2020 Word of the Year: Unprecedented **February 9, 2021**

The year 2020 proved to be one of the most tumultuous in modern history, marked by many historically unprecedented developments. But as we enter 2021, we are reminded of the resilience of institutions, our country, financial markets, and most importantly, of the unwavering spirit of people.

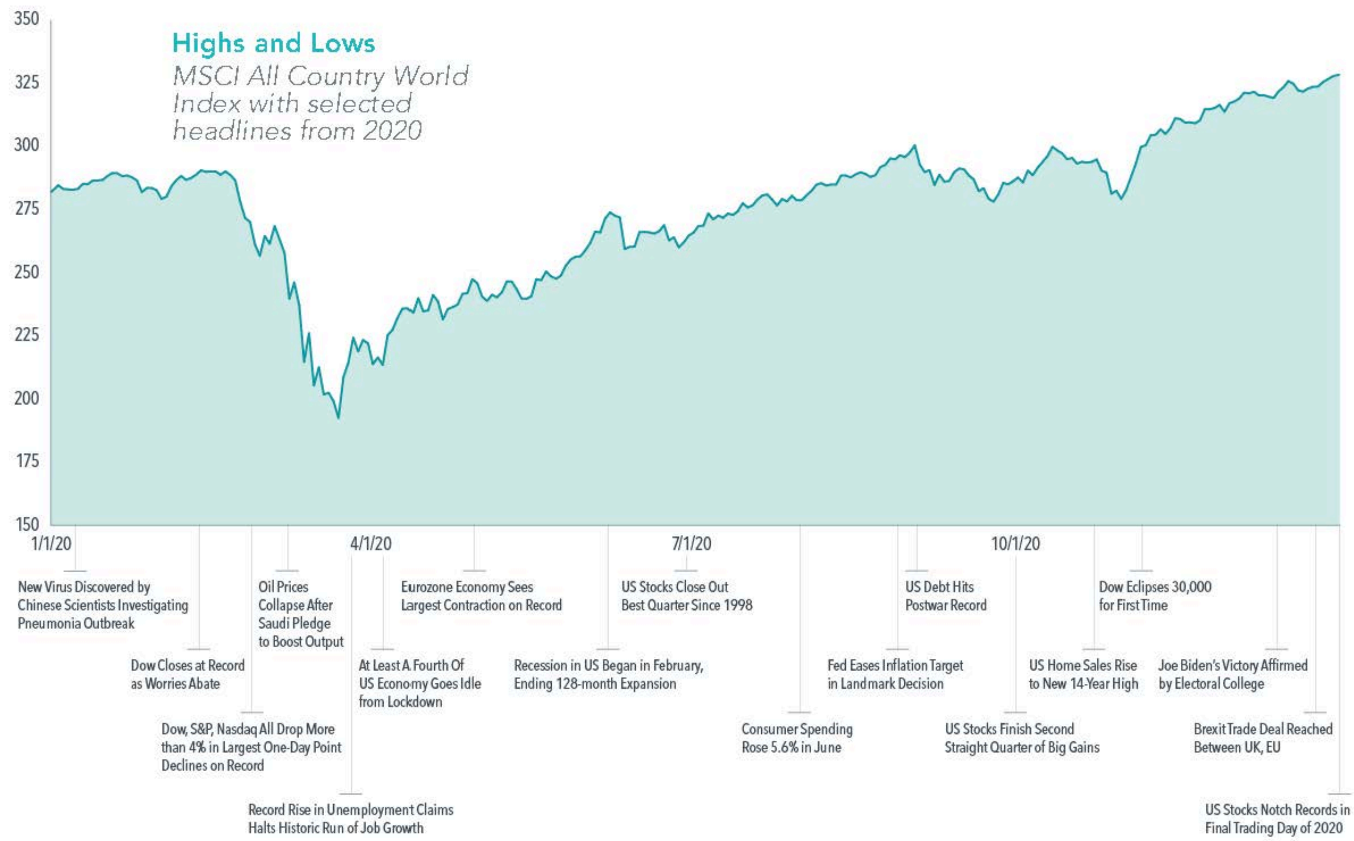
Pandemic, Civil Unrest, Market Cycles

Coronavirus was in the news early last year. As countries began reporting cases worldwide and COVID-19 was labeled a pandemic, it quickly became clear that the crisis would affect nearly every area of our lives. People stayed home, and businesses hunkered down. So governments and central banks around the world worked to cushion the blow by providing financial support and adjusting lending rates.

