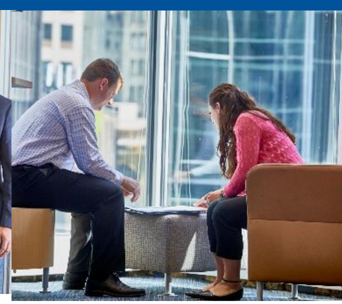
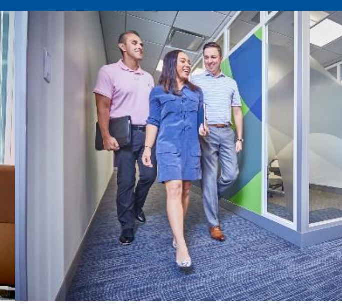
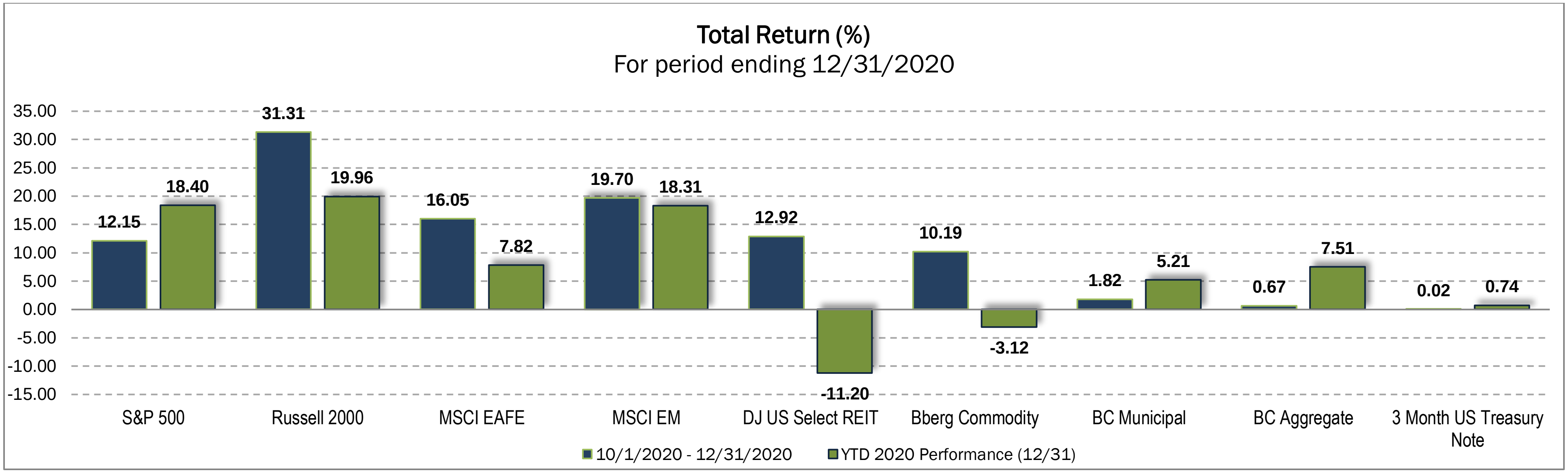
SCHNEIDER DOWNS
Wealth Management

A Historically Consequential Year Leads to a Year (Decade?) of Transition



Schneider Downs Wealth Management Advisors, LP
Q4 2020 Market Commentary

Big Thinking. Personal Focus.



To describe the year 2020 as a roller coaster would be giving it short shrift. However, as we sit down to write our year in review, it remains the best description of one of the most turbulent and consequential years of the last half century. If 2020 has given us anything, it is a giant dose of perspective about the human condition. Insight gleaned from these perspectives must inform our prospective outlook as we look to navigate capital markets in 2021, a year that promises to be one of transition, and highly leveraged to the efficacy, distribution, and usage of the various COVID-19 vaccines. This next decade will be about perspectives that manifested themselves in 2020 and how they affect our prospective outlook moving forward. To have success in investing, the former must inform the latter.

2020 Perspectives

In early 2020, most of the world couldn't locate Hubei[1] province in central China on a map, let alone identify its capital city of Wuhan. By the end of the year, you would be hard pressed to find someone that didn't know of the city of Wuhan as it became a 21st century version of Chernobyl[2], a symbol of colossal failure and loss of life. What the Chinese government said was a small, isolated virus outbreak has morphed into COVID-19 and wreaked havoc on the world, devastating economies and, most importantly, leading to 1,936,614 deaths[3] at the time of this writing. The virus outbreak laid to bear just how interconnected the world really is, and how vulnerable our economies and populations are as a result of this interconnectedness. The old adage "there is no such thing as a free lunch" never rang truer; but for all the benefits of global interconnectedness, it comes with more exposure to external factors that previous generations were impervious too.

