Market Review and Outlook—January 9, 2021

WOW—The human impact of the global COVID-19 pandemic has been horrific. While the market impact was horendous for the first half of 2020, by year-end both stock and bond markets had fully brushed off the worst pandemic in a century. The table, below, shows only one loss out of 55 trailing performance measurements.

Borrowing from Tomorrow—While inflation is low, as it has been for years, a reasonable annual return goal for a portfolio is 6%. In the past two years, the Moderate Allocation Morningstar category (a proxy for a moderate risk portfolio) has earned 30%, unannualized. Thus in two years investors have earned five years' worth of returns. The piper will have to be paid eventually. These very high two-year returns have left bond prices very high, and this leads us to expect that bond returns for the next few years will be very low. Stocks are more complicated, however, overall, we expect lower-than-average results from stocks for a few years.

Bonds' 2020 Results—Most quality bonds did fine in the first half of 2020, averaging almost a 5% return. In the second half they slowed down, but still posted a solid 2% gain. Opportunity bonds, however, had a poor first half, falling about 3⅓%, but then in the second half they returned about 8%. Despite this strong second half recovery, for the full year, most quality bonds outperformed most opportunity bonds in 2020.

Stocks' 2020 Results—There are many more ways to slice and dice up stocks than bonds, but, like bonds, 2020 brought a "tale of two halves" for stocks. The S&P 500 US stock index lost 3% in the 1st half but jumped over 22% in the 2nd. The MSCI foreign stock index lost 6¾% in the first half, but surged over 25⅓% in the second. Sectors mattered a lot in 2020, none more so than technology, which gained 14¼% in the first half (dramatically bucking the trend), and then leaping almost 36½% in the second half, gaining almost 56% for all of 2020. Healthcare, like technology, gained in both halves, but less than tech. Growth stocks largely fared OK in the 1st half, and then soared in the 2nd. Most value stock funds fell, 15% or more, in the first half. Thankfully, most value stock funds gained a lot in the 2nd half, close to as much as growth stock funds. As our newsletter article notes, in the last months of 2020 value stocks actually outperformed growth stocks. These trends were true both in the US and overseas.

Markets in Denial?—There is a dramatic disconnect between the 2020 stock markets, the economy, and the pandemic. The disconnect is largely one of timing, as investment decisions today are driven by earnings forecasts in 2+ years, and this pandemic is expected to be largely behind us by the end of 2021. Even so, the lack of losses in the table, below, is almost incomprehensible. Investing can seem to be a parallel universe, especially in 2020.

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.00%	+0.27%	+1.23%	+0.87%	+0.44%
Intermediate Core Bond	+0.95%	+7.52%	+5.11%	+4.26%	+3.69%
Intermediate Muni Bond	+1.92%	+4.51%	+3.99%	+3.23%	+3.89%
Large-Cap Stock	+12.81%	+15.83%	+11.89%	+13.39%	+12.28%
Mid-Cap Stock	+20.78%	+12.39%	+8.27%	+11.08%	+10.32%
Small-Cap Stock	+28.06%	+10.99%	+6.41%	+10.50%	+9.83%
Foreign Large-Cap Stock	+15.77%	+9.30%	+4.18%	+7.57%	+5.33%
Health	+14.70%	+27.63%	+16.12%	+11.77%	+15.97%
Real Estate	+11.15%	-4.49%	+4.18%	+5.26%	+8.07%
Technology	+21.90%	+55.91%	+26.79%	+25.41%	+17.79%
Moderate Allocation (60% stocks)	+10.30%	+11.72%	+7.76%	+8.99%	+7.90%

The data in this table comes from Morningstar and is as of December 31, 2020.
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What Have You Done For Me Recently?—As noted in the first page, investors have earned about five years' worth of returns in the past two years. That said, I am skeptical that investors will be pleased with zero returns for the next three years. I know that at Mallard we would not be at all pleased. So what are we doing?

Eating an Elephant—Planning for investing in 2021 reminds me of the question: "How do you eat an elephant?" The answer is "One bite at a time." While we really prefer to emphasize the big picture, the overall stock/bond balance, the unique challenges we face in 2021 lead us to spend more time focusing on the individual decisions. The bond/stock balance for each client's portfolio is indeed very important, however that is primarily the client's decision. The Investments Division's high level strategy at this time is to increase our lean into stocks, and thus lean away from bonds, due to our conviction that the odds are much higher than normal for stocks to outperform bonds in the coming year or two. The Division also focuses on trying to obtain the best results from our clients' bonds (whether 20% or 80% of their portfolio), and, similarly, trying to obtain the best results from our clients' stocks.

Bonds First—In 2021, with bond prices historically high, our two-level classification of bonds is more important than ever. We divide bonds into quality bonds and opportunity bonds. Quality bonds are higher-quality bonds, which trade primarily on the movement of interest rates. When analysts note that bond prices are high, they are typically speaking of quality bonds. With quality bond prices high, their yields are low. This leads to a situation in which returns from quality bonds for the next two or so years are likely to be very low, and can even produce losses. We expect that 2021 will be closer to the second half of 2020, with opportunity bonds more likely to continue to outperform quality bonds.

For these reasons, we are following two strategies with our quality bonds. First, we are minimizing them. A neutral stance is to hold 80% of clients' bonds as quality bonds. We have cut this to 60-70% allocation to quality bonds. Quality bonds still serve a critical role as a stabilizer to portfolios during uncertain times (as we saw clearly in early 2020), and as such we feel that it would be inappropriate to cut quality bonds much further. The second strategy is to be very deliberate with the maturity of clients' quality bonds (remember, these bonds' prices trade primarily based on movement of interest rates). With interest rates so low, we agree that the next move should be upward (hurting returns from quality bonds), however the continued weakened economy leads us to expect that interest rates will not move up anytime soon. We thus are holding a smooth balance of short, intermediate, and long-term quality bonds.

We have no earth-shattering revelations to share with our opportunity bond strategies. We continue to blend high-yield bonds, bank loan (floating rate) bonds, and largely unconstrained, multi-sector bond funds. We believe that this portion of clients' bonds is most likely to outperform in 2021, and so in most client portfolios we plan to introduce a new fund to the multi-sector sleeve, to broaden the 'opportunity set.' It is worth mentioning that municipal bonds are less overpriced, and so our strategies for clients with municipal bonds are closer to our 2020 strategy.

Stock Conundrum—We can justify today's stock prices. Markets are expecting very strong economic growth to begin by the 2nd quarter and to remain very high for a full year. The recent Georgia Senate election results are likely to boost this further, as a followup COVID-19 relief bill becomes likely. Nonetheless, this upcoming economic growth is already priced into market levels. It enables us to say that stocks aren't expensive. Economic growth past early 2022 is not expected to be great. Thus stock market growth from this point is uncertain. There are some areas that appear a bit pricey, but also some that appear to offer reasonable prices. Given their very strong trailing results, we are no longer leaning into technology. We are maintaining a modest lean into healthcare, as they did not enjoy the sky-high gains in 2020 that tech did. We are leaning a little more into value for 2021, and we are introducing a fairly significant lean into real estate. The weak (very weak, compared with most stocks) trailing results for real estate has created, we believe, a very attractive entry point to establish an ongoing lean into real estate. We feel that this piece of the stock portfolio offers solid return expectations, with much more downside protection than most stock categories.

It's Foreign to Me—It appears that in late 2020 we are finally seeing foreign stocks begin to outperform US stocks. We have been expecting this for a long time, and thus are already positioned for this. We expect this to continue through 2021, but don't need to make any further changes to prepare for this overdue change.