Widespread civil unrest throughout the summer, a mostly virtual presidential campaign season, and historic turmoil in the wake of the election add to the long list of extraordinary events that we dealt with as a country. Then as autumn turned to winter, we faced another spike in COVID-19 cases, but it was tempered with the hopeful news of viable vaccines in the United States and elsewhere.

For investors, the year was characterized by sharp swings in global markets. We experienced both a bear market and bull market within six months. These cycles usually last an average of five years. As a result, they are relatively short-lived cycles for the record books of 2020. To be sure, uncertainty remains about the pandemic, long-term effectiveness of the new vaccines, lockdowns, and social distancing. But the events of 2020 remind investors of an important lesson: following disciplined and broadly diversified investment approaches are reliable ways to pursue long-term investment goals.

One central theme of the year was the perceived disconnect between financial markets and the economy. How could equity markets recover from their lows in March when the economic news remained so bleak? The market's behavior suggests that investors looked past the pandemic's short-term impact in order to assess business activities that were expected to rebound, and return to more normal conditions. Seen through those lenses, the move upward in share prices shows a market looking ahead, incorporating current news, and eyeing future expectations.



Economic Decline and Recovery

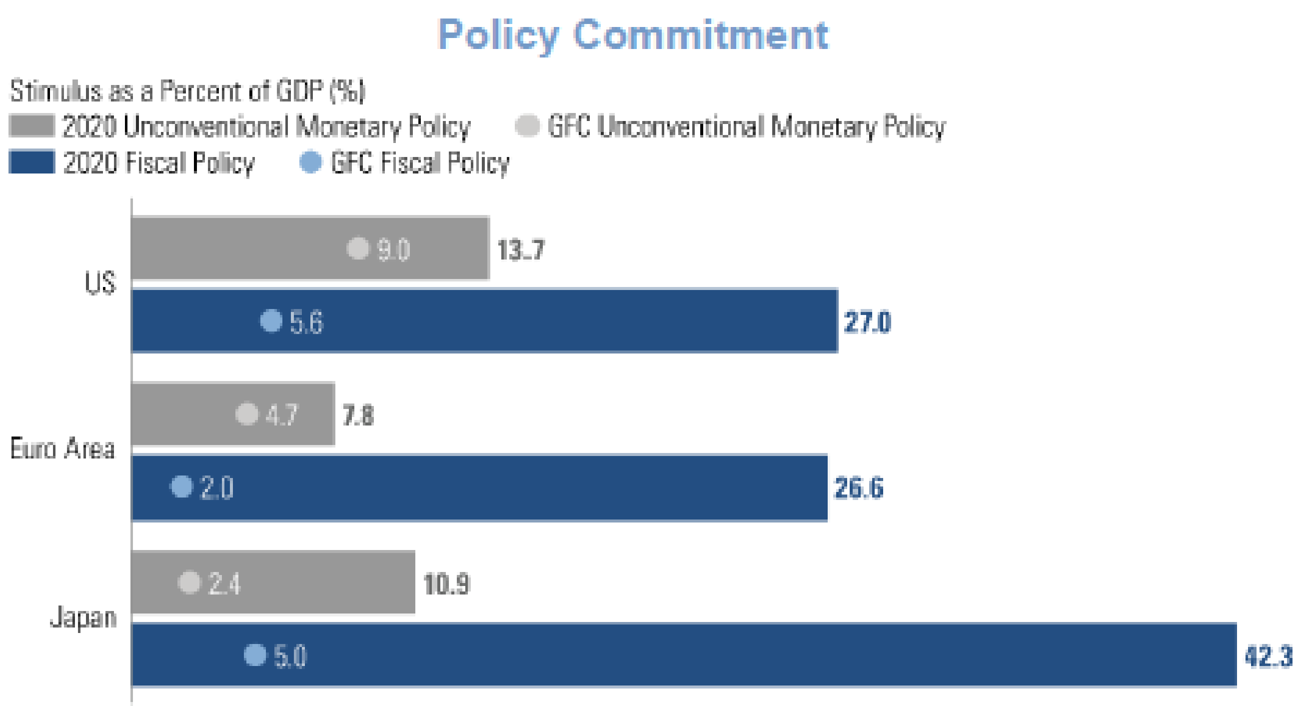
Starting in November, renewed shutdowns finally showed declining retail sales and employment, especially at restaurants and bars. But much of the economy, like manufacturing output and housing, kept growing in the fourth quarter. As a result, the most-recent "stimulus" bill didn't pass until December. Those resources will now help lift the economy in the first quarter of 2021 when it's most needed.

