2021 Themes & Outlook
"Are we there yet?"

As we entered 2020 no one would have predicted the calamity that lied ahead. A little more than a decade after the last once in a generation market event (i.e. Great Financial Crisis), investors were thrown into yet another unprecedented event, a deadly pandemic. As SARS-CoV-2 started to infiltrate the world, global equities ended their historical bull market, and the longest U.S. economic expansion in history came to a screeching halt. As hospitals in the U.S. began filling up, the S&P 500 was making its fastest way into bear market territory in U.S. history. Crude oil prices turned negative as the world went into lockdown. Tanker trucks were left to drift at sea until someone would take possession. Global governments swiftly pumped massive amounts of cash into their economies while urging businesses to shutter their doors to "slow the spread."

As we say good riddance to a year of sorrow, frustration and the unthinkable, we do see brighter times ahead for 2021, especially in the second half of 2021 when we can start putting COVID-19 in the rear-view mirror. We offer four market themes for 2021. The most important takeaway for investors is that 2021 will be another year that requires patience, discipline, and flexibility.

Fasten your seat belt!

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The Federal Reserve piled a variety of bond investments onto their balance sheet to avoid the human crisis turning into a credit crisis. Even with the Government efforts, U.S. economic growth plummeted to levels not seen since the Great Depression, Americans stockpiled cash and over 22 million Americans lost their jobs.

However, in a year that most of us would like to forget, all those events happened over the course of two months. In fact, as the world reopened activity rebounded at jaw-dropping rates. The S&P 500 saw its fastest move out of bear market territory in history and went on to post 18 fresh record highs and posted its second consecutive year of double-digit gains. The broad MSCI AC World Index is back to its record high. Crude oil has recovered and is at pre-pandemic levels and the U.S. has regained ~60% of the jobs that it lost during the depths of the pandemic.

As we look toward 2021 and with Operation Warp Speed delivering the fastest vaccination in history, we are all wondering, when can we finally put COVID-19 behind us? Like any long family road trip, the question looming in everyone's mind is "Are we there yet?" Our answer to investors is "Not quite." The vaccine is a game-changer, but it will take time for full distribution and we cannot take our eyes off the road. We are still fighting the virus and it will be a focus for most of 2021. We expect delays and disruptions as we navigate through the ramifications of the deadliest wave of the pandemic yet and it will take time before we reach our destination—"the new normal."

Economy: First half slow before multi-year acceleration

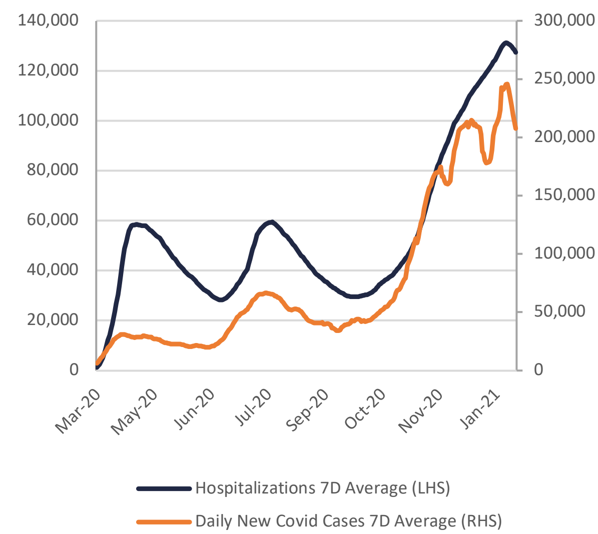
As we await the full rollout of the vaccine, the main influence on GDP in 2021 will continue to be COVID. The combination of ultra-accommodative Fed policy and additional fiscal stimulus is expected to bridge the gap until we can get full distribution of the vaccine and the economy opened again. However, the first half of 2021 is likely to present the economy the biggest headwinds of the year as we absorb the negative impacts of the most recent wave of COVID cases. We expect a much brighter second half but acknowledge the battle we are still fighting and warn of the challenges we expect in the coming months. Below we highlight the initial headwinds we will face and what we see as we move into the second half of 2021 and beyond.

- **COVID surge a risk:** While we have finally seen the 7-day moving average of new COVID cases turn lower we are still seeing hospitalizations near a record high and deaths rising at an alarming rate. **(Chart 1)**. This impacts the short-term outlook for economic growth. Especially for small businesses which have been hit the hardest by the pandemic. While stimulus will help bridge the gap before we can get the economy opened, its aid can only stretch so far if portions of the economy are shut down.

Chart 1

Surge in COVID Cases Will Challenge Growth in 1H21

Data is as of January 18, 2021. Source: The COVID Tracking Project, Verdence Capital Advisors.



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- **Speed up vaccine distribution:** The vaccine is a game changer but if we do not get it out into the economy faster, it is only delaying us returning to a normal way of life. Out of the top 10 countries in regard to distribution of the vaccine per 100 people in the population, the U.S. is fifth behind several emerging market economies and even the United Kingdom. **(Chart 2).**

- **Labor market will take time to repair:** The labor market is typically one of the last areas of the economy to recover after a recession. This recession is no different and has its own unique complexities. Small businesses, which make up most U.S. businesses and ~50% of the workforce, have been the hardest hit by the pandemic. Currently, there are almost four million Americans that are considered long term unemployed. **(Chart 3).** The labor force participation rate is slipping with over two million women leaving the work force due to having to choose between home schooling children or careers. Even with additional stimulus, the labor market will take time to fully repair and time for us to decipher what is permanently lost and what is temporary.

Chart 2

Need to Speed up Vaccination Distribution

Data is as of January 18, 2021. Source: Our World in Data, Verdence Capital Advisors.

