JANUARY 2021

Economic & Market Commentary

Prepared by the Private Ocean Investment Committee

Executive Summary

- The COVID-19 Pandemic brought record levels of market volatility and severe selloffs in what is now dubbed the "Corona Crash". COVID-19 related economic shutdowns caused GDP to plummet in the second quarter of the year, which was accompanied by record levels of unemployment.

- Interest rates dropped precipitously as the Federal Reserve stepped into ease liquidity concerns and offer additional avenues to aid in credit markets. Inflation rates also stalled as the demand shock from global economic shutdowns caused earnings and growth in sectors like airlines, energy, hospitality, and travel to come to a halt.

- Despite large selloffs and uncertainty regarding the COVID-19 virus as well as the 2020 United States Presidential Election, equity markets reached all-time highs, aided in part by unprecedented fiscal and monetary stimulus globally. Fixed income markets enjoyed a positive year in the face of stymied inflation, sinking interest rates and the general risk-off attitude of investors. Both domestic and international real estate markets were shaken by the move to widespread remote work as well as harder hit sectors like restaurants, malls, and hotels.

Executive Summary (Cont'd)

- Going forward there are several risks that we continue to monitor including potential policy changes coming out of Congress, additional stimulus, and the continued distribution of the COVID-19 vaccine.

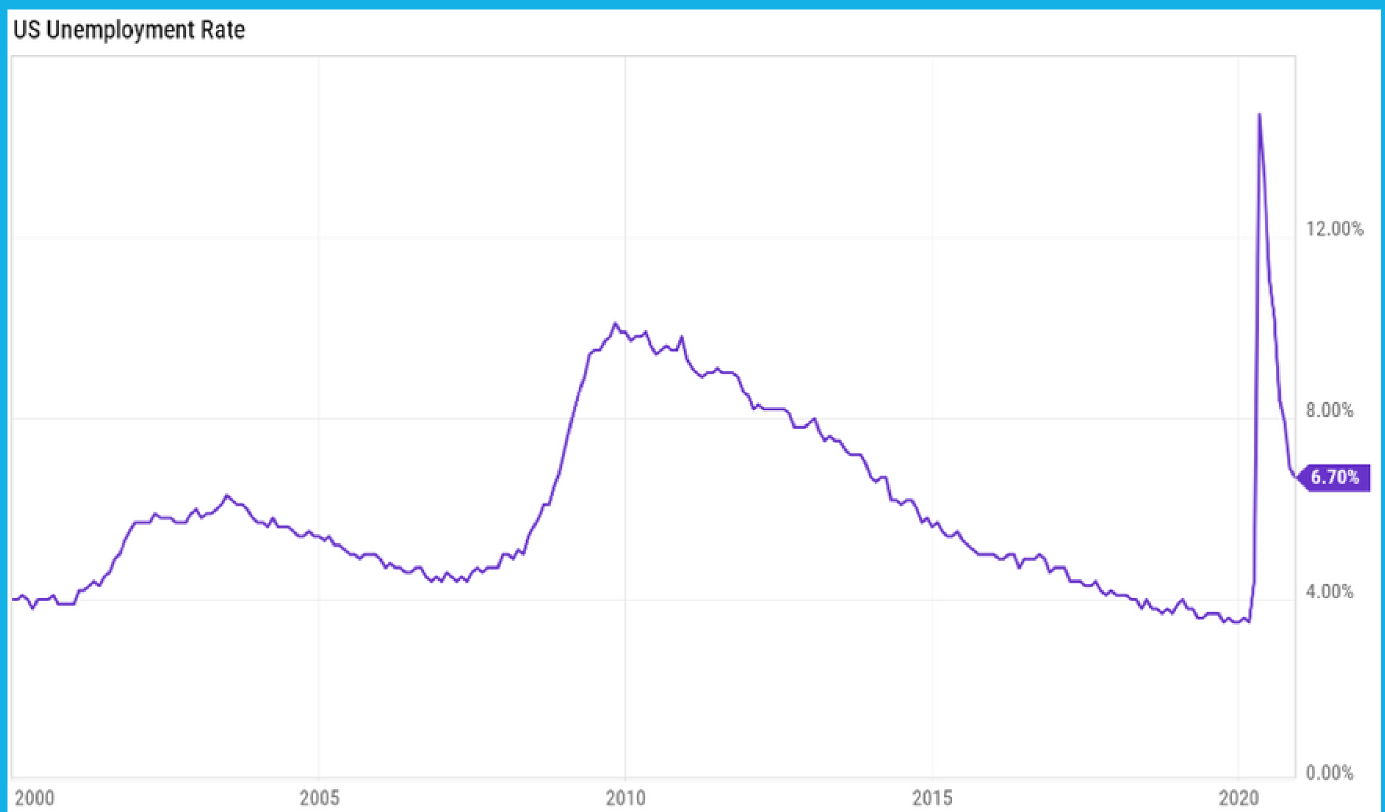
Economic Environment

Major Themes

