Independence Asset Advisors

MarketMatters

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COVID-19 Update

The COVID-19 pandemic remained at the top of the news cycle throughout the fourth quarter.

A sudden surge in new virus cases led to a second round of business closures. However, public markets were hardly impacted following the announcement that two effective vaccines had been approved and were ready for expedited global distribution. The announcements led investors to speculate that small and mid-sized businesses would return to normal operation by the end of 2021, which sent small and mid-cap indexes soaring up to 9% higher in December.

We agree with this logic, but believe the sharp spike in returns was likely a swift, momentum-driven event.

Over the next few months, we anticipate that the widespread vaccination of the global population will undoubtedly benefit smaller companies, though it will take time for governments to fully relax the restrictions that remain in place given higher present infection rates.

Market Overview & Key Themes

Key Insights:

- COVID-19 continued to dominate headlines with the announcement of two effective vaccines.
- Small and mid-sized companies benefitted most from the announcement.
- Energy infrastructure and REIT investments recouped some of their first-half losses.
- The U.S. elections and a fresh round of government stimulus boosted optimism.
- Housing and interest-sensitive sectors strengthened into the new year.
- Bond spreads narrowed further, interest rate risk increased and defaults leveled off.
- The economy showed signs of recovery and momentum is growing.

The fourth quarter was a hopeful way to cap off a traumatic year. Global equities surged higher, supported by effective vaccine news, the November U.S. presidential election results, and a $900 billion stimulus package. Investors were also reassured during the quarter that the Federal Reserve would maintain policy support, including its quantitative easing initiative. Bond markets were universally higher, with lower quality bonds and leveraged loans contributing the bulk of the gains as spreads narrowed.

While nearly everything was up during the quarter, some asset classes produced truly exceptional returns. Small cap U.S. equities, for example, gained 31% as investors anticipated COVID-19 vaccines would allow the gradual normalization of businesses' activities. Energy infrastructure is an example of market rotation to more cyclical sectors as recovering oil prices sent the midstream energy index up nearly 30%, despite a new "green" administration.

Taking a quick look at the economy, the fourth quarter may be considered an inflection point. Despite a surge in new confirmed COVID-19 cases, averaging over 200,000 per day by late December, the (albeit) slow distribution of vaccines was considered a step in the right direction and a much-needed boost to sentiment. Guidance suggests that acceleration of vaccine distribution and better testing and tracing should result in a steep decline in new cases and fatalities by the summer of 2021.

In addition, the economy showed general signs of recovery as evidenced below:

(1) Profit margins and wages continued to recover in line with past recessions.
(2) The unemployment rate dropped to 6.7% in November (more than half of jobs regained).
(3) Corporate cash as a % of current assets (S&P 500 companies) rose to 36%.
(4) 3Q 2020 real GDP was revised higher, strong momentum entering the fourth quarter.
(5) Inflation remained subdued in 2020 and guidance suggests it will remain below target.
(6) The FOCM maintained the federal funds rate at 0-0.25%.
(7) Strong housing starts and permits both topped a 1.5 million annualized rate.

Sources: eVestment Analytics, JP Morgan, Eaton Vance, Bloomberg

Market Focus – "Rate Risk"

In this section we focus on interest rate risk, a topic that is likely to impact most well-diversified investors in 2021 and beyond.