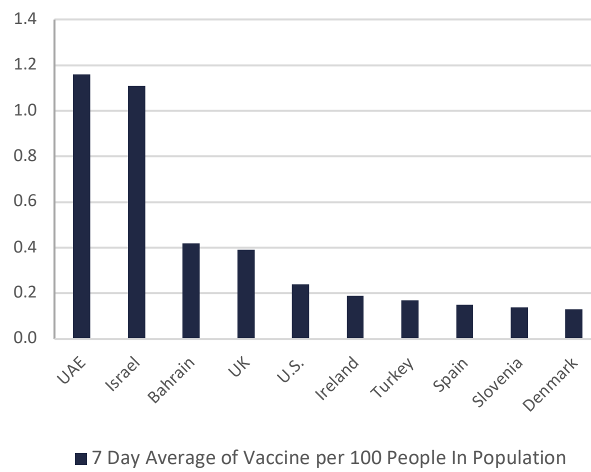
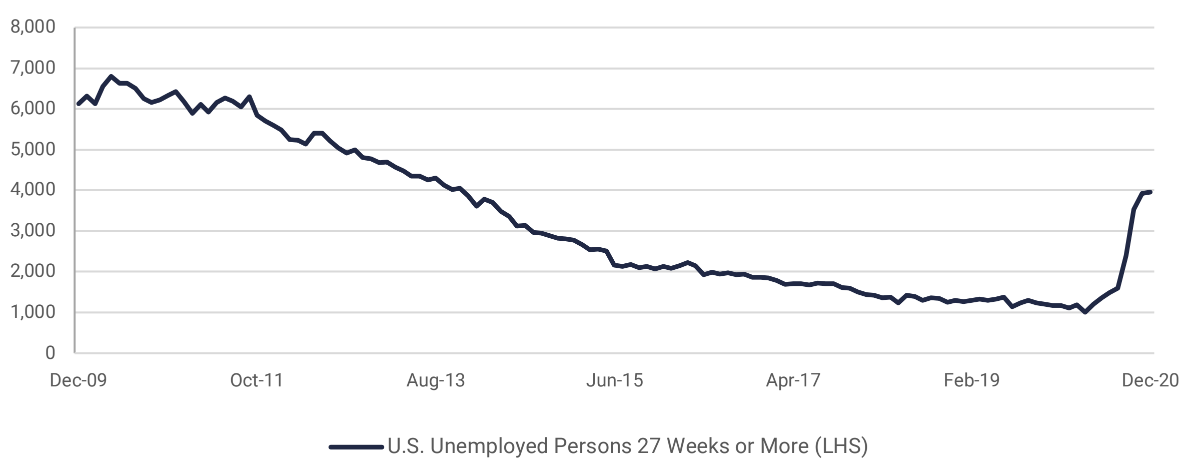


Chart 3

Labor Market Will Take Time to Repair

Data is as of December 2020. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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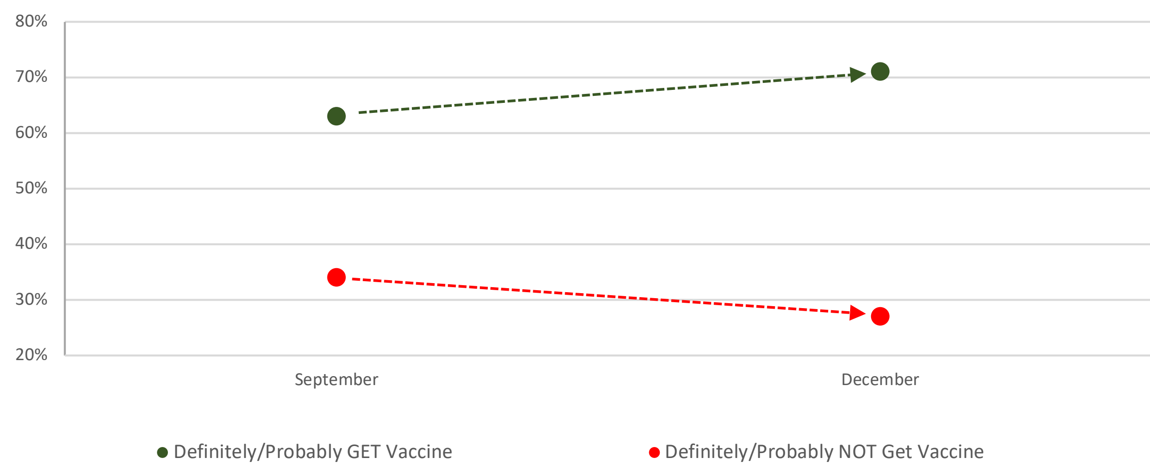
Despite the bumps along the way at the start of 2021, **we see a brighter, smoother ride in 2H21** that should begin a global, multiyear, sustainable acceleration in economic growth.

We are confident that the vaccination is the game changer and while widespread adoption of the vaccine is crucial in ending this war, Americans are growing more confident in taking the vaccine. In a recent Kaiser Family Foundation survey, ~70% of Americans said they would get the vaccine if it is deemed safe by scientists and free to the public, up from ~60% in September. **(Chart 4).** In addition, the improvement in willingness has been seen across all racial/ethnic groups. While the CDC does not know exactly what percentage of the population needs to get the vaccine to reach herd immunity, estimates range from 70%-90%, so we are moving in the right direction. The vaccine and widespread adoption along with the following supportive factors should bolster growth in the coming years.

Chart 4

Americans Getting More Comfortable with Vaccine

Data is as of December 15, 2020. Source: Kaiser Family Foundation, Verdence Capital Advisors.



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- **Yellen/Powell/Biden = Hat trick for stimulus:** The appointment of Janet Yellen to lead the Treasury Department, Jerome Powell to continue at the head of the Federal Reserve and President elect Joe Biden's recent plans for additional stimulus are all supportive of a multiyear acceleration in growth. Yellen has publicly voiced her desire for more fiscal stimulus and Jerome Powell has said he will use "all tools" necessary to support the economy through the pandemic. We expect interest rates to remain unchanged until 2023 at the earliest, as the Fed has expanded their balance sheet over $7 trillion and the Federal Government has already spent ~$4 trillion to combat the virus. These combined efforts are more than 50% of U.S. nominal GDP (~$22 trillion).

- **Housing supportive:** With 30-year mortgage rates at a record low, we have seen housing activity surge in 2020. Homebuilder sentiment is at a record high while inventories of existing homes are running at the lowest levels seen in history. Near record high prospective buyers traffic and low inventories are supportive of continued housing market activity in 2021. **(Chart 5).**

- **Inventory replenishment:** The U.S. economy is still in dire need of replenishing inventories that were drawn down during the depths of the pandemic. As can be seen by **Chart 6,** customer inventories as measured in the ISM Manufacturing Index are at a decade low. This should be supportive of ongoing job additions and improvement in the manufacturing sector.

