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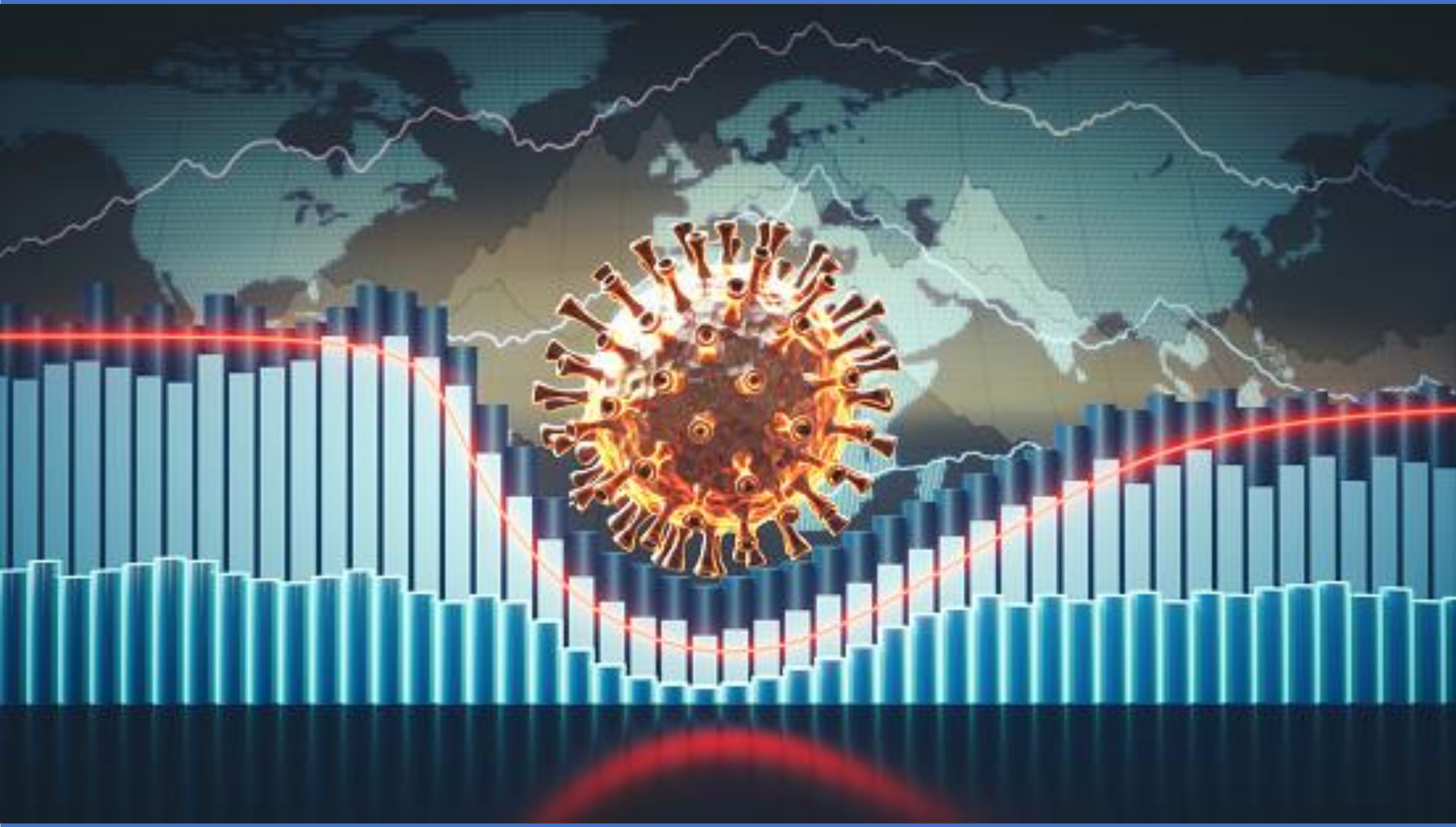

2021 Outlook

Hope Over Despair

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Executive Summary

- 2020 will be remembered as a seminal year that challenged humanity's compassion, ingenuity, resolve and tolerance. However, with all the despair and divisiveness, hope was provided through several highly effective vaccination prospects and therapeutics.
- Despite all the carnage caused by COVID 19 during 2020, the S&P provided investors with a total return of over 18%. However, unlike 2019, which we coined as the year of the "everything rally," capital market performance was more discerning.
- We find that risk assets and equity markets, in particular, enjoy robust returns during periods of limited volatility. While 2020 proved to be a volatile year for equities, we expect volatility to subside post the 2021 Inauguration.
- We believe that the type and magnitude of geopolitical and event risk moving into 2021 may be somewhat subdued compared to the last 12 months. Still, we are concerned about global income inequality, further civil unrest if meaningful reforms are not implemented and accepted across communities, as well as the growing economic threats of rival super-powers.
- COVID 19 and the ensuing global recession ended the129th consecutive month of economic expansion here in the U.S. and the 132nd month of an equity bull market. But we believe we are on the precipice of a new cycle, supported by pent-up consumer demand, positive vaccination/therapeutic trends, additional COVID and government stimulus (including potential for local and municipal funding), and unprecedented central bank/FOMC support.
- Our Interest Rate Regime framework defines our economic and capital market outlook going forward. Specific client positioning across asset allocation, styles, and sectors remains subjective. Still, we believe cyclical growth sectors (Financials, Discretionary, Industrials, to name a few) will lead equities higher, along with a renewed focus on Credit (vs. Duration) for fixed-income investors.
- Some investors believe equity markets are priced to perfection. However, when assessing market valuations through the lens of an earnings yield analysis, we believe there could be as much as 8% of compound annual growth in the S&P 500 through 2022.

2020 Year In Review

Hope Over Despair

2020 will be remembered as a year that challenged humanity's compassion, ingenuity, resolve and tolerance.

In January, US/Iranian tensions escalated to a boiling point following an airstrike that killed an Iranian major general in the Islamic Revolutionary Guard. Devastation also erupted across Australia, as brush fires grew to encompass over 25 million acres, an area roughly the size of Indiana, and causing almost $100 billion of destruction.[1] In early February, COVID began to spread across Southeast Asia rapidly. Cases exceeded 10,000 in Wuhan alone, but transmission to neighboring countries and the rest of the world was just beginning. By the end of the month, the total number infected with COVID in China grew to almost 80,000, with a total of 2,870 dead[2]. While back here in the U.S., the second death was confirmed in Washington state, with the first cases reported in Rhode Island, Florida, and New York, bringing the total cases confirmed at 50. By the end of March, there were over 97,000 positive cases in the U.S., and the total number of dead surpassed 4,300[3].

March also ushered-in the worst U.S. recession in almost 100 years[4], while capital markets braced for a global drawdown in equities of over 30%. Even once-thought to be liquid fixed-income markets in the U.S. fell prey, as investment-grade corporate debt fell as much as 15% while some individual municipal bonds were trading at 50 cents on the dollar. In May, the murder of George Floyd sparked a wave of mass protest and civil unrest both here and abroad, demanding an end to police brutality and racial inequality.

By the end of the Summer, there were over 6 million positive COVID cases in the U.S., with over 175,000 dead and the mortality rate just a hair below 3%. However, the U.S. stock market not only recovered all its lost ground but rallied over 6% above its February 20th, 2020, all-time high.