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[1] https://en.wikipedia.org/wiki/Hubei
[2] https://www.world-nuclear.org/information-library/safety-and-security/safety-of-plants/chernobyl-accident.aspx
[3] https://coronavirus.jhu.edu/map.html

"Don't fight the Fed" became an axiom and an intellectual underpinning of investment philosophy over the past ten years in domestic capital markets. Treasury Secretary Henry Paulson and the authors of TARP 1.0 and 2.0,[4] the Benjamin Bernanke led U.S. Federal Reserve's quantitative easing and operation twist programs,[5] laid the modern-day foundation for what was possible in fiscal and monetary policy. However, what Treasury Secretary Mnuchin and U.S. Federal Reserve Board Chairman Jerome Powell achieved in expanding and utilizing the levers of fiscal and monetary policy during March and April of 2020 will go down as the greatest expansion and use of government to combat an economic crisis. Mnuchin and Powell (with the explicit backing of President Trump) created a comprehensive and ever-evolving policy response that created the conditions wherein personal income rose during a recession for the first time on record.[6] Jerome Powell's U.S. Federal Reserve would end up purchasing a variety of fixed income instruments (most notably a coterie of ETFs[7]), including high yield/junk bonds, with an announcement nearly every week expanding what securities it was allowed to hold. In sum, Mnuchin and Powell signaled a paradigm shift with their intermingling of fiscal and monetary policy. While market participants, to a degree, felt that the Fed would be there to support capital markets eventually, the Fed's ability to handle a non-financial calamity was very much in doubt. The expansion of power within fiscal and monetary levers in 2020 illuminated to investors what is possible and how far monetary authorities are willing to go to stave off significant declines in the price of risk assets.

The U.S. stock market is not an accurate reflection of the entirety of the U.S. economy. Never has that been more evident than in 2020, where we saw equity markets rally to all-time highs while food bank lines were miles long and millions of our fellow citizens were losing their jobs. Despite the strong rally in risk-based assets in the second half of the year, 140,000 jobs were lost in the month of December. While twelve million jobs have been regained since March/April lows, 10.7 million people remain unemployed and on some form of economic assistance from the government.[8] What 2020 reinforced is that the stock market is an emotionless, forward-looking instrument that ruthlessly and meticulously rewards participants willing to look through near-term shocks/dislocations, and focus their attention on long-term growth and cash flow prospects. In an era defined by fiscal and monetary accommodation, owners of financial risk assets disproportionately benefited from these policy prescriptions.

Identifying risk tolerances and behavioral biases are critical components to long-term investing success. Markets can be unpredictable, and as traders are fond of saying, "risk happens fast." Never was "risk happens fast" more exemplified than in a 45 trading day stretch from February 19th through April 8th, where the S&P 500 reached an all-time high, entered an equity bear market in record time (23 trading days),[9] and entered into a new bull market recovering 25% from the March 23rd bottom in twelve trading days.[10] The price movement in equities closely resembled the aforementioned roller coaster, but almost lost in the ride in equities was the temporary, but no less extreme, dislocation in the fixed income markets. High-quality bonds were down 7% (high-quality U.S. government bonds), 11% (municipal fixed income), and 20% (investment-grade corporate bonds), from their previous highs during a tumultuous period in the middle of March.

The volatility across capital markets, where diversification for a moment in time *was not* working, combined with 22 million people losing their jobs, was a recipe for capital destruction. Making rash investment decisions based on headline employment loss, fanatical headlines on CNBC and Bloomberg, or on a binary political outcome are behavioral biases that are far from abnormal. The best way to combat these biases is identifying your

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[4] https://www.treasury.gov/initiatives/financial-stability/tarp-programs/pages/default.aspx#
[5] https://www.federalreserve.gov/newsevents/speech/bernanke20120831a.htm
[6] https://www.pewtrusts.org/en/research-and-analysis/articles/2020/11/05/federal-assistance-boosts-states-personal-income-as-economy-falters
[7] https://www.bloomberg.com/news/articles/2020-05-29/fed-reveals-which-etfs-it-purchased-in-emergency-lending-program
[8] https://www.bls.gov/news.release/empsit.nr0.htm
[9] https://www.forbes.com/sites/juliejason/2020/04/08/the-coronavirus-stock-market-a-market-gone-wild/?sh=389ed84ba31f
[10] https://www.ally.com/do-it-right/investing/stock-market-week-in-review-april-9-2020/

risk tolerance during calmer periods in capital market activity and eschewing a more emotional approach to growing capital. Many investors wouldn't have predicted in late March that we would finish the year up mid-teens across most equity markets, nor would they have predicted that a Joe Biden win over Donald Trump (with a constrained and almost evenly divided congress) would drive the S&P 500 up an additional +13.8%. The unpredictability of markets will only continue as markets transition from survival and advance to reopen in 2021.