Chart 5

Housing Market to Continue to be Strong in 2021

Data is as of November (Months' supply) and December 2020 (Prospective Buyers Traffic). Source: Bloomberg Finance LP, Verdence Capital Advisors.

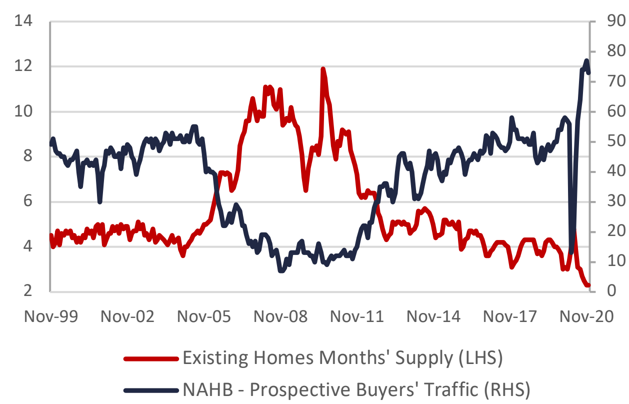

Chart 6

Manufacturing to be Supported by Inventory Replenishment

Data is as of December 2020. Source: Bloomberg Finance LP, Verdence Capital Advisors.

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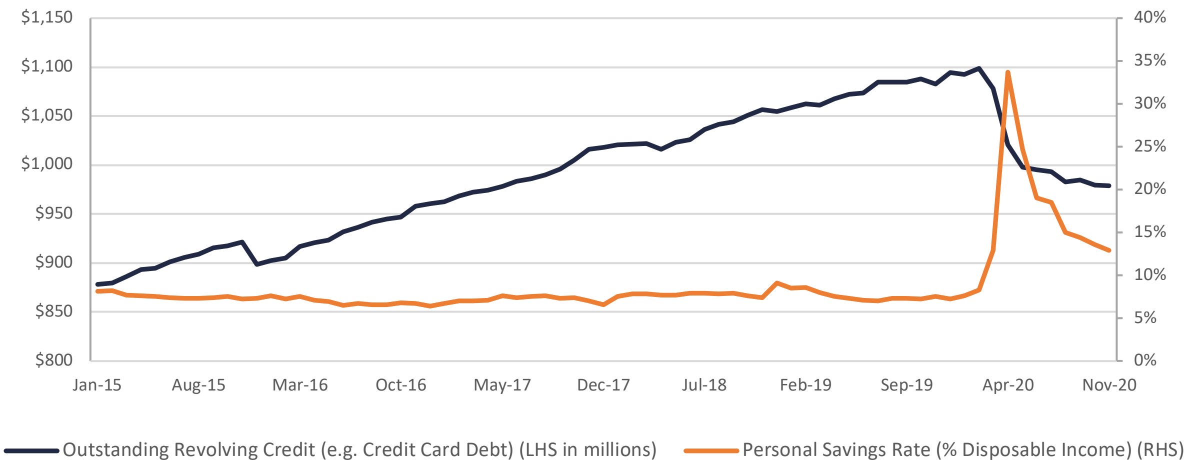
- **A different type of pent-up demand in 2H21:** While consumer spending may be volatile in 1Q21 as virus cases remain heightened and we await additional stimulus, it is important to remember that consumer balance sheets are healthy. Household debt service ratios are strong, savings rates have come down but are still in the double-digit range, and consumers have taken the time to pay down debt. **(Chart 7).** We believe we will see an entirely new pent-up demand materialize as the economy reopens in 2H21. Instead of splurging on furniture, electronics and other "stay at home" items, Americans want to get back to the movies, concerts, sporting events and travel. After the announcement of both Pfizer and Moderna's vaccine, some travel search engines saw explosive traffic and even saw surging activity for bookings in some cities hurt the most by the pandemic (e.g., New York, LA).[1] This is important because these types of industries have far reaching tentacles for economic growth. Travel and leisure contribute immensely to small businesses and job creation. In fact, it is estimated that domestic and international travelers spent over $1 trillion in the U.S. alone in 2019 which accounted for nine million jobs. Every $1 million spent on travel goods and services contributes to eight jobs. This is more than any other industry in the U.S.[2]

Chart 7

Consumer Balance Sheets Remain Strong Despite Pandemic Struggles

Data is as of November 2020. Source: Bloomberg Finance LP, Verdence Capital Advisors.



Economy Bottom Line:

Things will be tough before they get better to start 2021 as we absorb the recent surge in COVID cases. We expect restrictions to be a theme in 1Q21 until case levels come down. However, the combination of massive monetary and fiscal stimulus, more vaccines in circulation, a low interest rate environment and pent-up demand should buoy economic growth in 2H21 and into 2022.

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Fixed Income: Expect Muted Returns; Be Conservative

One main driver of interest rates is inflation. While we believe inflation will be a long-term concern given the massive amount of stimulus put forth to keep our economy afloat, reflation is the theme of 2021. Inflation is the broad increase in prices typically brought on by a surge in economic activity and tight labor market. This typically occurs towards the end of a business cycle and is detrimental to fixed income returns as interest rates rise along with inflation and reduce a fixed income investor's return.

