TFC FINANCIAL
The Financial Counselors

COMMENTARY | 4Q 2020
JANUARY 2021

OUR VIEW

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Fourth Quarter Review

U.S. stocks reached all-time highs in 2020. The market's rise was surprising, given nearly 20 million reported coronavirus infections and 345,000 fatalities, an estimated GDP decline of 3.5%, an estimated earnings decline of 17%, and about 11 million unemployed people in the U.S. The strong market performance during 2020 may have seemed irrational but in our view, investors responded with reasonable logic to the events of 2020.

There were three distinct stages in a roller-coaster year for capital markets. The spread of Covid-19 caused stock and bond prices to plunge in February and much of March, with U.S. government bonds among the only safe havens. Massive liquidity injections from central banks and fiscal stimulus from governments stemmed the tide of selling in March. The "policy bridge" provided by governments and central banks provided the backdrop for a second stage in which capital markets rebounded strongly from the March lows. The third stage of 2020 came in response to promising vaccine trial results and the conclusive result in the U.S. Presidential Election. During this third and final stage, market leadership shifted from beneficiaries of the "stay home" economy to those that would benefit from a reopening of the economy.

Global equities, as represented by the MSCI All Country World Index, rose by more than 16% for the year. The S&P 500 gained more than 18%, while U.S. small company stocks gained 20%. The Russell 2000 small-cap stock index has roughly doubled from its March low. Developed international stocks, as measured by the MSCI EAFE Index, rose by nearly 8%. Emerging markets stocks staged a strong 4th quarter rally to gain more than 18% for the year.

The market did not rise uniformly during the year. For much of the year S&P 500 returns were driven by the performance of 5 stocks that were major beneficiaries of the stay home economy: Apple, Amazon, Microsoft, Facebook, and Alphabet (Google). The other 495 stocks in the index lagged far behind. Although the market rally broadened in the last weeks of the year, major differences in performance remained. The Russell 1000 growth index outperformed its value counterpart by more than 35%, the largest margin on record according to Dow Jones. In sector terms, despite a strong 4th quarter rally, the S&P 500's energy sector declined by more than 30% for the year; the real estate and financial services sectors also finished in negative territory for the year. In contrast, the technology sector gained nearly 44% and consumer discretionary more than 33%.

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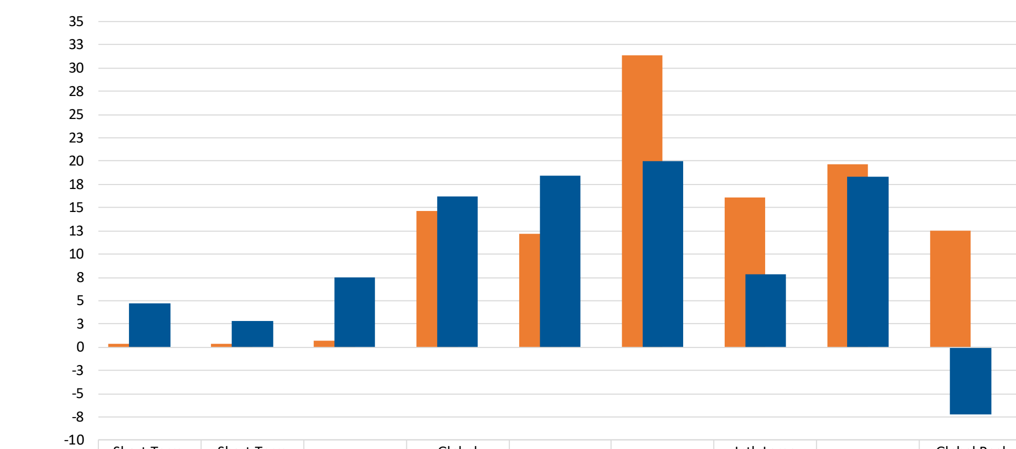
Falling interest rates were a positive for the government bond market during the pandemic-related flight to safety, with intermediate and long-term bonds providing both capital appreciation and coupon income. Corporate bonds benefited from central bank support and pandemic relief, recovering alongside the equity rally that started in March. State and local governments continue to face daunting pandemic-related challenges, consequently municipal bonds recovered at a slower pace from March lows.

