BALLENTINE PARTNERS

Market Update

2020 Market Review: Investors Position for Post-Pandemic World

BALLENTINE PARTNERS | BRUCE D. SIMON, CFA, CPWA®

As we close out this most unusual and difficult year, investors are confidently looking ahead to a time when life may return to a semblance of normalcy. Despite the severe economic hardship imposed by the COVID-19 pandemic that stunted economic activity and resulted in the deaths of more than 1.8 million people worldwide, equity prices have been rising almost without interruption since late March. This obvious contradiction confuses casual stock market observers and confirms the oft-stated axiom that the stock market is not the economy.

The pandemic has widened the increasing gap between economic winners and losers in the US and elsewhere. The winners are those companies that are best positioned to exploit the technological advances brought about by the online revolution, and those employees who can seamlessly shift from an office setting to a work-from-home setup. The losers are the many industries that rely on personal contact and experience (e.g. entertainment, travel, restaurants, hotels, etc.) and the millions of people that these companies employ. Unfortunately, many of these employees occupy the lowest rungs of socioeconomic status.

For investors, the ability to differentiate between the winners and losers early in the crisis led to some spectacular performance among certain companies and industries, while punishing those on the wrong side of change. Tesla, the world's leading electric car manufacturer, soared 743% in 2020. Technology stocks[1] rose 43.7% and online retail shares[2] (dominated by Amazon) bolted 111%. On the flip side, energy stocks fell 32.6%[3] and real estate investment trusts[4] dropped 4.7% in 2020.

Investors staying the course in broad-based equity funds enjoyed strong returns. The S&P 500 posted a return of 18.4% in 2020, after losing about a third of its value from mid-February to mid-March. Stocks extended their gains in November and December as election uncertainty subsided and better-than-expected news on the COVID-19 vaccine was reported. In the fourth quarter, international equities made up some of the ground they had forfeited to US stocks earlier in the year. The MSCI EAFE Index of developed international stocks rose 16.0% in Q4, bringing its year-to-date gain to 7.8%. Emerging market stocks (MSCI EM), spurred by a resurgent Chinese economy, rose 19.7% in Q4 and 18.3% for the full year.

[1] Technology Select Sector SPDR ETF (XLK)
[2] ProShares Online Retail ETF (ONLN)
[3] Energy Select Sector SPDR ETF (XLE)
[4] Vanguard Real Estate Index ETF (VNQ)

Bond yields remained in a narrow range as the Fed's intervention in the Treasury and mortgage markets served to calm jittery investors concerned about rising rates. Most bonds eked out small returns in Q4, with the biggest gains occurring in the lower-rated sectors of the market. On the year, bond markets posted solid mid-single digit returns, helped by the bellwether 10-year treasury note falling from 1.88% at the start of the year to less than 1% by year's end.

Outlook and Strategy

The relentless rise of stock prices since March is the result of several factors that have combined to create a very positive climate for equities: 1) the low valuation of stocks as the fear of the pandemic was unfolding; 2) the strong governmental response to address a debilitating shutdown of the economy; 3) a faster-than-expected rebound in economic activity during the summer; and 4) more recently, the rollout of two highly effective vaccines that portend the end of the pandemic sometime in 2021.

As usual, there is no shortage of market pundits eager to divine the future path of the stock market in the financial press. The bears argue that stock prices have already discounted the economic rebound expected in 2021 as the world anticipates the end of the pandemic, and elevated valuation levels increase the risk for a nasty selloff. The potential culprits: a surprise win by Democrats in the Georgia senate races leading to a new round of higher taxes and progressive legislation, or a major setback in the control of the pandemic (such as the emergence of a new strain of virus that fails to respond to the current treatments, or an unexpected adverse side effect after the vaccine is administered to a large swath of the population). The threat of higher inflation leading to a sharp backup in interest rates is also cited as a potential threat but one about which we have lesser concerns.

The bulls cite the continuation of fiscal and monetary support to keep the economy afloat until broad-based relief arrives, the low level of interest rates expected to continue for the foreseeable future, and the expected sharp rebound in corporate earnings as the global economy returns to full strength.

Our view is that equities can continue to work their way higher so long as the fundamental underpinnings that brought stocks to this level remain in place. The Fed needs to continue to support credit markets with rock-bottom interest rates. The new Biden administration must be willing to support additional fiscal stimulus (including avoiding any new, significant tax increases) if the economy continues to struggle. And most importantly, the successful rollout of vaccines that effectively eliminate the threat of COVID-19 must continue, at the pace that investors expect.

Markets tend to anticipate the economic environment some six to nine months into the future, rather than focusing on the present. That partially explains why the stock market can rally in the face of severe economic weakness. While we recognize the risk of higher interest rates to stock prices as the economy rebounds, we believe inflation remains only a distant threat. High levels of unemployment are likely to keep wages in check, and the Fed's aggressive monetary policies should result in only a modest rise in interest rates as the economy returns to full strength.

In short, our outlook for 2021 is positive. High valuations may limit the extent of the advance in stock prices this year, but market corrections along the way are likely to be relatively modest so long as we continue on the current path of eradication of COVID-19 by mid-to-late 2021.

We wish all our clients and friends a happier and safe 2021.

About Bruce D. Simon, CFA, CPWA®

Bruce is a Partner and the Director of Research at the firm. In addition to working directly with a number of family clients, Bruce serves on Ballentine's Investment Management Committee, which is responsible for the oversight of all of the investment activities for the firm.

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