4th Quarter 2020

Market Recap
Performance Review
and Near-term Outlook

Market Recap

Q4 provided a strong, broad-based close to 2020's surprisingly positive market performance. For most of 2020 it was a small group of mega-cap technology and consumer stocks that lifted broad-market indexes from the lows of the Q1 downturn. The divergence in performance, particularly that of the largest of US technology company stocks, versus essentially the rest of the market, reached historical extremes.

The technology and consumer stock recovery was driven, in large part, by historically low interest rates, by overwhelming monetary and fiscal stimulus, and by the "stay at home trade". But Q4 developments provided catalysts for a shift in leadership, one that would broaden the market's recovery into market sectors yet to rebound from the Q1 downturn. The approval, and availability, of multiple Covid-19 vaccines, and the "blue sweep" of the US Presidential election cycle — along with it the economically expansive policy measures to accompany a Democratically controlled government — raised expectations for the "reopening trade", and an acceleration of global economic recovery.

Reignited investor confidence fueled a rotation out of the technology and consumer stocks and in to value-oriented cyclical stocks, international stocks, and small-company stocks. In anticipation of a reheating economy, bond markets sent interest rates higher and the US dollar lower. While nearly all US and international asset types finished higher for Q4, investment styles, company size, and sector performances were widely mixed YTD.

As measured by the Russell 3000 Index, a measure of the largest 3,000 US companies and a proxy for the complete US stock universe, US stocks climbed +14.68% during Q4, for a YTD return of +20.89%. While the Growth Index component climbed +12.41% during Q4, for a YTD return of +38.26%, the Value Index component climbed +17.21%, for a YTD return of only +2.87%.

> Don't throw away a single shot,
> my brave fellows;
> don't throw away a single shot,
> but take good aim;
> nor touch a trigger,
> till you can see
> the whites of their eyes.
>
> Mason Weems
> quoting General Israel Putnam
> The Life of George Washington

When looking at small-company stocks — as measured by the Russell 2000 Index — a similar pattern is exposed. The Russell 2000 Index climbed +31.37% during Q4, for a YTD return of +19.96%. While the Growth Index component climbed +29.61% during Q4, for a YTD return of +34.63%, the Value Index component climbed +33.36%, for a YTD return of only +4.63% YTD.

This pattern reveals itself within market sector returns as well. The beaten-down cyclical sectors, such as Energy (+28.20% Q4) and Financials (+23.25% Q4), those which we avoided for several years, did lead during Q4, besting our portfolio sector overweights of Technology (+11.75% Q4), Communications (+13.85% Q4), and Health Care Tech (+9.24% Q4). However, on a YTD basis Energy (-32.81% YTD) and Financials (-1.83% YTD) finished in the red while our sector overweights finished the year at +43.57%, +26.82%, and +23.83% respectively.

US GDP contracted at an annualized rate of 5% in Q1, followed by an unheard of decline of 31% in Q2. With an equally staggering rebound during Q3 of 33%, the two back-to-back quarterly GDP numbers will be little more than statistically unreliable outliers in hind sight. The Atlanta Fed's GDPNow model estimate for US GDP growth in Q4 is +8.7%. If on target, the result for 2020 would be a total loss to GDP of a more historically reasonable -5.3% annualized loss.

Most full-year estimates for *global* economic output for 2020 reflect a 4-5% reduction to global GDP. The US has been impacted more severely than the global economy on average. And while the impacts within the US are likely to linger for longer due to continued and widespread resistance to basic containment measures, any objective observer is relieved that the economic fallout has not been worse.

Employment and consumer spending/consumption, currently, are the most impactful metrics we are watching. The trend in initial unemployment claims had been to the downside. The unemployment rate continued to fall. Personal spending rebounded from the bottom, although remained well below early 2020 levels. On the back of improving consumer confidence, the US economy continued to recover until the final weeks of 2020. Soaring infection rates, efforts to contain the spread of Covid-19, expiring unemployment benefits, and delays in the passing of additional stimulus measures negatively impacted employment, weakened consumer confidence, personal consumption, and business activity once again.

The upside, if one can be found, of the year's economic slowdown is that inflation risks remain low. December's CPI release showed a general price increase of just 0.4%, for a 1.4% increase over the last 12 months. Inflation is persistently running well below the Fed's target; "a sustained period of moderately above-target (2.0%) inflation."

Performance Review

Lake Jericho client portfolios are typically invested in some variation of either one of two general strategies - either a global-macro strategy broadly diversified by geography and incorporating varying combinations of multiple asset types executed via exchange traded funds, or a predominantly individual stock/bond strategy heavily biased towards US large-company technology, health care, and consumer-focused stocks. Within each strategy, asset type and geographic location has a meaningful impact upon returns.