Quarter To Date Returns 12/31/2020



	Short Term Bonds	Short Term Muni Bonds	Barclays Agg.	Global Equities	S&P 500	U.S. Small	Intl. Large Core	EM	Global Real Estate
QTD	0.3	0.3	0.7	14.7	12.1	31.4	16.0	19.7	12.5
YTD	4.7	2.8	7.5	16.3	18.4	20.0	7.8	18.3	-7.2
Full Cycle*	2.8	2.5	4.4	5.4	9.3	8.4	2.1	2.2	2.8

* Full Cycle is the annualized return from October 2007 peak to present.

TFC's portfolio changes during the pandemic helped absolute and relative performance.

TFC client portfolios rose in absolute terms during 2020. Despite trailing relative to client benchmarks during the first quarter downturn, TFC portfolios gained considerable ground in relative terms over the remainder of the year. TFC's portfolio changes during the pandemic helped absolute and relative performance. Our reduced allocations to the more cyclical segments of the market, including value and small company stocks, helped to stabilize portfolios during the turbulent year, as did our emphasis on quality in the form of strong balance sheets, cash flow and liquidity. Increased investments in the innovation and growth-oriented holdings that benefited from the "stay home" economy also helped performance. TFC's value holdings lagged the core and growth holdings for the year despite participating in the strong recovery during the 4th quarter. TFC's short-term, high quality bond holdings provided income and capital appreciation when needed most in the early part of the year; with interest rates now at low levels short-term, high quality fixed income holdings are providing positive but relatively low returns.

Market Outlook

We are optimistic about the outlook for stocks in 2021. In the words of J.P. Morgan's David Kelly, "2021 will be the year of the vaccine." We expect a robust economic recovery in the second half of the year, predicated on success in vaccinating much of the population.

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Near-term risks remain high, given the surge in Covid-19 case counts and a disappointingly slow rollout of vaccines in much of the world. There are also unknown factors associated with newly developed vaccines, such as the length of protection provided by vaccines, whether vaccines prevent transmission of the virus, and the effectiveness of different vaccines against Covid-19 mutations. The latest surge in case counts has been met with a reversal of high frequency economic indicators such as mobility measures. We expect a meaningful portion of the population will be vaccinated by mid-year, leading to strong economic growth in the second half of the year. However, until more of the world's population is vaccinated, economic growth is likely to be inextricably tied to Covid-19 case counts and hospitalizations, contributing to elevated market volatility.

After a long, bitter U.S. election campaign followed by post-election instability, the policy outlook is easier to project. In our opinion, constraints matter more than preferences in forecasting government policy. For example, Joe Biden's campaign platform reflected a preference for significant increases in taxes and spending. However, with the slimmest of possible Democratic majorities in the Senate, President Biden faces constraints on his ability to enact legislative policy preferences. Biden will need support from centrist Senate Democrats, who are less likely to support the substantial tax increases and policy priorities favored by the Progressive wing of the Democratic party. Democratic and GOP centrists in the Senate may find common ground on pandemic relief and infrastructure spending during the early days of the Biden Administration. Some tax increases are likely, including increases in personal tax rates for the individuals in the highest tax bracket and a partial reversal of the Trump corporate tax cuts. Given the slim Democratic majority in the Senate, investors are relieved that tax increases should fall far short of the dramatic restructuring of the tax code proposed in Biden's campaign platform.

U.S.-China relations will remain strained under Biden. Biden's approach to China is likely to be less openly confrontational than Trump's America First approach, and he will seek support from European and other allies. Biden is more likely to recognize mutual dependency with China and the importance of Chinese revenues to American companies. He will be less focused on the U.S. trade deficit with China, which disappears once sales of subsidiaries of U.S. companies in China are included. Conflicts relating to Taiwan, technology and human rights are potential sources of frictions that could create market volatility. According to Enodo Economics founder Diana Choyleva, "For China the recovery of Taiwan is as much as anything a question of morality and national prestige, while for the US its willingness and ability to defend Taiwan are critical to maintaining its status as the leading global superpower." We expect the U.S. to continue to support Taiwan and for Xi Jinping to refrain from forceful reunification, but an inadvertent escalation of hostilities is a market risk to monitor. Tensions and conflict with China are here to stay, but investors will welcome Biden's more measured approach to geopolitics.

We expect 2021 to be a good year for stocks. Market leadership rotated late last year from technology stocks to more cyclical value and small cap stocks. "COVID-19-laggards," including airlines, hotels, and energy stocks, may be the biggest winners from pent-up demand that gets unleashed when lockdowns and social distancing are in the rear-view mirror. The initial move in many of the left-behind segments of the market comes from reduced fear of worst-case scenarios, further gains are likely when a durable and safe economic reopening is in sight. Financial stocks, a major sector within value indexes, would benefit from a steeper yield curve, moderate economic growth and avoidance of a consumer and business bankruptcies. Healthcare stocks should benefit from demographic mega-trends and a golden age of medical innovation, but the increasing role of government in drug pricing creates uncertainty.

