Fourth Quarter 2020 Key Takeaways

Last year was a tragic one, yet global stocks were up 16% in 2020. U.S. stocks did a bit better. During the dark days of March, with pandemic fears rampant and the global economy falling off a cliff, very few (if any) would have predicted this year's outcome for stocks. Despite being a cliché in investing, the benefit of "staying the course" in times of volatility once again proved prescient.

In fixed-income, core investment-grade bonds gained a strong 7.6%, benefiting from falling rates as investors sought low-risk assets earlier in the year. Our flexible bond strategies and floating-rate loans materially outperformed core bonds during the last three quarters of the year. But they still have some ground to make up from the tremendous selloff suffered in March.

In a challenging and chaotic year, our client portfolios performed well. Broadwing executed two tactical allocation shifts that added value.

I am optimistic that recent portfolio performance is the beginning of a more sustained trend. There are reasons to believe prior years' macro and market headwinds may be turning into tailwinds for our portfolio positioning.

For 2021, the likelihood of widespread vaccine distribution supports the case for an economic recovery beginning in the second or third quarters. Central bank monetary policy is almost certain to remain very accommodative for at least the next year or two. And fiscal policy is unlikely to be restrictive and could be stimulative, depending on political outcomes. This macro backdrop should be supportive of equities and other financial risk assets at least for 2021.

Over my five-year tactical horizon, U.S. stocks continue to look expensive in absolute terms but not relative to extremely low bond yields. Meanwhile, non-U.S. stock markets, emerging-market stocks in particular, have much higher five-year expected returns than U.S. stocks. If the U.S. dollar continues its recent decline, U.S. investors in international assets could receive an additional currency return. Portfolios remain underweight to U.S. stocks and overweight to emerging-market stocks for these reasons.

Of course, we must assess the risks. In the next few months, there could be a sharp economic slowdown from pandemic-induced lockdowns and, potentially, inadequate supplemental fiscal relief. And the current extreme investor optimism leaves the market vulnerable to disappointment. Longer term, two big concerns are the specter of inflation and China.

Financial market history teaches us: expect the unexpected; expect to be surprised. And positive surprises happen too. It's important to note that although my base case is for a cyclical recovery, our balanced portfolios are built to be resilient across a wide range of potential scenarios. That said, I'd be happy to see my formerly contrarian views become the consensus in 2021 and beyond.

Fourth Quarter 2020 Investment Letter and Annual Recap

In the first quarter of 2020, I said that we would get through this crisis and that things would improve and recover. Financial markets recovered first, quicker than they ever have from such a deep economic hole, and quicker than anyone could have hoped for. The world's economies have made great progress too, but are not back to their pre-COVID-19 levels yet and may not be for another year or two. As for the world's health side, authorities warn us we may be in for dark days this winter before the vaccines can be widely available to the general populace. This may set back economies and markets in the near term and keep us isolated and sheltered in place in some places. But I expect that 2021 will see the end of the pandemic, and our society will follow markets and the economy in bouncing back.

In the meantime, my wish remains the same as it was in April, that you and your loved ones stay safe and healthy.

Market Recap

As we close out a tragic and turbulent year, here's where the financial markets stand.

Stocks around the globe, as represented by the iShares MSCI ACWI ETF, ended the year at all-time highs with a 16.3% gain. It hardly needs saying, but during the dark days of March, with pandemic fears rampant and the global economy falling off a cliff, very few if any market observers would have predicted this outcome. That includes me, though I try to avoid short-term market predictions about *any* event. What I did write in concluding my first quarter investment commentary was: "Stay the course." This is generally wise (albeit clichéd) advice for long-term investors who are following a disciplined investment strategy. And it proved prescient once again.

In 2020, U.S. stocks led the major equity markets. The S&P 500 (Vanguard 500 Index) gained 18.2% and the small-cap iShares Russell 2000 ETF shot up 20.0%. Developed international stocks (Vanguard FTSE Developed Markets ETF) gained 9.7%. Emerging-market (EM) stocks (Vanguard FTSE Emerging Markets ETF) rose 15.2%.

