MORAN
WEALTH MANAGEMENT

Tom Moran
Founder, Chief Executive Officer
Senior PIM Portfolio Manager

Charlie Chesebrough
Senior Vice President

2020….What a year!!

It goes without saying that 2020 was an unusual year. A frightening pandemic, global lockdown, cities shut down and deserted, along with some of the most political divisiveness this country has ever witnessed, one would think the markets would have been hammered. Instead, after one of the swiftest declines in the history of stock markets, followed by one of the fastest recoveries, with a short/deep resulting recession, who would have guessed in their wildest dreams that the S&P 500 would finish up 18% for the year?

Over history and many lessons learned from the school of hard knocks it has become evident that investors do very well by staying the course and not panicking during times of market stress. This was never more important than in 2020. One of the notable differences between this pandemic induced market downturn and prior episodes was that by in large, most individual and institutional investors did what they should do….nothing! To their credit!

Let's review some of the notable characteristics of 2020 which will help set the table for how we are thinking about 2021 and beyond.

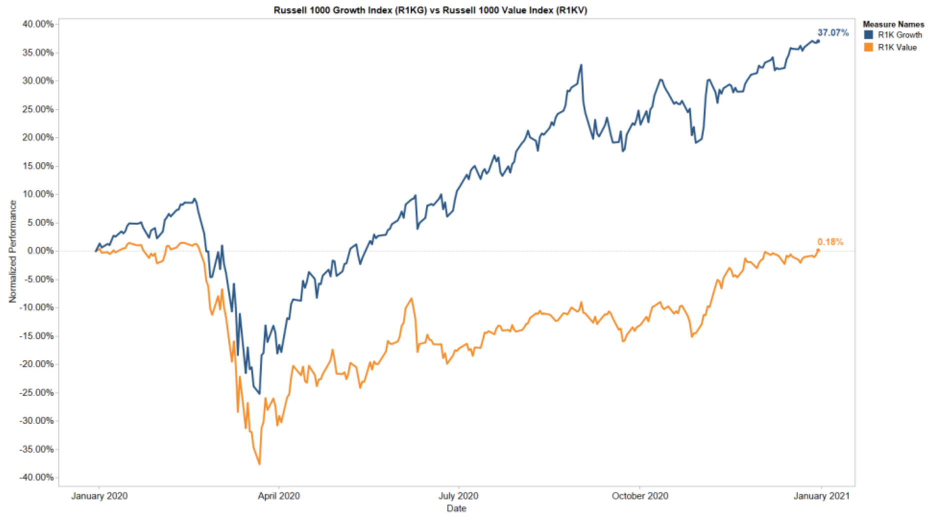
Yay Technology!

In typical downturns those that had invested most conservatively in defensive strategies tended to outperform. Think of sectors like consumer staples and utilities and industries such as pharmaceuticals. Very stable companies with consistent cash flows that do not waiver much when the economy wobbles. In addition to these certain investing strategies that are inherently less volatile such as dividend and income or low beta tend to do relatively well doing selloffs. Unlike prior market downturns, the 2020 market selloff and recovery was to say the least, unique. During this go around, those that had invested most aggressively in high growth, high valuation industries along with secular growth themes performed the best. Most notable was the Technology sector which finished up 42% for the year, compared to the S&P 500 which was up 18%. This extraordinary return was mostly on the back of the largest technology/consumer oriented stocks and the newer fast-growing Cloud, 5G, Cybersecurity, Fintech, Networking, and Ecommerce securities. Intuitively we know why…technology of all kinds saved the day for us and enabled the global economy to continue functioning productively mostly from our homes in the midst of the worst public health crisis in 100 years.

The trends of S&P 500 and Tech Sector (XLK) for Date Day. Color shows details about S&P 500 and Tech Sector (XLK). The data is filtered on Date (MDY), which keeps 254 of 504 members.

Growth vs. Value

There has been the long running debate about where is a better place to be invested over time….in "growth" stocks or in "value" stocks. There is no correct answer as times and circumstances in the global economy nudge the factors that favor these. Historically growth stocks (faster than average earnings and sales growth along with higher valuations) have outperformed when there is concern about the dependability of growth or as GDP/economies peak and then slow in an economic cycle. Value stocks tend to outperform coming out of a recession, have depressed earnings or/or trade very inexpensively. Generally, you tend to see these two fight it out for supremacy with one outdoing the other by a noticeable but not dramatic amount. In 2020, however, the Russell 1000 Growth index beat the Russell 1000 Value index by over 37 percentage points!! This was the biggest divergence since the inception of those indices.