Technology stocks face challenges in 2021. Heightened antitrust scrutiny, potential tax hikes, and moderately higher interest rates may be headwinds for the stock prices of leading technology companies.

Technology stocks face challenges in 2021. Heightened antitrust scrutiny, potential tax hikes, and moderately higher interest rates may be headwinds for the stock prices of leading technology companies. The valuations of many technology stocks may also reflect overly optimistic expectations about the pace of growth or the total addressable market opportunity for the company. Longer-term, however, there are meaningful shifts in how we work, where we work, the nature of how our economy works, and the speed of disruption. It is important to recognize that because the marginal cost of scaling business over the Internet can be so low, businesses can grow more rapidly and at greater profitability than has been the case in the past. Many of the companies that were big winners last year will continue to benefit from these mega-trends, while many of the "cheaper" companies in the market may find themselves on the wrong side of the same mega-trends. Investors may want to "rent" rather than "own" some of the companies that are likely to do well this year.

European stocks, which are more export-centric and cyclical than U.S. stocks, should benefit from economic reopening and from fiscal stimulus that will be more meaningful in the second half of 2021. The U.K. market may rebound rapidly when Covid-19 is contained, given the conclusion of the latest chapter in the Brexit saga. Although the U.K. has done a poor job managing the pandemic, the country may be among the best equipped to acquire and distribute vaccines. We are reasonably optimistic about the prospects for emerging markets stocks but expect distinct winners and losers among emerging markets countries and companies. Selectivity in emerging markets is increasingly important, as there is no longer a "rising tide" that lifts the entire emerging markets asset class.

Short-term bond yields should continue to be restrained by central banks, while longer-term bond yields are likely to drift upward. The risk-reward trade off in longer-term bonds is unattractive, but a well-diversified allocation to bonds remains a necessary counterweight to equity risk. An inflation scare is entirely possible this year.

There may be some temporary price spikes in comparison with last year when the economy reopens -- such as in airline and hotel prices -- but inflationary pressures are likely to remain muted if unemployment is elevated and the economy continues to have excess capacity.

Central banks will look past temporary effects until there are longer-lasting signs of inflation. Municipal bonds should benefit from increased fiscal support and higher tax rates.

Portfolio Positioning

We expect 2021 to be a year of recovery for the global economy and for corporate profits, which supports a cautiously optimistic outlook for equities.

TFC is positioned in line with long-term strategic targets for stocks. We expect 2021 to be a year of recovery for the global economy and for corporate profits, which supports a cautiously optimistic outlook for equities. Diversification within the equity portfolio continues to be important because the rotational shifts we have seen in recent years are happening so quickly. Diversification must be emphasized not just across sectors, but also across market cap, geographies, asset classes, and within asset classes. Just as important as diversifying is thoughtful rebalancing to trim back on segments such as small company growth stocks that have outperformed and add to segments that lagged.

We continue to expect the time-tested value investment approaches of Benjamin Graham and Warren Buffett to pay off in the long run. However, it is important to properly define what we mean by “value investing.” We subscribe to the definition used by Oaktree Capital Management co-founder Howard Marks, in which value investing “consists of quantifying what something is worth intrinsically, based primarily on its fundamental, cash-flow-generating capabilities, and buying it if its price represents a meaningful discount from that value. Cash flows are estimated as far into the future as possible and discounted back to their present value.” Value investing, as practiced by Buffett and Marks, is not about buying what is “cheap” as defined by P/E ratios or other price metrics. The pace of change, in large part because of technology, is such that many companies today may be “cheap for a reason.” It is increasingly important to distinguish between companies that are vulnerable to disruption and those that are positioned to create or effectively respond to disruption. Consequently, TFC has increasingly invested in funds that go beyond simple price metrics to determine company “value.”

We are positioned cautiously within bond portfolios, with a core of short-term, high quality fixed income holdings that will provide safety and liquidity but unfortunately not a lot of coupon income in a low-rate environment. We expect the municipal bond market to further recover in 2021 and expect incremental income relative to government bonds from our corporate and mortgage-backed bond holdings.

We look forward to seeing you “virtually” during the early part of this year and look forward to seeing you in person later in the year.

As always, we welcome your comments and questions.

Sincerely,

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