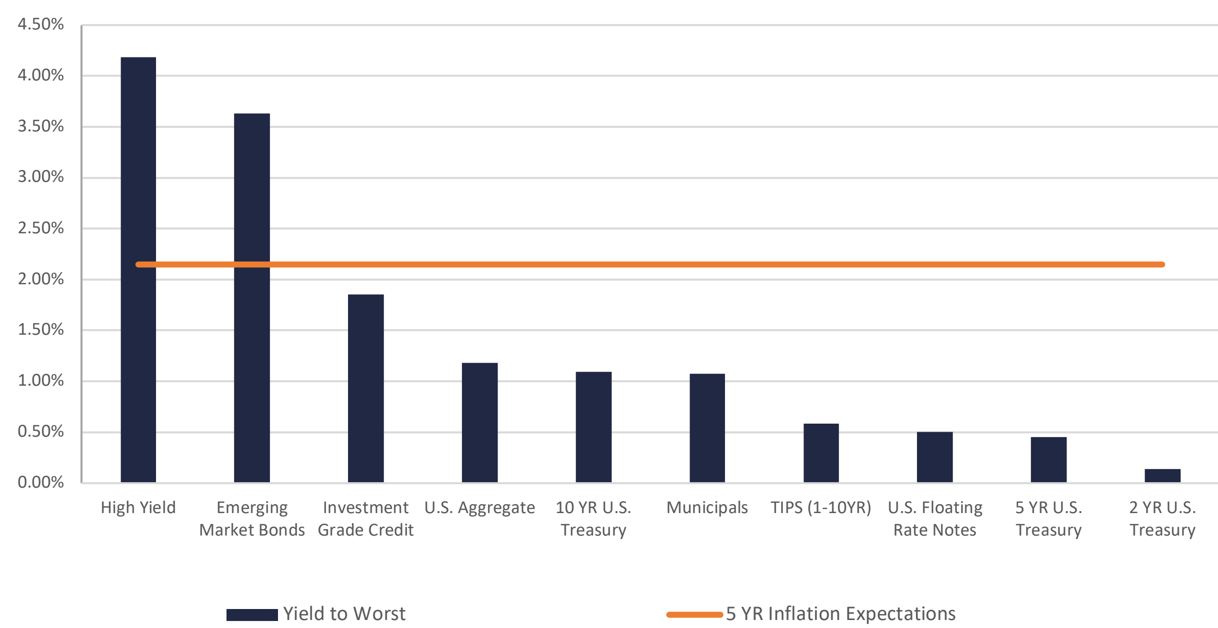
However, reflation typically occurs at the start of a new business cycle and is the use of fiscal and monetary stimulus to increase economic output and avoid a deflationary spiral. Typically interest rates rise once activity starts to recover but the Federal Reserve is going to use all tools necessary to avoid a significant rise in interest rates in 2021. We expect the Fed to keep their benchmark rate unchanged until 2023 at least and if they need to intervene in long term rates to keep the rise limited, they have not ruled that out. In addition, they are expected to continue purchasing a variety of different debt instruments ($120 billion a month) to support a healthy functioning credit market. At their committed pace, the Federal Reserve's balance sheet could be approaching $10 trillion by the end of 2021/early 2022.

As a result, interest rates will likely remain lower for longer. Credit will likely remain expensive for longer and not reward investors for the risk associated with buying them. In addition, until growth materially picks up, most fixed income yields will likely offer less than inflation. **(Chart 8).**

Chart 8

Most Fixed Income Investments Offer Less Than Inflation Expectations

Data is as of January 18, 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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Fixed Income Bottom Line:

With the Federal Reserve manipulating the fixed income market, being able to fundamentally value fixed income is difficult. We know that rates will rise once growth and inflation normalizes and that fixed income investors will price in rate hikes well in advance of them taking place. Therefore, we would be cautious in fixed income. Be defensive in duration and credit.

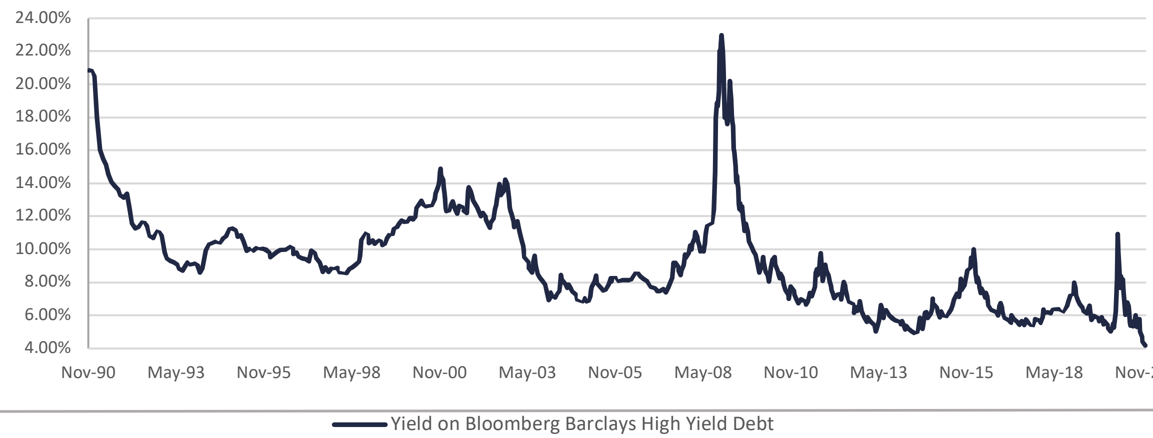
Therefore, fixed income should solely be considered as a portfolio diversifier, especially if growth weakens more than expected, but investors should not expect the types of returns seen in recent years. We would recommend the following positioning to increase the diversification benefits in an environment of historically low yields.

- **Defensive in duration:** There is little to no value over the coupon in long term bonds and much more downside risk when (not if!) interest rates start to normalize. Therefore, we would focus on short to very intermediate maturing bonds.
- **Credit expensive; be defensive:** Corporate bonds have benefitted from the Fed's purchases and investors searching for anything that offers yield over government bonds. They are not reflecting weaker credit fundamentals, especially in high yield. With the yield on high yield debt at a record low we would be cautious sacrificing credit quality at this time. **(Chart 9).**
- **Emerging market bonds offer value:** Emerging market bonds offer extra yield and are not manipulated by central bank action as seen in many domestic bond markets. Fundamentally, inflation is declining in many of the major emerging market economies and offers central banks flexibility to cut interest rates. In fact, several of the major emerging market economies are expected to cut interest rates again next year (e.g., Mexico, Indonesia, Turkey, Russia, Philippines) which should support emerging market bonds.