In the fourth quarter, foreign stock markets were particularly strong, with gains in the mid-teens, outperforming the S&P 500 by several percentage points. Value stocks also beat growth stocks and small caps crushed large caps. Riskier assets in general got a boost from the resolution of presidential election uncertainty (at least for the most part, if not yet fully) and surprisingly positive Phase 3 COVID-19 vaccine results announced in early November.

The comforting full-year returns masked the incredible volatility and stress investors faced earlier in the year. As the chart below shows, stock markets around the world were down between 30% and 40% from January 1 to the market bottom on March 23, in what was the quickest/sharpest bear market in history. From the low point, stocks skyrocketed into year-end. The S&P 500, developed international, and EM stock indexes all roared back more than 65%. Small-cap U.S. stocks soared nearly 100%.

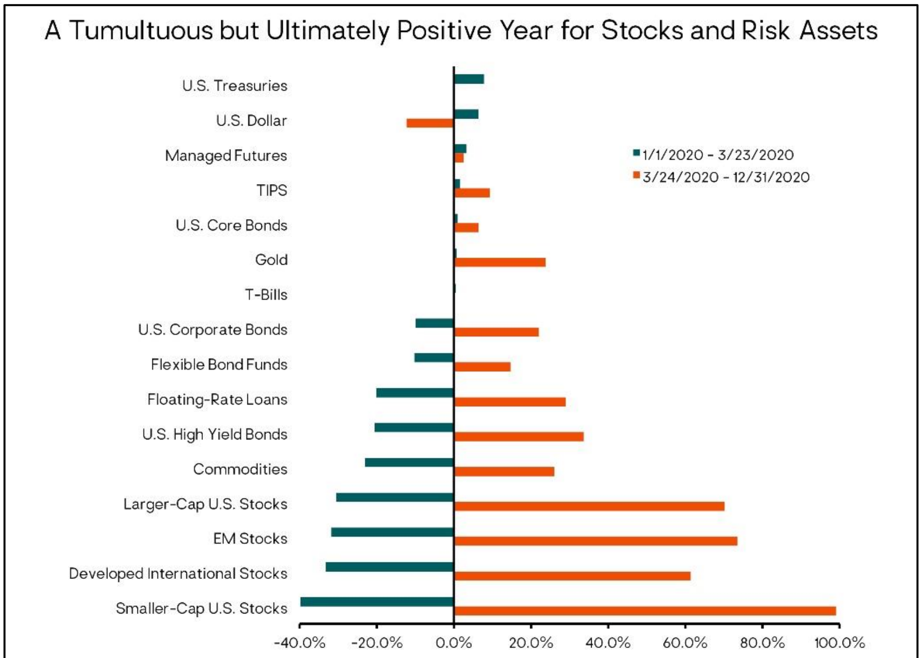
Moving on to fixed-income, core bonds gained a strong 7.6% for the year, providing positive returns both during and after the market crisis period (Vanguard Total Bond Market Index). The 10-year Treasury yield touched an all-time low of 0.5% in August and ended the year at 0.93%, roughly a full percentage point below where it started 2020.

In the credit markets, high-yield bonds and floating-rate loans posted 6.2% and 3.1% gains, respectively, for the year (the ICE U.S. High Yield Cash Pay Index and the S&P/LSTA Leveraged Loan Index). Both asset classes materially outperformed core bonds during the last three quarters of the year, but still have some ground to make up from the tremendous credit market dislocations in March before the Federal Reserve rode to the rescue.

Key Drivers of 2020 Portfolio Performance

In a challenging and chaotic year, I am pleased to report our portfolios performed well.

