The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets — January 2021

From: *Philadelphia* Investment Management Group

OVERVIEW

- ***2020 Was a Year With No Comparable Events to Predict Either the Path of the Coronavirus or the Measures Governments Would Take in Response.*** *We saw near-panic equity selling in the first part of the year, then a swift rebound as markets concluded the spread of the virus would be under control.*

- ***Business and Individual Response to the Stimulus Programs Has Been Very Ragged, at Best.*** *The pandemic has created a cautious stance with all aspects of life, with no real idea on how to react.*

- ***The Inflation Question Seems to be Front and Center in Investors' Minds as a Result of the Amount of Money Creation Necessary for the Stimulus Packages.*** *Never before have government agencies purposely kept the lid on interest rates to allow this stimulus with near zero interest rates.*

THE ECONOMY

While 2020 was a year when economists failed in their recognition of what was to happen, 2021 could be equally tough in sorting out where the gaps will be in the economy stemming from the stimulus payments. Business may not be good coming out of the pandemic, and the pockets of where the renewed strength will surface are difficult to predict. Gaps will be left in the initial surge in activity and there's the possibility that many unemployed will find work very difficult to locate. Employer shutdowns and/or downsizing will make it hard for some to replace their lost income. The Government is not able to target people's needs perfectly, although it is recognized that many will need retraining for a post-pandemic economy.

While U.S. manufacturing continues to advance from the sharp contraction, this recovery will follow a path different from recoveries in the past because the downturn has been so unusual. Previous major recessions tended to originate with high interest rates hitting the construction and manufacturing industries, which then rebounded strongly after rates eventually fell. This time, services provided in person were among the business activities hardest hit.

Consumer spending is key in analyzing where and when business will accelerate. Psychology is difficult to predict as to when consumers will feel comfortable going back to spending as they did before the pandemic. And all of this behavior is so new from the past as American consumers have accelerated their embrace of digital shopping, telehealth appointments, online fitness classes, while shunning malls, doctors' offices, and gyms.

We will see economic improvement in 2021. However, as earlier stated, it will be spotty in the areas that get the attention.

FINANCIAL MARKETS

EQUITIES

If there was ever a rollercoaster ride with equity investing, it was 2020. And if there was ever a market that only rewarded certain sectors and accompanying equities within those sectors of business, it was 2020. Come along 2021, and we begin with a legacy that may prevent a normal recovery. There is a huge hangover of debt and deep uncertainty about how consumer behavior might have changed. Fundamentals should matter most this year, as it will be all about fiscal and monetary support.

After the swiftest equity bear market in history, the recovery from the trough in March has been remarkable, as shown in the following chart, with U.S. stock markets finishing the fourth quarter and year at new record highs. The Russell 2000 index of small cap companies led the way in the fourth quarter, well outpacing the larger cap S&P 500, as well as the Dow and NASDAQ. Hopes around the COVID-19 vaccines bolstered investor confidence, which helped fuel a rally in small cap stocks during the quarter. However, the NASDAQ, with its heavy weighting in Technology, was clearly the winner for the whole year with a return of 43.64%. The S&P 500 ended the year with a return of 18.40%, while the Dow, with a return of 9.72% for the year, reached 30,000 for the first time ever in November.

	Equity Returns*				
Index	**4th Qtr**	**3rd Qtr**	**2nd Qtr**	**1st Qtr**	**2020**
S&P 500	12.15%	8.93%	20.54%	-19.60%	18.40%
Dow	10.73%	8.22%	18.51%	-22.73%	9.72%
NASDAQ	15.41%	11.02%	30.63%	-14.18%	43.64%
Russell 2000	31.37%	4.93%	25.42%	-30.61%	19.96%

*Total: price change + reinvested dividends

As reflected in the following table, all sectors of the S&P 500 had positive returns for the fourth quarter. Although both Energy and Financials had the two highest returns for the quarter of well over 20%, it was not enough to bring the sectors out of negative territory for the full year. The only other sector which was negative for the year was Real Estate. On the flip side, Information Technology and Consumer Discretionary soared in 2020, achieving gains of 43.89% and 33.30%, respectively. The wild success of Technology may stay with us, but our thought is that the equity market will broaden out into other areas of interest, such as travel and leisure and entertainment, to name a few of the depressed businesses left behind in 2020.