As Autumn began, Americans hit their six-month mark of working from home while schools and universities attempted to reopen. At

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[1] theconversation.com
[2] National Health Commission of the People's Republic of China
[3] thecovidetrackingproject.com
[4] National Bureau of Economic Research

the same time, the most contentious election in U.S. history was about to kick into high gear, starting with the first Presidential debate in late September. As we pointed out in our note, entitled, "Debate Debacles and Debauchery," the first debate provided for a fair amount of theatre, embarrassment, and relief–or perhaps a combination of all three, depending on what side of the aisle you sit. But all along, it was clear to us that having a definitive result on election night was a low probability event. In the end, former Vice-President Joe Biden would become the 46th U.S. President, while Senator Kamala Harris would become the first woman of color elected Vice-President.

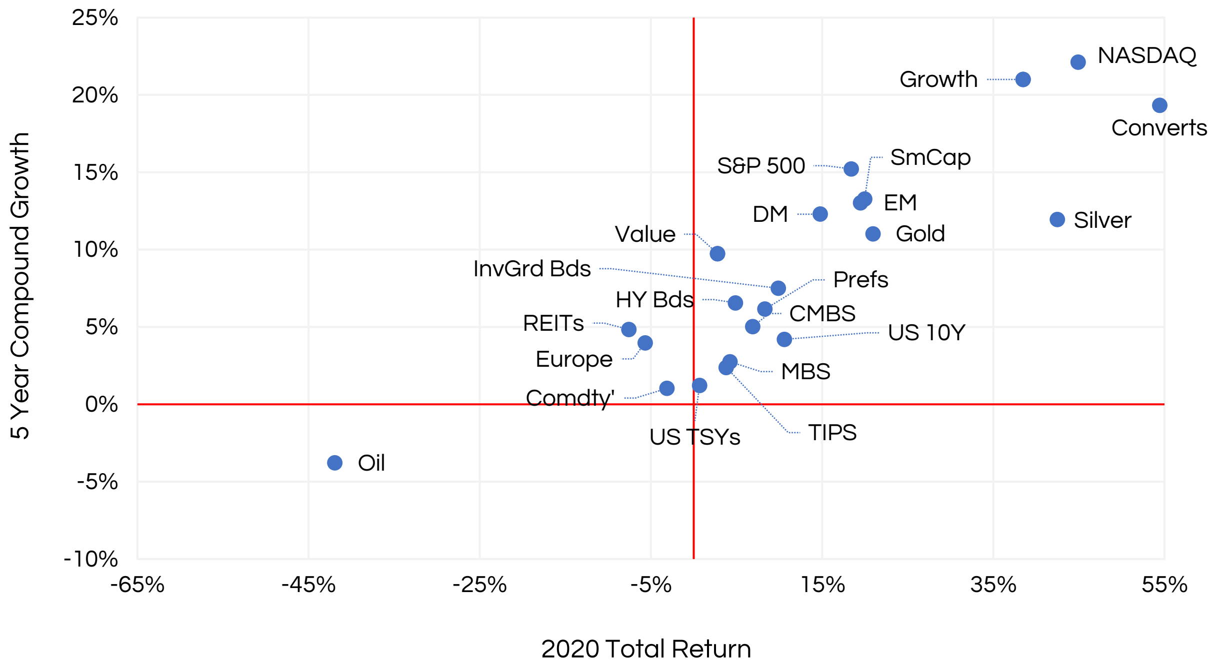
However, with all the despair and divisiveness endured during 2020, hope was provided through several highly effective vaccination prospects and therapeutics. As we pointed out in our November 20th, 2020 note entitled, "One Step Up And Two Steps Back," the Milken Institute publishes a comprehensive global database of vaccinations and therapeutics for COVID 19. Based on this list, we feel confident that it is a matter of when, not if, COVID will be defeated, and the U.S. will regain a sense of normalcy. And despite the appalling and embarrassing events that occurred at our nation's capital in early January 2021, we are encouraged that the U.S. can find a way to heal, reconcile, and move forward.

2020 Capital Market Review

Despite all the carnage caused by COVID 19 during 2020, the S&P provided investors with a total return of over 18%. The technology-laden NASDAQ Composite returned almost 45% for the year. Further, since the bottom of the Great Financial Crisis (GFC) in March of 2009, the S&P recorded an annualized total return of 27%, while the NASDAQ provided investors with an annual total return of 33%.

However, unlike 2019, which we coined as the year of the "**everything rally,**" capital market performance was more discerning. This was especially true during, and post the COVID drawdown period between February 19th and March 23rd, 2020.

Exhibit 1: 2020 Capital Market Total Returns



NEPCG and FactSet, data as of 12/31/2020

The best performing asset class in 2020 was convertible bonds[5], which surprised many. However, we have discussed this asset class with clients and included it in our asset allocation models for the better part of the year. Following "Converts," the next best performing capital market segment was the NASDAQ[6] (Technology), higher by almost 45%. 2020 also witnessed the return of commodities, as Silver was the third-best performing segment, higher by about 43%.

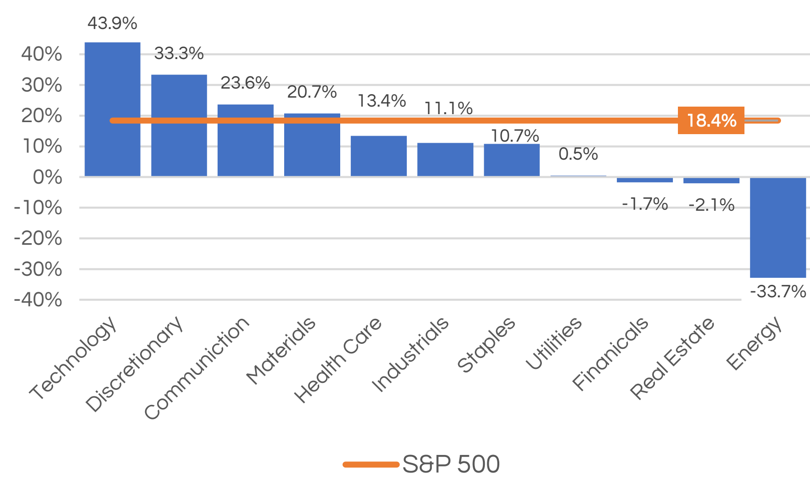
Bonds, as an asset allocation, generally lagged in absolute performance relative to equities but still provided investors with an attractive total return for the year. Further, the traditional "risk-off" proposition historically provided by fixed-income was tested during the February-March sell-off.

From a sector perspective, Technology was once again the top-performer in 2020, returning almost 44% and outperforming the S&P 500 by over 25%. Consumer Discretionary was the next best

[5] Convertible bonds (Converts) give the holder the option to convert or exchange it for a predetermined number of shares in the issuing company. When issued, they act just like regular corporate bonds, albeit with a slightly lower interest rate.
[6] The Nasdaq Composite is an index comprised of around 3,000 stocks. While it features companies from all sectors, it has a technology-heavy focus.

performing sector, which returned over 33%. Underperforming sectors included REITs, which were down about 2%, and the Energy sector, down almost 38%, underperforming the S&P 500 by 21% and 52%, respectively.

Exhibit 2: 2020 Total Returns by Sector



NEPCG and FactSet data as of 12/31/2020

From a style perspective, Growth[7] once again outperformed Value[8] for most of the year. Growth provided investors with a total return of 38%, while Value tallied a 3%total return in 2020. However, following the 2020 Presidential Election, a rotation from Growth to Value began whereby Value rallied almost 14% through the end of the year, compared to only 8% for Growth. And this trend has continued into 2021. From the 2020 election to January 15, 2021, Value has outperformed Growth by roughly 9.0%[9]. And as we pointed out in our November 20th, 2020 report entitled, "One Step Up and Two Steps Back," we remain cautiously optimistic that this trend may continue, which we further highlight later in this report.