We made two tactical changes to our portfolio allocations during the year, both of which added value. In mid-April, as stocks were just beginning their recovery and investor fear was still rampant, I shifted portfolio allocations across BCA Flexible and Variable Annuity portfolios to contain greater exposure to growth stocks. Specifically, I established a new position in the ARK Innovation ETF (ARKK) for our balanced and growth-oriented portfolios, added to an existing position in the iShares USA Momentum ETF (MTUM), and established a new position in the Vanguard Small Cap Value ETF (VBR). These changes contributed substantially to portfolio returns for the year, with the funds up 146%, 42%, and 55% respectively for the period covering purchase date to the end of 2020. All of these changes were funded from selling lower-risk Gateway fund (GATEX) and a portion of the Schwab International Equity ETF (SCHF), both of which turned in respectable 15% and 39% returns for the same period, but still lagged their replacements by a significant margin.



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In late July, I swapped our position in the Litman Gregory Alternative Strategies fund (MASFX) with a combination of the following funds: ARK Innovation ETF (ARKK), JP Morgan Hedged Equity (JHQAX), Vanguard Intermediate Term Bond ETF (BIV), Vanguard Long Term Bond ETF (VGLT), and the SPDR Gold ETF (GLD). So far, this trade has had mixed results, with BCA Flexible conservative portfolios (Principal Preservation, 25/75 and 40/60) faring worse through December 31, 2020 than would have been the case with no change, and BCA Flexible growth-oriented portfolios (50/50, 65/35, 80/20, and 100/0) faring better than would have been the case with no change.

More broadly, our portfolios produced strong performance in the second half of the year as financial markets recovered from the sharp, pandemic-induced selloff and started looking ahead to a global economic recovery. In addition to the above, portfolios benefited from our Emerging Markets equity overweight and from our position in the JP Morgan Hedged Equity fund, a bond-alternative that turned in a performance of 7.56% for period covering purchase date to the end of 2020, while most bond funds had negative returns for the same time period.

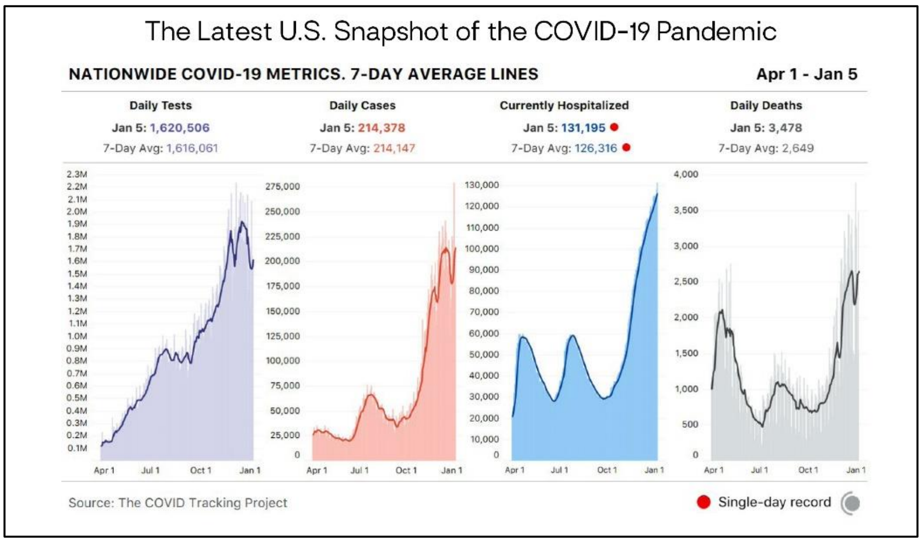
I am optimistic that this recent portfolio performance is the beginning of a more sustained trend: that prior years' macro and market headwinds may be turning into tailwinds for our portfolio positioning. As discussed in my outlook below, I see good reason for optimism in this regard, and for patience and discipline to be rewarded. Of course, there are always uncertainties and risks, and below I discuss those as well.

Macroeconomic Backdrop & Outlook

The Pandemic

Unfortunately, any discussion of the big-picture outlook must still begin with the COVID-19 health crisis and its recent "third wave" resurgence in the United States and second wave surge in many other countries, particularly across Europe. The public health impact in the United States is increasingly severe, reaching all-time highs in daily deaths (3,800-plus) and current hospitalizations (130,000-plus).