The COVID pandemic and its associated lockdowns as well as the United States Presidential Election were the major themes this past year. As we head into 2021, there are some key themes to assess as the economy tries to get back on its feet. These include: the economic recovery patterns like employment markets and business closures, Democratic control of the executive branch as well as Congress and what that may mean for fiscal policy, interest and inflation rates and their impact on the economy, and finally, issues surrounding Big Tech including censorship, competition, and the strong run we saw in 2020. Despite these events, markets continued to march north and offered long-term investors solid returns both in equities as well as diversified fixed income markets. Volatility in the markets reached historical levels and the mass selloffs that occurred early in the year were some of the swiftest seen in history, but so was the recovery in equity and fixed income markets, which saw them reach all time highs. The test now is how we heal the underlying economy: getting people back to work, rolling out the much-anticipated vaccine, reopening the economy, and hopefully returning to a sense of normalcy.

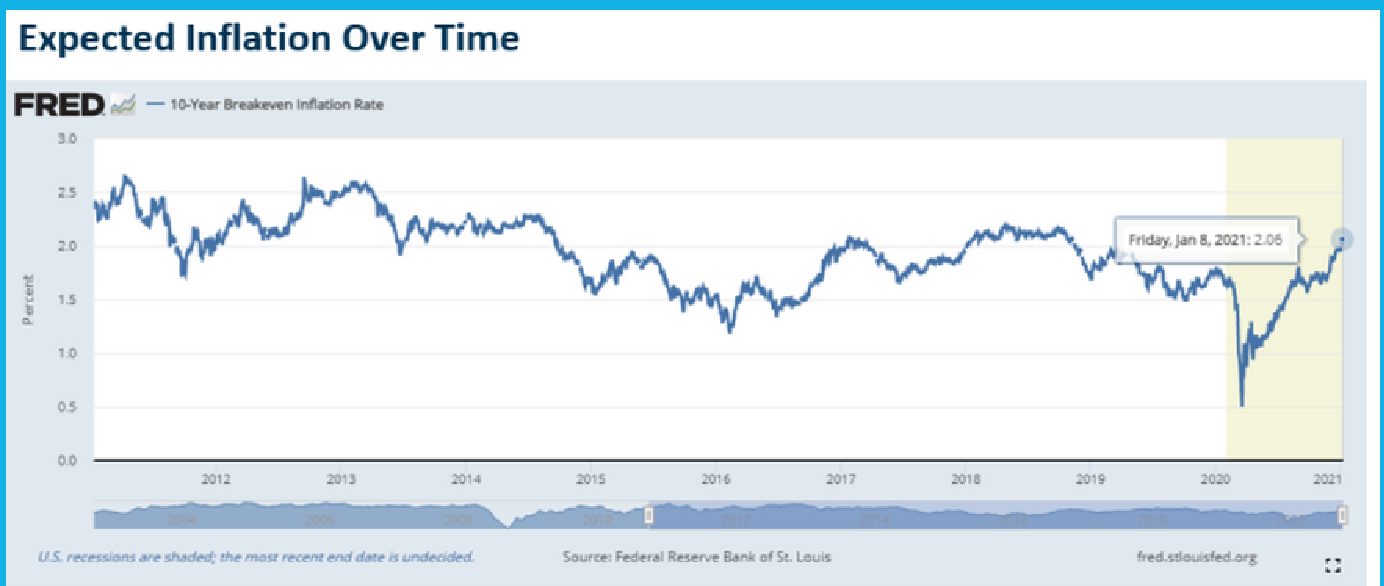
Employment Market

Unemployment dropped substantially in the second quarter of the year and has since only partially recovered. There is some speculation as to how much of this is temporary versus permanent, as some percentage is likely to be permanent, but we cannot say for certain until the economy recovers. Upon the release of April's unemployment figures, we saw the unemployment rate skyrocket to 14.7%, the highest since the peak of the Great Depression (24.9%) in 1933. Since then, unemployment figures have steadily dropped to 6.7%, however the share of these new jobs is disproportionately skewed to middle- and upper-income households. (1)