Historically, recessions have similar problems that manifest in slowdowns of the economy or corrections in the financial markets. The causes are often fundamental: problems in banking, the oil/gas industry, the Federal Reserve, consumer spending, and/or the housing industry. It's important to note that those traditional complications are not evident in our current environment. We have a unique medical problem, and it appears that we are at the precipice of resolving that.

Vaccine: Forecasters assigned a 99% chance of vaccinating 25 million people in the United States by May 31, 2021. U.S. vaccines and supply will likely improve alongside efficacy, public health official approval, and time. With more than 10 million current cases as of December 31st, an economic recovery is dependent upon sustained virus control.

Stimulus: The magnitude of countercyclical policy support dwarfs anything deployed in modern history. Monetary policy freed critical funding markets while fiscal policy built a bridge to recovery for corporations and consumers. Collectively, the stimulus may exceed the cumulative gross domestic product (GDP) lost to COVID-19.

Monetary policy refers to central banks' actions (i.e., Federal Reserve) to achieve policy objectives, such as price stability, full employment, and stable economic growth. **Fiscal policy** refers to the tax and spending policies of the government. The chart below compares monetary and fiscal stimulus levels as a percentage of GDP for 2020 and during the global financial crisis (2007-2008).



Since the heart of the economic damage is with consumers and businesses, the U.S. government delivered a multi-trillion dollar fiscal package to mitigate permanent economic damage at the onset of the pandemic. Pending further fiscal support and possible infrastructure spending, the budget deficit could increase in 2021, but will likely still be below that of 2020.

However, the national debt as a share of GDP will continue to grow to the highest levels since World War II. While we do not believe this will result in a fiscal crisis in the next couple of years, failures to rein in deficits and debt monetization once the economy accelerates in the wake of vaccinations could lead to significant problems. This suggests that eventually the government will have to make some tough choices on tax hikes and spending cuts.

Re-opening: The market remains keenly attuned to evidence of economic normalization. After businesses fell to a rate of only being 38% open in early April, the U.S. economy is now roughly 67% re-opened. This is significant improvement. However, the need for considerable recovery remains, particularly for vulnerable sectors like entertainment, retail, lodging, and transportation. For restaurants, hotels, retailers, airlines, and small businesses, it has been the worst of times.