Similarly, large market capitalization names (Large Cap) also outperformed smaller market capitalization names (Small Cap) for most of 2020. For our analysis, we considered the S&P 500 as our Large Cap proxy and defined our Small Cap universe as the Russell

[7] Growth investing is a style of investment strategy focused on capital appreciation. Capital appreciation is the goal of an investor seeking long term growth on the principal amount invested, not necessarily current income from the asset. For this comparison, we measured the performance of the Russell 1000 Growth Index, versus the Russell 1000 Value Index.
[8] Value investing is an investment paradigm that involves buying securities that appear underpriced by some form of fundamental analysis.
[9] Source: FacSet.

2000[10]. But as we illustrate in Exhibit 4, starting in late-summer 2020, Small Caps began to outperform Large Caps and subsequently erased all the year's relative prior underperformance.

Exhibit 3: Growth vs. Value

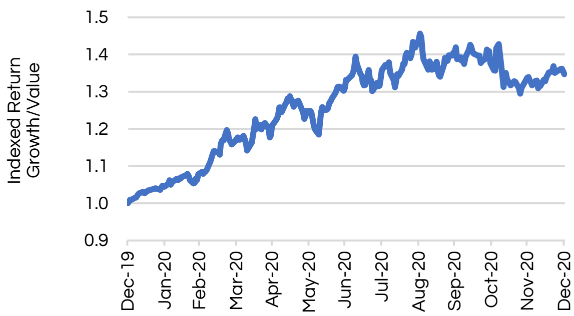


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Exhibit 4: Large Cap vs. Small Cap

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Finally, the Cyclical[11] sector continued to outperform in 2020, despite a short bid into Defensive[12] names during the shutdown's most restrictive period. Year-to-date through December 31st, 2020, Cyclicals outperformed Defensives by about 18% and have outperformed by almost 25% since early April[13].

Expect Volatility To Subside Post Inauguration

We find that risk assets and equity markets, in particular, have historically enjoyed robust returns during periods of limited volatility. Below we illustrate this relationship by looking at the VIX, or the CBOE Volatility Index. The VIX is a widely accepted measure of the equity market's overall volatility, employing a complicated algorithm using S&P 500 index options. In Exhibit 5, we illustrate that volatility spiked in 2020, from a low of roughly 12 in early January to a high-water mark of 83 by mid-March, only to subside back down to about 20 in late December. What Exhibit 5 also illustrates is a negative correlation between the VIX and The S&P 500, or in the simplest terms, a relationship between two

[10] The Russell 2000 Index is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

[11] Cyclical stocks represent companies that make and/or sell discretionary items and services many consumers buy when the economy is doing well.

[12] Defensive stocks have historically outperformed the market when economic growth slows. Non-cyclical securities are generally profitable regardless of economic trends because they produce or distribute goods and services we always need, including things like food, power, water, and gas.

[13] Data and returns obtained through FactSet,

variables, such as when one moves up, the other moves down.

More importantly, we illustrate the impact on the VIX during, and just after, previous Presidential election cycles. Exhibit 6 shows that implied market volatility typically increased leading up to a Presidential election (four Democratic Presidents and three Republican Presidents ultimately prevailing) but then subsides in the six to nine months following. Taken in isolation, this would imply that the direction of least resistance for equity markets over the next several months following the 2021 Biden Inauguration should be higher.

Exhibit 5: VIX and S&P 500

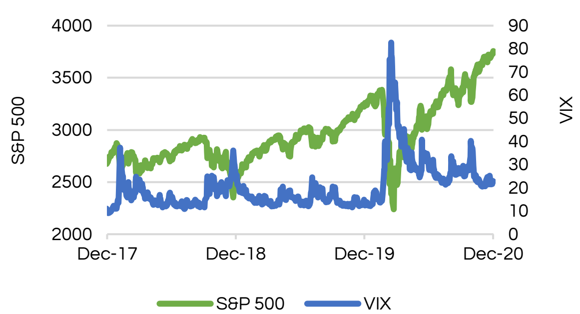

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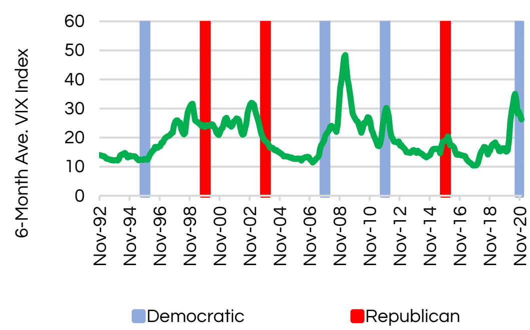
Exhibit 6: VIX and Election Cycles



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Geopolitical Outlook

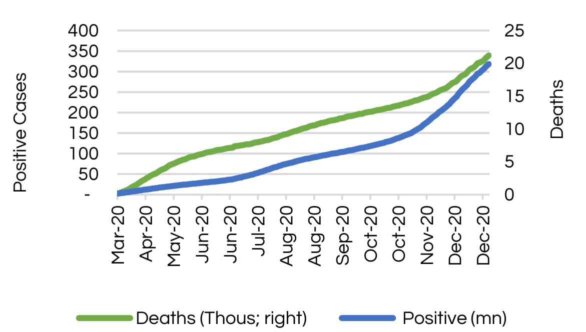
So Long, 2020!

A year ago, we were overly sensitive to the geopolitical backdrop, especially moving into a contentious election year. China trade implications, saber-rattling across the Middle East, and a break-down of denuclearization talks with North Korea were just a few of the worries that added to our anxiety. Interestingly enough, none of these could have rivaled what was in store for all of us in 2020.

As we pointed out in our January 31, 2020 note entitled, "The Punch You Don't See Coming," the Novel Coronavirus was the uppercut that knocked us all out. This global pandemic was not prejudiced in who, what, and where it struck. We began tracking the COVID-19 outbreak in mid-January 2020, just as the Chinese New Year was about to begin, potentially creating the first "super spreader" event. At that time, only a few research firms and news outlets understood the negative impact that such an exogenous event such as COVID would have on the world economy. And in retrospect, there were even fewer investors who fully appreciated its potential destruction.

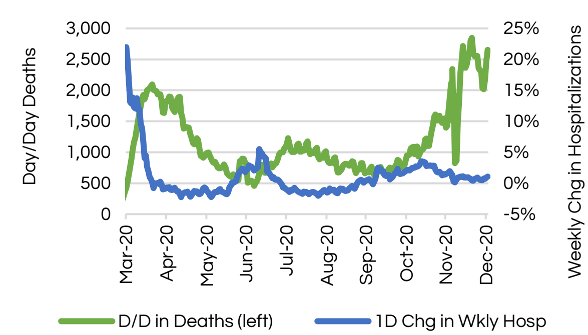
As of December 31st, 2020, the number of positive cases here in the U.S. was around 20 million[14], resulting in about 337 thousand deaths. And following a brief reprieve from Thanksgiving-related hospitalization rates, we expect another uptick following New Years', further increasing the recent uptrend in fatalities, which at year's end rose to almost 2,500 victims a day.