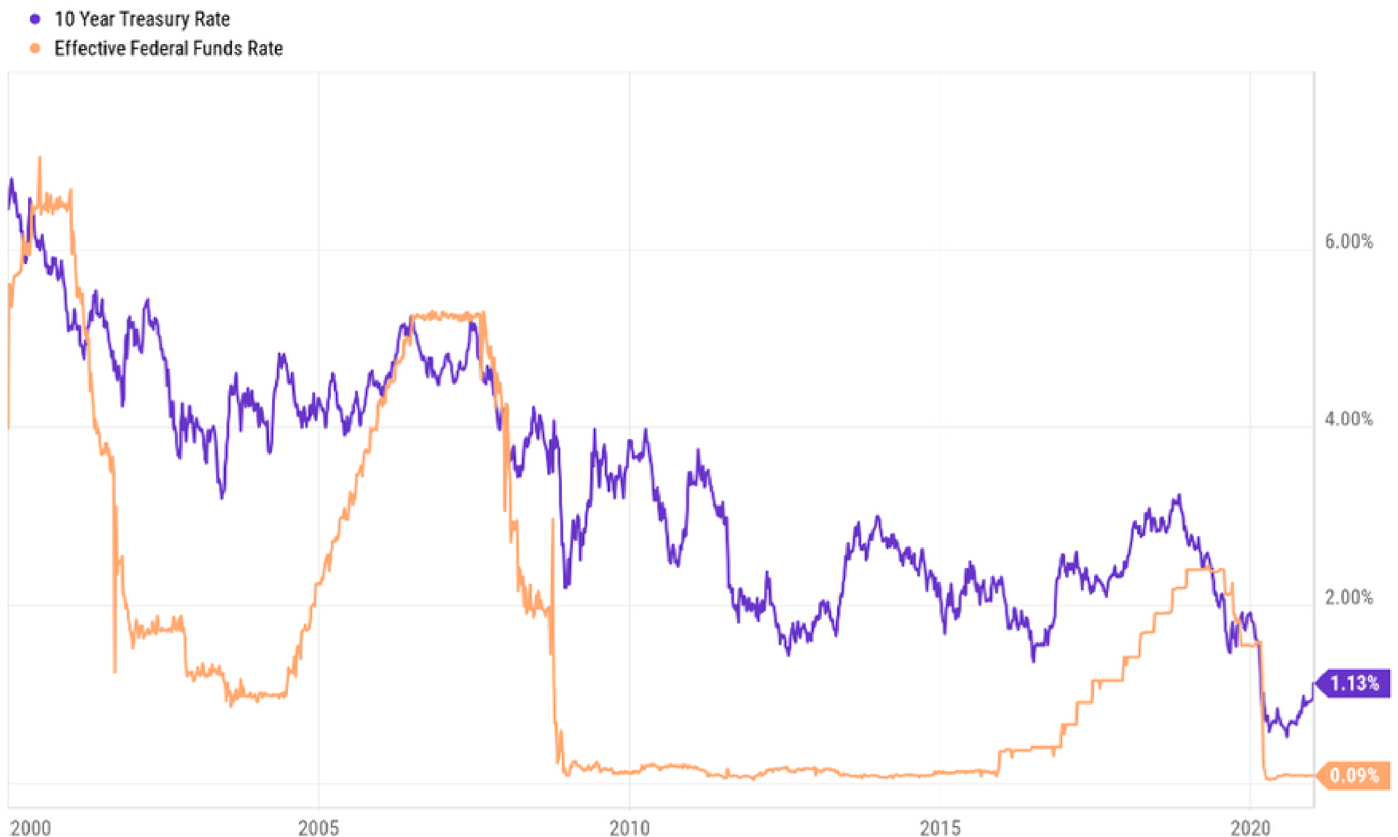


Inflation & Interest Rates

One of the key themes we saw and continue to experience is consistently low inflation figures. What is interesting is that inflation has remained low even when monetary policy and fiscal policy have remained very expansionary. This is due in part to the demand shock caused by the government's response to the Coronavirus, which pushed many businesses to shutter, and consumer spending to slow drastically. While some of this stimulus has been spent, we have seen savings rates increase dramatically, with this trend continuing into 2021. It could be the case that going forward we see inflation pick up as 1) the Fed lets inflation run above its 2% average inflation target, and 2) as consumer demand begins to kick back up once national shutdowns ease and the vaccine is more widely distributed. The 10-year breakeven inflation rate (which is an indicator of what the market anticipates inflation to be in the future) more recently passed the 2% threshold for the first time since late 2018.



Interest rates also dropped rapidly in the beginning of the year and have remained near-zero as the Federal Reserve stepped in to help the market during unprecedented selloffs in March and April. This seemed to calm markets and signaled the