AMB Wealth Management

Market Update January 8, 2021

2020 Recap

In March, it would have been difficult to find predictions of equity markets posting double-digit returns by year's end. The economy was in shambles as societies around the globe shut down. Supply chains were destroyed and millions of people were without a job. However, the economic trough seemed to bottom out in the summer and the recovery began thereafter. The recovery did not occur in a vacuum as it was aided by the biggest fiscal and monetary support in history. Additionally, positive vaccine news and the reopening of world economies helped spur the recovery along. For the year, US equity markets once again outperformed the rest of the world.

The outlook from our October letter has largely played out as anticipated. In it, we thought the economic low was behind us and anticipated a recovery. We said specifically, "We would expect the more economically-sensitive sectors to begin to outperform. We would also expect to see a shift in style winner, where emerging markets, small and mid-cap companies start outperforming developed large caps." This happened during the last quarter of the year with U.S. small-cap, mid-cap and value's outperformance over large-cap and growth stocks. This rotation into cyclical, economically-sensitive sectors was further evidenced with the strong performance in emerging market equities.

Fixed Income Markets

This year has been difficult for fixed income investing. While rates have increased recently, the 10-year Treasury is only slightly above 1%, making an attractive income stream very difficult to find. Further, credit spreads tightened dramatically earlier in the year when the Federal Reserve stepped in to backstop much of the credit markets. This reduced the rewards for taking risk as default risk seemed to be non-existent for many fixed income markets.

Our outlook for fixed income has not materially changed since last quarter. We are maintaining a more neutral duration portfolio. This means we are investing closer to the front end of the yield curve as we do not believe there is sufficient reward for the risk assumed with investing further out. Also, in our view, increasing credit risk is likewise unfavorable as yield suppression caused by the Federal Reserve's backstop does not reflect the true risk of the credit markets. It now appears the Democratic party will control both the house and senate along with the presidency which raises the probability of tax increases at the federal level. As a result, we may see demand increase for tax-free municipals; but with yields where they are, a dramatic move is unlikely.

We believe fixed income continues to offer diversification from equity markets, but yields have now become scarce. We are focusing our attention on only the highest of quality names in the credit markets and reducing our duration exposure until we believe risk/reward dynamics have better aligned themselves.

Equity Markets

As is evident to all, 2020 was a year of extremes and perhaps this was most evident in the performance of growth and value in the equity markets. From the March lows, growth stocks rocketed past value stocks with the spread between the two styles growing to over 3300 basis points – the largest disparity in history. This move was very reminiscent the Nifty-Fifty and the Dot-com bubbles. In addition to this valuation divergence, 2020 was a record year for IPOs with companies raising hundreds of billions of dollars through 480 IPOs. Retail trading took off and fundamentals seemed to be thrown out the window. However, as we know, the more price appreciation that is pulled forward, the less one will have in the future. This was our thinking heading into 2020 when we positioned to a more value-oriented portfolio. That move was premature and the pandemic exacerbated it.

In the fourth quarter, we began to see this trade unwind as value began to outperform with small caps leading the way. This was brought on by better-than-expected economic numbers, inflation expectations increasing, and interest rates moving up. We discussed in our October letter that historically, value stocks tend to outperform for an approximate two-year period following a recession. We believe this trend could be starting and have kept our portfolios tilted toward fundamentally sound companies trading below their intrinsic value.

We believe 2021 will be more volatile than most other market participants predict. A new administration is taking over with a majority in the House and Senate. This could lead to tax rates increasing on corporations and individual investors along with increased regulations to name a few. However, it may also bring more fiscal help than what the market has priced in which would further benefit the more economically-sensitive sectors.

With the vaccine rollout starting and global economies beginning to regain their footing, we expect fundamentals will once again be the driver of stock performance and not rampant speculation. As of now, we do not believe the overall market is in a bubble, although we continue to believe that some specific sectors and styles are. In our view, as long as we do not have a double dip recession, value will continue to outperform.

We will continue to navigate this difficult environment to the best of our ability. As always, we at AMB thank you for your support and allowing us to help you reach your financial goals.

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