A Tale of Two Economies: December 2020 Letter to Investors

Dear Friends,

Merry Christmas, Happy Hanukkah, and Seasons Greetings to you and your families!

As I sit down to write this year's annual letter to our investors, I can't help but remember the opening line from Dickens' *A Tale of Two Cities*:

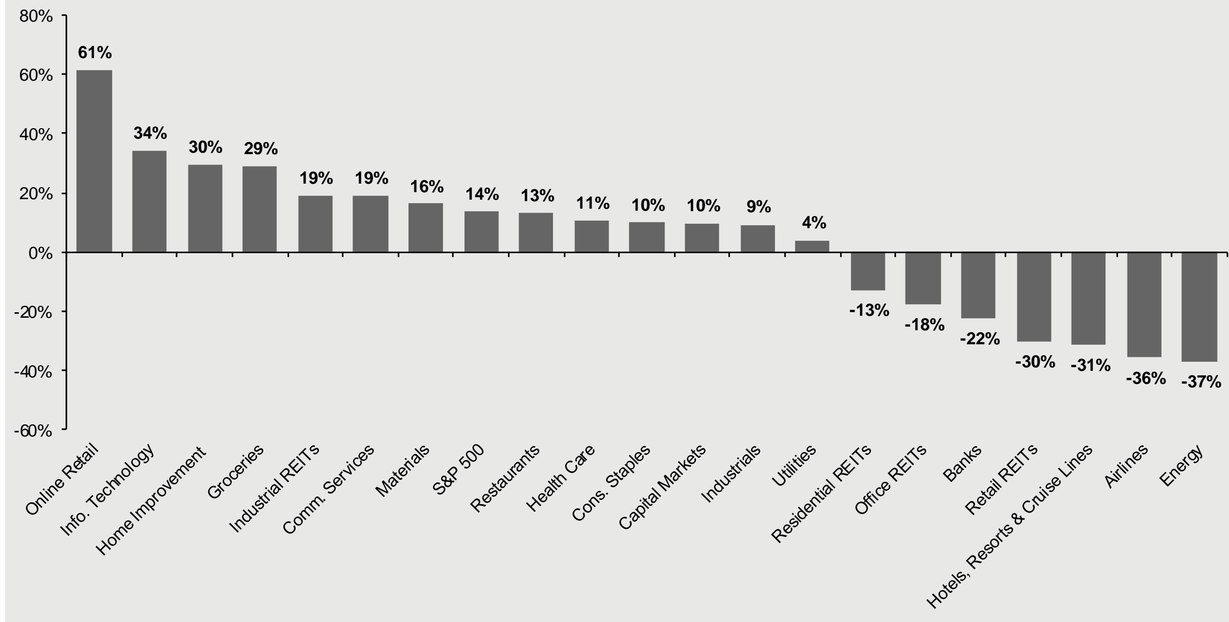
It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of light, it was the season of darkness, it was the spring of hope, it was the winter of despair...

2020 has certainly been a tale of two economies. Many service sectors (Economy #1) - in particular, travel, leisure, hospitality, and brick and mortar retail - have suffered greatly from the economic malaise associated with the COVID shutdowns and the subsequent change in consumer behaviors. The energy sector has seen oil prices plummet as a result of decreased global GDP. Financials have suffered from low interest rates and a decline in the credit quality of their loan portfolios. Retail, office, and multi-family REITs have felt the sting of falling occupancy rates, real estate values, and tenant defaults.

These trends have led to financial stress, widespread unemployment, and permanent job loss for many consumers. And even they pale in comparison to the loss of loved ones and separation from friends and family due to the impacts of the virus. Longer-term, we are left wondering what the impact of a "lost year" of education will mean for our children and grandchildren, their career paths, and their mental health. We also worry about the impact government debt will have on the US Dollar, interest rates, and the ability of our economy to continue to grow at the pace we have grown accustomed to. Afterall, a penny borrowed today must be repaid tomorrow.

Yet, there is also a wide swath of the economy for which 2020 has been a stellar year for profits and stock prices (Economy #2). The technology, healthcare, online retail and home improvement sectors, are but a few examples of where the virus has either led to an acceleration of behaviors already beginning to take place – such as remote learning, work-from-home, e-commerce, and cloud computing - or created new behaviors that benefit these sectors directly.

Total Returns by Sector and Industry



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. U.S. Data are as of November 17, 2020.

