TOTAL WEALTH PLANNING

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Economic & Investment Outlook 2021

There is no question that 2020 was a difficult year for most Americans. Investors faced a unique set of circumstances while navigating many negative headlines and uncertainties concerning their own physical, mental, and economic health. In spite of these events, however, a globally diversified, long term investor could limit his temporary losses and even take advantage of the market volatility to produce strong positive results, while experiencing far less risk than the overall stock markets.

The Year in Review

In order to review 2020 investment returns, please see the chart below, which illustrates diversified indices. Note that while investment returns were positive for these particular asset classes, this data does not tell the full story of the volatile roller coaster of returns that many investors have experienced during the year.

Index	4th Qtr.	2020	3 year*	5 year*	10 year*	Description
S&P 500 Index	12.15%	18.40%	14.18%	15.22%	13.88%	Large-Cap Stocks
Russell 1000 Growth	11.39%	38.49%	22.99%	21.00%	17.21%	Large-Cap Growth Stocks
Russell 1000 Value	16.25%	2.80%	6.07%	9.74%	10.50%	Large-Cap Value Stocks
Russell 2000 Growth	29.61%	34.63%	16.20%	16.36%	13.48%	Small-Cap Growth Stocks
Russell 2000 Value	33.36%	4.63%	3.72%	9.65%	8.66%	Small-Cap Value Stocks
MSCI – EAFE	16.09%	8.28%	4.79%	7.97%	6.00%	International Stocks
MSCI – Emerging Market	19.77%	18.69%	6.56%	13.22%	4.00%	Emerging Market Stocks
Barclay's Agg. Bond Index	0.67%	7.51%	5.34%	4.44%	3.84%	Domestic Bonds
Consumer Price Index**	0.12%	1.27%	1.80%	1.86%	1.75%	Inflation

**Returns are annualized; ** CPI returns are as of November 30th, 2020*

The year of 2020 was full of unprecedented events. Investment returns, had they been negative for the year, could have been justified for a myriad of reasons: wild fires in the West, the trade war with China, difficult 'Brexit' trade negotiations and a global flu pandemic. Also, governors of 27 states shut down economies and issued stay-at-home orders affecting 225 million Americans. There were large-scale violent protests in many US cities, global supply chain disruption, an unemployment rate as high as 14.7%, and a heated Presidential election.

However, all of our client portfolios experienced significant increases for the year. Why is this? There are three primary reasons: Market Volatility, Portfolio Philosophy, and Investment Management.

- *<u>Market Volatility</u> – Stock markets are often fluid concerning what they tell us about current corporate intrinsic valuation and the certainty of future economic growth. Generally speaking, when the short term is more certain, market valuations tend to represent expected growth over the coming months and, sometimes, even years. When the current environment experiences vast uncertainty, the market tends to focus on a much shorter time horizon and clearly price in a 'worst case' scenario of the immediate future. It is the movement between these general market states that causes sharp declines, and these are often followed by a rapid, "V" shaped recovery once confidence and certainty return. From a portfolio management standpoint, this creates rebalancing opportunities by buying low and selling high on an opportunistic basis.*

- *<u>Portfolio Philosophy</u> – We embrace the Nobel Prize winning approach, referred to as Modern Portfolio Philosophy, which involves diversification and maintaining exposure to multiple asset classes (bonds/stocks, foreign/domestic, large/small, growth/value) at all times. This ensures that your portfolio will always have exposure to the best performing asset classes, avoiding high concentration in underperforming securities, and lowering the volatility that may otherwise be experienced. Not timing the markets and avoiding significant concentration to individual securities reduces the potential for experiencing permanent losses to portfolio values.*

- *<u>Investment Management</u> – Our implementation of the Modern Portfolio Philosophy involves maintaining a systematic process of rebalancing portfolios and removes emotion from the buy/sell decision. Simplistically, it helps to ensure that profits are trimmed as necessary while also buying low in other asset classes when they have temporarily declined in value. In periods of significant volatility, we review portfolios very frequently, as these opportunities for meaningful rebalance of capital are more prevalent in these times. Combining this with the "V" shape recovery of the markets has provided client portfolios with a huge boost in returns for the year. This is very important to the investment process because even if bonds are generating modest results, as they often do, these returns may be quite attractive compared to stocks during periods such as a recession. In this scenario, opportunities arise to sell bonds in order to buy stocks while they are low. Then, when stocks recover, you will own more shares for the upside than you did for the downside.*

Last year was also unique in that we saw at least 3 of the 4 stages of the business cycle occur within a single calendar year. First, we experienced peak growth at the beginning of the year. Then COVID-19 triggered recession with a 4.8% decline in economic output as measured by GDP (Gross Domestic Product). Finally, the US government provided massive stimulus through both monetary and fiscal policy, which led to a full <u>stock</u> market recovery and expected full <u>economic</u> recovery in 2021 or early 2022. Expectations are that we are now beginning to see the start of the fourth and often longest stage of the business cycle—expansion. It is rare to see most of this cycle occur within such a short period of time. Years from now one may look back at the annual market returns and think, "that actually wasn't a bad year." What is not evident without further research is that US large cap stocks experienced a decline of -32.5% and subsequently bounced back with a +70.3% return from low. Similarly, US small cap stocks declined -42.4% and rebounded with a +104.6% return from its low point—a wild ride for sure!