This is leading to increasingly aggressive—albeit still localized—economic lockdowns across the country. And that raises the risk of a sharp slowdown in the economy, if not an outright contraction, heading into 2021. Recent weak labor market data (weekly initial claims for unemployment insurance have been rising again), falling household income (down 1.1% in November), and slumping retail sales (down 1.1% in November, the largest decline since April and the biggest November monthly drop since 2008) indicate this is already happening. At their mid-December meeting, the Fed reiterated yet again that "the path of the economy will depend significantly on the course of the virus."



Along with the pandemic surge, the expiration of emergency federal aid programs for individuals and small businesses is contributing to the economic slowdown. For this discussion I am putting aside the undeniable human suffering, physical and financial. Consider these recent economic stats:

- The poverty rate in the United States has increased from 9.3% in June to 11.7% in November - an increase of 7.8 million Americans - as benefits from the previous COVID-19 relief package lapsed, even while the unemployment rate improved from 11.1% to 6.7%.
- The number of American adults saying they live in a household that either "sometimes" or "often" doesn't have enough to eat has risen sharply, by roughly six million (to 27 million total), compared to before the pandemic.

A lack of further government support would present a major near-term risk to the economy. Commenting on this situation in mid-December, Fed chair Jerome Powell said, "It looks like a time when what is really needed is fiscal policy."

Thankfully, after months of political bickering and delay, congressional Republicans and Democrats reached agreement in the eleventh hour on a compromise $900 billion pandemic relief bill. Among its key provisions, it will make direct payments of $600 to qualifying individuals, extend $300 per week in extra unemployment benefits through mid-March, and authorize nearly $300 million in forgivable loans to small businesses. More fiscal aid may be requested in the early months of President-elect Joe Biden's administration, including money for strapped state and local government budgets. In fact, with Democrats prevailing in Georgia's recent runoff election and taking control of the senate, the odds of an additional $1,400 stimulus to all qualifying Americans seems all but certain. This will help relieve some of the short-term economic pain.

While the economy faces these very-near-term dangers, the likelihood of widespread distribution of effective vaccines in the first half of 2021 supports the case for a relatively strong economic rebound beginning in the second or third quarter—barring a derailment of the vaccine rollout or some other shock—as lockdowns are lifted and pent-up consumer and business spending is released.

For example, the International Monetary Fund (IMF) currently forecasts 5.2% global real GDP growth in 2021; this compares to a -4.4% global economic contraction in 2020 and 2.8% growth in 2019. Among some of the independent research services I subscribe to, Capital Economics forecasts 6.8% global GDP growth and 5% GDP growth for the United States; and Ned Davis Research forecasts 5.8% and 4.6%, respectively. These are all well above long-term historical average growth rates. The Fed is more conservative with a 4.2% U.S. GDP growth forecast for next year.

Monetary Policy

Critically, monetary policy is almost certain to remain very accommodative/loose/stimulative for the foreseeable future, even if the above GDP forecasts are in the ballpark and we get a decent economic recovery in 2021. The Fed continues to communicate it is several years from seeing a need to start tightening policy, either in terms of raising the federal funds rate (currently near zero) or reducing its quantitative easing (QE) asset purchases (currently at a rate of $120 billion per month).

The recent rollout of the Fed's "average inflation targeting" framework is further evidence of their apparent commitment to achieving "maximum employment" and core inflation "moderately above" their 2% long-term target before they start to raise interest rates. Currently, most Federal Open Market Committee (FOMC) participants don't expect that to happen until *at least 2024*. Of course, that is subject to change, and the Fed's track record of predicting even their *own* behavior is quite blemished. But barring an extreme inflationary shock, the Fed's current stance is likely to sustain for at least the next year or two. The Fed is forecasting core inflation of 1.8% in 2021 and 1.9% in 2022.