bottom as investors felt confident the Fed would do whatever it took to aid the market. Yields across fixed income instruments have reached record lows, including in areas such as high yield corporate bonds and emerging market bonds. These two asset classes still offer comparatively attractive yields. The Federal Funds rate (or the interest rate at which banks lend reserve balances to other banks overnight) remains effectively at 0%, with 10-year treasuries near historic lows having touched 0.52% back in April amid the market crash.

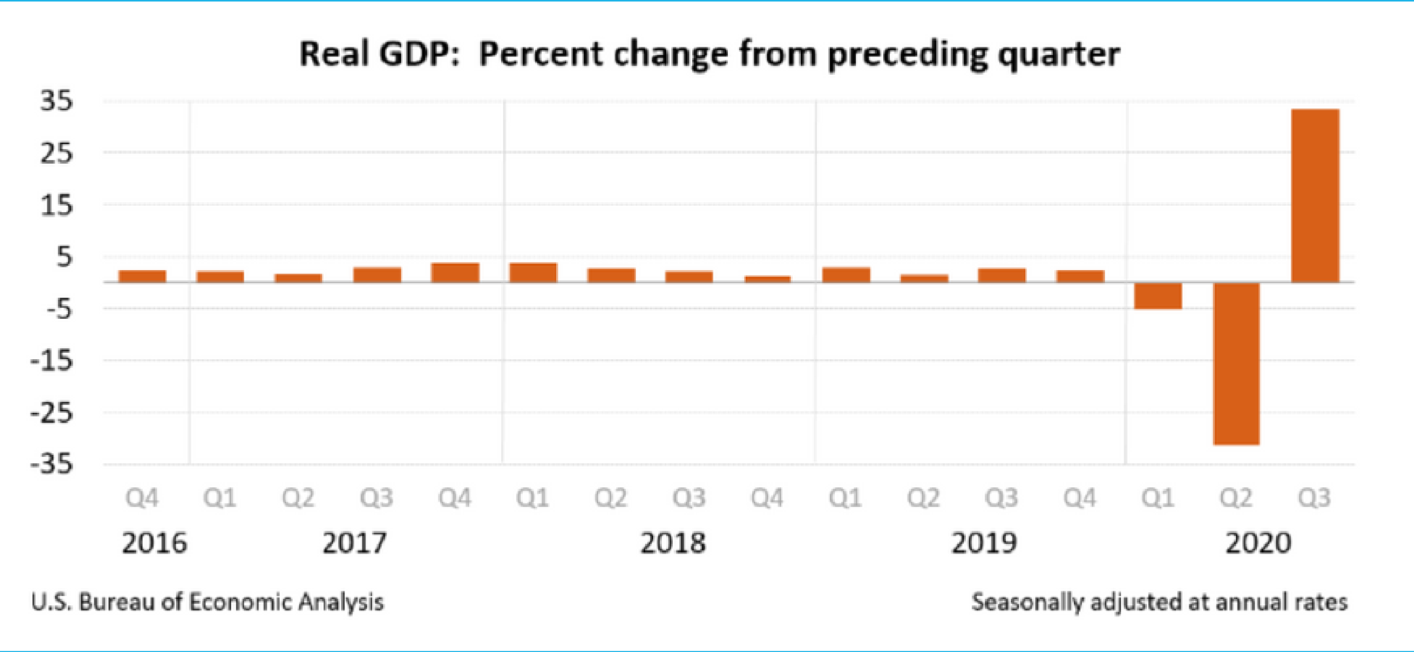


Consumer Confidence

Consumer confidence is an important economic indicator and gives some sense of how consumers are thinking about the current state of the market and the economy. Consumption makes up a large component of GDP and therefore consumer confidence tends to offer some insight into how the economy may fare going forward. According to the Consumer Conference Board - a leading authority on consumer confidence - consumer confidence suffered a large shock with the rest of the economy back in April and has since recovered modestly, though not to pre-COVID levels. More recently in November and through December, consumer confidence did slow down due to the new resurgence of COVID-19 cases and related deaths.