Exhibit 7: Cases and Deaths



COVID Tracking Project and NEPCG

Exhibit 8: Weekly COVID Trends



COVID Tracking Project and NEPCG

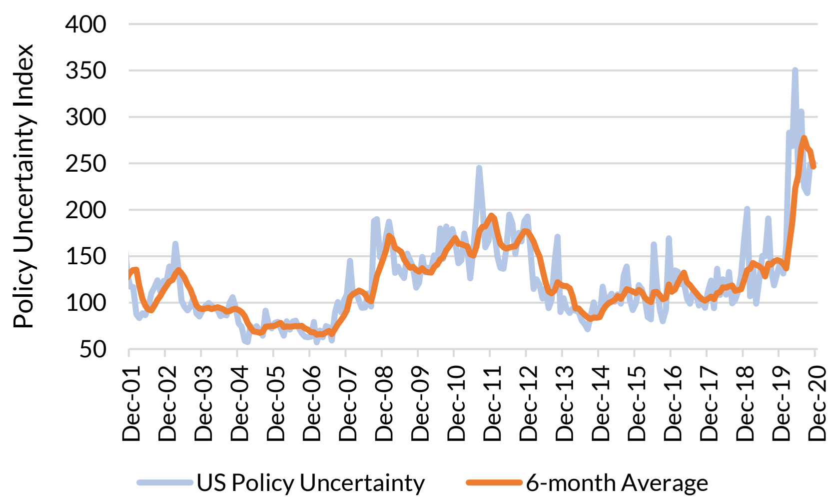
[14] Thecovidtrackingproject.com

We can never entirely discount unknown-unknows such as COVID 19 because these types of risks will always be present in speculative markets. But we believe that the type and magnitude of geopolitical and event risk moving into 2021 may be somewhat subdued compared to the last 12 months. Helping us gauge this premise, we once again utilize data obtained from policyuncertainty.com.

As Exhibit 9 shows, U.S. policy uncertainty peaked in late Spring 2020, with the six-month average reaching its highpoint in mid-Summer.

Increased uncertainty leading into the Georgia Senate run-off, doubt regarding an additional round of COVID stimulus, concerns over post-BREXIT trade policy, and the sluggish pace of vaccination delivery has combined to push uncertainty higher in recent months. But the trailing 6-month average, overall, remains on a downward trend.

Exhibit 9: U.S. Policy Uncertainty



PolicyUncertainty.com[15] and NEPCG

[15] To measure policy-related economic uncertainty, PolicyUncertainty.com constructs an index from three types of underlying components. One component quantifies newspaper coverage of policy-related economic uncertainty. A second component reflects the number of federal tax code provisions set to expire in future years. The third component uses disagreement among economic forecasters as a proxy for uncertainty.

Risks Remain

This is not to suggest that all uncertainties are fully priced into the capital markets. We believe income inequality is growing into a global phenomenon, which could carry broader and longer-lasting consequences as emerging and developing economies have been disproportionally impacted by COVID. Also, civil unrest may erupt again if meaningful reforms are not implemented and accepted across communities.

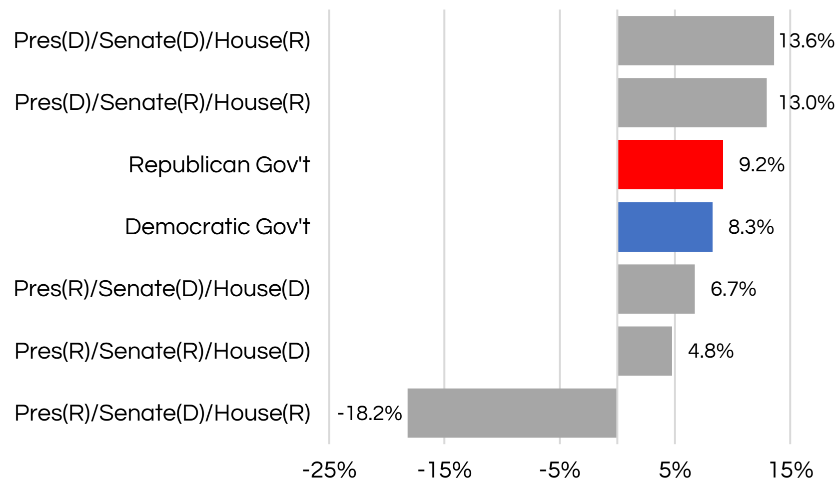
In addition, there is the evolving concern that the unprecedented level of monetary and fiscal stimulus utilized to combat COVID-19 may fan the flames of inflation. And we cannot discount the desires of competing economic and military super-powers. Russia continues to push the limits of diplomacy, from hacking elections to rebutting state-sponsored assassination allegations. China remains in a full-court press in all facets of international relations with the U.S., including trade, technology, and dogma.

Still, the most significant uncertainty, in our opinion, continues to be the continued spread of COVID. Vaccine delivery speedbumps, more variant strains, and citizens' unwillingness to get vaccinated are all significant uncertainties, which could materially impact the path of the economy going forward.

Is Chess Like Politics?

How all of these risks impact our capital markets is still developing, and a significant piece of the puzzle is the makeup of the U.S. government. In chess, there is a critical gambit called “control the center.” This allows a player to have greater mobility of pieces, a more significant influence over the board, and restricts enemy pieces' movement. We feel the same is true for politics. **Further, we think the more “centrist” both parties can become, the more predictable economic and capital market outcomes can be.** However, given the current chasm between our two political parties, we looked historically to determine if “elections have consequences” for markets. So, we conducted an analysis identifying what type of government is most favorable to equity market returns. To do this, we analyzed the political makeup of the House, Senate, and Executive, by term and compared that to the corresponding annual return for the S&P 500. We present our results in Exhibit10.

Exhibit 10: Dems, the GOP, and S&P 500



FactSet and NEPCG

Based on our analysis, the two best governing outcomes for equity market returns were a Democratic President, ***and*** ***either***: 1) a Democratic Senate and Republican-controlled House, or 2) an entirely Republican Congress. **However, these scenarios occurred historically only 14 times out of 93 instances**: only four times in the former case (D/D/R) and ten times in the latter case (D/R/R). One party controlled the Executive and Legislative branches of government on 44 occasions. **Thirty-three times by Democrats (the most frequent outcome dating back to 1928), resulting in an average return for the S&P 500 of 8.3% per year**, and eleven times by Republicans, resulting in an average S&P return of 9.2% per year.

Once again, taken in isolation, equity markets may enjoy an attractive return proposition if this historical relationship holds. Further, fearing the "one-party" rule may be somewhat of an overreaction, and maybe the lack of division will actually allow "centrists" policies to prevail.

Economic Outlook

All Good Things Come To An End

Apart from the devastating impact on human life, COVID 19 also marked the end of the longest U.S. economic expansion, post-WWII. Due to individuals, businesses, and municipalities' decisions to lock down, U.S. GDP contracted at an annualized rate of over 31% in 2Q20, with harsher results felt across other developed economies[16]. These actions ended the U.S. economy's 129th consecutive month of economic expansion[17] and the 132nd month of an equity bull market. In the end, COVID-19 will be responsible for almost a 4% annual contraction in global GDP for 2020[18].