Fiscal Policy

In 2021, fiscal policy is unlikely to be restrictive and will likely be stimulative given recent political outcomes. Democratic victories in the two Georgia senate races increase the odds of larger fiscal stimulus, possibly offset to some extent by corporate and individual tax increases. But even with Democrats in control of the Executive and Legislative branches, they likely still won't get everything they want. There are many fiscally-minded Democrats that will moderate the new administration's proposals (especially on taxes). One would think politicians' self-interest (not to mention the *common* interest) would prevail in that event and lead to other compromise packages.

With the above as my short-term (12-month) macroeconomic base case, I'll move on to what the implications might be for financial markets.

In a nutshell, an economy in the early stages of cyclical recovery, assisted by highly accommodative monetary policy, and, at worst, neutral fiscal policy, should provide a supportive backdrop for stocks and other "risk assets" over the course of the next year.

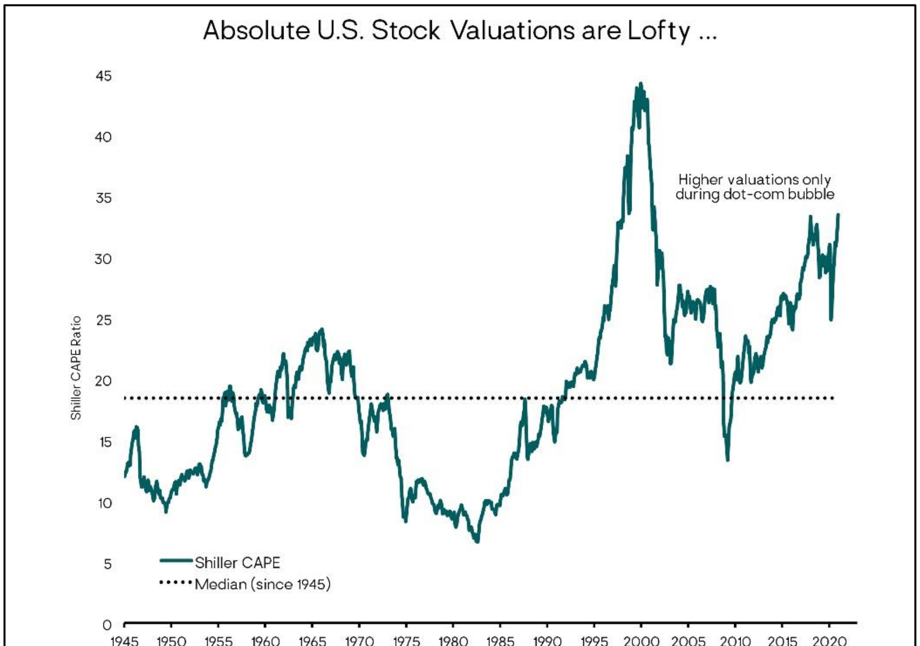
Global Equities Outlook

In an environment in which the U.S. and global economies are in a synchronized early-cycle growth phase, corporate profits should be strong. Consensus estimates are for S&P 500 operating earnings-per-share growth of 38% in 2021, after a 23% drop in 2020. And monetary policy is loose, which should be fundamentally positive for risk assets such as stocks and "non-core" (lower-credit-quality) bonds.

But when investing one cannot just look at the fundamentals. In other words, one must also consider valuation - the price one pays for an investment. And over the "medium term" (five-year horizon), my base-case analysis indicates the U.S. stock market is overvalued on an *absolute* basis (compared to its underlying fundamentals or its normalized earnings power). My base-case five-year expected annual return for the S&P 500 is in the very low single-digit percent range.

However, as I've also discussed in prior commentaries, in this environment of extremely low bond yields, U.S. stocks still look *relatively* attractive compared to core bonds or Treasury bonds. This relative valuation perspective has dominated market behavior for several years—memorialized in the acronym TINA (there is no alternative). In other words, with core bond yields so low, investors have "no choice" but to move out on the risk spectrum and buy stocks and other riskier assets to try to meet their investment return and income objectives.