Our continued commitment to meaningful small-company allocations, and our commitment to long-term investment themes represented by our sector overweight decisions, provided for meaningful outperformance for global-macro portfolios during Q4 and all of 2020. The market rotation away from technology and consumer-oriented stocks during the second half of Q4 negatively impacted our individual stock/bond strategy for the quarter, but the strategy widely outperformed for all of 2020.

Reviewing the bulleted benchmark returns that follow, you will see where and how Lake Jericho managed and advised portfolio returns were impacted. Within the table, we present the iShares (by Blackrock) Core Allocation ETF Portfolio Series benchmarks. Lake Jericho provides the tabled information for a relative performance comparison against independent, balanced, globally diversified strategies managed to similar risk profiles.

- The Dow Jones Industrial Average, 30 "blue-chip" US companies with an industrial company bias, finished Q4 with a total return of +10.73%, for a YTD total return of +9.72%.
- The S&P 500® Index, a broad, but committee selected index of 500 large-cap US companies, finished Q4 with a total return of +12.15%, for a YTD total return of +18.40%.
- The technology and consumer-cyclical heavy NASDAQ Composite Index finished Q4 with a total return of +15.63%, for a YTD total return of +44.92%.

The iShares Core Allocation ETF Portfolio Benchmark Series

Total Return Comparisons For All Periods Ending December 31, 2020

Core Allocation Portfolio (Ticker)	Q4 2020	YTD 2020	1 Year	3 Year Return	5 Year Return
Conservative (AOK)	5.11%	9.33%	9.33%	20.48%	38.53%
Moderate (AOM)	6.31%	10.02%	10.02%	22.22%	43.71%
Growth (AOR)	8.82%	11.41%	11.41%	24.76%	53.34%
Aggressive (AOA)	11.69%	12.81%	12.81%	27.43%	63.35%
S&P 500® Index	12.15%	18.40%	18.40%	48.86%	103.05%

- The iShares Core Allocation ETF Portfolio series is designed to meet the needs of investors who would like to maintain fixed target levels of exposure through a portfolio diversified across domestic, international, and emerging market equities, bonds, and other instruments. The Core Conservative Allocation Strategy seeks approximately 30% exposure to global equity markets. The Core Moderate Allocation Strategy seeks approximately 40% exposure to global equity markets.. The Core Growth Allocation Strategy seeks approximately 60% exposure to global equity markets. The Core Aggressive Allocation Strategy seeks approximately 80% exposure to global equity markets. Presented here is the iShares Core Allocation ETF Portfolio Benchmark performance, constructed with no management fees, and with no transaction costs, while Lake Jericho portfolio performance is actual performance, net of all fees, including investment management, administration, and transaction expenses.

- Small- and mid-sized companies (SMID), as measured by the Russell 2500™ Index, finished Q4 with a total return of +27.41%, for a YTD total return of 19.99%.
- International developed markets, as measured by the MSCI World (ex-USA) Investable Market Index, finished Q4 with a total return of +16.16%, for a YTD total return of 8.82%.
- International emerging markets, as measured by the MSCI Emerging Markets Investable Market Index, fared better than their developed markets counterparts and finished Q4 with a total return of +19.95%, for a YTD total return of 18.39%.
- The Bloomberg Barclays US Aggregate Bond Index, a measure of the performance of the US investment grade bond market, finished Q4 with a total return of +0.58%, for a YTD total return of +7.41%.

Near-term Outlook

Covid-19 defined the 2020 stock market. Lingering effects frame my expectations for 2021. Most hold lofty expectations for 2021. Although I remain constructive, I am less enthusiastic than most. As with other recent attempts by both the economy and the cyclical sectors to overtake their pure-growth counterparts, I tend more towards General Putnam's (or was it Prescott's) position of "don't fire until you see the whites of their eyes".

It is uncomfortable to watch much of the investment world move away from us in the short-run. But for Lake Jericho clients and advised portfolios we are, for now, remaining with our long-term outlook and current portfolio positioning. While we might, as a result, underperform broad-market indexes in this current rotation, I believe our commitment will again be rewarded during 2021.

As a forward-looking pricing mechanism, markets have priced in a quick arrest of the pandemic and quick economic recovery. With investors betting on rapid economic recovery, Q4's shift in market leadership to cyclical, value, and small-company stocks was not surprising. No doubt, the stock market enters 2021 with favorable trends:

- The S&P 500® Index ended 2020 about 60% above the Q1 lows. The NASDAQ ended 2020 with one of the five best years in its history. New market highs do tend to beget even more new market highs.
- S&P 500® Index company earnings are expected to rebound. FactSet estimates S&P 500® Index company earnings will surge 22.1% in 2021, more than double the 10-year average of 10%. Such a recovery would be the best increase since 2010, when earnings soared 39.6%.
- Fiscal stimulus just signed into law will lift consumer and business spending. Should the Biden agenda come to fruition, additional stimulus would further lift consumer, state and local government, and business spending.
- Multiple new vaccines will slow the spread of Covid-19.
- The Fed has assured markets that it will not raise short-term interest rates any time soon, suggesting short-term rates will remain near zero through 2023. Although there exist current and near-term pressures driving long-term rates higher, I do not believe those pressures will persist.