Economic growth

US Economic growth, and global economic growth more broadly, were severely impacted by the government measures taken to shutdown the economy in response to the COVID-19 pandemic. In March and April, we saw the brunt of this impact take its toll as US economic growth dropped by a jarring -32.9%. In the third quarter, as parts of the economy began to reopen and our understanding of the virus and preventative measures improved, we saw some of this economic growth return, with third quarter 2020 GDP clocking in at 33.4%. The rollout of the COVID-19 vaccine started in December but has since experienced some distribution bottlenecks and slower than expected distribution. However, we look to the success of this rollout and the subsequent reopening of the economy to restore some of the main drivers of economic growth like consumption. As it stands, the International Monetary Fund is anticipating a growth rate in the US economy of 3.1%, and a global economic growth rate of 5.2%.



Domestic Markets

Despite large selloffs and historic levels of volatility, domestic equity markets ended the year in positive territory. US equity markets, as measured by the Russell 3000 index, returned 20.3%. Domestic large cap stocks as measured by the S&P 500 index offered a total return of 18.4%. US small cap equities enjoyed a late year-end rally which pushed them to outperform large cap equities. Small cap stocks as measured by the Russell 2000 offered a total return of 19.5% for the year. The final few months of 2020 saw domestic equity markets begin a rotation into value and cyclical stocks and away from growth and defensive stocks in addition to a strong rally from small cap stocks.

Developed International Markets

Global equity market performance was largely impacted by the COVID-19 virus and its impact on different economies as well as their governments' responses. Some markets, such as the United Kingdom, were particularly hard hit, and ended the year in negative territory, dropping -8.5%, whereas other countries that fared better with the virus, such as Japan, ended the year in positive territory, with a total return of 14.5%. Developed international equity markets were a mixed bag, which emphasizes the importance of global diversification, especially in the face of so much uncertainty. International developed equities, as measured by the MSCI All World Ex USA index offered a total return of 7.6%. This was driven in part by the lower weighting to large and mega-cap growth and technology stocks, which are more heavily concentrated in the US equity market.

Emerging Markets

Emerging market countries were disproportionately impacted by the virus and its fallout for a few reasons: they had less relative fiscal and monetary stimulus (as a percentage of GDP) and many of emerging market economies are dependent on industries that were severely impacted by the virus (tourism, exports, manufacturing, and energy, as examples). Despite all of this, emerging markets in general had a strong resurgence in the second half of the year, which pushed their returns up near those of US equity markets. Emerging market equities, as measured by the MSCI Emerging Market index, returned 18.4% in 2020.

Fixed Income

Fixed income markets performed well from a total return perspective during 2020. Some of this stemmed from the synchronized interest rate cuts made by central banks globally as well as the rotation out of stocks and into bonds. Towards the latter part of the year, we did see many investors rotate back into equities, but still, given the volatile year and investors' propensity to rebalance throughout the year as equity markets rose, we saw bonds continue their strong performance through year end. The broad based, domestic fixed income market, as measured by the Bloomberg Barclays US Aggregate Bond Index, returned 7.8% for the year. Short term corporate bonds, which suffered some liquidity pressure during the March sell-off, returned 5.4% for the year according to the Bloomberg Barclays US Corporate 1-5 Year Bond Index. As we head into 2021, there is a keen focus on the current low yield environment, which has further emphasized the need for diversification within and across fixed income markets including in such sectors as high yield corporate bonds and emerging market debt.

High Yield

High yield corporate bonds received much needed help from the Federal Reserve in March and April when the Fed made the unprecedented move to purchase corporate and high yield corporate bond ETFs. This helped dramatically with liquidity issues in these markets as many of these bonds sold off rapidly. This intervention from the Federal Reserve helped high yield bonds rebound and ultimately led to a positive performance for the year. High yield corporate bonds, as measured by the Bloomberg Barclays High Yield Corporate Index offered 7.1% for the year.

