

January 21, 2021

TO: All BMT Clients
FROM: Eileen Alexanderson, Christine Ackert and Dana Manganelli
cc: Kelly Murphy and John Tortolani
RE: ***2020 – YEAR OF GREAT DISRUPTION***

We experienced disruption in just about every aspect of our lives in 2020. The Covid-19 pandemic may be the Ultimate Disruptor. A recession was a side effect of the pandemic. This was not a typical recession, nor was the action taken by the Fed and the Administration to address the situation typical. We witnessed both the fastest bear and bull markets in history. Simultaneously, there was hardly a sector in the economy not being disrupted by new applications of technology. “Unprecedented” was the word used most often to describe both the events of 2020 and the remedies.

US equity markets advanced to new highs, finishing the year +18.4%. For most of the year this action was led by a handful of the largest technology companies which were the most obvious beneficiaries of pandemic. These stocks were bid up for their visible growth in an environment where growth was scarce. Record low interest rates also accommodated higher multiples on the earnings of these companies. The technology sector of the S&P 500 rose an amazing 43.9% for the year. The equal weighted S&P Index, more representative of the broader market, gained 12.8% despite spending three quarters of the year in negative territory. Growth styles of investing far outpaced Value with the Russell 1000 Growth Index advancing 38.5% vs a paltry 2.8% advance by the Russell 1000 Value Index. Importantly though, in the fourth quarter, for the first time in recent memory, markets rotated to favor Value over Growth with a 16.3% advance compared to 11.4% in the relevant indices. The Russell 2000 Small Cap Index, always more sensitive to the economy, rallied 31.4% in 4Q. International equity markets, which have consistently lagged their US counterparts, came to life in Q4 with a 17% gain in the MSCI World x-US Index.

Markets were remarkable in adapting to the flow of news and information throughout the year including the Democratic victories in the November elections and January’s run-off in the State of Georgia, deciding the benefit of strong stimulus and spending to come from the Biden/Harris Administration outweighs the negative consequences of the more than likely higher taxes and

renewed regulatory efforts from Democrats to come later. Markets focused mostly on the light at the end of the Pandemic tunnel rather than the pain at hand. At current high valuation levels, markets clearly are looking forward to a remarkable recovery in the year ahead. Despite a depression like environment for several sectors including leisure and hospitality, both the manufacturing and services purchasing managers indexes (PMI) are solidly in positive territory. Cyclical sectors of the market are in recovery mode with easy earnings comparisons beginning in 1Q21.

Interest rates moved to record low territory as part of the remedy to the pandemic. As rates dropped, fixed income index returns advanced in the mid to high single digit range led by credit sensitive bonds as spreads over Treasuries tightened. By Q4, though, bond markets began to reflect some expectation of rising inflation, leading to higher rates on long-term US Treasuries and slightly negative returns.

On the cusp of a cyclical rebound and better economic growth, we would like to touch on several issues top of mind for investors:

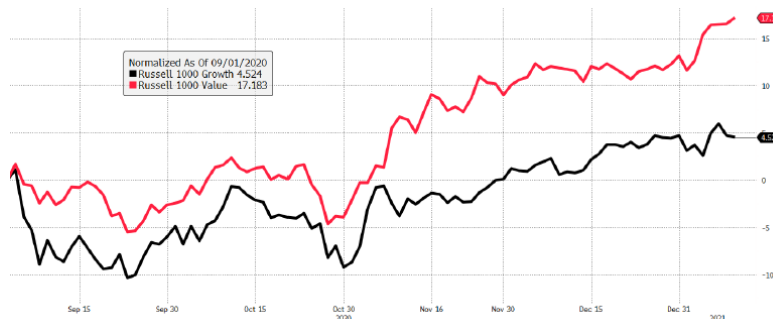
THE GREAT DEBATES

Debate #1 - Do we have a stock market bubble?

Price/earnings multiples are high vs. long-term average multiples so it will be of critical importance for companies to “grow” into these high multiples in 2021 and 2022. Significant liquidity, higher savings rates, stimulus checks, and extreme efforts to support markets and the economy presently provide a backdrop that allows patience as companies do. Earnings comparisons should be quite positive when held up against the most difficult times of 2020. We know Corporations have trimmed expenses through the downturn, also setting the stage for better earnings and profit margins. While “the market” looks rich in valuation there are numerous pockets of opportunity and inexpensive stocks. We acknowledge some speculative activity in cryptocurrencies, special purpose acquisition companies, and a heady IPO market. Also, we should remember that this is a market unnaturally supported by accommodative monetary policy, which will not be with us indefinitely. Historically, modest corrections in the neighborhood of 10% are common in most years. Near term, we do not see imminent risk of a “bubble bursting”.

Debate #2 - Is the long awaited rotation to Value from Growth here to stay?