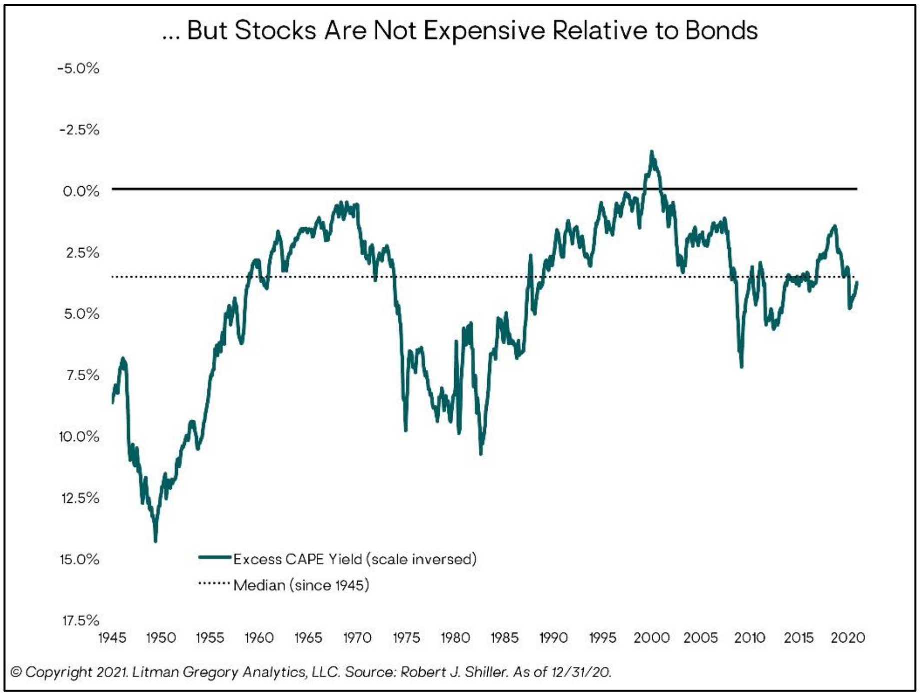
As long as bond yields remain very low and corporate earnings growth is meeting or exceeding expectations, U.S. stocks can continue to decently. High absolute valuations imply subpar medium-term absolute returns in my base case. I see much better mid- to long-term opportunities in other markets, but this doesn't mean a bear market in the U.S. is imminent.



Foreign equity markets should be even stronger beneficiaries of a global recovery, given their generally higher cyclical sensitivity to global growth—a trait that has hurt them throughout the generally lackluster economic period since the 2008 financial crisis. Plus, as I've highlighted for the past several years, they have significantly lower valuations compared to U.S. stocks.

So, I see potential for better-than-expected earnings growth and possibly also some increase in valuation multiples for stock markets outside the United States. Also, while I'm not in the business of forecasting currencies, a continuation of the recent strength of emerging markets currencies relative to the dollar, will add to emerging markets equities' returns. My base-case five-year expected returns for developed international and emerging markets stocks are in the upper single digits. This is a substantial premium above U.S. stocks. As such, I remain overweight to emerging markets stocks, where my conviction is highest, and moderately underweight to U.S. stocks.

Importantly, my tactical position in foreign versus U.S. stocks is based on my *medium-term* (five-year) analysis. But this positioning also aligns very well with the shorter-term macro-economic outlook I've been describing.



In addition to favoring foreign over U.S. stocks in the mid-term, many of the above economic conditions also favor cyclical/value stocks over growth stocks. Cyclical/value stocks have been crushed, most recently by the pandemic, and before that by the U.S.-China trade war, and finally by an extended period of low growth, low inflation, and very low interest rates that has strongly favored large-cap tech/growth stocks.

