Summary:

- The passage of the December stimulus package and clarity around the vaccine timeline has renewed optimism for growth in 2021. Signs of long-term damage to the economy remain surprisingly limited so far and recently issued stimulus checks and extended unemployment insurance are expected to help to sustain consumer spending.

- The recent outperformance of small cap and value indices reflects a significant 2021 earnings growth rebound from companies most impacted by the pandemic and will likely continue for multiple quarters. Non-mega cap tech companies may outperform due to higher earnings growth.

- Emerging market equities appear best poised to outperform in the medium term, although Europe and Japan may benefit in 1H 2021 due to depressed valuations, growth acceleration and larger weights to cyclical sectors. We expect global equities to be supported by the lack of investment opportunities in a zero and negative interest rate environment.

- Inflation is unlikely to be a 2021 issue. The Fed’s “flexible average” inflation targeting (FAIT) strategy translates into keeping its policy rate at 0% through 2023-2025. This will avoid the upward pressure on interest rates which usually accompanies fiscal expansion. For this reason, the Fed’s policy enhances the effectiveness of fiscal policy at a low cost although it constrains monetary policy.

- 2021 risks include a slower vaccine rollout, a sharp rise in long maturity interest rates, policy missteps and a lack of funding for Fed emergency measures.

### Exhibit 1: Q4 2020 and YTD Asset Class Returns through December 31, 2020

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Q4 2020</th>
<th>Year to Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small Cap</td>
<td>35.0%</td>
<td>35.0%</td>
</tr>
<tr>
<td>EM</td>
<td>25.0%</td>
<td>25.0%</td>
</tr>
<tr>
<td>International</td>
<td>15.0%</td>
<td>15.0%</td>
</tr>
<tr>
<td>US Large Cap Value</td>
<td>5.0%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Europe</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Japan</td>
<td>-5.0%</td>
<td>-5.0%</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>5.0%</td>
<td>5.0%</td>
</tr>
<tr>
<td>US Large Cap Growth</td>
<td>10.0%</td>
<td>10.0%</td>
</tr>
<tr>
<td>Commodities</td>
<td>-15.0%</td>
<td>-15.0%</td>
</tr>
<tr>
<td>HY Bonds</td>
<td>-20.0%</td>
<td>-20.0%</td>
</tr>
<tr>
<td>Munis</td>
<td>-25.0%</td>
<td>-25.0%</td>
</tr>
<tr>
<td>Core Bonds</td>
<td>-30.0%</td>
<td>-30.0%</td>
</tr>
<tr>
<td>Treasuries</td>
<td>-35.0%</td>
<td>-35.0%</td>
</tr>
</tbody>
</table>

Source: Bloomberg
Market leadership shifted in the fourth quarter as seen in Exhibit 1. Large cap value and domestic small cap outperformed large cap growth in Q4 but lagged significantly year to date.

Value has only outperformed in 5 of the last 20 calendar quarters. See Exhibit 2. The outperformance of growth in 2020 compares only to the tech boom of the late 1990’s.

We could possibly see 2-3 more quarters of value and small cap outperformance. GDP growth acceleration and progress towards a full economic reopening should continue to benefit smaller and more cyclical companies.

The cumulative fiscal and monetary easing since March has boosted the availability of credit. Liquidity and solvency concerns have abated and there is an increased demand for equity and credit assets.

The GS Financial Conditions Index hit a record low in Q4 (Exhibit 3). A weaker dollar, credit spread compression, equity market appreciation and low interest rates have contributed to easier financial conditions, which are essential for strong growth in 2021.

Despite temporary weakness in Q4 due to shutdowns, global business surveys reflect optimism for a recovery. We expect continued improvement in new orders, exports and global trade volumes.

Equity valuations are elevated but the equity risk premium (ERP) for the S&P 500 is not at an extreme. High current valuations may limit overall gains, but equities are attractive relative to bonds.

We expect significant earnings growth in 2021 due to higher operating leverage and acceleration of GDP growth through the economic reopening phase.

Mega cap tech companies are skewing valuations higher and may underperform in the future. We expect market breadth to expand in 2021 and recommend rebalancing into more diversified portfolios.
We don’t expect significant legislative reform from the change in government this year. The early focus will be on the virus, vaccine distribution and additional stimulus.

The Fed’s Flexible Average Inflation Targeting (FAIT) will keep overnight rates at 0% and asset purchases at $120B per month through 2021.

Unemployment should continue to fall throughout 2021 as lockdowns ease. The December stimulus package should buoy consumption in Q1 and Q2.

The euro area economy likely contracted in Q4 due to additional lockdowns.

