Quarterly Investment Perspective

Aldo S. Vultaggio, CFA®, CPA, AIF®, Chief Investment Officer First Quarter 2021

Key Points:

- *After losing more than one-third of their value (in about a month) earlier in the year, global stock markets in aggregate ended 2020 with significant gains for the second consecutive year. We expect a vaccine-driven recovery, fiscal stimulus, low interest rates, and contained inflation to continue providing support for both stocks and bonds.*
- *We expect that central bank monetary stimulus and government fiscal support will continue to keep the economic recovery on track. Although stimulus will be important in the near-term, successful vaccination deployment efforts will be more critical for a sustained long-term economic recovery.*
- *Looking ahead, it seems likely that the world will soon start to overcome this terrible pandemic. Even so, investors should be prepared for current challenges and for the bumps along the road to recovery. We outline a few ways that we are helping clients to be well-positioned for the year ahead.*

Market Review

Stocks go from bear market to new bull market cycle

After losing more than one-third of their value (in about a month) earlier in the year, global stock markets in aggregate ended 2020 with significant gains for the second consecutive year. (See **Figure 1**.) Throughout most of the year, investors looked past the continued spread of COVID-19, and instead, focused on a combination of unprecedented monetary and fiscal stimulus, as well as positive news on vaccine development and distribution. Global stocks ended the year at record highs despite U.S. election uncertainty.

Bonds once again exceed return expectations

Bonds broadly gained in 2020 as the U.S. Federal Reserve lowered interest rates to zero in March, and in September said that it would peg interest rates near zero through at least 2023. Meanwhile, central banks worldwide have remained committed to buying government and other high-quality bonds to support the smooth functioning of bond markets and to keep interest rates low. These central bank bond purchase programs have benefited investors who own investment-grade bonds in their portfolios. Demand for safe bonds remains strong amid continued uncertainty about the future.

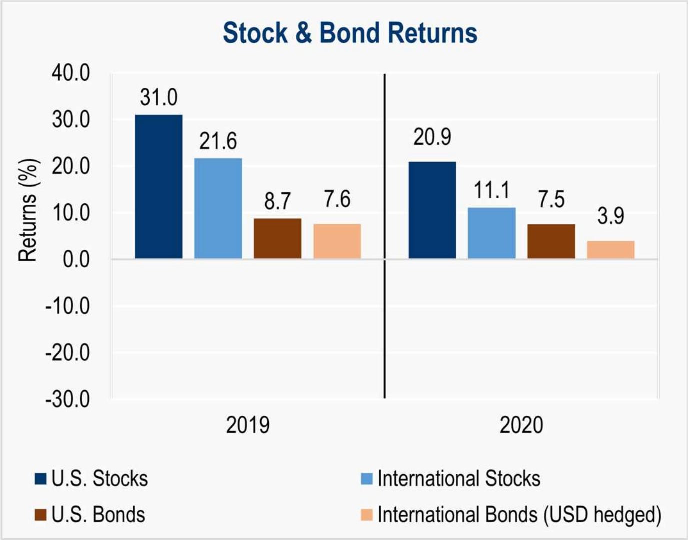

Figure 1. Despite an uncertain 2020, overall stock performance was strong, with each successive COVID-19 wave having had a smaller market impact amid unprecedented stimulus. Both U.S. and international stocks finished the year in positive territory as Congress approved another economic relief bill and the U.K. finally approved its post-Brexit trade deal with the European Union. Meanwhile, bonds benefited from lower interest rate policies worldwide. Strong demand from central banks and investors further boosted high-quality bond returns.

Source: Morningstar, Russell, MSCI, Barclays. Data as of 12/31/2020. See endnote 1 for additional disclosures.

Market Outlook

2021: A Year for Optimism?

To start 2021, investors can breathe a sigh of relief. The contentious U.S. election (and inauguration) are behind us, COVID-19 vaccines have arrived, and the U.K. finally approved its post-Brexit trade deal with the European Union. Although we have overcome big hurdles, we are not yet in the clear. Vaccine distribution must now outpace the spread of a significantly more contagious variant of the virus. Restrictions will remain in place, and most countries are unlikely to return to 'business as usual' for a while.

Overall, despite the tremendous health challenge that remains, we are optimistic. We will likely begin to see a return to normalcy in 2021. We expect that a vaccine-driven recovery, fiscal stimulus, low interest rates, and contained inflation will continue to provide support for both stocks and bonds. From a fundamental perspective, company earnings in cyclically oriented sectors, which were hurt most in 2020, are expected to realize the sharpest earnings rebound, while technology and health care sector earnings should remain strong. (See **Figure 2**.)

