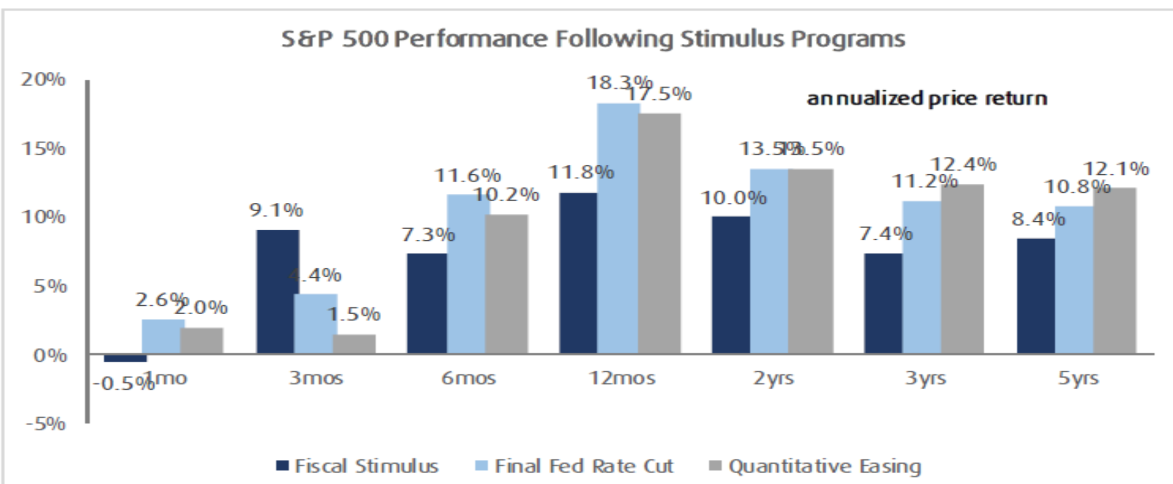
Some Analysts Expect a Full GDP Recovery by H2 2021

The GDP decline during the pandemic was dramatic and record breaking. The recovery has been as well, and economists' growth estimates have generally been rising. If economists are correct, GDP should reach pre-pandemic levels sometime over the next few quarters.



