WESTEND
Advisors

Economic and Market Commentary

December 14, 2020

2020 Year-in-Review
Reflection on Inflection

The COVID-19 pandemic ended a decade-long bull market, but the COVID bear market reversed almost as quickly as it began. 2020 has since been a story of resilience and recovery, with risks and opportunity along the way.

As we near the end of 2020, we look back at some of the year's key economic and market developments, as well as how our portfolio allocation decisions evolved along the way (see call-out boxes).

FROM LATE-CYCLE CAUTION…

We entered 2020 with cautious optimism that the decade-long economic expansion and bull market could continue with slowing but positive economic and earnings growth and moderate market returns. We expected selective opportunities for outperformance at the sector level. At the same time, we believed that the maturing economic cycle and extended equity valuations made the market vulnerable. In our view, 2019's strong equity returns had gotten ahead of economic fundamentals. This view was reflected in portfolio adjustments we made in the second half of 2019 and early 2020 to reduce the economic sensitivity of portfolios, including eliminating large-cap U.S. Financials exposure and selectively reducing equity exposure.

…TO UNPRECEDENTED ECONOMIC INFLECTION

Initially, 2020 seemed to be developing as we had anticipated, then COVID-19 began to spread widely outside of Asia. The first case of COVID-19 in the U.S. was confirmed on January 21, U.S. restrictions on travel from China were enacted on February 2, and, on February 25, the CDC warned Americans to be prepared for local outbreaks. As we now know, the coronavirus was already spreading widely, and the decade-long global bull market had peaked on February 19 as the S&P 500 began its sharpest decline from a peak on record, falling more than 30% in just 22 days.

To navigate portfolios through this rapidly evolving backdrop, we continued to rely on our data-driven investment approach, which incorporates flexibility to focus on information that we deem most important in a given environment. We focused our attention on higher frequency and near-real-time data, including various weekly economic releases, daily consumer mobility and consumer activity, and daily COVID-19 case data. By mid-March, total U.S. cases of COVID-19 moved into the thousands and localities began instituting "stay-at-home" orders. Our analysis led us to reduce the expected economic sensitivity of our already defensive positioning.

Feb. to Mid-March 2020
Increased overall U.S. allocations and less economically sensitive U.S. sector exposures; trimmed cyclical U.S. sector exposures and corporate bond exposures.

U.S. and global economic activity began a rapid decline in March and essentially fell off a cliff in April, largely matching the steep market selloff. U.S. industrial production fell nearly 17% and the number of employed Americans dropped by more than 25 million from February to April as shutdowns took hold. New unemployment insurance claims peaked at nearly 7 million per week and credit market functioning deteriorated at the end of March. The initial shock of March carried over to Q2, as U.S. real GDP declined at a -31.4% annualized rate. The economic decline in Europe was even more severe, while many economies in Asia, the original epicenter of the pandemic, held up relatively well. Unsurprisingly, more economically sensitive sectors were generally hit hardest in the market downturn, while less cyclical sectors like Consumer Staples and Health Care outperformed.

REBOUND AND RECOVERY

In mid-to-late March, however, our analysis of high frequency data, fiscal and monetary responses, and medical developments signaled that conditions were emerging for an economic turnaround. Given the market declines to that point, our analysis also suggested we may be closer to the end than to the beginning of the market downturn. We began to pivot our portfolios' positioning with what became the first of several actions throughout the year to increase expected economic sensitivity of portfolios as we sought to balance risks with opportunities presented by a prospective turnaround.

Mid/Late March 2020
Pivoted toward higher economic sensitivity, e.g. trimmed U.S. Cons. Staples and added new U.S. Energy, Industrials, and Financials allocations, and, in global portfolios, added a U.S. small cap allocation.

The U.S. economic recovery and market rebound began as sharply as the downturn. That said, the pace of recovery has slowed somewhat recently, and we see a

dual-speed recovery when we dig below the headline data. Goods production and consumption have rebounded sharply, while many areas of the service economy remain depressed. Similarly, while many white collar jobs transitioned to remote work and have been relatively insulated from the economic impacts of stay-at-home orders, lower wage jobs in areas like hospitality bore the brunt of the downturn and have been slow to recover. Still, many economic measures have made significant recoveries. The U.S. has added back over half the jobs lost in the downturn, Q3 GDP regained over half its earlier decline, and new orders for non-defense capital goods ex-aircraft (a proxy for business investment) rose over 6% year-over-year in October.

Consumer resilience has been a key factor in the U.S. economic recovery, in our view, supported by an unprecedented amount of fiscal stimulus. Even as the U.S. unemployment rate spiked to 14.7% in April, personal income *rose* sharply. Direct stimulus payments to consumers and supplemental unemployment benefits *more than offset* the aggregate decline in wages and salaries from job losses in the spring and summer, in part because job losses skewed toward lower-income workers.

Internationally, many Asian countries demonstrated some of the greatest success in containing coronavirus spread, using various approaches including testing, lockdowns, and contact tracing. As a result, many Asian countries were able to begin reopening their economies well before western countries, and they are generally farther along in economic recovery. Europe, in contrast, continues to struggle with reopening amid the current COVID-19 resurgence, and also faces ongoing uncertainty from factors like the imminent prospect of a no-deal Brexit.

June 2020
Further increased economic sensitivity, e.g. eliminated large-cap U.S. Utilities exposure and added to U.S Industrials.

Global equities have rebounded sharply from March lows, led by relatively economically sensitive areas of the U.S. market, including large-cap Industrials, Materials, and Info. Tech, as well as U.S. small cap stocks. Emerging markets also outperformed international developed markets in the rebound, even as China underperformed. Overall, global markets have achieved new highs in late 2020. Thus, while the COVID-19 pandemic ended the longest bull market in at least a century, a new one has begun almost as quickly as the last ended.

THE U.S. ELECTION

We believe the 2020 election played a supporting role in the market's rebound as the year progressed. Joe Biden's primary win in South Carolina on February 29 set him on a path to secure the Democratic nomination. This aligned with the first pause in the stock market's pandemic plunge – perhaps not coincidentally, as it eased investor fears of an extreme-left agenda topping the ticket.

As the Presidential race progressed, it was widely perceived as too close to call, but markets increasingly seemed to appreciate that divided government was the most likely outcome, regardless of who won the White House. Thus, for much of the year, we believe the lack of a strong consensus limited the risk of a market-dislocating surprise, and markets largely looked past the Presidential race to an environment with limited legislative risk.

August to December 2020
Continued to increase expected economic sensitivity, e.g. reduced large-cap U.S. Staples exposure; added to U.S. Financials, EM Asia, and corporate bond allocations.

AS 2020 ENDS - DARKEST BEFORE THE DAWN?

Today, we are in the midst of a serious resurgence in coronavirus infections, with daily new confirmed cases more than triple the level of their summer peak, hospitals reportedly approaching capacity across the country, and deaths at a new high despite improved treatment regimens. Still, there are reasons for optimism. The FDA has just approved a vaccine that has shown about 95% efficacy. We believe this could put the ongoing U.S. recovery on a faster trajectory than our previous assumptions. Further, the contentious 2020 election is largely behind us with what seems to be a fairly benign outcome for markets, interest rates remain near their lowest levels on record, and additional stimulus seems likely, in our view.

We continue to analyze the evolving economic, political, and market landscapes. We look forward to providing our formal 2021 outlook as part of our regular Q4 2020 commentary in early January.

WestEnd Advisors Investment Team | December 14, 2020

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