Heightened sentiment raises the risk that the slightest disappointments rattle overly-confident investors. Having safely side-stepped cyclical risks during 2020, I have no motivation to take on those risks now. It is exceedingly difficult to quantify the risk of high expectations. But a richly valued market is showing up in multiple gauges; put-call volume ratios, bull-bear spreads, sentiment polls, net foreign purchases of domestic investments. Indications of other's exuberance causes near-term caution within my contrarian mind.

Although richly valued, I do not believe that markets, or the technology and consumer stocks, are wildly over-valued. Certainly not so much so that it warrants a meaningful shift in our strategic, or even tactical, positioning. Rather, current market valuations and expectations call for restraint rather than following others headlong into a pro-cyclical rotation.

With investors betting on rapid economic expansion, the shift in market leadership to cyclical, value, and small-company stocks could continue. If growth broadly improves from a reopening economy, then, all else being equal, investors should seek out those cheaper sources of growth. If all goes according to expectations, cyclical, value, and small-company stocks should outperform their large-company, growth-oriented peers in the near-term.

But what if it does not?

At this point in time, and at least at fully-valued market levels, it is my opinion that the risks to valuations from potential economic disappointments outweigh the potential profits of following markets blindly into the same rotation.

- The new year arrives with elevated numbers of Covid-19 cases and hospitalizations. In the race between virus and vaccines, the latter have a lot of catching up to do. Markets are banking on immunizations to halt the virus, but we could be in for a rough surprise. A December 8th IBD/TIPP Poll found that just 52% of Americans stated that they are likely to get a Covid-19 vaccine. An additional 41% said they will refuse, and more than 1/3rd responded as skeptical of the vaccines. Numbers have improved in recent weeks, but still demonstrate the challenge before us, as 27% of New York state residents not already vaccinated when recently surveyed by Siena College Research Institute said they do not plan to receive a coronavirus vaccine.
- Although we are likely to have a third approved vaccine within days, the on-the-ground logistics of getting needles into arms has been disappointing. To reach herd-immunity, if possible, at the current rate of vaccination, it could take an additional 18 months to get close. The daily pace must increase significantly to reach expectations for a full reopening of the economy by late spring.
- The tracking of multiple mutations in the virus, particularly so the recent identification in South Africa of a variation that shows sign of an ability to escape the vaccine mechanisms, causes concern that herd-immunity might not be possible. Should Covid-19 become a constant companion, more of a seasonal, but more deadly, flu regimen, one that demands a continued adjustment in daily living, work, leisure? We have yet to grapple with the economic costs of such permanent disruption to normal daily living.
- With the thinest of margins in the US Senate, including deficit-hawks within the Democratic leadership, additional relief for individuals, corporations, and state and local governments is not a certainty.
- Likely by late 2021, and into 2022, we will begin grappling with the next mid-term election cycle. One can assume that state and federal budgets, and the tax implications resulting from the Covid-19 fight, will receive top-billing. Although I do not believe that Federal tax increases would ultimately be necessary, state and local governments will be another issue without Federal support. Regardless of necessity, the political potential for significant tax increases is among the primary reasons I lowered our long-run expected GDP growth rates.

From the early days of the Covid-19 downturn, I have held far more conservative expectations for economic recovery than the market, generally. My meaningful shift of our own global growth thesis, in lowering our long-run GDP growth trend line, and in projecting a negative-GDP growth rate for all of 2020 has thus far been spot on. We shall see if my revised forecast of not returning to sustainable growth rates until mid-2021 holds. On this last point, I am not the lone voice out on an unpopular limb. Just last week, Federal Reserve Chairman Powell claimed that the US would not return to pre-Covid economic activity before mid-year 2021.

Admittedly, I have been a bit too conservative in my estimates of the investment market recovery timeline. However, having positioned portfolios for less rosy recovery scenarios did benefit Lake Jericho clients when things worked out better than anticipated. We may not be so fortunate in the current environment should I be wrong. But then again, should things actually be less rosy than market consensus, we just might. I believe it the prudent path, nonetheless.

As always, I am available at any time, any day of the week, to discuss anything within this Outlook, or specific portfolio performance questions. Until then, be well. And thank you!

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