Exhibit 11: U.S. Economic Expansions

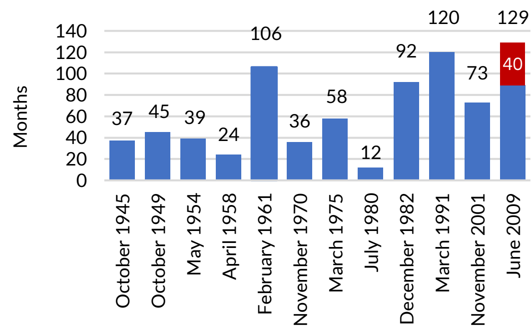


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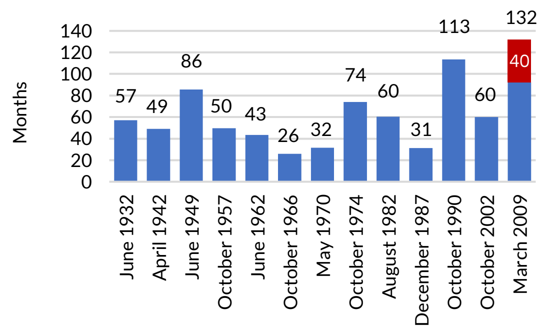
Exhibit 12: U.S. Bull Markets



FactSet and PCG

A New Cycle Begins

As we pointed out in last year's report, any subsequent economic trough will be short-lived but was essential for the economy to reaccelerate. Once again, we did not count on COVID as the catalyst to this prediction. As we consider the classic characteristics of an economic life cycle moving forward, we believe that COVID 19 has both disrupted and accelerated our path along this curve. Therefore, as we illustrate in Exhibit 13 and further discuss in this report, we believe the U.S. is currently somewhere at the tail end of the Trough phase and the onset of an Expansion phase.

However, the exact location where we are on the economic curve is

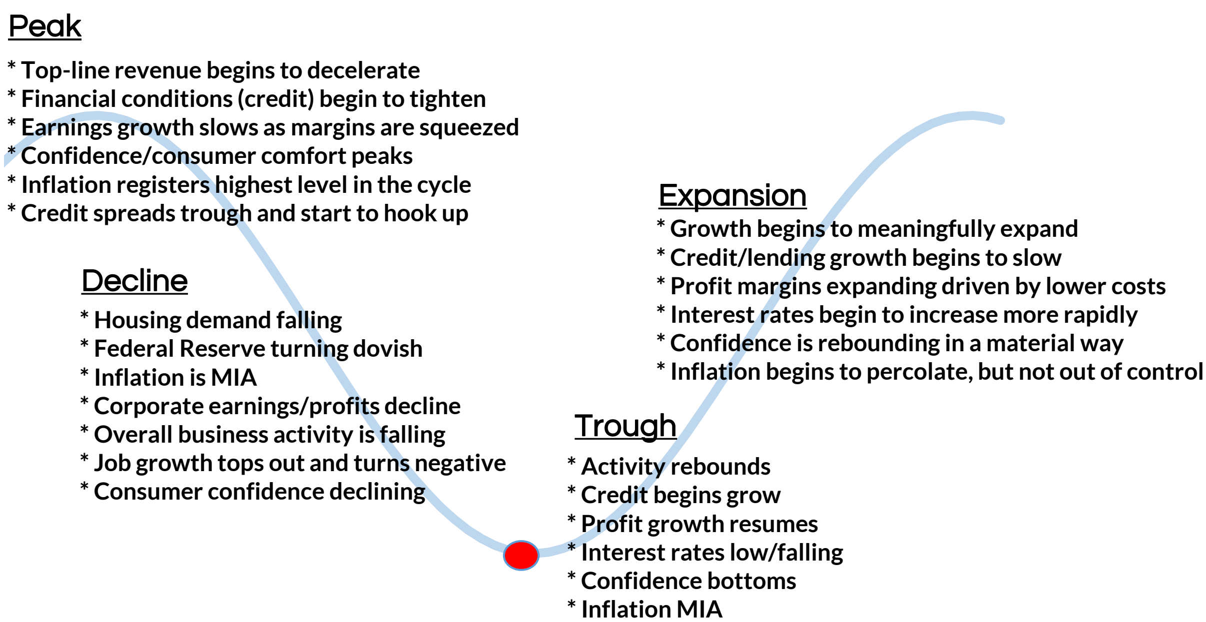
[16] Source: Factset

[17] Defined herein broad terms as positive GDP growth.

[18] Source: FactSet consensus estimates

unknown given both the idiosyncratic nature of a global pandemic that resulted in both an economic supply and demand shock but was also compounded by the unprecedented fiscal and monetary response provided by global central banks.

Exhibit 13: Typical Economic Life Cycle



NEPCG

We have already witnessed a strong snap back in hiring trends, small business optimism, [global manufacturers](), and several other economic data series.

Exhibit 14: Unemployment Rate (inverted)

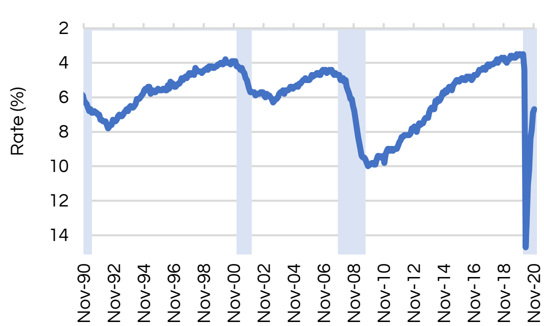


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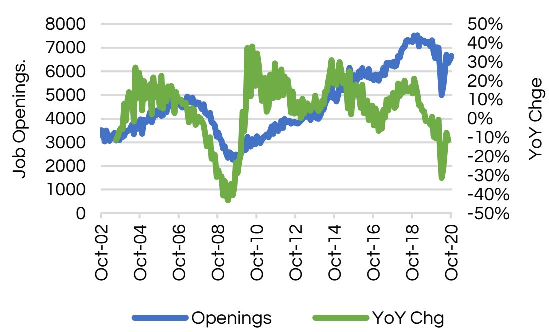
Exhibit 15: U.S. Job Openings



FactSet and NEPCG

Exhibit 14 illustrates that the Unemployment Rate has bounced (inverted scale) from almost 15% to roughly 6.7% (November '20 data). And in Exhibit 15, we show that the overall level of job openings[19] in the economy increased by 33% between April 2020 and October 2020.

We have also witnessed a strong recovery in manufacturing, both domestically and on a global scale. We once again note that the idiosyncratic nature of the COVID pandemic and the resulting lock-down of the economy negatively impacted the demand of goods and the supply of goods and services. In Exhibit 16, we illustrate the rebound in domestic manufacturing through the Institute for Supply Management's PMI[20] report. Exhibit 17 shows a similar trend illustrated by the JP Morgan Global PMI for both manufacturing and services. In both instances, a sharp "V" recovery is displayed.

Exhibit 16: ISM/PMI Manufacturing Index

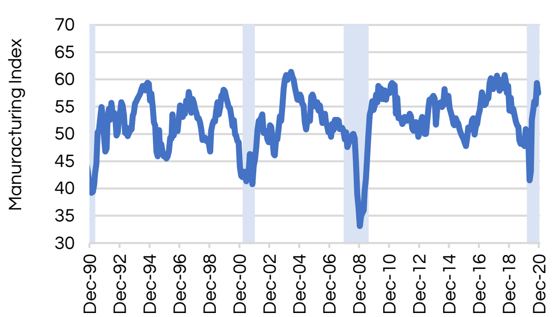


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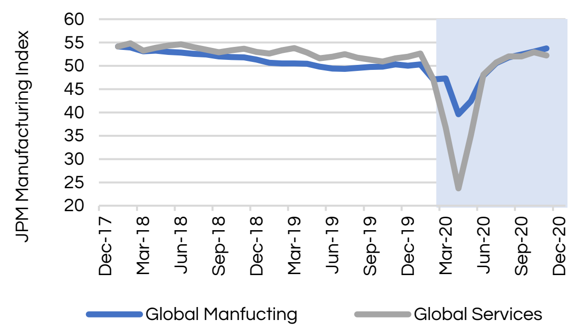
Exhibit 17: JP Morgan Global PMI



FactSet and PCG

We have also seen a "V" recovery in Small Business Optimism, as well as Leading Economic Indicators.