RUSSELL 1000 GROWTH VS VALUE SEPTEMBER 2020 - JANUARY 2021



Typically, Value oriented investing leads markets as economies emerge from a period of recession. Many components of the Value universe certainly seemed due for some catch up. The recent rotation since September toward value oriented sectors as can be seen on the above chart does have substantial underpinnings, though a full rotation toward Value is dependent on a durable economic recovery. Financials have been rallying because loan losses look to be less than originally feared and the now steepening yield curve puts the lending business back in a moneymaking mode. The Energy sector, which experienced massive pressure when oil prices fell in the face of global growth grinding to a halt is now rallying with demand recovering and a tighter supply situation around the world. Both sectors offer vivid examples of the extent of disruption technology brings. As the new Administration moves to address the impact of climate change, companies focused on clean energy, energy efficiency, and solutions for the impact of climate change have a much brighter outlook than those with a core business centered in fossil fuels. Similarly, the financial sector's competitive landscape is being significantly disrupted by the accelerated migration to mobile payments and mobile banking as well as market share gains by non-bank lenders. Even the Insurance sector is in the throes of change as technology based analytics disrupt the pricing structure of the industry.

Often a rotation in dominance from one style of investing to another involves a significant correction in the share prices of the companies which have been the leaders. This time may be different in that there are such strong secular drivers that will continue to enable many sectors within the Growth space to deliver strong and accelerating profit growth and coincident strong stock price appreciation. Rather than a significant correction, we may see a contraction in the current high valuations of the largest Tech leaders like Facebook, Apple, and Netflix as their

revenue growth decelerates from levels inflated by the pandemic, and a rotation to a new set of growing companies exposed to areas like Cloud Computing, 5G, and Cyber Security, just to name a few. Innovation in Healthcare offers a multitude of growth opportunities. Likewise, though, great secular growth opportunities are also present in value oriented sectors of the market as supply chains are repatriated and rebuilt and automation improves productivity of manufacturing plants. We encourage representation of both Value and Growth styles in our clients' portfolios.

Debate #3 - Inflation

Given the historic amount of stimulus, one could say that inflation is inevitable. However, until very recently the market has put this concern 'on the shelf' for another day. Inflation is a matter of concern because typically once inflation starts to heat up the Fed steps in and raises rates to cool the economy which often results in a recession. With the somewhat unexpected shift in the US

Senate to Democratic control, inflation concerns have moved to the fore. Long-term Treasury rates have moved well off the bottoms reached in March. The more deficit spending and stimulus is pursued by the new Administration, the heavier the national debt burden will become, the more the US \$ will weaken, and the more likely it is that we will see inflation. Those more skeptical about inflation make the case that the inflation we would naturally expect will be offset by the deflationary disruption occurring in so many sectors of the economy.

ONE EXCITING HIGHLIGHT

This year has seen broader acceptance and recognition of the importance of environmental, social and governance factors. For a very long time our faith based clients have articulated these as priorities in their investment policy statements. We see greater acceptance at both the Corporate and Investor levels. It feels like we are at a crossroads in that companies who choose to avoid consideration of these factors which support sustainability on so many fronts will be left behind. Corporate Managers have come to understand that they must serve a broader set of stakeholders which includes employees, customers, suppliers, and the environment rather than just shareholders.

THE OUTLOOK - Still many risks but a light at the end of the tunnel!

Unfortunately, we are by no means "out of the woods" mainly due to the pandemic. Risk that the pandemic is extended by new strains of the virus and delays in vaccinating the public is real. While some quadrants of the economy are certainly well into recovery, the issue of high unemployment especially, in our lower income population, will be more challenging to address but is of the



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utmost importance. Despite the Democratic victories, without a strong majority we are likely to see a fair amount of political gridlock which markets usually respond well to, but the present tension and turmoil within both political parties which has spilled over to parts of the general public is an unwelcome disruption.

Mention of another “roaring twenties” environment post pandemic may be appealing in what it could mean for equity markets but is somewhat worrisome given the outcome for markets in that period a century ago. Remembering investors in the year 2000 banking on the “New Economy” bid stock prices up only to be disappointed when the tech bubble burst, but it does feel like we are in a period of transformative innovation with great investment opportunities ahead. In the meantime, money supply growth has been robust due to huge stimulus. Personal savings rates have doubled as many consumers banked stimulus, providing visible spending power post pandemic. Merger & Acquisition activity has increased. Many corporations are poised to restart share repurchases. Manufacturing and Service Purchasing Manager Indexes are firmly in positive territory and bode well for a rebound in corporate profits. These are all positive factors for equity markets. While the Fed is committed to keeping short-term rates low, it will be important to keep a close watch on the yield curve with long-term Treasury rates creeping higher. Low rates and negative real rates on fixed income investments have been drivers of equity market flows and the current generous valuations of markets. Most importantly, a Fed Chair biased toward rates “lower for longer” and a Government with propensity to provide varied sorts of stimulus is a definite positive for investment returns.