Investment Review and Outlook – Winter 2021

The Current Landscape in Washington, D.C. and the U.S.

There have been significant changes in Washington D.C over the past several weeks. Joseph R. Biden, Jr. has become the 46th President of the United States, after a bitter election and a tense aftermath. There was also a shift in Congress, where the Democrats hold an unexpectedly slim edge in the House of Representatives. Following victories in the Georgia runoffs, the Democrats also hold a one vote, tie-breaking margin of control in the Senate.

The new administration is facing very tough challenges. At the forefront is the need to address and heal the sharp divisions that exist within our country and in both political parties. This is also complicated by the former President's second impeachment trial that is scheduled to commence during the week of February 8. At the same time, serious concerns about COVID-19 persist while the distribution of vaccines has been slow. Importantly, there is a widening debate relating to how a new $1.9 trillion economic stimulus package will play out in Congress.

How the Biden administration will address and prioritize these and other challenges, including campaign promises made to supporters, the formation of the cabinet and the positioning of other high-level government officials, is likely to set the stage for what we can expect as 2021 unfolds and beyond. Already, an unprecedented 40 executive orders were signed in the first 10 days in office. Many of the orders were anticipated while some were very much unexpected. To name a few, orders ranged from environmental issues, significant immigration mandates, the curtailment of an important, politically-sensitive energy pipeline with Canada, a minimum wage increase, some controversial regulatory issues, and important items addressing the COVID-19 pandemic and vaccines. Congressional members from both sides of the aisle were concerned as to the timing of some of the orders, the economic cost and impact on the economy, especially potential job losses.

In the short run, control of Congress by the Democratic Party may lead to more generous fiscal stimulus proposals. Longer term, it could result in tighter regulations for businesses, consumers and financial institutions. It is also expected that corporate and individual tax rates will rise.

The Status of COVID-19 and the U.S. Economy

In our last Investment Review and Outlook Fall - 2020, we stated the following:

> "On the vaccine front, Pfizer appears to be at the front of the race to create a vaccine. The company, along with its partner BioNTech, has developed a potential vaccine that is in late, third stage trials. If results show the vaccine is effective and safe, the company plans on submitting an application to the FDA for emergency use, possibly by late November." (10/26/20)

On December 11, 2020, the Food and Drug Administration issued an emergency use authorization for the Pfizer-BioNTech COVID-19 vaccine for persons aged 16 years and older. The development was accomplished in record time, less than 12 months. As a result, there was a sea change of thought that this vaccine would help bring an end to the most devastating pandemic in a century. The dire situation we have all been living through is changing for the better. As the stepped-up mass distribution of the COVID-19 vaccines accelerates, by late spring a meaningful decline in the coronavirus infection rate appears a reasonable expectation. Soon, we are likely to have 3 COVID-19 vaccines with Johnson & Johnson nearing completion of its successful vaccine trials. Following review by the FDA, J&J is likely to join Pfizer-BioNTech and Moderna in a suite of three highly effective vaccine options. So, by mid-year, most Americans could be vaccinated and the beginning of the end for this pandemic may be at hand.

In the meantime, economic sluggishness appears to be surfacing again, following a pickup in the closing months of 2020. Renewed lockdowns have multiplied along with infections, and retail sales (excluding auto sales) are off dramatically. The very sharp downturn in consumer spending within the hospitality industry, especially the food and beverage segment, exemplifies how the impact of COVID-19, with the restrictive federal, state and local government mandates and guidelines, has dramatically changed America and constrained overall consumer spending patterns.

A bright spot in the overall economy, however, is the housing industry where both existing home sales and new housing starts have generally been sustained and have benefited by the exodus from city centers to the suburbs by homeowners and renters. According to the Labor Department, about 24% of the labor force is currently working from home, resulting in demand for additional space for online schooling of students and needs for in-home office space.

Clearly, it will take time to get the economy back on a normal growth track. For now, we expect little or no growth in the first quarter of 2021. The next few months will be challenging, with continued business closures and reduced operating flexibility expected to negatively impact overall economic activity. The current employment picture is also sobering, with jobless filings rising and job totals declining, resulting in lower disposable personal income for consumers.