But as the global economy recovers, these underperforming and out-of-favor stocks should show some life. Once the pandemic is perceived as under control and the economy is in a sustained upswing, I would expect "value" to have its day in the sun again, after an unprecedented 13-year run of massive underperformance. In fact, a rotation from growth to value might already be underway as evidenced by value's relative outperformance since the Pfizer vaccine announcement in November. One of the largest positions in most of our portfolios is the Schwab U.S. Equity Dividend ETF (SCHD), which is heavily invested in value/cyclical stocks and stands to benefit from this rotation away from growth.

Fixed-Income Outlook

The outlook for fixed-income is relatively more certain (there are a narrower range of potential outcomes) than for equities given the tight mathematical relationship between bond market yields and total returns. Given the 1.03% current yield for the core bond index, I have a high degree of confidence that core bonds' five-year expected returns will be in the 1% ballpark. On an after-inflation basis - assuming roughly 2% inflation - the "real yield" is negative. So, <u>from an absolute- and relative-return standpoint, core bonds are very unattractive.</u>

However, core bonds still play a vital risk management role in our balanced portfolios. They provide “ballast,” or safe-haven protection and positive return potential in the event of a recessionary or deflationary shock. The pandemic was the most recent example. So, I maintain meaningful exposure to core bonds with higher allocations in our more conservative/risk-sensitive portfolios. However, given recent strongly negatively price momentum in intermediate and long-term Treasury bonds, I am reviewing risk-management options that offer the potential for better short-term investment performance.

The Risks to My Outlook

While the macroeconomic and investment backdrop is positive, there are risks to my outlook, as always. Some are very-near-term market risks (over the next few months), which mirror the very-near-term macro/pandemic risks I discussed above. Others are more relevant looking out over my tactical five-year medium-term horizon.

The Very-Near-Term Market Risks

After the U.S. stock market’s incredible rebound since late March—with the S&P 500 up 70% and the Nasdaq up 89%—market sentiment (investors’ collective willingness to take risk) is very bullish and very optimistic. When sentiment reaches such extremes, it can be a contrary indicator for the market in the very near term. As an example, the Ned Davis Research chart below shows a composite of sentiment indicators. It is currently in the “Extreme Optimism” zone, where subsequent market index returns have historically been negative on average. In contrast, crowd sentiment hit its most pessimistic reading in 11 years when the market plunged in late March. This set the stage for a powerful market rally given the catalyst of an overwhelming monetary and fiscal policy response.

Two Key Medium-Term Market Risks

The medium-term risks are numerous; some are known and some are unknown. I will highlight two here: inflation and China.

Inflation

Ever since the Fed embarked on QE and zero interest rate policy in 2008, many prominent investors, strategists, and economists have been warning of an imminent inflationary spiral. They, and I, have been dead wrong. But with even more extreme Fed accommodation and money supply growth in 2020, the prospect for further debt-financed (monetized) government spending still to come, and a post-pandemic global economic recovery eventually driving the economy to full employment/full capacity, at some point over the next five years, I see increased inflation risk.

A period of sharply higher inflation and rising interest rates will obviously be bad for core bond and nominal Treasury returns, although it will set up subsequent bond investments with higher yields.

High inflation is also bad for stocks, especially those with high price-to-earnings ratios (P/E multiples) as they will no longer get a valuation boost from exceptionally low rates. The reverse will likely be true and P/E multiples will compress. Once valuations reset and inflation stabilizes, stocks can perform well. So, over the long term they have been an excellent inflation hedge. But they are likely to take an initial hit if inflation accelerates above say 2.5% to 3%.

China

Given China's outsized influence within the emerging markets (not to mention the world at large), I am very focused on the risks it presents, in addition to the investment opportunities.

China's economy has weathered the pandemic relatively well and recovered from it the fastest, among the major economies at least. In October, the IMF estimated China would be the only country in the world with positive economic growth in 2020. China has also been among the best-performing stock markets in the world, up almost 30% for the year, while its currency, the yuan, has appreciated more than 6% versus the U.S. dollar since the end of May. Investors are acknowledging the relative growth differentials between the U.S. and Chinese economies.

