

MARKET REVIEW AND OUTLOOK

Fourth Quarter 2020



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Market Review

While large technology companies greatly benefited last year from the pandemic-generated work-from-home movement, price multiples on some of these tech darlings reached extreme levels, causing investors to shift focus to underappreciated segments such as small-cap and value stocks. After lagging the broader equity market for years, domestic small-cap value stocks surged more than 30% in the final quarter of 2020.

Other overlooked segments, such as emerging-market equities, gained nearly 20% in the fourth quarter. More broadly, international stocks outpaced the U.S. equity market after struggling earlier in 2020 to keep pace with U.S. tech leaders.

Within fixed income, high-yield bonds and emerging-market debt benefited from the continued contraction in credit spreads since the spike in the first quarter of 2020.

Outlook

Though they experienced quite a roller-coaster ride, investors who held firm to their positions generally gained in 2020 because by year-end, nearly all markets erased significant losses from the first quarter. We anticipate that governments will remain highly accommodative amid these unprecedented times. Dispensing the COVID vaccine to the masses likely will accelerate the pace of the recovery in 2021 and beyond. These two factors should bode well for further appreciation of risky assets such as stocks and credit.

COVID-19 Impacts

Although new coronavirus cases surged in the U.S. in the fourth quarter of 2020, the approval and implementation of vaccines provided a light at the end of the pandemic tunnel. An inoculated consumer base may unleash pent-up demand, especially for the services sector—which includes many smaller and cyclical value firms that have been suppressed for nearly a year.

Small-Cap Recovery

The hope of additional fiscal stimulus and a relatively healthy global recovery fueled the strong run-up in small-cap value. We anticipate the rotation between sectors and styles seen in the fourth quarter will carry momentum throughout 2021. Fundamental factors, such as accelerating revenue growth and quickly improving earnings, should be a tailwind for small-cap companies. Furthermore, the administration under newly elected President Joe Biden may seek to level the playing field for various sectors. Such measures could include regulations that reduce monopolistic practices and/or hinder buy-back activity, which would likely be headwinds for larger companies. We believe small-caps and value stocks may, after more than a decade of underperformance (on an annualized basis), be better positioned than their larger growth counterparts.

Performance data quoted represents past performance, which does not guarantee future results.

China

We continue to expect that the Biden administration will take a different approach to China compared to former President Donald Trump's aggressive tactics, which caused China to respond with its own aggressive measures, including a military presence around strategic assets in key regions.

President Biden will have to deal with Chinese President Xi Jinping, whose long-term vision for his country is to be the world's dominant superpower. President Joe Biden will need to maintain a delicate balance of carrot and stick to convince China to play fairly and abide by global standards of trade and business. While former President Donald Trump may have tried simply to contain China's growing power and influence, President Biden probably will need to take a different approach of being stern, yet taking the time to understand China's true objectives. President Biden also is likely to shore up ties with old allies, such as the European Union, to help pressure China. The specter of military involvement between superpowers may loom if animosity between China and the United States rises to untenable levels.

Given the deteriorating relations between the West and China, we could potentially end up with a divided world that is run on two 5G platforms—one based on Western standards and the other driven by the Chinese system. The outcomes of segmented technology also will depend on many factors, including how respective countries treat and regulate their domestic conglomerates, such as Facebook and Google for the U.S. and Alibaba and Tencent for China.

A Reshaped Foreign-Exchange Market and Cryptocurrencies

Cryptocurrencies, such as Bitcoin, continued to gain momentum in 2020, enticing traders to invest in those volatile investments. Many of these cryptocurrencies bear little-to-no fiat value, but Facebook, for instance, has been preparing to launch Diem (previously called Libra) that would be backed by traditional currencies such as the U.S. dollar, euro, and yen. Cryptocurrencies, such as Diem, have the potential to uproot traditional central banks and their abilities to conduct monetary policies. In other words, the Federal Reserve (FED) may have less control over interest rates, which in turn can impact discount rates and market valuations.

The New Modern Warfare

While the likelihood of escalating military conflict has risen in the region around the South China Sea, many of today's battles are fought through economic and political measures. Foreign hacks into U.S. government and company computer systems continue to rise, with the potential to do tremendous damage to the U.S. economy and erode confidence in security. Information security likely will become an increasingly important area of interest. Investors now may prefer to seek protection amid this environment.

The U.S. network-infrastructure market continues to evolve, as cyber threats affect all sectors and industries. The cybersecurity industry continues to grow with hundreds of new start-ups being launched every year with venture capitalists investing at a record pace. Some of the companies gaining market share in this cybersecurity industry include CrowdStrike and Fortinet, which are listed in the Russell Mid-Cap® Growth Index; some of the larger and established players include Cisco Systems and IBM, both of which are represented in the Russell 1000® Value Index. Developing trends in the network-security industry could also remain positive for small- and mid-size cybersecurity companies, as larger entities may look to consolidate. The positive momentum and necessity for better information protection should boost demand for services offered by cybersecurity providers.

Conclusion

In general, we see economic optimism generated by the COVID vaccines and unleashed pent-up demand caused by the pandemic. We also believe the latest tech revolution, driven by the coronavirus ramifications and the related shutdowns, will enhance productivity, which should support risk assets. Other potential investment bright spots in 2021 include small-cap and value stocks, which we believe will have tailwinds this year, and cybersecurity companies that likely will experience increased demand from governments and firms due to the escalating number of hacks.

But, like 2020, this year could experience significant headwinds, including the deterioration of United States-China relations, the continued foreign hacking of U.S. digital infrastructure, and the lingering effects of the pandemic—especially as there are several remaining hurdles to scaling up vaccine distribution.

As always, we will remain optimistic about carefully considered investment opportunities in 2021 while being mindful of potential pitfalls.

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