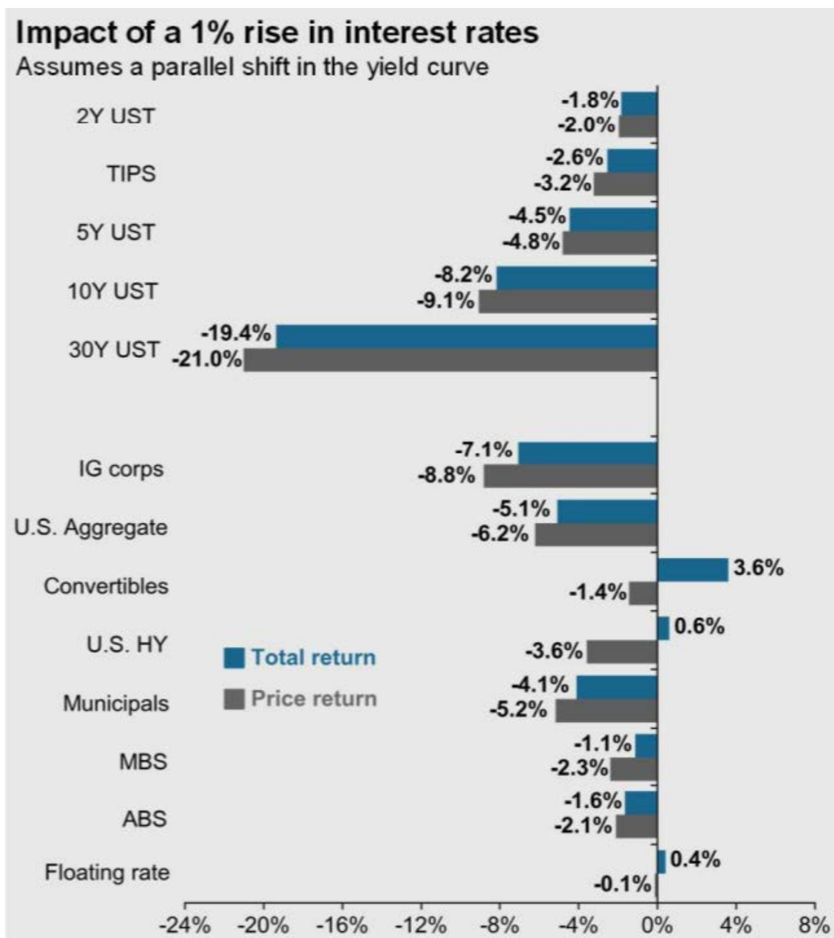
"Rate risk" refers to the risk of the decline in bond prices as a result of higher interest rates. Bond prices typically move inversely with interest rates, with bond prices falling as interest rates rise. Generally, bond owners are less concerned with rate risk when considering total return, but as spreads have tightened and yields have fallen, there is considerably less cushion to protect bond owners from experiencing unrealized losses.

In the table below, we show the current yields for the primary bond categories compared to 12 months prior. The yield declines are massive and the lowest yielding bond categories, such as investment grade taxable and municipal bonds, will likely experience meaningfully negative total returns as rates invariably rise.

	Yield	
U.S. Treasuries	**12/31/2020**	**12/31/2019**
2-Year	0.13%	1.58%
5-Year	0.36%	1.69%
TIPS	-1.06%	0.15%
10-Year	0.93%	1.92%
30-Year	1.65%	2.39%
Sector		
IG corps	1.74%	2.84%
U.S. Aggregate	1.12%	2.31%
Convertibles	5.04%	5.36%
U.S. HY	4.18%	5.19%
Municipals	1.07%	1.78%
MBS	1.25%	2.54%
ABS	2.23%	2.87%
Floating rate	0.54%	2.30%

The table below shows how a 1% rise in interest rates can affect the total return of a bond sector based on current low yields and average duration of maturities. Even though the Federal Reserve is likely to keep short-term rates at a stimulatingly low range over the near term, until inflation exceeds 2%, even the Fed's long-run projection is 2.5%. Inflation is likely to move higher, not lower, so bond owners may want to begin evaluating their bond portfolio duration and diversification strategies before inflation shows up in the headlines. Keep in mind, markets are forward-looking.

Considering Treasuries, it is clear that the further out a bondholder moves on the yield curve, the more severe the change in interest rates can be on the projected return. Other categories, such as investment grade bonds, are also at risk as yields are too low to offset negative price returns. Note that some bond categories may benefit, or be minimally impacted by rising rates. High yield bonds, for example, have a high enough current yield to more than offset the impact of negative price returns. Floating rate loans carry almost no duration risk and their yields rise along with higher rates.



Sources: JP Morgan, eVestment

Global Market Outlook

Key Insights:

- COVID-19 will continue to dominate headlines but widespread vaccine deployment should result in fewer new cases.
- The economic recovery will likely continue as central banks and governments maintain stimulative measures.
- Equities, especially smaller U.S. and foreign categories, may offer a better total return opportunity compared to bonds.
- Bond owners should prepare for rising rate risk and begin evaluating rate-sensitive exposures before inflation appears.