The EU Recovery Fund will be more stimulative than post 2008 measures. A deepening of the recovery is dependent upon increased capital investment and lending.

The ECB and BOE will extend asset purchase programs. We don’t foresee inflation reaching central bank targets in the UK or EU in 2021.

Japanese Q4 growth will slow, but vaccine progress and confirmation of the summer Olympic games should propel the economy to above trend growth in 2021.

Japanese cyclicals should benefit in 2021 but technology related industries provide upside longer term.

The BOJ will likely maintain yield curve control and keep rates at 0%. JGB issuance should wane unless another fiscal stimulus is required.

China’s ability to contain COVID has resulted in a broadening of their recovery. Retail sales, fixed asset investment and exports have all accelerated.

Asian economies have led the recovery. Latin America economies have struggled with containing the virus. We favor Asia but more cyclical countries may outperform in the near term.

EMs should attract capital flows in 2021 due to the continuation of easy monetary policy in DMs. We expect broad EM currency appreciation relative to the US dollar.
Asset Class Views as of December 31, 2020

Domestic Equities
- We recommend an overweight to US equities in 2021. Acceleration in US GDP growth and earnings growth provide a backdrop for positive returns over the next 12 months. We expect equities will outperform fixed income.
- We believe the market leadership that occurred in the fourth quarter could continue in 1H 2021. We remain diversified and continue to monitor our holdings and managers.
- We foresee continued volatility in 2021 and expect multiple 5-10% corrections as forecasts and policies change.

International Equities
- For non-US developed markets, lower starting valuations, higher weightings to cyclical sectors and a depreciating US dollar may lead to outperformance in a strong recovery. We will maintain an equal weight until we have more clarity around the vaccine rollout and economic data.
- EM outperformed non-US DM in 2020 due to a large index weight in China and internet companies. Like the S&P 500, the MSCI EM Index has become concentrated in large cap technology companies. We foresee a leadership shift in 2021 and favor active managers. We continue to prefer an overweight to Asia in our emerging markets allocation and may overweight EM sometime in 2021.

Fixed Income
- Longer dated US Treasury yields drifted higher in the fourth quarter but real yields are still negative. Central bank buying and easy monetary policy is unlikely to abate in the near future. Further stimulus and YoY inflation comparisons that exceed 2.0% could put upward pressure on yields, but we believe 10-year Treasury yields will peak near 1.50% in 2021. We remain underweight duration and overweight credit relative to the Bloomberg Barclays US Aggregate Index.
- We are overweight high yield credit and securitized credit in our fixed income allocation through active managers. Credit selection will be important as we see high dispersion amongst issuers in 2021. We are maintaining our position as buyers of non-agency RMBS. A strong housing market and lower unemployment has helped valuations.
- Private or less liquid credit strategies offer a significant pick-up in yield relative to liquid strategies.

Alternatives/ Real Assets
- The Fed is not purchasing lower rated corporate bonds and parts of the securitized credit market. These securities are significantly mispriced and offer potentially attractive total returns for investors with 3-4-year time horizons.
- We are evaluating distressed opportunities in leveraged loans, unsecured bonds and real estate for investment in 2021.
- We continue to believe private equity secondary positions will be available at significant discounts in the coming quarters.
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**Municipal Bonds:** Barclays Municipal Index is an unmanaged index that is considered representative of the broad market for investment grade, tax-exempt bonds with a maturity of at least one year.

**US Treasuries:** Barclays US Agg Total Treasury is a subset of the Barclays Aggregate US Bond Index and consists of most US Treasury bonds with a maturity of one year or more. It excludes TIPS and STRIPS.

**High Yield:** Barclays US Corporate High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody’s, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included.

**Core Taxable Bonds:** Barclays US Aggregate Bond Index, which used to be called the “Lehman Aggregate Bond Index,” is a broad base index, maintained by Barclays Capital, represents investment grade bonds being traded in United States.

**Commodities:** Bloomberg Commodity Index is made up for 22 exchange-traded futures on commodities that represent 20 commodities. These commodities are weighted to account for economic significance and market liquidity.

** Emerging Markets:** MSCI Emerging Markets Index is a stock market index that is designed to measure the equity market performance of emerging markets outside developed markets, markets such as Brazil, China, Russia, etc.

**International Equities:** MSCI ACWI ex US Index is a stock market index that is designed to measure the equity market performance of all equity markets excluding the US.

**Europe:** The Stoxx Europe 50 Index covers 95% of the free-float market cap of the stocks in Europe.

**Japan:** The TOPIX Net Total Return Index includes the stocks traded on the Tokyo Stock Exchange. It has approximately 1700 companies.

**S&P 500 Index** includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

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