Chart 9

Most Fixed Income Investments Offer Less Than Inflation Expectations

Data is as of January 18, 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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Global Equities: Policy Supportive; Look Beyond U.S. and Tech

Global equities have been one of the largest beneficiaries in the second half of 2020 as the world gradually reopened, political risks subsided in the U.S. and aggressive stimulus measures pushed investors into global equities. The MSCI AC World Index reached a new record high after its more than 30% decline in the depths of the pandemic. **(Chart 10).** Around the world valuations have reached levels that look stretched and some areas even look “bubble like” (U.S. tech). However, we recommend an overweight to global equities in 2021 and beyond for several reasons:

- **New business cycle:** While the bear market move was quick and many indices have returned to fresh record highs, we are in the beginning stages of the next business cycle. Historically, that is an attractive period for equity investors as earnings rebound with economic growth.
- **Relative to bonds there is no comparison:** Bond yields are at historical lows, globally and the dividend yield on the MSCI AC World Index is higher than the yield on the 30-year U.S. Treasury bond. When looking at Europe, interest rates are negative out to 30 years in Germany so even a stock that is paying no dividend in Europe is better off for an investor than buying a negative yielding 30-year bond.
- **Monetary stimulus supports heightened valuations:** The Federal Reserve has stated that it will not raise interest rates until 2023 at the earliest. This is a common theme globally with the European Central Bank suggesting they will keep their negative interest rate policy in place until inflation approaches their target 2% level (currently it is negative). This is important because low interest rates historically support heightened valuations.

Chart 10

Global Equities Back to Record Highs

Data is as of January 18, 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors.

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That does not mean we expect a smooth ride in 2021 as we navigate our way through what might be the worst of the pandemic yet. In 1H21 economic data is likely to disappoint and we do not rule out temporary weakness in GDP around the world due to the elevated COVID cases and lockdowns in specific countries. However, we will continue to evaluate periods of market weakness as buying opportunities as we will look beyond the short-term disruption and focus on the 2H21 economic and earnings reacceleration. Below is our recommended equity allocation for 2021.

- **Favor international over U.S. equities:** COVID left no country unturned and our international developed counterparts have struggled with the same waves of virus surges and rolling lockdowns. However, they are also likely to benefit from the 2H21 global growth resurgence because of the vaccinations as well as highly stimulative monetary and fiscal stimulus. While our global counterparts may have seen a more dramatic decline in growth due to COVID in 2020, the IMF sees a more dramatic recovery in many areas than in the U.S. **(Chart 11).** Another catalyst for international equities is that our developed international counterparts have lagged the tech heavy U.S. rally for the past decade (by ~8% per year) and look ripe for an opportunity to catch up when global growth accelerates **(Chart 12).**

Chart 11

More Pronounced Pick-up in Growth in 2021

Data is as of October 2020. Source: IMF, Verdence Capital Advisors.

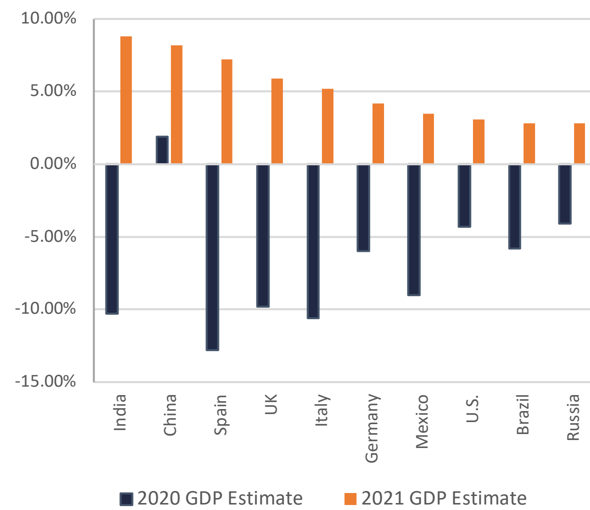
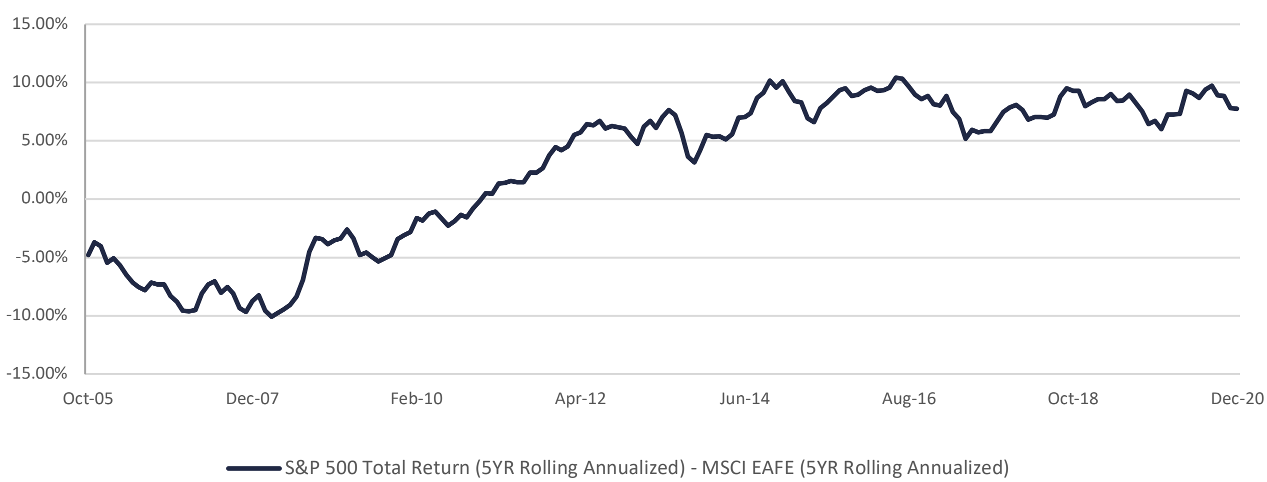


Chart 12

Time for International Developed Markets to Catch Up?

Data is as of December 2020. Source: Bloomberg Finance LP, Verdence Capital Advisors.