S&P 500

		Returns*	
Sector	**Weight**	**4th Qtr**	**2020**
• Energy	2.3%	27.77%	-33.68%
• Materials	2.6%	14.47%	20.73%
• Industrials	8.4%	15.68%	11.06%
• Cons. Discretionary	12.7%	8.04%	33.30%
• Consumer Staples	6.5%	6.35%	10.75%
• Health Care	13.5%	8.03%	13.45%
• Financials	10.4%	23.22%	-1.69%
• Info Technology	27.6%	11.81%	43.89%
• Communication Svcs	10.8%	13.82%	23.61%
• Utilities	2.8%	6.54%	0.48%
• Real Estate	2.4%	4.94%	-2.17%

12/31/20
*Price + income
Source: S&P Dow Jones

Whether investors should gear up for inflation is the question that comes up every time another stimulus package is announced. Yes, the massive amount of liquidity thrown into the financial system in 2009 was small compared to the present surge in money supply to over 25% year-over-year. While asset prices have risen, the real economy has not been affected. Savings rates have shot up, so the money found its way into these asset prices. We could see certain measures of inflation up to and a little above 2% when the economy opens up more fully, as the Federal Reserve would like inflation to go higher than it has been.

Diversification is key to investing in 2021. As rotations in industries are happening so quickly, the safest way to capture returns is to be diversified. As we have mentioned, with the extreme overweight in the Technology sector, we recognize that more and more attention will be directed into other areas.

FIXED INCOME

Fixed income investing has not been terribly rewarding for yield in 2020, leaving many investors piling into the junk bond market to pick up return. With these yields approaching five percent, considerable risk was experienced in bonds with low-grade triple-C ratings. High grade corporate bonds and U.S. Treasuries lived up to their billing as a stock market hedge in 2020. As of year-end, the 10-year Treasury yielded 0.92%, the 30-year Treasury 1.65%, and short-term Treasury Bills, at 0.09%, near zero, reflecting the desire of the Federal Reserve to hold short-term rates around zero for the next few years.

The investment grade fixed income markets ended 2020 with solid returns across the board, particularly in the long end of the spectrum, as reflected in the chart below. Corporates posted the strongest returns for the quarter and year; and for the full year, the highest-rated AAA bonds outperformed other investment grade corporate ratings. Further, with robust investor demand and record issuance, the municipal market also posted solid returns for both the quarter and year, and we expect this demand and issuance to continue into 2021.

Fixed Income Returns

Index	**4th Qtr**	**2020**
Corp/Govt	0.65%	8.76%
Int. Corp/Govt	0.50%	6.30%
Long Corp/Govt	1.02%	15.51%
U.S. Government	-0.91%	8.22%
- Intermediate	-0.23%	5.65%
- Long	-2.96%	17.37%
Corporate	2.99%	9.81%
- Intermediate	1.82%	7.66%
- Long	5.10%	13.83%
- **Quality**		
- AAA	1.55%	12.24%
- AA	1.77%	9.47%
- A	2.07%	9.81%
- BBB	3.97%	9.76%
Municipal	2.01%	5.26%
- Intermediate	0.88%	3.81%
- Long	2.75%	6.18%

Source: ICE BofA

Barring unexpected weakness in the economy, bond returns in 2021 are likely to remain low for quality credits. Investors, despite these low yields, should continue to hold high-grade corporates, municipals and Treasuries as a hedge against any equity turmoil.

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In conclusion, 2021 will, at best, be a most interesting year. As 2020 brought many surprises in the capital markets, so too will 2021. Our best recommendation is to remain invested, but well diversified with broad market industry participation.

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