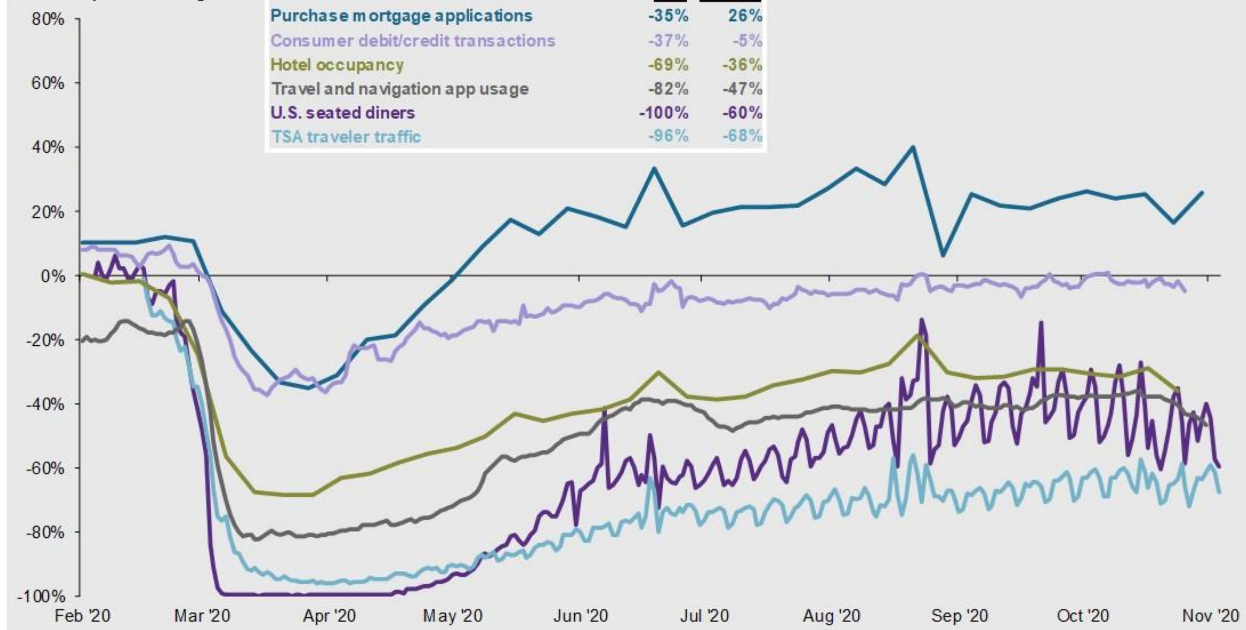
Surprising many, these trends, along with low interest rates, fiscal stimulus, and an understanding that the current crisis will eventually end after a vaccine is widely distributed (which appears to be sometime in the second quarter of 2021), have led to the S&P500 generating a 14%+ YTD return to investors. Once again, the old axiom of *Don't Fight the Fed* has proven faithful.

Asset Class	Index	Ticker	YTD Returns
US Large Cap	S&P 500	SPY	**14.07%**
US Mid Cap	S&P 400	MDY	**9.03%**
US Small Cap	S&P 600	SLY	**7.42%**
International Developed	MSCI EAFE	EFA	**4.19%**
Emerging Markets	MSCI EM	EEM	**13.62%**

Source: Charles Schwab, Collective Family Office. Data as of December 10, 2020.

Initial Stage of a Recovery is Underway

Looking ahead as we enter the early stages of a new economic cycle, we are seeing strong signs of an economy that is already beginning to recover. High frequency indicators can be used to gauge the success of the reopening efforts in the U.S. and show that not all industries are reopening at the same pace. Thus far, housing has been a bright spot of the economy. Spending has shifted rather than stopped with consumers buying online or purchasing goods rather than services. Less consumption of services such as hotels, travel, restaurants, and airlines are reflected in the bottom four lines of the following chart. These sectors are likely to continue to struggle in a socially distant environment.



*Source: Source: App Annie, Chase, Mortgage Bankers Association (MBA), OpenTable, STR, Transportation Security Administration (TSA), J.P. Morgan Asset Management. *App Annie data is compared to 2019 average and includes over 600 travel and navigation apps globally, including Google Maps, Uber, Airbnb and Booking.com. Consumer spending: This report uses rigorous security protocols for selected data sourced from Chase credit and debit card transactions to ensure all information is kept confidential and secure. All selected data is highly aggregated and all unique identifiable information—including names, account numbers, addresses, dates of birth, and Social Security Numbers—is removed from the data before the report's author receives it. U.S. Data are as of November 17, 2020.*

A Divergence in Regional Returns is Imminent

Global equity markets have certainly staged an impressive recovery from their March lows; however, the recovery has been regionally uneven. Both the US and Emerging Markets Asia have more than recovered their COVID losses for the year, while Europe, Emerging Markets ex-Asia, and Japan have only partially made up for lost ground.