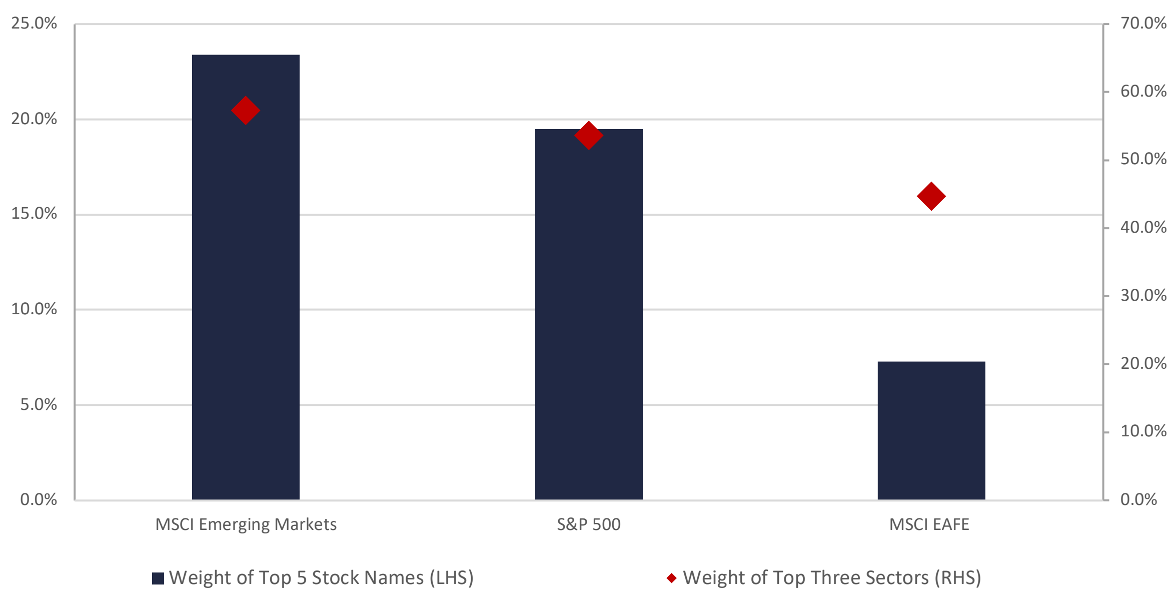


- **Slight overweight to EM equities:** Like our international developed counterparts, we believe emerging market economies stand to benefit from a global resurgence in economic growth in 2H21 and beyond. These economies tend to be more export dependent so they should benefit from increased global demand. In many major emerging economies, we have also seen flexible and accommodative monetary policy as well as fiscal stimulus. In fact, China is the only country that the IMF expects to post a modest GDP gain in 2020. However, selectivity is important as some Indices have rallied more than the U.S. out of the March lows and concentration risk remains a concern in the emerging markets. The top five stocks in the MSCI Emerging Markets Index make up 23% of the Index, compared to only 7% in the MSCI EAFE. **(Chart 13).**

Chart 13

Concentration a Bigger Risk in EM and U.S.

Data is as of January 12, 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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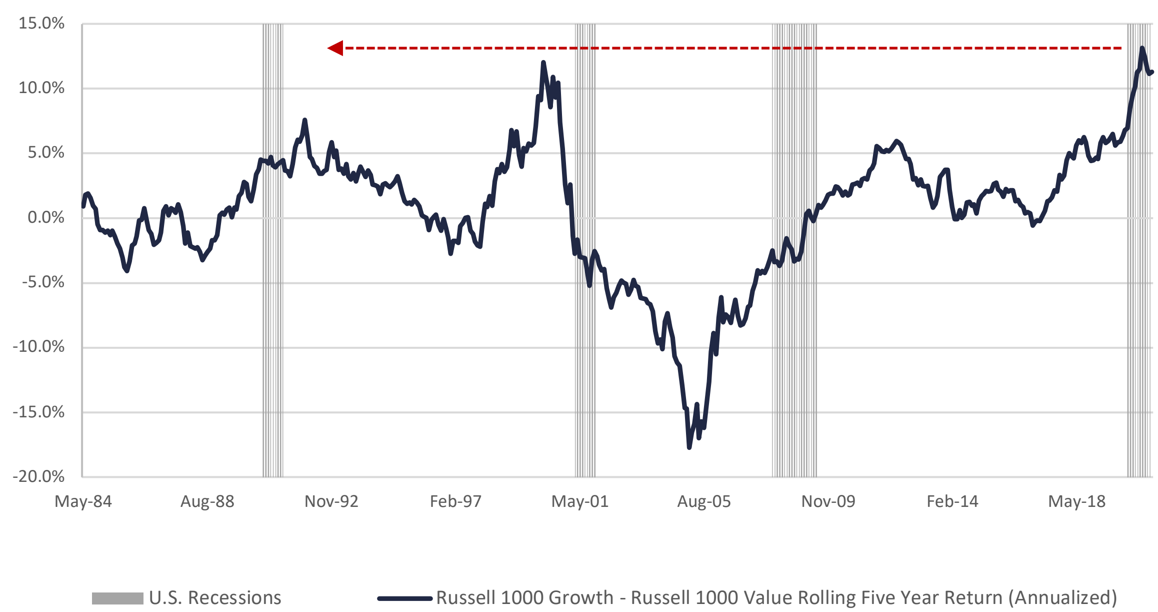
- **Within U.S. – Finding Balance:** Growth stocks have outperformed value stocks at all market cap levels over the past decade, primarily due to the below trend growth we saw in the years after the financial crisis. Too many investors were chasing too few growth companies. The dispersion between growth and value intensified in the aftermath of the pandemic lockdown because the recovery was not a traditional recovery. Interest rates did not rise like they traditionally would and aid financials because the Fed has kept them well anchored, energy remained weak due to a global supply glut and a decade worth of technological advancements was pushed into a short period of time. Therefore, investors drove the tech/growth names to new highs in 2020 and continued to leave the cheaper value stocks behind. In September, on a rolling five-year basis, the performance of large cap growth over large cap value stocks surpassed the performance leading up to the dotcom bubble. **(Chart 14).**

Growth stocks have outperformed value stocks at all market cap levels over the past decade

Chart 14

Growth vs. Value – Time for Reversal?

Data is as of December 2020. Source: Bloomberg Finance LP, Verdence Capital Advisors.