2021 is shaping up to be a good year for global markets, and despite some uncertainty, there is ample reason for optimism. The importance of the vaccine developments cannot be understated. It is probably the single greatest driver behind investor optimism heading into the new year. As the greater population is vaccinated, employees will begin returning to work, leisure and business travel will resume, healthcare systems will receive a much-needed breather, and governments should be able to relax their extraordinary fiscal support. The global economy will continue to recover, but the pace of the recovery is uncertain. With that said, here are some of our broad predictions for the year ahead:

(1) The spreading of the pandemic should subside by year-end, although the risks from new virus strains that develop are a very real concern. We expect a high level of short-term volatility as headlines change.
(2) U.S. stock markets are not particularly attractive in terms of price or yield, but corporations are flush with cash, earnings have been good, consumer spending is up, and M&A activity suggests an appetite for growth.
(3) History is on our side. Below, we show how past bear markets compare to their recovery periods in terms of return and duration. Typically, a bear market will last 22 months while the recovery period lasts 54 months. Bear market declines have averaged 42% while bull market returns have averaged 166% (past performance is no guarantee of future returns).
(4) Over the course of nine months, the world has experienced a digital transformation. The COVID-19 pandemic has changed the way we work, learn, shop, socialize, travel, etc. We do not expect the deployment of coronavirus vaccines to abruptly change all of this, but we do believe small and mid-sized businesses may benefit more. Looking back at other historical market drawdowns and their 12-month recovery periods, we notice small cap stocks typically outperform large caps.
(5) Foreign equity markets are well-positioned to recover further in 2021 for many of the same reasons we expect U.S. stocks to do well. The one key advantage foreign equities offer is that they are more cyclical and may benefit more from a new U.S. administration that we expect will improve foreign relations and realign trade agreements.
(6) Energy infrastructure equities may continue to benefit from higher oil prices, but investors in energy may want to consider broadening their portfolios to include companies that generate revenue through renewable energy sources.
(7) REITs may do very well in 2021 as normal business operations resume and lease revenue is confirmed or reestablished.
(8) Despite very narrow spreads, we do not see much credit risk in the bond market. We do see market and pricing risk, as bonds priced to future earnings could result in volatility, but with many businesses flush with cash we do not see any major risk to companies that need to sustain themselves until normal business operations resume.
(9) Lower quality bonds (B & BB rates) and leverage loans are likely to perform better than investment grade bonds as interest rates rise; default risk is less of a concern with strong corporate balance sheets.

Characteristics of bull and bear markets

		Bear Market			Macro environment				Bull markets		
	Market correction	Market peak	Bear return*	Duration (months)*	Recession	Commodity Spike	Aggressive Fed	Extreme Valuation	Bull begin date	Bull return	Duration (months)
1	Crash of 1929 - Excessive leverage, irrational exuberance	Sep 1929	-86%	32	◆			◆	Jul 1926	152%	37
2	1937 Fed Tightening - Premature policy tightening	Mar 1937	-60%	61	◆		◆		Mar 1935	129%	23
3	Post WWII Crash - Post-war demobilization, recession fears	May 1946	-30%	36	◆			◆	Apr 1942	158%	49
4	Eisenhower Recession - Worldwide recession	Aug 1956	-22%	14	◆		◆	◆	Jun 1949	267%	85
5	Flash Crash of 1962 - Flash crash, Cuban Missile Crisis	Dec 1961	-28%	6				◆	Oct 1960	39%	13
6	1966 Financial Crisis - Credit crunch	Feb 1966	-22%	7			◆	◆	Oct 1962	76%	39
7	Tech Crash of 1970 - Economic overheating, civil unrest	Nov 1968	-36%	17	◆	◆	◆		Oct 1966	48%	25
8	Stagflation - OPEC oil embargo	Jan 1973	-48%	20	◆	◆			May 1970	74%	31
9	Volcker Tightening - Whip Inflation Now	Nov 1980	-27%	20	◆	◆	◆		Mar 1978	62%	32
10	1987 Crash - Program trading, overheating markets	Aug 1987	-34%	3				◆	Aug 1982	229%	60
11	Tech Bubble - Extreme valuations, .com boom/bust	Mar 2000	-49%	30	◆			◆	Oct 1990	417%	113
12	Global Financial Crisis - Leverage/housing, Lehman collapse	Oct 2007	-57%	17	◆	◆	◆		Oct 2002	101%	60
13	Global Slowdown - COVID-19, oil price war	Feb 2020	-34%	1	◆				Mar 2009	401%	141
	Averages	-	**-42%**	**22**					-	**166%**	**54**

Sources: JP Morgan, S&P

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IMPORTANT INFORMATION