U.S. Company Earnings Are Expected to Improve Broadly
Estimated U.S. Stock Earnings Per Share Relative to 2019 (%)

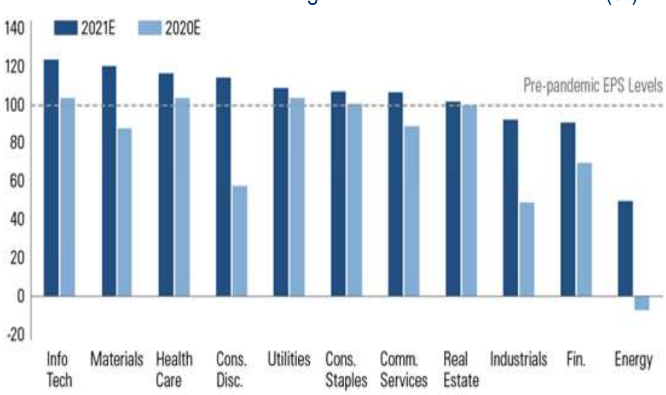

Figure 2. The pandemic disproportionally hurt company earnings in cyclically-oriented sectors in 2020, but a global growth recovery should help close this gap in 2021. Consumer discretionary and industrials may realize the sharpest earnings rebound, while technology and health care sector earnings should remain strong.

Source: Goldman Sachs[2]. U.S. Stocks represented by S&P 500 Index.

Economic Review

Economies experienced record falls and rebounds

Over 90% of the world's economies fell into a recession in 2020, the greatest synchronized downturn since 1870.[3] However, recessions in many major economies, including the U.S., ended in the third quarter. With the help of large-scale stimulus from governments and central banks, economic activity rebounded sharply from the COVID-19 induced collapse. U.S. economic growth fell at a 31.4% annualized rate in the second quarter, and rebounded at a 33.4% annualized rate in the third quarter.[4]

Recent economic data showing China's economy motoring ahead after the country largely contained the coronavirus has been encouraging. China's recovery has benefited other emerging markets and producers of raw materials. The U.S. and Europe still have some catching up to do. However, even with the pandemic worsening in the U.S. and Europe, economic data have largely remained steady, with the rollout of vaccines giving consumers and businesses more confidence. (See **Figure 3**.)

U.S. and European Confidence Is Holding Up
Consumer and Business Confidence

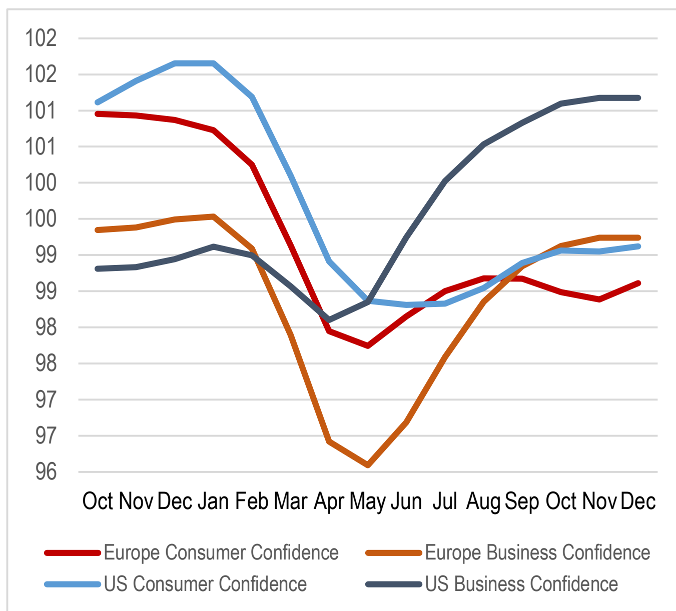

Figure 3. In the U.S. and Europe, the rollout of vaccines is giving consumers and businesses more confidence despite the pandemic worsening.

Sources: Organization for Economic Co-operation and Development (OECD). Data from October 2019 to December 2020. See endnote 5 for additional disclosures.

Economic Outlook

Near-term recovery to remain fragile (but supported)

Large parts of the global economy have adapted and become relatively resilient to the virus. However, many industries and countries are still struggling and are unlikely to return to normal until we achieve mass immunization. Widespread immunity timing will vary across regions of the world with the latest projections for some (like Europe) not reaching it until at least the fall.

