Fourth Quarter 2020

Fig. 1 – S&P 500

Fig. 2 – U.S. 10-Year Treasury Yield

Market Recap

Stocks gained ground again in the fourth quarter of 2020, continuing the remarkable recovery from the pandemic crash in March. The large cap S&P 500 index (**Figure 1**) posted a total return of +12.2%, finishing the year +18.4%. Small and mid cap US stocks posted especially strong results. The S&P Mid Cap 400 index finished +24.4%, and the Russell 2000 Small Cap index rose a remarkable 31.4%, finishing the year +20.0%, ahead of the large cap S&P 500. Value stocks outperformed growth stocks in the quarter, led by financials and industrials, but still trailed by a wide margin for the full year.

Returns outside the U.S. were also solid. Emerging markets rose 19.7%, while the Europe, Australia and Far East index rose 16.1%. Across the globe, economic activity in open sectors grew, and investors began to anticipate growth in other areas as vaccine adoption increases.

Corporate earnings continued to improve in the third quarter. According to Zacks Research, earnings fell 7%, a substantial improvement after dropping 32.4% in the second quarter. It is worth noting that, going into the quarter, earnings were expected to decline 22.8%. Companies have repeatedly topped analyst expectations over the past two quarters. Fourth quarter earnings reports have just started. S&P 500 earnings are expected to fall 11.3% on flat revenues, and only five of 16 sectors are anticipating growth. However, given the market's climb in the fourth quarter of 2020, investors will be looking for more positive surprises. The bar is higher, as 2021 earnings are expected to grow 21.9%. Companies that fail to provide promising guidance may be treated harshly.

Economic Data

Economic data in the fourth quarter was again mixed, but generally painted an improving picture in the U.S. Third quarter gross domestic product (GDP) increased 38% at an annual rate, after dropping a record 32.6% in the second quarter. Again, economic results were better than expectations, as forecasters had called for 31.8% growth. Some of the third quarter's trends continued. Construction spending rose to a record high in November, propelled by increased residential building. Surveys of purchasing managers in both manufacturing and services companies reported continued expansion. The manufacturing survey reached the highest level since August 2018 on strong demand for both consumer and industrial products.

Job growth continued to lag the recovery, as is usually the case coming out of a recession. In November, the U.S. added 245,000 jobs, a big drop from the 610,000 created in October, and much lower than the forecast of 440,000. The unemployment rate continued to drop, to 6.7%, but the workforce participation rate of 61.5% is still much lower than at the start of the pandemic. Weekly jobless claims did tick below 800,000 in the last week of 2020, providing some hope that the December jobs report will show improvement. Given the idle capacity in the travel, hospitality, and dining sectors, we may not see further large job gains until vaccine adoption becomes widespread later in the year.

Index returns taken from Morningstar.com

Interest rates remained historically low, although the 10-year Treasury yield rose steadily in the quarter (**Figure 2**), topping 1% this week for the first time since March of last year. The Federal Reserve has kept short-term rates close to 0% and will likely continue that for the foreseeable future to support the economic recovery. Inflation has been running short of the Fed's long-term 2% target. Some market watchers have warned about the possibility of higher inflation as activity resumes. However, with slack labor markets, plenty of vacant real estate, and abundant oil, the economy appears to have ample runway before demand starts pushing prices much higher. This should allow the Fed to be patient with interest rates, which in turn should be supportive of both stock and bond prices.

Looking Forward

The fourth quarter brought its share of difficult headlines including increased COVID-19 cases and deaths across much of the U.S., as well as uncertainty in November over the election. Markets have generally shrugged off bad news since March, even rising yesterday, when a rioting mob stormed the U.S. Capitol interrupting Congress. For some investors, this is difficult to comprehend. How can stocks go up when there are so many reasons to worry? The market tends to look ahead at least six months. The recent vaccine approvals and rollouts have raised expectations for increased opening of businesses in the latter part of this year. It's also worth remembering that while corporate earnings did decline sharply early in the pandemic, many companies recovered much faster than expected, another source of equity market strength. Finally, more economic stimulus is expected now that the Democrats control both the Senate and the House of Representatives.

The past quarter saw a change in market leadership, as both small cap stocks (**Figure** 3) and emerging markets (**Figure** 4) outperformed the S&P 500. This pattern may persist in 2021. Small caps are more sensitive to the reopening of the economy and may offer more attractive valuations after several years of trailing the large cap index. Similarly, emerging market stocks generally trade at lower multiples than U.S. companies with comparable fundamentals. In addition, some emerging economies, including China, Taiwan, and South Korea, have handled the pandemic much more effectively than the U.S., and are expected to grow faster in 2021. A diversified portfolio with exposure to these segments as well as the recent U.S. leaders may serve investors well.

Fig. 3 – S&P 600 Small Cap

Fig. 4 – iShares MSCI Emerging Markets

2020 was a difficult year for almost everyone, and tragic for many. I'm proud of the work that our team did in taking care of our clients and implementing important new systems, including the client portal through which you may be reading this letter. We hope that 2021 will be an easier year, filled with much happiness and good health for you and your loved ones. And we look forward to the time when we can see you in person again, hopefully soon.

Best regards,

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