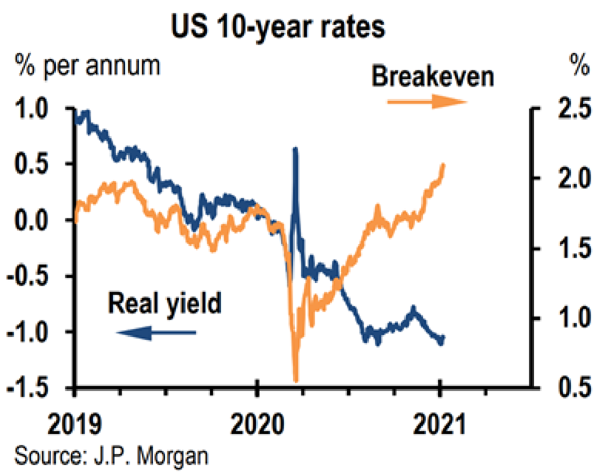
Source: Evercore ISI

Central Bank Actions and Fiscal Stimulus Should Have Lasting Impacts



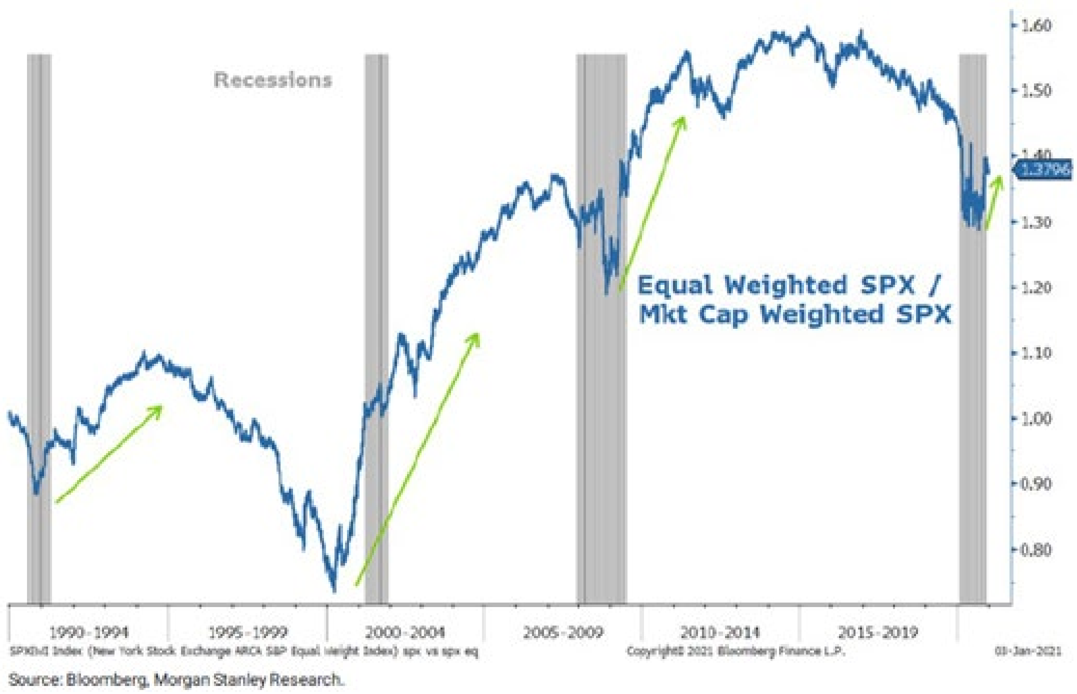
The chart above, from BMO, illustrates the lasting impact that Fiscal Stimulus, Fed Rate Cuts and Quantitative Easing have on markets. History suggests that these actions should lead to long lasting positive impacts on markets. Since the last Fed Rate cut was in March, and the final fiscal stimulus and QE actions are probably still ahead of us, this would suggest better than average price returns for the next 5 years. For purposes of comparison, the average annual price return for the S&P since 2000 is 5.4%.

Investors Anticipate an Inflation Pick Up



This chart compares real (inflation adjusted) 10 year interest rates, with the market implied inflation rate (breakeven). Real rates are very negative, which should prompt business and consumers to borrow. Breakeven rates have risen, implying investors are gaining confidence that the economy should improve and drive inflation higher.

New Leadership is Likely to Emerge



The S&P Equal Weighted index (broader exposure) appears to be recovering compared to the Market Cap weighted version (currently FANGMA dominated). Economic confidence allows investors to seek more diversified companies, implying a broader market advance is likely. History suggests that should last five to seven years.

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Russell 1000 Growth vs. Russell 1000 Value Relative Performance

Comparison: 1998-2001 vs. 2019-2021

While history does not repeat itself, it usually rhymes. Our current environment is reminiscent of the growth cycle of 1998 to 2001. After a surge between 1998 and early 2000, the Russell 1000 Growth Index rolled over compared to the Russell 1000 Value. The current episode appears to be tracking that one very closely. We would expect as earnings growth gains visibility and confidence in the economy returns, this relationship should turn to favor the value sector and growth could underperform like it did from 2000 to 2001.

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Summary

Over the short term, there are some worrisome signs of frothy sentiment within the market. We've all seen bitcoin spike, new IPOs surge, and the recent memory of the FANG stocks is fresh in most investors' minds. We would not be surprised if the market pulled back or simply tracked sideways at some point early-mid 2021 as investors begin to wrestle with the implications of a new administration in DC. As we look forward over the coming quarters and years, we are encouraged. The secular bull market remains intact, the mid-point recession and bear market is finished, and a durable economic expansion appears to be starting. We believe the start of this cycle should feature a rotation to favor sectors that have lagged during the first half of the bull, namely international, value oriented and smaller names.

As always, if you need any additional information, please feel free to contact any of us.

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1/15/21
S&P 500 – 3,768
Russell 1000 Value – 1,386

Refer to the following page for more information on the commentary presented. This is pertinent to this letter and should not be reproduced or duplicated without this disclosure.

Disclosure

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S&P 500 Index is a widely recognized index of market activity based on the aggregate performance of a selected portfolio of publicly traded common stocks. The performance data was supplied by Standard & Poor's. It is included to indicate the effect of general market conditions.

Russell 1000 Value Index is a widely recognized index of market activity based on the aggregate performance of common stocks from the Russell 1000 Index, with lower price-to-book ratios and lower forecasted growth values. The performance data was supplied by Frank Russell Trust Company.