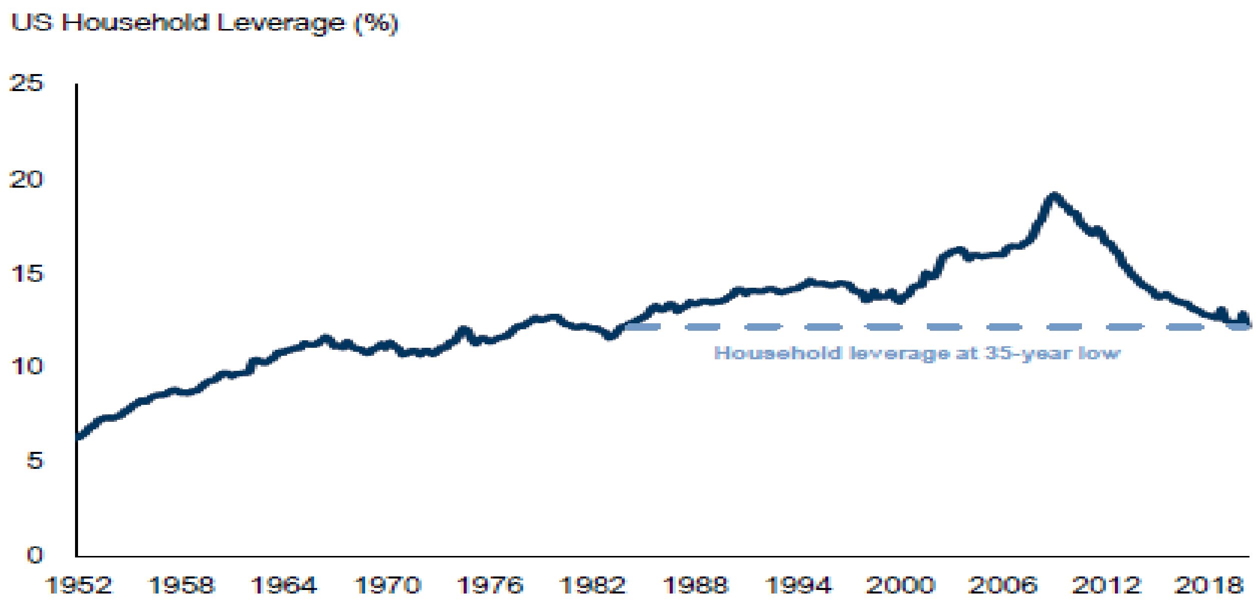
At the opposite end of the spectrum, the stay-at-home era has been a boon for e-Commerce, cloud computing, video streaming, digital payment processors, and home improvement stores. The damage to small businesses is real and will take years to heal. According to the *Wall Street Journal*, about half as many consumers visited stores on Black Friday 2020 as did a year earlier. Meanwhile, online shopping for the holidays rose by 32%, the largest percentage jump in six years.

Pro-risk: Our positive view of risk assets, particularly global equities, is supported by:

- Recovering global growth of 6.4%
- Double-digit corporate profits
- Limited need for structural repair
- Sustainable policy commitments that remove the extreme tail risk (the chance of a loss occurring due to a rare event, as predicted by a probability distribution)
- Relatively low global interest rates

Home Building: There have been 3.6 trillion dollars in mortgage origination during 2020, primarily due to low-interest rates and housing market strength. More than half of the loans are due to refinancing. On average, a homeowner who refinances unlocks $400 per month in cashflow. The housing market is strong in prices and desirable at the current interest rate levels. Residential construction continued to increase in the fourth quarter, likely hitting the highest level since 2007. We believe that the home building sector has further growth potential given the shortage of homes in many places around the country and the higher appetite for houses with more space in the suburbs.

Savings Rates: U.S. households are saving 12.9% of their incomes, which sets the stage for a potential consumer rebound. This means more consumer spending, which translates to further growth. The U.S. household leverage rate (a measure of debt-to-income ratio) is at a 35-year low. (See chart below.)



Financial Conditions: Strong recoveries are built around strong capital markets. The chart below is a measure of economic conditions. The lower the line, the more comfortable and more supportive the capital markets are. We are at one of the lowest levels in the last 30 years. Credit spreads, short-term rates, long-term rates, and the stock market levels are supportive of growth.

Labor: Unemployment in December was at 6.7%. By combining increased spending with more people getting vaccinations and the advent of warmer weather in the spring and summer, the U.S. economy should continue to grow. Payrolls are anticipated to expand by 6 million dollars. If this is the case, it will be the largest single calendar-year increase in the number of jobs created/regained, and the fastest percentage gain since the 1970s. But it will also leave us with more than two million payrolls short of where we were before COVID-19. It's progress, but not quite a complete recovery.

Conclusion

Moving into 2021, many questions remain about the pandemic, additional new and viable vaccines, business activities, changes in how people work and socialize, and the direction of global markets. Yet 2020's economic and market tumult demonstrated that markets continue to function and that people can adapt during difficult circumstances. The year's positive equity and fixed-income returns remind us that, with solid investment approaches and commitments to staying the course, investors can focus on building long-term wealth, even in challenging times.

Sources: *Goldman Sachs Asset Management*, *First Trust Advisors L. P., The Capital Group, The Wall Street Journal, Reuters News Service, J.P. Morgan Guide to the Markets, David C. Jennett's Investment Letter, Financial Research Publishing Inc. Money Forecast Letter and The Kiplinger Lette*r. Dimensional Market Review 2020; https://www.worldometers.info/coronavirus/country/us/

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