The trends of R1K Growth and R1K Value for Date Day. Color shows details about R1K Growth and R1K Value. The data is filtered on Date (MDY), which keeps 254 of 504 members.

Interest Rates

2020 began the year with the 10-year Treasury note trading at 1.70%. At its worst moment during the pandemic, it traded down to 0.43% and finished the year at 0.68%. For those who remember when home mortgages were north of 10.0% back in the 1980s, this has been a jarring ride. Great for borrowing money, terrible for finding new yield instruments to invest in and those on a fixed income. The world today is starved for yield!

Valuation

Ah yes, valuation. The S&P 500 started 2020 trading at a multiple of forward earnings (P/E) of around 18x. It finished the year trading north of 23x. Of course, earnings forecasts changed radically throughout the pandemic but suffice it to say, the market is trading at the high end of its long term historical averages. To put it in context, over many decades, the average multiple has been in the mid-teens. But given the incredibly low interest rate environment, one can understand why the investors have gravitated toward equities and over fixed income securities. The term TINA has been kicked around by pundits and strategists to describe this interesting phenomenon; “There Is No Alternative” to equities.

Election is over
After one of the most contentious elections in history, the market appeared to breathe a sigh of relief in early November. Not so much based on Joe Biden defeating Donald Trump, but based on the fact that it was over! Markets hate hate hate uncertainty. Always have. And even though election results took a while to affirm, it ended! The result…the S&P 500 rose +10% from the day after election through the end of the year. We believe this is significant as the election really marked a change in investor psyche, from a frightened bunker mentality to hope regarding re-opening and an optimistic take on the future. It also marked the clear beginning of a rotation from Growth to both Value and Dividend styles. Just for color, from the day following the election till Valentine's Day 2021, the broad basket of dividend paying stocks using the ETF ticker DVY as a proxy increased by 23%. Something is in the air.

2021…What may be coming

We are very encouraged about the prospects for the market in the shorter term. We think 2021 could be a reasonably good year provided the vaccination distribution machine continues as promised and re-opening happens at the pace we are all hoping for and expecting. 2021 looks to be one of the strongest economic growth environments in several decades with GDP expected to grow north of 7%. At this point, the pros outweigh the cons. When we pull out the chalkboard and list the positives and negatives, this is what we come up with:

Positives
1. Optimism. It is palpable. Hopes of a normal post-pandemic life are starting to take hold. Family gatherings, travel, eating out, and entertainment are the top categories that we will dream about and will flock to.

2. Change. Every new administration brings a sense of change and optimism.

3. Confidence. Consumer confidence is high. Corporate (CEO and CFO) confidence is higher than it has been in years.

4. Stimulus. $900 bill from the December bill last year is still not spent. Congress just passed another $1.9 trill that is already being distributed. Another $1 trill for infrastructure this summer is being discussed and

possible. This floodgate of liquidity will be a big boost in the short term, but will haunt us later. Globally, almost $20 trillion of aid has been provided by fiscal and monetary policy due to the pandemic.

5. 2021 should be strong year for markets. Generally stock markets follow earnings. There are periods of time when what we pay for the multiple of those earnings (the P/E) goes through expansion or contraction. Over the last several years the market was almost entirely driven by the expansion of the P/E. It is very likely that the baton is handed back over and it is now up to earnings growth to lift markets.

6. Wealth effect. The combination of the value of housing, savings, and investments are at an all-time high. Historically, a piece of increased wealth is spent back on the economy (GDP).

7. Pent up savings. The world's consumer has been in lockdown over the last 12 months. It is estimated than an additional $2-3 trillion of savings that is above and beyond what is normally socked away is waiting to come out to play.

8. Sharp rebound in company earnings. The S&P500 earned approximately $164 in 2019 and dropped to $144 in 2020. It is possible that the broad index of companies could earn north of $190 in 2021. A 30%+ increase is pretty rare!

9. Interest rates. Low interest rates are a positive for equities. Rising interest rates are a positive SO LONG AS they are rising for good reasons and are doing so at a gradual pace…that is…GDP is growing and inflation is not running wild. So short term positive, but stay tuned!