[19] The Job Openings and Labor Turnover Survey (JOLTS) tells us how many job openings there are each month, how many workers were hired, how many quit their job, how many were laid off, and how many experienced other separations (which includes worker deaths).

[20]The ISM manufacturing index, also known as the purchasing managers' index (PMI), is a monthly indicator of U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing firms. It is considered to be a key indicator of the state of the U.S. economy.

Exhibit 18: Small Business Optimism

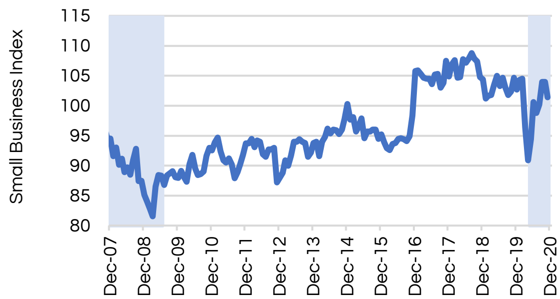


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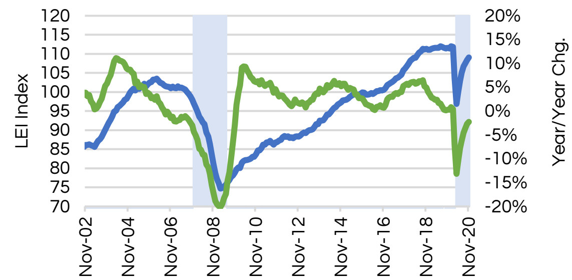
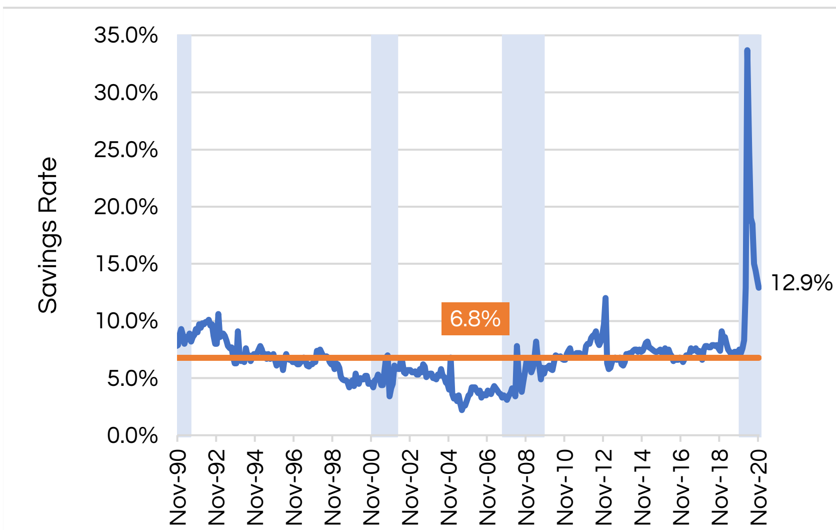
Exhibit 19: U.S. Leading Indicators



FactSet and PCG

According to Wells Fargo, roughly 65% of the economy's lost output due to COVID has been regained. And we believe there is more economic upside to come.

Exhibit 20: Savings Rate



FactSet and NEPCG

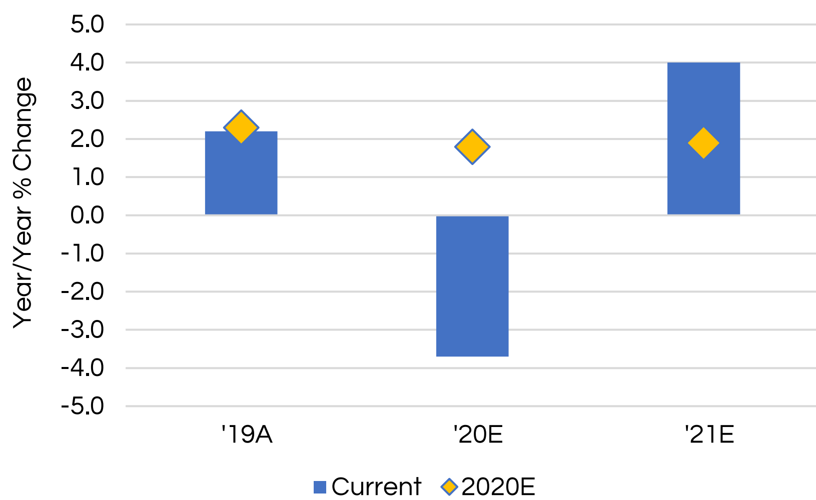
Exhibit 20 illustrates the domestic savings rate in the U.S. as of November 2020. It shows that consumers continue to save about 13% of their income, compared to an average dating back through four recessions (1990) of about 7%.

In our opinion, this increase in savings has elevated the level of pent up economic demand in the U.S. economy. Therefore, together with positive vaccination/therapeutic trends, additional COVID stimulus, and continued unprecedented central bank/FOMC support, we believe the U.S. is at the precipice of a new economic cycle.

Give and Take of Global Growth

A year ago, we expected real GDP growth in the U.S. to be in the 1.8%-2.0% range for 2020. However, COVID changed all that. Going forward, according to consensus mean economic estimates provided by FactSet[21], real GDP growth in the U.S. will be negative 3.7% in 2020, followed by roughly 4.0% in 2021. As we illustrate in Exhibit 21, FactSet previously estimated relatively flat growth (yellow diamonds) for 2020 and 2021 of only 1.9-2.0%.

Exhibit 21: Consensus GDP Growth Expectations



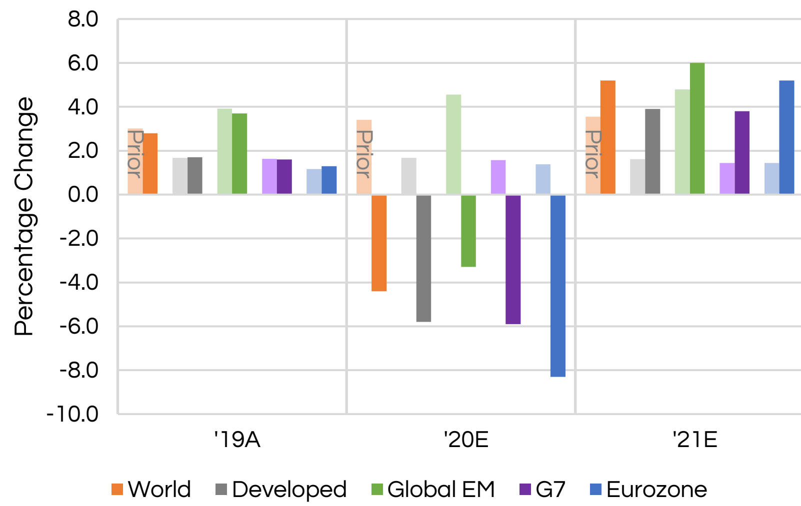
FactSet and FactSet consensus estimates as indicated by (E)

Global GDP growth is forecast to follow a similar vector to that of the U.S. According to the International Monetary Fund (IMF), real global GDP is expected to be negative 4.4% in 2020, compared to last year's forecast for 2020 of positive 3.4%. In Exhibit 21, we illustrate both the current and prior (year-ago; light shaded) mean GDP estimates forecast by the IMF for the World, Developed Economies, Emerging Economies, the G7[22], and the Eurozone.

[21] FactSet Research Systems Inc., or FactSet, is a financial data and software company that provides integrated data and software solutions to investment professionals across the world. FactSet monitors economies, industries, and companies with FactSet's fully global economic data, accessing 1.9 million economic series with economic data readily available alongside in-depth company and market statistics enabling streamlined, centralized analysis and economic intelligence

[22] The Group of Seven (**G7**) is an informal bloc of industrialized democracies—Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States—that meets annually to discuss issues such as global economic governance, international security, and energy policy.

