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MARKET COMMENTARY

December 31st, 2020

> *"Trying to determine what is going on in the world by reading newspapers is like trying to tell the time by watching the second hand of a clock."*
>
> -Ben Hecht

Most advisors write their commentaries on a quarterly basis (us included). We snap the chalk line at regular intervals to carve time into digestible chunks, then summarize them as if it were a cohesive narrative with a beginning, middle and end. However, reality can be much more nuanced. Just as a headline fails to tell the entire story, the trends that define a quarter neither begin on September 30th nor end on December 31st.

The fourth quarter was another unusual act in the very unusual play that is 2020. We wrote last quarter that "New cases of COVID-19 peaked on July 17th and seem largely in a downward trajectory." As the ink was drying on our commentary, cases began rising almost immediately and reached a new peak by mid-October. Currently, the 7-day average is almost four times our last writing and the death toll has eclipsed 330,000. By now, almost all of us know someone who has been personally impacted, lost a job or a loved one.

Talking about the stock market in such a context seems in very poor taste, and yet that's the assignment. If you told us at the beginning of the quarter that pandemic trends would become materially worse or that the economic reacceleration would slow due to mobility restrictions, we would have hoped for flat at best. Yet the S&P 500 is up 11% for the quarter and nearly 18% for the year. In fact, November was the best November on record, up 11%.

Reconciling a worsening pandemic and the human suffering it entails with a booming stock market takes a little doing. The most influential events in the fourth quarter were a quasi-well-functioning election and the release of clinical trials data for not one but two COVID vaccines. In a year full of uncertainty, it was easy to imagine how a contested election might result in months of angst and judicial wrangling stretching into 2021. In fact, the cost to hedge the S&P 500 suggested market participants were more than a little concerned. Avoiding the direst of outcomes and allowing the market to get back to pricing in the policies of a new administration was enough to move many investors off the sidelines.

On November 9th, the clinical trials data for Pfizer and BioNTech's vaccine were released, showing remarkable efficacy. This was echoed by Moderna and the NIH's vaccine data a week later, which was equally impressive. Developing two vaccines for a completely novel coronavirus in record time is an achievement that warrants recognition and we're grateful for the round-the-clock efforts of the life sciences community. While the discussion now shifts to one of logistics and availability, this is obviously preferable to having no vaccine. There are more questions to be answered before normalcy can return (how long does it provide immunity, can we make and distribute enough doses, will enough of the population get vaccinated, what happens if the virus mutates?) but it's a very tangible cause for hope.

These two events, an election where the worst-case scenario was avoided and science's answer to a devastating pandemic triggered a frenzy we would describe as 'risk-on.' The most economically sensitive companies experienced the strongest stock performance. The Russell 1000 Value index outperformed its Growth counterpart by more than 4% in the fourth quarter. Small caps, as measured by the Russell 2000 index and known for being more economically sensitive, returned almost 32%. Our clients' portfolios, which tend to skew towards large, durable and high-quality franchises couldn't keep up (and yet annual returns are still quite acceptable). While under-performance is never fun, knowing that we're adhering to a process meant to provide resilient returns across a market cycle regardless of the strength of the economy can provide some consolation.

We're all familiar with the adage, 'be fearful when others are greedy and greedy when others are fearful.' An extremely strong stock market combined with the fear triggered by worsening pandemic data suggests that the market may be experiencing both emotions simultaneously. The S&P 500 currently trades at 23 times forward earnings which exceeds both its five and ten-year averages. This, along with a frothy IPO market and the strong performance of securities we would describe generously as 'speculative' makes many fear that a bubble is forming. While we agree that the market is feeling its oats, it's also against a backdrop of negative real interest rates (where inflation exceeds the return on risk-free treasuries) and, in our opinion, an extremely probable earnings recovery in 2021. Knowing the market is not absolutely cheap on an historical basis, but still relatively cheap compared to returns available elsewhere isn't our favorite environment in which to invest. Bargains are scarce and expectations high. But we're hired to navigate all capital markets, not just those we prefer. We would love it if clients only gave us capital at times of maximum pessimism, when fear is highest and money raining from the sky. You can be sure we'll call when that's the case.

Our expectations for 2021 are nuanced to say the least. A quick end to the pandemic has been the wrong guess since hopes of its containment were dashed in late February. We would expect fits and starts in a vaccine roll out, continued disruption to our daily lives and moments of both hope and anguish (obviously we prefer the former, but prospective returns are probably better under the later). We do believe that society is likely to make substantial progress against the pandemic. We would expect above-trend GDP growth in 2021, although not until the second quarter, largely from easy comparisons. We suspect interest rates will continue to rise and to experience at least temporarily elevated inflation as consumers try to spend their way to a sense of normalcy. Pent-up demand for travel, leisure and entertainment are likely headlines to expect next year.

The market will also begin to price-in the new administration's economic priorities. Higher taxes seem likely, hopefully muted by Republican control of the Senate and a fragile recovery. We anticipate a continuance of extremely lax financial conditions as the Fed will be loath to put the punch bowl away too early. Of all the potential outcomes for 2021, we expect ups and downs, but nothing of the magnitude we saw in 2020. It won't feel normal. But it should feel *more* normal.

And in the meantime, we continue to adhere to the process, to identify securities with attractive growth trajectories, high quality franchises that can be bought at as close to reasonable prices as the market will offer. If the last decade has taught us anything, it’s that holding your breath waiting for bargains isn’t a repeatable investment strategy. We hope you and your family are healthy, we thank you for your business and as always, if you have any questions, please don’t hesitate to reach out to your relationship manager.

Bridges Investment Management Investment Committee

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