As such, we expect that central bank monetary stimulus and government fiscal support will continue to keep the economic recovery on track. In the U.S., the new Biden administration is likely to prioritize additional major fiscal stimulus to help the hardest hit individuals, businesses, and states still struggling to recover from the pandemic.

Health outcomes to drive next phase of the recovery

Although stimulus will be important in the near-term, successful vaccination deployment efforts will be more critical for a sustained long-term economic recovery.

When people feel safe enough again to resume some normal activity (most predicting by the end of 2021), the economy will likely develop momentum on its own. Pent-up demand by itself should significantly help depressed industries like hospitality, airline, retail, real estate, restaurant, and energy. As the virus fades, the global recovery is set to broaden.

On the Minds of Investors

Should I be worried about the market given the (now higher) possibility of tax increases?

Now that Democrats have secured a small Senate majority as a result of the Georgia runoff elections, there are concerns that it may be easier to enact policy change. One policy proposal that has gained investor attention is increased corporate tax rates as part of President Biden's broader tax policy plan to raise federal revenue. (See **Figure 4**.) A concern is that raising taxes on corporations (as well as affluent households) could halt, if not reverse, the economic and stock market recovery, as higher taxes would reduce future business earnings and consumer disposable income.

Increased Corporate Tax Rates Would Remain Below 35%

U.S. Corporate Tax Rate vs. Effective Tax Rate

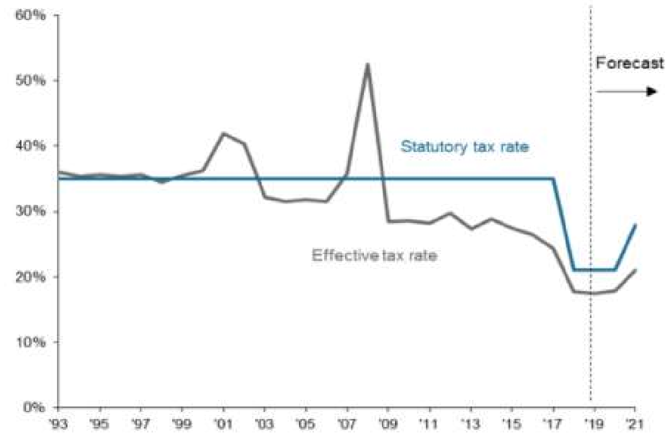

Figure 4. From 1993-2017, the top corporate tax rate was 35% until the 2017 Tax Cut and Jobs Act (TCJA) reduced it to 21%. President Biden has proposed to partially reverse this cut, increasing the top corporate tax rate from 21% to 28%. This would bring it in line with the OECD GDP-weighted average of 26.53%.

Source: Tax Policy Center, J.P. Morgan. Effective Tax Rate is for S&P 500 stocks.

Although a small Senate majority could somewhat ease Democrats' ability to introduce legislation, extreme policy change is likely to be constrained - meaning less tax increases than Democrats may prefer. Without a 60-seat majority, tax policy change will still be challenging and would need to be done through the annual reconciliation process. Given the state of affairs today, mainly with the economy not at full strength, an immediate and significant tax increase will be a hard case to make – especially for a newly elected Democratic senator from a red state.

With the focus likely to be on combating the pandemic with another spending bill during the first half of 2021, there is a possibility that tax increases do not happen until late-2021 or early-2022. There is also a possibility that tax increases get phased in gradually over multiple years. Either way, we do not expect that tax increases will derail the recovery, especially if they are enacted later when the economy is in better shape.

Tax hikes coinciding with an upswing in economic growth and stabilizing profits could minimize the damage to both. Ultimately, the impact of the reopening of the global economy over the next year with widespread vaccine availability will be more impactful to growth and markets than U.S. political (or policy) change.

Portfolio Management

What we learned about 2020

Although it's tough to fault anyone for failing to predict a global health pandemic that would send shock waves across financial markets, it goes to show that an investment approach based on discipline and diversification rather than prediction and timing is perhaps the better route to take. Success in the market does not require making accurate predictions. It requires the ability to stay in the game. An investor who is able to stay disciplined with their investment plan will be better off than one who constantly makes decisions based on speculative market forecasts.

Moving into 2021, many questions remain about the pandemic, new vaccines, business activity, changes in how people work and socialize, and the direction of global markets. Yet 2020’s economic and market tumult demonstrated that markets continue to function, and that people can adapt to difficult circumstances. The positive stock and bond market returns in 2020 remind us that, with a solid investment approach and a commitment to staying the course, investors can focus on building long-term wealth, even in challenging times.