Negatives

1. Interest Rates. Undeniably, the most important metric to pay attention to as a borrower or a saver. After almost 40 years of declining rates, we were bumping along the bottom having reached a pandemic low below ½ of 1% during the summer. It is becoming apparent now that as the vaccines roll out and optimism resides that rates are going higher. The question is how much higher. Rates that approach 2.5%-3% would be a signal that inflation is here and the equity markets will not like that. Also, the speed at which we get there matters.

2. Inflation. Historically, inflation is a killer for markets. We have not seen inflation to any noticeable degree since the 1970s, but it is likely dormant, not dead. Currently, however, we are seeing every sign that inflation is here. Look at commodities as a clue. Many up 30-100%+ in the last 12 months. It almost doesn't matter which one you pick…oil, lumber, copper, precious metals, base metals, soybeans. Moves like this are a sign.

3. National Debt. Yikes! We ended 2019 with over $22 Trillion in debt. It is highly likely that we will exit 2021 with almost $30 Trillion in debt. When the interest we pay on the debt is <1.0%, we can manage (sort of). The worry will be, what happens when interest rates go up?

4. Policy Mistake. Historically, many expansions are ended by policy mistakes. From a monetary standpoint, the Federal Reserve either acts too quickly or too slowly or too swiftly in setting short term interest rates and it causes an extreme move in flow of money and asset prices. From a fiscal standpoint, extreme changes in trade policies (think Smoot Hawley) or spending priorities or taxes can cause dislocation. Getting it right is tricky

5. Valuations. The broad markets are historically expensive. Even more so when one looks at certain subsets. The broadest growth index (Russell 1000 Growth) trades at a trailing PE of 39x as compared to the value index (Russell 1000 Value) that trades at a trailing PE of 21x.

6. Covid 19. With any luck, between vaccinations and people who have already contracted the disease, we will reach some form of herd immunity this year. Any substantial hiccup along this path or a new variant that crops up and sets us back would clearly be a negative event for the market.

7. Bubbles. Just to name a few that are blowing….bond, biotech, SPAC, shorting, space travel, and real estate.

<u>**2022 and Beyond….then what?**</u>

For now, we feel relatively optimistic about the markets in 2021 and into 2022 given that when weighed on a scale, the positives mentioned above outweigh the negatives. As the regime appears to have shifted coming out of this 2020 recession, we believe that we are in the early innings of a market rotation from Growth and into Value. This could last several years. Not that Technology and Healthcare and other growth sectors won't do well. This is more of a belief that the re-opening, the pent-up nature of consumer spending, the monetary and fiscal stimulus, high corporate operating leverage, and the much cheaper valuation of cyclical sectors like Financials, Industrials, Consumer Discretionary and Materials will lead the market. In addition, as interest rates rise, the valuation of long-duration expensive growth stocks should decline.

So as we think about the end of 2022 and beyond, we get more concerned and cautious in thinking about market direction. We will then be on the precipice of the Fed raising rates (currently projected to be a 2023 event), long term rates higher, a yield curve that is steepening, wage growth pressure becoming evident, inflation getting closer to 3%, unemployment getting near full under 5%, company earnings that are slowing, and valuations that are high.

We recommend staying the course and participating in the short to medium term equity markets. Value and Dividend strategies have the wind at their backs. Toward the end of this year and into 2022, it may be prudent to re-visit strategy allocations and begin to dial back on the risk. We believe we have numerous strategies that will provide more downside protection and offer less inherent risk in what might be a bumpier ride in the markets. In addition, do remember, Corporate, Treasury and Municipal bonds actually lose money when interest rates go up. To quote Warren Buffett in his most recent annual letter "Fixed-income investors worldwide- whether pension funds, insurance companies or retirees – face a bleak future".

For additional information and resources, please visit us at https://www.moranwm.com/

P: 239-920-4440 | F: 239-431-5239
Thomas.Moran@MoranWM.com | www.MoranWM.com
5801 Pelican Bay Blvd, Suite 110, Naples, FL 34108

instrument or to participate in any trading strategy. Additional information is available upon request.

All investing involves some degree of risk, whether it is associated with market volatility, purchasing power or a specific security, including the possible loss of principal. Stocks offer long-term growth potential, but may fluctuate more and provide less current income than other investments.

Index returns are not fund returns. An index is unmanaged and not available for direct investment.

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

The prices of small company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification, and competitive strengths to endure adverse economic conditions.

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