Emerging Market Debt

Emerging market debt was another fixed income market that benefited somewhat from the Federal Reserve. The Federal Reserve instituted several credit facilities over the year, which addressed issues in multiple fixed income markets, one of those being emerging market debt markets and the access these countries had to US dollars. The Fed released an in-depth analysis of how emerging markets had been impacted by COVID, namely, the issue of reduced capital inflows, large reductions in economic activity, and stress on their credit markets more broadly.(2) With some assistance from their own central banks in concert with some aid from the Federal Reserve, emerging market debt was able to recover significantly from its lows earlier in the year. Emerging market debt, as measured by the Bloomberg Barclays Emerging Market Bond Index, were up 5.6% to round out the year.

U.S. Tips

Treasury Inflation Protected Securities (TIPS) performed well this year as inflation expectations dipped markedly. As inflation expectations dropped due to the demand shock that was seen earlier in the year, TIPS prices jumped in response. TIPS returned nearly 11% for the year, according to the Bloomberg Barclays US TIPS Index.

Real Estate

Real estate, both domestically and abroad, suffered large losses and have not fully recovered. This is due in part to sub-sectors of the REIT market like healthcare, hotels, resorts, restaurants, and office space suffering from widespread economic shutdowns as well as a move to remote work for many firms. While the broader domestic REIT market suffered substantial losses, our fund managers at Dimensional Fund Advisors (DFA) were overweight more resilient parts of the REIT market like cell towers, data centers and warehousing, which fared better during the pandemic lockdowns. Domestic REIT markets were down -11.2% for the year while our preferred fund was down only roughly -5% for the year. On the international front, REIT markets were down -10.8% while our fund was down -9% for the year.

Alternatives

Liquid alternative markets were a mixed bag in 2020. In mid-March the Private Ocean Investment Committee approved the removal of the AQR liquid alternative funds (managed futures and the multi-strategy fund), which was subsequently replaced with the Vanguard Alternatives Fund and the BlackRock Systematic Alternatives fund. More recently, as part of larger portfolio change, the Private Ocean Investment Committee moved to reduce alternatives exposure overall in the portfolio with the removal of the Vanguard Alternatives Strategy fund. The sole fund we now hold across portfolios is the BlackRock Systematic Multi-Strategy fund, which fared well amidst all the volatility in the markets. The BlackRock fund returned 3.6% for the year, which outperformed its peers in the same group.

Conclusion

Sharp market movements and uncertainty were a key theme in 2020, but even still, markets rewarded the patience and perseverance of those investors that remained in their seat and focused on the long-term returns. While 2020 was a year of volatile swings and political, social, and economic uncertainty, we remain positive that 2021 will bring good news as vaccines continue to be distributed and monetary and fiscal stimulus remain accommodative. The year may be off to a shaky start thus far, but as some of this uncertainty begins to subside and we gain some clarity around the current political and economic environment, we remain positive for the year ahead. As always, we at Private Ocean continue to monitor the markets and your portfolios. We encourage you to reach out to your advisor should questions arise. We thank you for your continued faith in us and the markets and look forward to continuing to serve you and your families as we head into what we hope to be a more positive year ahead.

Footnotes

1. *Ycharts, graph of unemployment, January 1, 2000 – December 31st, 2020. Econlib.org for data referencing the Great Depression. https://opportunityinsights.org/paper/tracker/ for data on disproportionate recovery (the so-called "K" shaped recovery).*
2. *See more here: https://www.federalreserve.gov/econres/notes/feds-notes/the-impact-of-covid-19-on-emerging-markets-economies-financial-conditions-20201007.htm*

Sources

- *FRED St Louis Federal Reserve*
- *Bureau of Labor Statistics*
- *University of Michigan; Consumer Confidence Board*
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- *Morningstar Direct*
- *Goldman Sachs Economic Research*
- *IMF: https://www.imf.org/external/datamapper/NGDP_RPCH@WEO/OEMDC/ADVEC/WEOWORLD*
- *Organization for Economic Cooperation and Development*
- *JP Morgan's Guide to Markets: https://am.jpmorgan.com/us/en/asset-management/gim/adv/insights/guide-to-the-markets*