However, as more people receive COVID-19 vaccines, economic growth should respond as businesses reopen, the labor force ramps up, deferred business and consumer spending improves and manufacturing activity regains its footing. In addition, when a new comprehensive fiscal stimulus package is put in place along with the continuation of an accommodative monetary policy by the Federal Reserve, GDP growth could recover strongly during the second and third quarters of 2021.

While it will take some time before the coronavirus is fully in the rearview mirror and the nation is operating on all cylinders, 2021 should be an improving year for the economy as the months go by. It is also interesting to note that we are in the fourth quarter 2020 corporate earnings reporting season. To date, results have generally exceeded relatively weak forecasts and we would expect this pattern to continue. With price-earnings ratios historically high, a continued, decent showing of company profitability is needed to sustain current security valuations.

During the second half of 2021, we anticipate that the economy is likely to resume a slow growth path, expanding by approximately 2%-3% annually, roughly what we had been experiencing before the COVID-19 pandemic dramatically impacted businesses and consumers in the spring of 2020.

The Stock Market

Following the dramatic decline in the stock market that commenced in March 2020, hopes for a vaccine to combat the pandemic and infusion of liquidity into the economy by the Federal Reserve get much of the credit for the stock market's recovery and overall strength in 2020. Any improvement at all for the year, given the tumultuous backdrop and the upheavals to our economy caused by COVID-19, is a pretty remarkable outcome.

The strength in the stock market so far in 2021 suggests that investors are now focusing on the potential for stronger economic growth with increased fiscal support, especially with the wide array of ambitious goals being established by the Biden administration on spending initiatives, including investment in our country's infrastructure. A large expectation built into current positive market psychology is the anticipated success of the COVID-19 vaccines, stemming the spread of the virus and hopefully signaling the beginning of the end of the pandemic.

What does this mean for investors going forward? Currently, the investment backdrop is still relatively positive. Given Wall Street's penchant for looking ahead by several months, and now expecting better times for business and the consumer during the spring and into the second half of 2021, it is reasonable to expect stocks to "hang in there" as long as the recovery timetable is not unduly extended. While optimism is in the air, the historically high price-to-earnings ratios currently in place for equity securities, especially in the technology sector, coupled with the uncertain strength of the economy and how corporate earnings develop in the months to come, will leave little room for error. With extended security valuations, stocks remain vulnerable to disappointment with possible headwinds in the months ahead until there is more clarity on several issues. Historically, such crosscurrents are indicative of potential volatility in the market and should be expected during 2021.

Investment Strategy

As suggested in our last quarterly investment review, once there was more clarity regarding the November elections and developments relating to the cornavirus pandemic, including the possible introduction of vaccines, we would readdress areas of the economy that will be beneficiaries from renewed growth and potentially new governmental policies. As a result of the historic success in the approval of COVID-19 vaccines and with the November elections behind us, we have fine-tuned our investment strategy going forward.

In recent weeks, we have added more economically sensitive securities to our investment universe, especially in the industrial and materials sectors. Also, segments within the broad hospitality area, including travel, tourism, lodging, recreation, food and beverage, are likely to be attractive going forward. In the months to come, we will be introducing these types of economically sensitive names to client portfolios, as they become attractive based on our valuation parameters.

In the meantime, portfolios may be carrying higher than usual cash levels as we make substitutions, selling securities that would be less attractive going forward or that have reached our objectives, as we make substitutions with new positions. Despite the market's recent upward direction, it is also important to note that some sectors have lagged the overall market, notably consumer staples and selected technology stocks, due to their historically high valuations. These areas are under review.

Lastly, some companies with above-average, attractive dividends that add stability to portfolios during market corrections and represent quality entities with positive earnings prospects, will also be part of client portfolios, especially where an increasing income stream is part of the overall strategy.

G. Frederick Schroeder, CFA
President and Chief Investment Officer

January 30, 2021