Exhibit 21: Global GDP Growth Expectations



IMF estimates as indicated by (E)

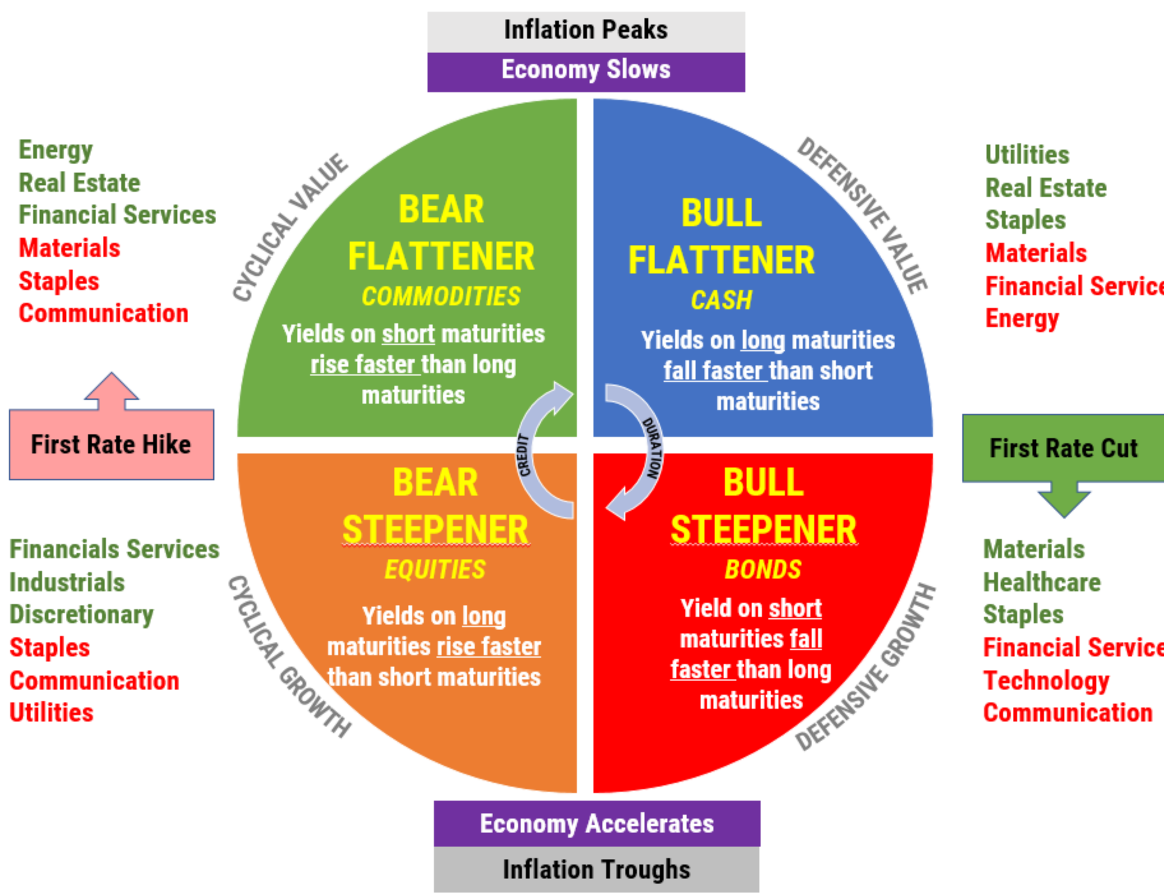
Based on the data provided above, the IMF expects growth outside the U.S. to be modestly greater than the U.S. But key variables to the trajectory of domestic GDP growth will be how quickly consumers unleash pent-up savings, the level of additional monetary and fiscal stimulus, and of course, the future vector of COVID vaccinations and therapeutics.

2021 Positioning
Interest Rate Regimes

Our readers continue to hear us utter this phrase, "bonds see around corners." While equity analysts would indeed find an exception to this, we believe fixed-income managers typically need to better understand and react to credit concerns and considerations to protect bond investors against default. But understanding Credit also helps in positioning equity portfolios.

Last year, we introduced our **Interest Rate Regime** paradigm, which we review herein. In our opinion, by understanding historical relationships between bond prices and yields, aka the yield curve [23], we can help predict economic and capital market trends.

Exhibit 22: Interest Rate Regimes and Preferred Sector Positions



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[23] A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity.

First, we need to define each of the four interest rate regimes; Bull Flattener, Bull Steepener, Bear Steepener, and a Bear Flattener.

In a **Bull Flattener** (blue shaded area), yields on long-maturity bonds fall faster (price increases quicker) than the yields on shorter-maturity bonds (prices increase slower). This historically happens after inflation peaks, and the economy begins to slow. At the same time, central banks become more dovish[24], ultimately leading to the cycle's first-rate cut. During these periods, we find that defensive-oriented equities tend to perform well, led by Utilities, Real Estate and Staples; underperforming sectors typically include Materials, Financial Services, and the Energy complex. Also, during this interest rate regime, we find that Duration[25] begins to outperform Credit, meaning that credit spreads start to widen as the economy begins to cool. In other words, investors will opt to invest in the full-faith and guarantee of U.S. government bonds (or cash) over corporate bonds, thus lowering corporate bond prices and increasing their yields.

In a **Bull Steepener** (red shaded area), yields on short maturity bonds fall faster (prices increase quicker) than yields on long-maturity bonds (prices increase slower). This historically happens as the economy moves toward recession with a bottoming in economic activity and inflation prospects. During this interest rate regime, central banks are in full rate-cutting mode, resulting in a preference for risk-free[26] duration (government bonds over corporates or high yield), with the Materials, Healthcare, and Staple sectors historically outperforming. On the downside, we typically observe Financial Services, Technology, and the Communication sector to lag the overall market.

In a **Bear Steepener** regime (orange shaded area), yields on long-maturity bonds rise faster (price falls quicker) than yields on short maturity (prices fall slower). At the beginning of this regime, the

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[24] A dove is an economic policy position that promotes monetary policies that usually involve low interest rates, which may promote inflation.

[25] The duration of a bond is the weighted-average period of time before the cash flows involved are received.We use the term "Duration" to describe U.S. Government bonds with like maturities to that of Corporate bonds. Being that Governments typically have yields lower thant Corporates, we suggest that their duration is longer, hence posing greater interest rate risk.

[26] The term "risk-free rate" is an accepted axiom in finance describing the 10yr bond, or other "guaranteed" security backed by the full-faith of the U.S. If you buy a US bill, bond or note, you will get 100% of your principal back, so there is no principal risk. The "risk-free rate" is the basis of several financial theories, but is theoretical.

economy emerges from an economic trough, and inflation begins to drive growth, ultimately moving toward the first rate hike of the cycle. During this period, cyclically oriented growth sectors and stocks historically tend to outperform the overall market, including Financial Services, Industrials, and Consumer Discretionary. To the downside, underperforming sectors typically include Staples, Communication Services, and Utilities. Lower-credit quality fixed-income investments usually begin to recover and start to outperform government and other relatively low-risk bonds.

A **Bear Flattener** Regime (green shaded area) historically begins with the first-rate hike of the cycle and is characterized by yields on short maturity bonds rising faster (prices falling quicker) than long-maturity bonds (prices falling slower). During this regime, inflation is accelerating, and the economy typically peaks. Especially toward the latter stages, cyclical-value oriented sectors and stocks outperform. We observe that Energy, Real Estate, and the Financial sectors have historically done well, while Materials, Staples, and the Communication Services sectors have lagged the overall market.