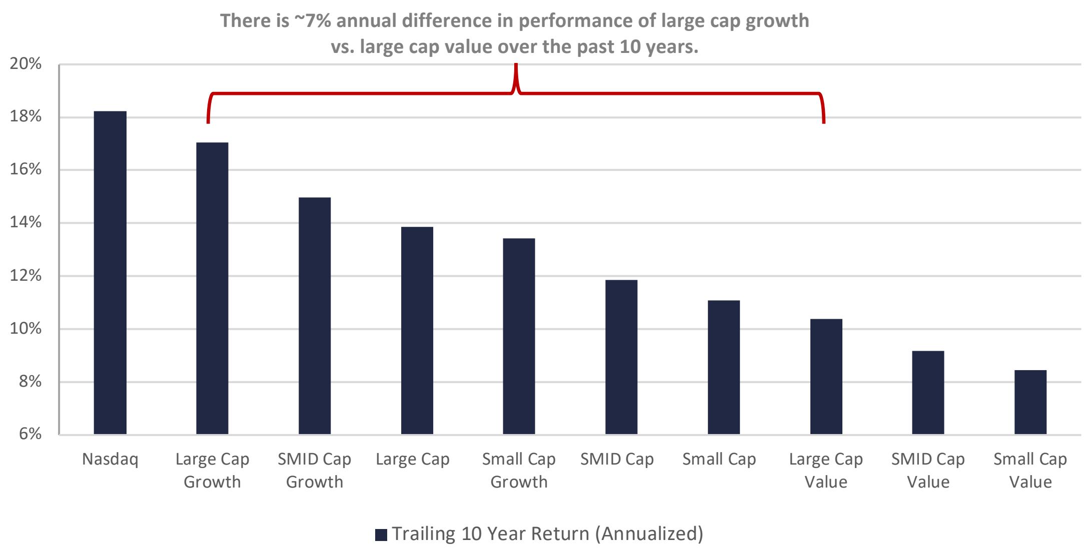


However, news of the vaccine has caused a sentiment shift and investors are once again looking for value in areas that have been left behind. We believe a broad adoption of the vaccine combined with massive fiscal and monetary stimulus could buoy growth to levels we have not seen since before the Great Recession. This supports investors having a modest tilt to value in their portfolios and to areas that have lagged over the past decade (small and midcap). **(Chart 15).** We do not suggest abandoning growth, especially if the economic environment remains uncertain in 1H21 and select tech heavy names may revert to dominating market performance. We will continue to look for opportunities to balance our value and growth allocation as valuations deem appropriate.

Chart 15

Look for the Alternate Route – Areas That Have Lagged

Data is trailing 10 years as of December 2020. Source: Bloomberg Finance LP, Verdence Capital Advisors.



Global Equities Bottom Line:

Volatility is likely to cast a cloud over the global equity market in 1H21 as we await the full distribution of the vaccine, continue to fight the virus, and await the return to a "new normal." Select areas of the global equity market are likely borrowing from 2021 returns (e.g., U.S. technology). We think international equities can outperform U.S. equities as the global economic resurgence takes hold in 2H21 and 2022. In addition, those areas in the U.S. that have lagged since the Great Recession have room to catch up as a record amount of stimulus should create a multiyear acceleration in growth.

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Alternatives: Valuation Differentials Support Private Over Public: Hedge the Volatility

While we would never suggest abandoning the public markets, we believe it is more important than ever for investors to consider alternative investments in their portfolios. We are in a period where we are watching equity markets make record highs on the back of weak economic data, Governments are racking up records amount of debt, Central Banks are playing the buyer of last resort and driving interest rates to record lows. **(Chart 16 – next page).**

Therefore, the traditional benefits one may receive from a simple 60/40 portfolio of stocks and bonds may not offer the same diversification or returns as has been experienced historically. It is also likely to produce much more volatility than an investor is accustomed to. In contrast, investing in the private market removes the daily volatility, offers negative correlation, attractive risk adjusted returns and may be a better way to hedge against the inflation that will arise (one day) due to the pandemic related spending. Some of the areas we like in 2021 include:

- **Private real estate –** Not only do we have a housing shortage in the residential space but there is opportunity in the commercial space. As commercial space remains under pressure, businesses will be forced to consolidate and revamp traditional office space. In a distressed environment, this is attractive for a long-term private investor.
- **Infrastructure –** Infrastructure is historically known to be a good inflation hedge due to its real asset characteristics. Investing in infrastructure through the public markets is concentrated in a select few industries (e.g., utilities and pipelines). However, investing in the private markets opens opportunities in hard assets such as timber and farmland. Historically, this type of investment has outpaced inflation and outpaced a traditional portfolio of stocks and bonds. **(Chart 17 – next page).**
- **Private credit –** As yields in the public bond market are historically low for distressed credit, there is opportunity to pick up additional income producing investments in the private credit space.

There are other options that have gained attention to hedge against inflation, but we would be cautious. Bitcoin is a highly volatile investment that has no store of value and is subject to regulatory risks. In addition, commodities have rallied drastically in recent months and select commodities are still experiencing a supply/demand imbalance (e.g., crude oil). Therefore, we are likely to see better buying opportunities.

Alternatives Bottom Line:

Traditional ways of diversifying a portfolio are going to be even more challenging in the years to come as we try to unravel the nontraditional measures that were taken to get us through the pandemic. We believe that alternative investments offer attractive risk adjusted returns and can take advantage of the market dislocations that have resulted from the pandemic related weakness.

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Chart 16

Alternatives in an Unprecedented World

Data is as of December 2020. Source: Bloomberg Finance LP, Verdence Capital Advisors.