2021 Prospective

Winston Churchill remarked, in a speech to the House of Commons in 1948, that "those who fail to learn from history are condemned to repeat it." A warning of sorts to the legislature to never forget how and why the world found itself in the campaign against Nazism/Axis powers. The perspectives we gained from 2020, enumerated in the graphs above, will serve as catalysts and guideposts for our asset allocation and investment strategy going forward.

Long before COVID-19 laid to bare the vulnerabilities of a globalized/interconnected world, there were fissures in an economic system that relied on countries pursuing their own self-interests while also being cognizant of the interests of other counterparties. President Trump and then Secretary of State Clinton both ran in the 2016 U.S. presidential race on abandoning the Trans-Pacific Partnership (a trade alliance that linked countries from Peru and Vietnam to Australia, Canada, and Japan). China, who had long ruthlessly pursued its own economic self-interest, began bilateral trade negotiations with several countries in the Asia-Pac region. President Trump, upon election, dramatically altered the course of American trade relationships as well with his MAGA/America First (and sometimes alone) policy foundation. In short, de-globalization, be it caused by the pursuit of economic self-interest or political populism taking hold in a government, is a trend that is undeniable. Whereas international equities dramatically underperformed U.S. equities through the last decade, as supply chains and political and economic relationships were reimagined, the opportunity set for international equities (developed and emerging) looks increasingly more attractive than it has in previous years.

Regardless of the result of the 2020 election, fiscal and monetary conditions are likely to remain highly accommodative in 2021. Both major U.S. political parties, Republican and Democrat, have largely abandoned any governing philosophy that centers around restrained fiscal/deficit spending. Replacing a more constrained approach to budget and spending plans is a reliance on the U.S. Federal Reserve to contain volatility in capital markets and for government to supplement the liquidity provided by the Fed with monetary measures that augment and support risk-based assets and income levels. There will likely be volatility related to these accommodative measures realized in the markets, but over the intermediate and longer term, these policy proscriptions are supportive of owning risked-based assets. Opportunities in small and medium-sized companies, infrastructure, and companies that are levered to economic growth (e.g. quality/value companies within the industrial, materials, financials, and real estate sectors) are poised to rebound after a difficult 2020. While we are not advocating abandoning exposure to growth/technology or the "work from home" stocks that pushed the market higher throughout 2020, instead we are advocating to fight the urge to chase those names in favor of maintaining a balanced exposure to growth, core, and value.

As a result of global central bank policy that will err on the side of holding interest rates lower for longer to ensure a smooth recovery from the effects of the COVID-19 lockdowns, fixed income investors are placed in a particular predicament. The current yields are paltry as investors are being compensated at historically low levels (in the form of yield) to take on credit and duration (interest rate risk) risk. With real yields (nominal interest rates + inflation) still well into negative territory, fixed income investors are being forced to choose stability (and in exchange for that safety they are either locking in negative real rates of return in government and municipal (pre-tax) securities) or the burden of being undercompensated to squeeze more yield by moving out on the fixed income risk spectrum. In response to this predicament, we will accept the lower rates of return on our core fixed income, but we will be moving some funds into equities and alternative equity strategies, where the compensation for the risk being taken is more reasonable. In our last quarterly letter to investors, we said we would never abandon fixed income (their diversification properties and cash flow generation, however meager, are too valuable). As investors, we need to realize that owning core fixed income will likely mean lower expected rates of return over the short to intermediate term for the asset class.

As we turn the page on 2020 and move into 2021, we would be remiss if we didn't once again voice our sincere appreciation for you, our clients. The year has presented its challenges for everyone. How we interact with friends and family, educate our children, and do our jobs has been interrupted by a virus that is diminutive in size (70-90 nanometers) but seemingly ubiquitous in nature. Our team has enjoyed all of our Zoom/Microsoft Teams calls with all of you; the next best thing to being with you in person is being able to see you virtually. We don't know when we will be able to get back into our offices in Pittsburgh, Columbus, or Washington D.C., (the target date is May 1st), but we do know why we get up and work every day: you, our clients. Thank you for continuing to place your trust and assets in our care; it is a privilege that we wake up every day grateful for and excited at the opportunity. From the team at SDWMA, we wish you a healthy, prosperous, and joyful 2021.