There has also been increased global demand for China's bonds. China's 10-year government bond yield is around 3.2% and appears attractive to yield seekers in an era of very low to negative government bond yields in much of the developed world. Given China's economic recovery has been faster than expected, China's government has indicated it will be looking to normalize monetary policy next year (it is relatively hawkish). In addition, China is increasing regulatory scrutiny on some of its large tech companies that have performed well. Given these shorter-term headwinds, it would not be unreasonable to think that the Chinese stock market takes a breather relative to the rest of the emerging markets and some other developed markets, such as in Europe.

Medium to longer term, I remain bullish on China and emerging markets stocks in general. For emerging markets stocks, I believe valuation and earnings assumptions are relatively conservative and think there is a good chance emerging markets may surprise on the upside.

Trade war and tech war-related issues will likely remain a headwind for China and the emerging markets over the medium to longer term. If anything, a Biden administration may end up putting more coordinated pressure on China. In this respect, China's increasing focus on domestic consumption–led growth while strengthening intra-Asia trade and seeking new agreements (such as an investment agreement with the European Union currently underway) could help offset U.S.-China trade war–related headwinds.

Importantly, if the trade war between the United States and China accelerates the aforementioned economic regionalization, especially given the growing importance of China, it becomes even more important for investors to diversify across global equities and not be very U.S.-centric. I believe we are in the early stages of this rebalancing toward greater emerging markets allocations in global investor portfolios, as the current relatively low allocations to emerging markets stocks and recent capital flows data suggest.

Closing Thoughts

I incorporate a wide range of potential outcomes in my scenario analysis and portfolio construction. For 2021, I think a reasonable base case is that a widespread distribution of vaccines (along with testing, treatment, and other public health responses) will be effective in bringing the pandemic under control. This will enable the U.S. and global economies to stage a reasonably robust growth recovery. The recovery will be supported by ongoing highly accommodative central bank monetary policy, keeping interest rates low. And there will be enough fiscal aid to households and businesses to at least bridge the economic chasm while the pandemic rages earlier in the year.

This macro backdrop should be positive for global equity returns—particularly for undervalued international and emerging markets stocks and other beaten-down cyclically-sensitive assets. Credit-oriented fixed-income strategies and alternative strategies should also outperform core bonds (Treasuries).

I acknowledge that my view seems to be the consensus view for 2021. That makes me a little wary; the consensus is often wrong. But there is no payoff to being contrarian just for contrarian's sake. From a portfolio performance perspective, I'd be very pleased to see my until-now contrarian view on foreign stocks vs. U.S. stocks and value stocks vs. growth stocks become the consensus in 2021 and beyond. My analyses of these asset classes suggest there is still a lot of room for more gains (and for the consensus to turn more bullish on them), even with their rebound in the latter part of 2020.

Our portfolios are well positioned if the consensus view plays out in 2021. However, portfolio positioning is based *not* on one-year market predictions or economic forecasts that are notoriously difficult to consistently get right but on my five-year expected-return framework, in conjunction with my shorter-term risk assessment. That said, it is encouraging to see such strong alignment between my medium-term baseline scenario and my shorter-term view.

If I have learned anything from financial market history, it is that one should expect the unexpected; expect to be surprised. There is no certainty, and much can go wrong in any given year. Much can also go right, such as the incredibly fast development of COVID-19 vaccines and the overwhelming bipartisan policy response to the pandemic early in the year (unfortunately, this bipartisan spirit didn't last long).

As always, our portfolios remain diversified across a range of asset classes and investments that should provide balance and resilience in the event my short and mid-term (sanguine) outlook doesn't play out. I am prepared to respond thoughtfully and opportunistically as unexpected events unfold, just as I did in April of 2020.

I appreciate your confidence and trust and invite you to contact me to discuss your portfolio and personal finances. In the meantime, I sincerely wish everyone a healthier, happier, peaceful, and prosperous 2021.

Best,

Kelly D. Kane, ChFC, CFP