In our 2020 Outlook, we suggested the U.S. capital market was somewhere between the end of a **Bull Steepener** and the beginning of a **Bear Steepener**. **At this point, we believe the U.S. capital market is firmly within a Bear Steepener regime. However, given the disruptive nature of COVID, certain historical yield curve/sector relationships may be dislocated.**

For example, during a **Bull Steepening** regime, Technology names were thought to underperform the S&P 500. But with interest rates extraordinarily low, several Technology related companies like Apple and Microsoft not only helped support the "COVID economy" but also offered a dividend yield above the 10 year Treasury[27]. Another example is the Communications Services sector, which historically underperformed the S&P 500 during **Bear Steepening** regimes. However, work/school from home lock-downs supported the demand for Communication Services names like Zoom and Netflix. Finally, it would not surprise us to see REITs benefit during the middle of a Bear Steepening regime(vs. a **Bear Flattener**) if constructive vaccination and therapeutic trends result in 1) workers returning to urban office buildings, 2) apartment renters return to

[27] Source: FactSet

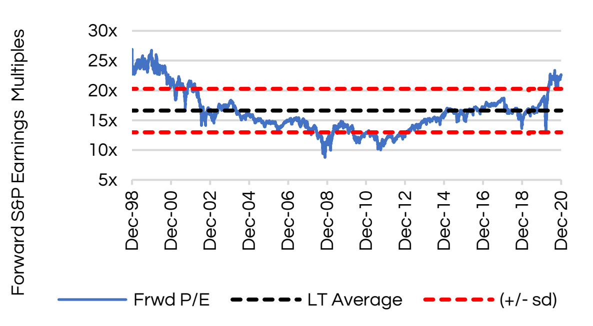
major cities and, 3) increasing travel and tourism raises the demand for hotel stays.

Flip The Script And Buy The Dip

A year ago, we suggested that the S&P 500 seemed rich, trading at 18.2x next twelve-months earnings (or forward P/E ratio), compared to the long-term average dating back to 2001 of about 15.5x and 16.6x dating back to 1997. Fast forward 12 months, we observe consensus EPS estimates for the S&P over the next year to be only $166[28] (compared to $177 at year-end 2019). Yet the S&P is trading at $3,756[29], implying a forward P/E ratio of 22.7x. Further, the current forward S&P 500 P/E estimate is roughly two standard deviations[30] wide to the 2001 average (15.5x) and well over one standard deviation wide to the 1997 average P/E (16.6x).

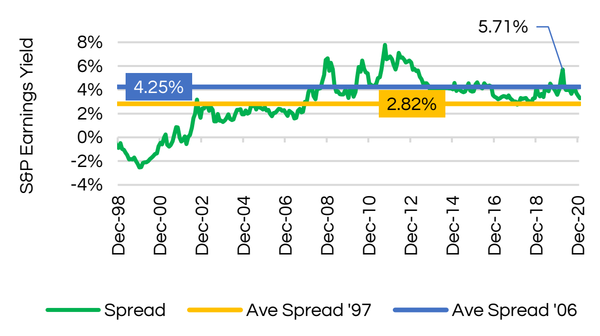
So if valuations were rich a year ago based on a P/E valuation construct alone, one could infer that stocks are significantly overvalued today. However, the actions undertaken by global central banks by unleashing an unprecedented level of monetary stimulus, in conjunction with massive fiscal stimulus (government spending), have lowered interest rates to the point that viewing equity valuations primarily based on historical S&P multiples is no longer appropriate, in our view.

Exhibit 23: S&P 500 P/E Multiple



FactSet and NEPCG

Exhibit 24: Earnings Yield Spread



FactSet and NEPCG

(a) Earning yield = 1/S&P Multiple less 10Yr Note yield

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[28] Source: FactSet estimates as of 12/31/2020

[29] Source: FactSet, data as of 12/31/2020

[30] Standard deviation measures a security's volatility. Specifically, it measures the typical fluctuation of a security around its mean, or average return over a period of time. In most cases, a security's return can be expected to trade within one standard deviation of its average roughly 68% of the time and 95% of the time within two standard deviations.

As a result, we are also now considering equity market valuations through an earnings yield analysis. The earnings yield of any stock or equity index is nothing more than the reciprocal of its P/E multiple. For example, if the S&P 500 exhibits a P/E multiple of 23x, its earnings yield is equal to 1 divided by 23 or 4.35%. Once we infer the "yield" on the S&P, we then compare the current yield spread between the S&P 500 and the 10Yr Treasury Note to the historical average.

So, the wider the spread (S&P earnings yield less the yield of the 10Yr), the more attractive (and undervalued) the S&P is. For example, in Exhibit 24 above, the earnings yield spread in late March 2020 was roughly 570bps, implying an attractive relative valuation compared to the long-term average dating back to 2006 of 425bp, as well as the 282bps average spread dating back to 1997.

The current earnings yield spread[31] of roughly 328bps, while almost 100bps tighter (negative spread) to the 2006 average spread (425bps), it is still wider than the longer-term (back through 1997) average spread of 282bps. So, in aggregate, while multiples suggest an overbought condition for the S&P 500, viewing equities through the lens of an earnings yield suggests valuations are fair, in our opinion.

Going forward, our 2021 Outlook sees the potential for the eventual reinflation of the economy, which may be accelerated by the recent shift in the U.S. Senate. As we pointed out in our November 6, 2020, note entitled, "The Great Reset," the result of a Blue Wave would usher in significant COVID relief stimulus along with other outsized spending measures, even potentially providing support to state and local municipalities. Also, following on from our September 18, 2020, note entitled, "Four More Years…Of Zero Rates," we believe the FOMC will remain extraordinarily accommodative through at least 2023, thus firmly anchoring down short rates. As a result, in our opinion, we do not believe the 10 Yr Treasury Note cannot significantly back up over 1.5% over the next 12 months.

So, with such pent-up demand, the potential for additional stimulus, extraordinarily high savings rates, and accommodative short rates,

[31] 12/31/2020 pricing data.

we believe the run-rate in S&P earnings by mid-year 2021 could be significantly higher. In fact, according to FactSet, consensus estimates for the S&P 500 suggest a quarterly run-rate close to $45 by the second half of 2021. These FactSet projections imply full-year earnings at about $180 per share starting in September 2021.

If our assumption that the 10Yr Note does not back up beyond 1.5% comes to fruition, and the long-term average yield spread between the S&P and the 10Yr Note stays intact (285bps), then we believe there could be as much as 8% of annual growth in the S&P between now and 2022[32]. Coincidentally, this is roughly the same average annual return observed during the 33 instances that Democrats occupied both the Executive and Congress.

Finally, as for sector-specific observations, we believe in the near term that Cyclical stocks, including Financials, Materials, and Industrials, should outperform. In this scenario, Value-oriented stocks could also outperform as interest rates and bond yields could modestly increase. At the same time, the short end of the yield curve (Fed Funds Rate) may be anchored in place by the Federal Reserve through perhaps 2023 or 2024. In this scenario, we may expect Governments to underperform Credit, while Preferred Equities, short-duration High Yield Corporates, and even Convertible Bonds to outperform.

[32] Long-term yield spread of 285bps pluss 150bps 10Yr Note assumption equals 435bps, or 4.35%. Take the reciprolcal of this earnings yield, which equates to 22.9x. Then multiple 22.9 times $180, you arrive at $4,137.

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