Market Review and Commentary
Fourth Quarter 2020

Market Review: A strong fourth quarter capped one of the most remarkable years in stock market history. The 12.1% fourth quarter gain for the Standard and Poor's 500 stock index advanced the return for 2020 to 18.4% for the year, bringing the two-year return to 55%. This stellar performance included the fastest 30% decline in history and a 64% recovery into year-end. The market continues to look past the grim pandemic news and the fourth quarter offered a very positive broadening of the market, as expectations for sharply higher economic growth added momentum to the "reflation trade." Treasury yields rose and economically sensitive sectors that had been punished led performance into year-end with Energy +25.8% and Financials +22.6% serving as good examples although they both remained in the red for the year. The Russell 2000 Small Cap Index spiked 31.4%, pulling it to a 2020 return of 19.9%. The MSCI All World ex-U.S. Index gained 17.0% in the quarter and 10.7% for the year. The Barclay's Aggregate Bond Index and Gold both offered marginally positive returns in the fourth quarter but returned 7.6% and 24.1% for the year, respectively.

The Reflation Trade: The positive news on COVID vaccine development and the massive amount of government stimulus has bred much optimism regarding 2021 economic growth, particularly in the second half of the year. The Federal Reserve has made clear its ongoing support for low interest rates and bond purchases and, not surprisingly, the Goldman Sachs Financial Conditions Index shows the easiest money conditions on record. To top it all off, the incoming administration plans additional fiscal stimulus. While still very low by historical standards, the rate of the 10-year U.S. Treasury has risen to 1.1%, up .40% since September. The cyclical value category is gaining momentum and stocks such as J.P. Morgan, DuPont and General Motors have rallied while the mega-cap tech market leaders such as Microsoft and Amazon have stalled on a relative basis. To illustrate, the DFA Large Cap Value Fund gained 15.7% from 8/31 through 12/31 while the iShares Russell 1000 Growth Index gained 6.2%. The value category's under-performance versus growth had reached historical extremes so there is the potential for this short-term trend to become persistent.

A New Paradigm? We enter 2021 with political uncertainty behind us, indications that corporate earnings will bounce back, and with vaccines being rolled out across the country. Investor bullishness has carried traditional measurements of the broad market to record valuations, whether using metrics such as price-to-sales ratios or total stock market capitalization to GDP. Low inflation and low interest rates have been the key underpinnings of the market for some time, with "long duration" growth stocks most notably benefiting. We think it is likely that a new paradigm of rising interest rates and increasing inflation will be in force on the other side of the pandemic. Pent up demand may make the Fed's ongoing attempt to spur inflation too successful and when adding in the ballooning budget deficit, higher rates become a significant risk factor regardless of policy. Current market levels are dependent on the old regime of low rates and we will be attentive to indications of a paradigm shift as we come out of the economic shock. Appropriate diversifying strategies include growth and value exposure, inflation hedging and non-dollar equity exposure.

We wish you a happy and healthy 2021 and we thank you for your support and trust. As always, we welcome a detailed discussion of your investments.

Your Staley Capital Investment Team