How portfolios are positioned for 2021

Looking ahead, it seems likely that the world will soon start to overcome this terrible pandemic. Even so, investors should be prepared for current challenges and for bumps along the road to recovery. In addition to the pandemic, we face policy uncertainty with new leadership in Washington DC, and a stock market that could experience significant (albeit temporary) pullbacks from current high levels. There are a few ways that we are helping clients to be well-positioned for the year ahead.

Doing more with cash

One of the downsides of the current low-interest-rate policy period is that investors earn almost zero percent on cash, including savings accounts and money market funds. With an improving economic outlook and inflation, holding excess cash is likely to be a significant drag on portfolio returns and destroy future purchasing power.

As such, we are making concerted efforts to keep portfolio cash levels minimal through the funds we use and by monitoring accounts to make sure interest and dividend payments are reinvested. Additionally, for clients with significant cash reserves for liquidity needs beyond six months, we are recommending bond fund investments that seek to provide relative safety and liquidity, as well as yields that should offset some inflation risk. With safety as a priority for cash needs, we recommend ultra-short-term investments consisting of only high-grade bonds.

Maintaining broad diversification (tilting toward value) within stocks

To help defend against potential market turbulence in 2021, as well as to participate in the stock rally, we are maintaining broad diversification within stocks. This means diversifying growth assets across U.S. and international securities; real estate and infrastructure investments; and growth, value, large, and small company stocks. This diversification helps portfolios participate in market growth while avoiding concentration risk in areas of the market that are very expensive or are hurting amid the pandemic.

As we get closer to moving past the virus, the recovery in stocks will eventually broaden out to the many sectors and industries of the market that have not yet participated much in the rally. As such, portfolios are positioned to underweight technology and more growth-oriented stocks that are trading at higher prices amid lofty expectations and projections. In turn, we favor more value-oriented (cheaper) stocks that should perform well as the breadth of the rally increases.

Staying strong at the core within bonds

Balancing a portfolio’s stock allocation with a strong core bond allocation remains important. Investors, like our clients, who held reliable defensive asset (i.e.high-quality bond) allocations throughout 2020 should be more convinced than ever of its value and its role in a balanced portfolio. (See **Figure 5**.)

High-Quality Bonds Held Steady as Stocks Sank
2020 Total Returns – Growth of $10,000