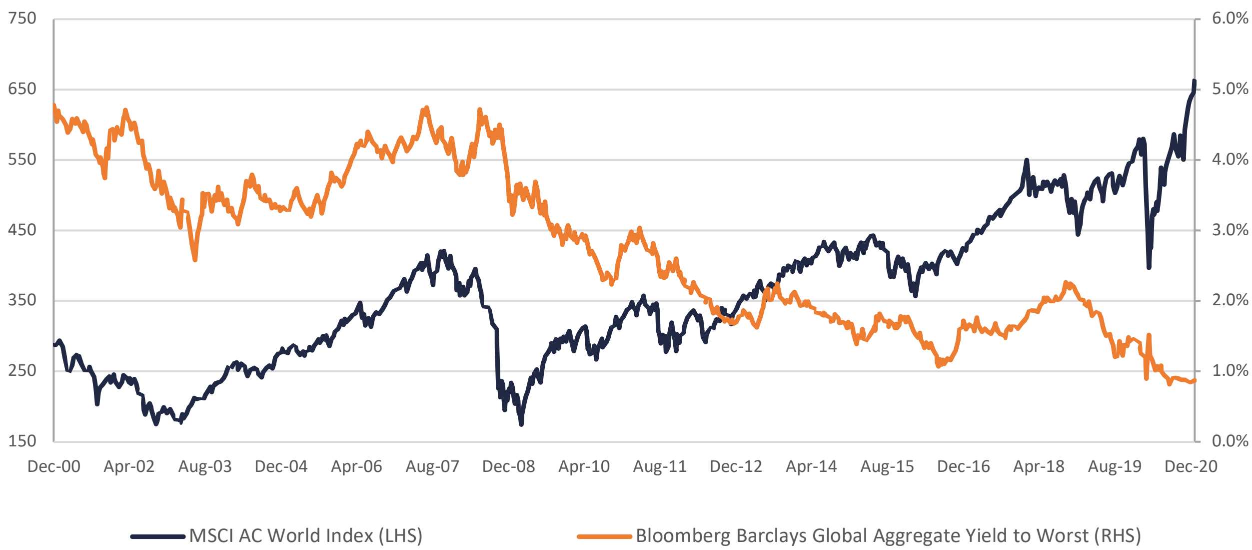
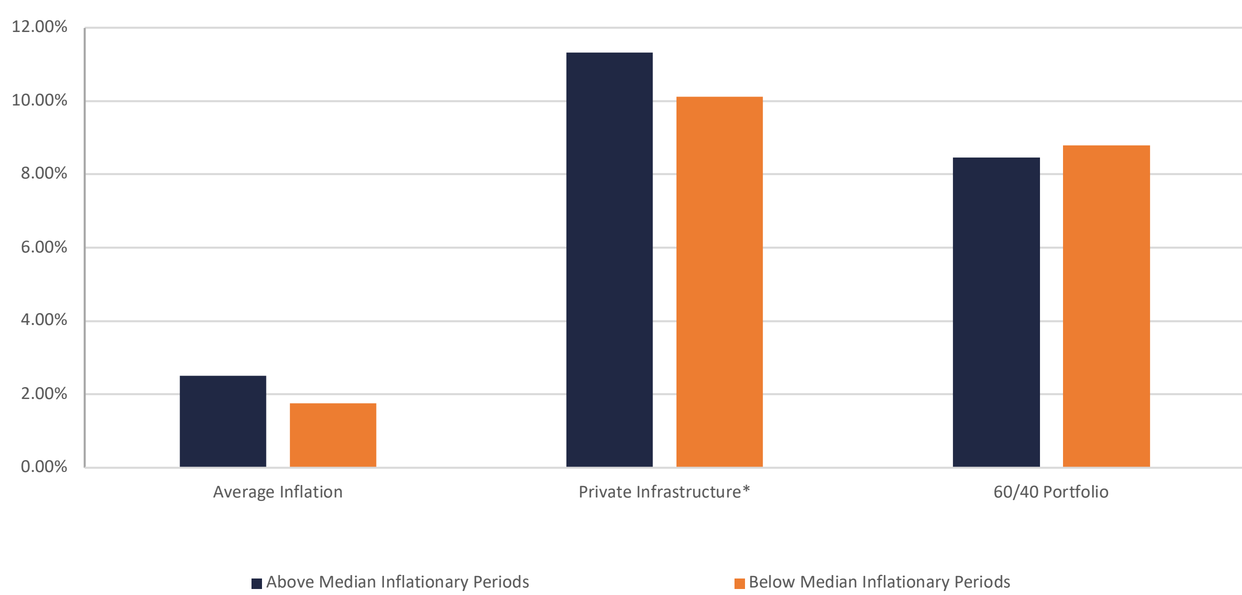


Chart 17

Average Annualized Return During Above or Below Median Inflationary Periods

Time period reflects January 1993-June 2020. Source: Versus Capital MSCI, JPMorgan, NCREIF, Morningstar, Bloomberg Finance LP, Verdence Capital Advisors.



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Verdence Summary:

COVID-19 has AFFECTED even those people that it did not directly INFECT in 2020. It has challenged mothers, fathers, grandparents, siblings. It has pushed our healthcare professionals, essential workers, scientists, politicians, and teachers to a breaking point. It has bewildered our children, young and old and they will carry these stories for generations to come.

For investors, we sympathize that it was likely one of the most unsettling years of your long-term investment cycle. A pandemic, an inconceivable drop in GDP, a bear market, a government order to stay home and a highly contentious election all wrapped up into one short year. Nerves were tested as you worried about preserving your own WEALTH and HEALTH at the same time. We realize it was arduous to turn off the TV, to stay disciplined and focus on long term objectives. However, we will continue to reiterate the foundation of a successful long-term investor, and that is to stay disciplined, but flexible, focus on your long-term investment objectives, and do not get drawn into short-term disruptions. This is especially important as we enter 2021.

The start of the new year will be challenging and COVID will still be part of our daily lives. However, as we enter the year, we have many more knowns than unknowns. We are not amateurs like we were in 1Q20. We have not one, but two highly effective vaccines and more in the pipeline. We have a promising therapeutic approved by the FDA (remdesivir) and a newly created FDA program (Coronavirus Treatment Acceleration Program) in place to streamline additional therapeutics. We know how to take care of ourselves and our elderly to lessen the virus' stronghold. We have seen the American spirit and entrepreneurship at its best. We have seen restaurant owners transform parking lots into dining rooms for us to go somewhere and feel normal again. We have witnessed monetary and fiscal stimulus of a magnitude that has never been seen in U.S. history to help us come out ahead in this fight, stronger and better. We will persevere and 2021 will look much brighter than 2020. So yes, kids, "we are almost there."

As always, if you have any questions about our perspective, please do not hesitate to reach out to your advisor.

[1] Skyscanner search engine. Article on insider.com dated November 20, 2020.

[2] https://www.ustravel.org/system/files/media_root/document/Research_Fact-Sheet_US-Travel-and-Tourism-Overview.pdf as of March 2020.

Important Disclosures:

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