If there's a lesson to be learned from the 2020 stock market roller coaster, it is that volatility is not always our foe, but it can be our friend. At Total Wealth Planning, we prudently use volatility to your advantage as we rebalance your portfolio and deploy capital, which was previously not exposed to the downside. This will then further enhance the return of the upside when it occurs.

Where Are We Now?

Although the political landscape can often fuel either positive or negative expectations as it relates to future prospects for the economy, the reality is that many historically significant events are now providing optimism for the potential of continued economic recovery. This optimism is brought about partially by the development of three separate vaccines for COVID-19 occurring 15 months after the discovery of the virus. Also, a massive government stimulus has been issued to keep businesses afloat and citizens in their homes. There is a collective tenacity to stand together against the challenges of the virus. Companies have begun to implement work from home policies, allowing employees to be productive and meet business needs. Finally, investors clearly have more confidence in the direction of the global economy today resulting in equity markets continuing to hit new all-time record high levels.

The US economy has nearly fully recovered, even though the US stock market had already recovered last year. As a result, many market pundits and media outlets are likely to begin describing the markets as having reached full value or possibly even being over-valued. The reality is that earnings have not fully recovered which can provide the appearance that values are too high. However, as our economy enters the final stages of reopening, making way for more business travel and other events, we will then see earnings increase, potentially providing equity values the opportunity to appear more attractive.

Outlook for 2021

The new year brings many reasons for optimism. We share this hope and optimism—cautiously. We are not "out of the woods", relative to risk and volatility. There are still many unknowns to be determined in 2021 and there will likely be some surprises along the way. Quick market recovery during the second half of 2020 makes it difficult to forecast anything more than modest growth for portfolios overall. We are expecting most portfolios to experience mid to high single digit growth for 2021, but, as usual, the potential for short-term volatility exists.

Consensus earnings forecasts expect 2021 corporate earnings to be comparable to 2019, and 2022 earnings are expected to exceed on a total dollar basis. While we take these analysts' forecasts with a grain of salt, it is encouraging to see that so many US companies are expected to grow profits in the coming 12-24 months.

Long term bond rates are likely to creep up as we expect to see those industries most damaged by the global health crisis begin to return to more normal operational levels. Meanwhile, short term rates will continue to be held down by the Federal Reserve. The combination of lower short term rates with rising long term rates is typically a positive economic indicator.

The expectation for gridlock also continues as it relates to Congress and the Senate. Although technically the Senate has now won a slim majority, the reality is that Democrats are not likely to be completely united in the agenda they wish to pass; therefore, the likelihood for dissenting votes is high. The result is that we are unlikely to see major law changes in 2021, even though tax policy change has been a key objective of President-Elect Biden.

Conclusion - Where We See Opportunity

During the recession in 2020, large cap and tech stocks were thought to be immune from the effects of the pandemic and were benefitting from a "flight to quality" by many investors. Traditionally, these asset flows have gone to US Treasuries. However, because US and Global Treasury yields were at the time at unprecedented lows, this did not occur. In March 2020, the 10-year Treasury, for example, was offering a dividend yield of 0.50% to 0.75%, whereas the dividend yield of the S&P 500 was at 2.31%. Therefore, US large cap & tech stocks, led by companies such as Amazon, Apple, Google, Facebook, Microsoft, Tesla and Netflix were popular alternatives, leading to immense growth in their company valuations. This has resulted in these seven stocks growing to represent almost 35% of the S&P 500 Index, calculated by market capitalization weight. A reasonable investor is likely to conclude that stocks have priced in most of their anticipated economic recovery and maybe there is even a case for overvaluation. However, many other asset classes, including small cap, value style and international stocks have been out of favor for quite some time and have much more room for growth. We have begun to see hints of a potential 'changing of the guard' in the fourth quarter of 2020, and we are expecting to see more of this in the coming months. There is also recent news from Europe that the UK has reached a trade agreement with the rest of the European Union, resulting in more clarity and minimizing the risk of large tariffs negatively impacting those economies. Ultimately, this could allow greater Europe to realize their 2021 GDP growth forecast, which is currently higher than the US 2.1% aggregate growth forecast.

Prudent Portfolio Management Integrated with Comprehensive Financial Planning Provides the Best Long-Term Results

As described in previous communications from Total Wealth Planning, we advocate a proven Nobel Prize-Winning Approach for managing our client's investment portfolios. By maintaining consistent exposure to a diversified array of 15-20 individual asset classes, clients' investment portfolios will have every opportunity for growth. By making tactical shifts, over and above periodic rebalancing and profit-taking opportunities, we seek to add value, especially during periods of elevated volatility. At Total Wealth Planning, our team of financial planning and investment management professionals work closely together to ensure that opportunities for adding value to your financial situation are not overlooked. In our opinion, wealth building and preservation must include not only investment management, but also financial planning activities, such as cash management, debt management, tax planning, risk management, college funding, retirement planning, and estate preservation.

We appreciate the trust and confidence clients have placed in us for the past 30+ years, and we look forward to seeing you in 2021!

Total Wealth Planning Investment Policy Committee:

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