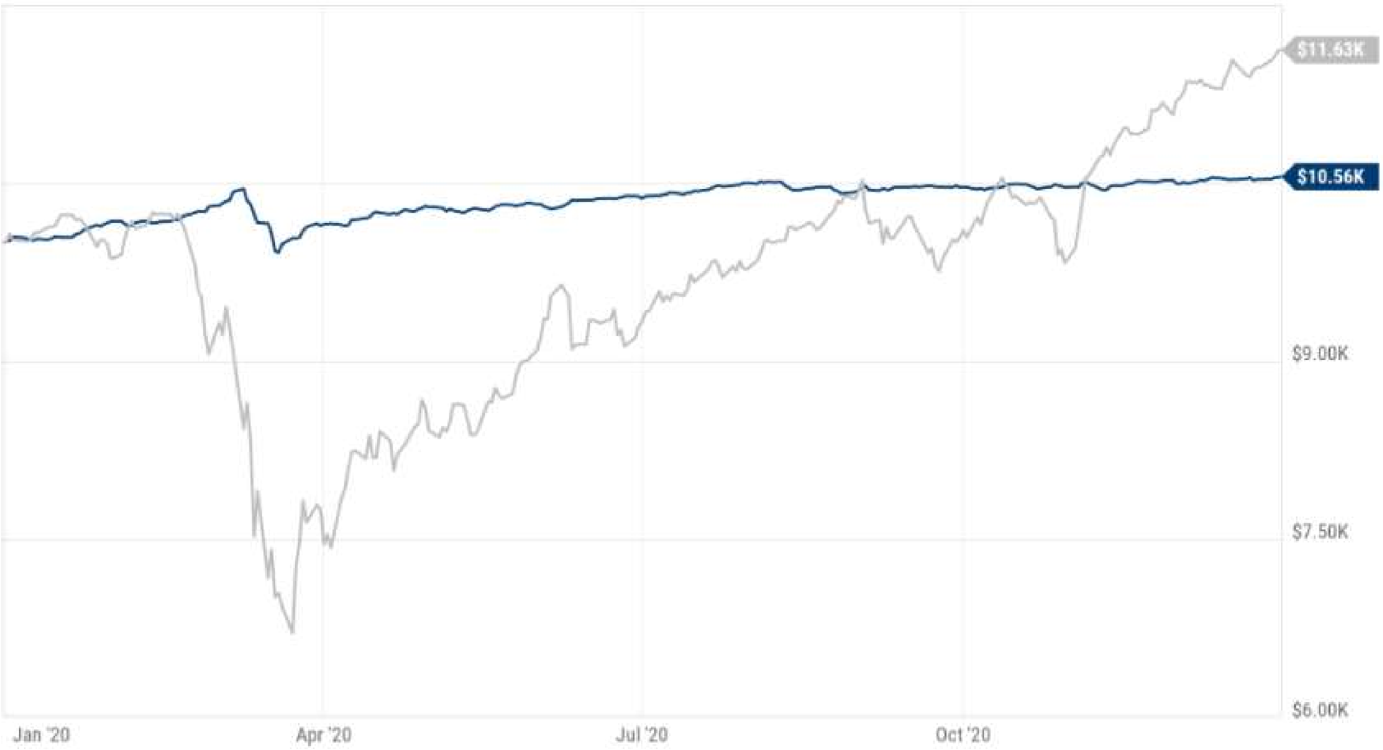

Figure 5. During the deep stock bear market in March and the pullbacks in the fall, high-quality bonds did exactly what they were supposed to do. Bonds zigge ng both diversification and capital preservation. Even as stocks have recovered, bonds have held u

Sources: YCharts, Bloomberg Barclays, MSCI. Data as of 12/31/2020. See endnote 6 for additional disclosures.

Uncertainty around major government policy shifts— a significant setback in the world's quest to get past the pandemic—and a global economy that is still healing, could result in big swings in the financial markets. As such, we remain committed to staying strong at the core within bond allocations.

Rebalancing back to target

Over the last several weeks, investors have received welcomed news on the development of vaccines against COVID-19, which has led to a powerful rotation and appreciation in stock markets. While the recent news around the vaccines is positive, we are still not out of the woods. There are crucial hurdles to overcome until the population is immunized, so market volatility will likely remain.

As a result, we have been rebalancing portfolios that are overweight in stocks by trimming from them and adding back to high-quality bonds.

With now elevated stock valuations and a recent move n interest rates, it has been a good balance portfolios back to target.

Focusing on what you can control

To have a better investment experience, we believe that investors should focus on the things they can control. It starts with an investment plan tailored to one's specific needs and goals. Once investment objectives are established, investors should focus on actions that add investment value, such as managing expenses and portfolio turnover while maintaining broad diversification.

Equally important is to stay disciplined and stick to the investment plan through various market conditions. Focusing on what you can control can increase the chances of achieving investment success and substantially growing wealth over time.

Sources & Endnotes

[1] U.S. stock returns are represented by the Russell 3000 Index. International stock returns are represented by the MSCI ACWI Ex USA IMI. U.S. bond returns are represented by the Barclays Aggregate Bond Index. International bond returns are represented by the Barclays Global Aggregate Ex USA Hedged Index.

[2] Goldman Sachs: https://www.gsam.com/content/gsam/us/en/advisors/market-insights/market-strategy/global-market-monitor/2020/market_monitor_121120.html

[3] Goldman Sachs: https://www.gsam.com/content/gsam/us/en/advisors/market-insights/market-strategy/market-pulse/2021/market-pulse-Jan21.html

[4] U.S. Bureau of Economic Analysis: https://www.bea.gov/data/gdp/gross-domestic-product

[5] Europe represented by the 19-country Euro Area. The business confidence indicator provides information on future developments, based upon opinion surveys on developments in production, orders and stocks of finished goods in the industry sector. It can be used to monitor output growth and to anticipate turning points in economic activity. The consumer confidence indicator provides an indication of future developments of households' consumption and saving, based upon answers regarding their expected financial situation, their sentiment about the general economic situation, unemployment, and capability of savings.

[6] Global Stocks represented by the MSCI ACWI IMI Index. Global High-Quality Bonds Index represented by the Bloomberg Barclays Global Aggregate Bond Index USD-Hedged Index. Returns indexed to $10,000 as of 01/01/2020.

Past performance does not guarantee future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

CAPSTONE™

FINANCIAL ADVISORS

Capstone Financial Advisors, Inc.
2001 Butterfield Road, Suite 1750
Downers Grove, IL 60515
Phone (630)241-0833
Fax (630)241-0834