Sectoral differences between regions primarily explain this divergence in performance. The U.S. and EM Asia markets are heavily tilted towards technology, communications services, and e-commerce – sectors that have all done well during the pandemic – while other regions tend to be more heavily tilted toward cyclical sectors such as financials, industrials, materials, energy, and consumer discretionary. The latter are harmed most in a recession and perform best during an economic expansion.

The extreme difference between regions can best be understood through the end of October 2020, whereby technology was up 33% and banks down 40% year-to-date. As a result, the U.S. and EM Asia indices were up 3% and 12%, respectively, while Europe, Japan and EM ex-Asia were still negative year-to-date.

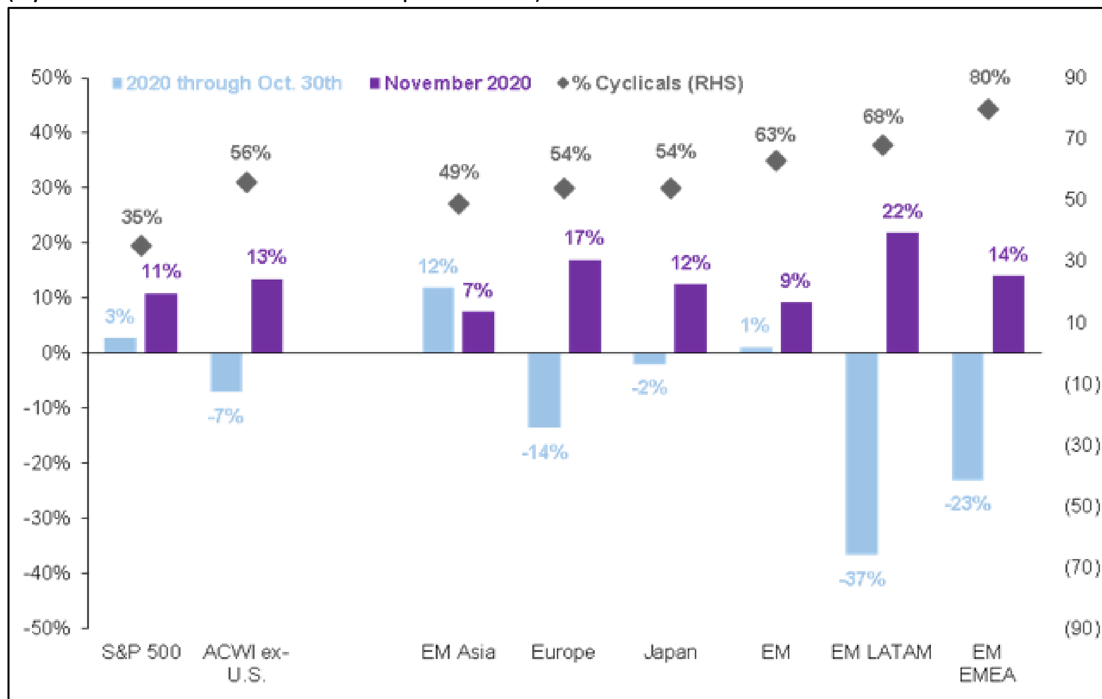
November has provided us a preview of things to come in 2021. During the month, investors received positive news about the trials of three COVID-19 vaccines, providing confidence that global distribution will occur in 2021, allowing the economy to return to normalcy. Additionally, the US elections concluded with a Biden victory, curtailing uncertainty around heightened foreign policy risk from trade protectionism.

As a result, cyclical sectors and cyclical regions saw the strongest performance during the month of November. European equity markets had their strongest monthly performance ever, while Japanese equities hit their highest level since 1991. More defensive regions like the U.S. and EM Asia lagged in relative terms.

This cyclical economic and market recovery is just beginning, suggesting strong performance ahead for International Developed and Emerging Markets. Extreme relative valuation discounts and a declining dollar should only provide additional support to this thesis. The MSCI All Country World Index ex-U.S. trades at a 24% discount to the U.S. compared to its 20-year average discount of 13%.

It is crucial for investors to ensure they have enough international exposure in their portfolios for the new cycle ahead. As we have discussed before, investors can expect to see an overweight toward International Developed and Emerging Market equities in their portfolios in the years to come.

Cyclical Regions Have Lagged in The Pandemic Year, But Are Likely to Lead in The Recovery
(Cyclicals as % of index market capitalization)

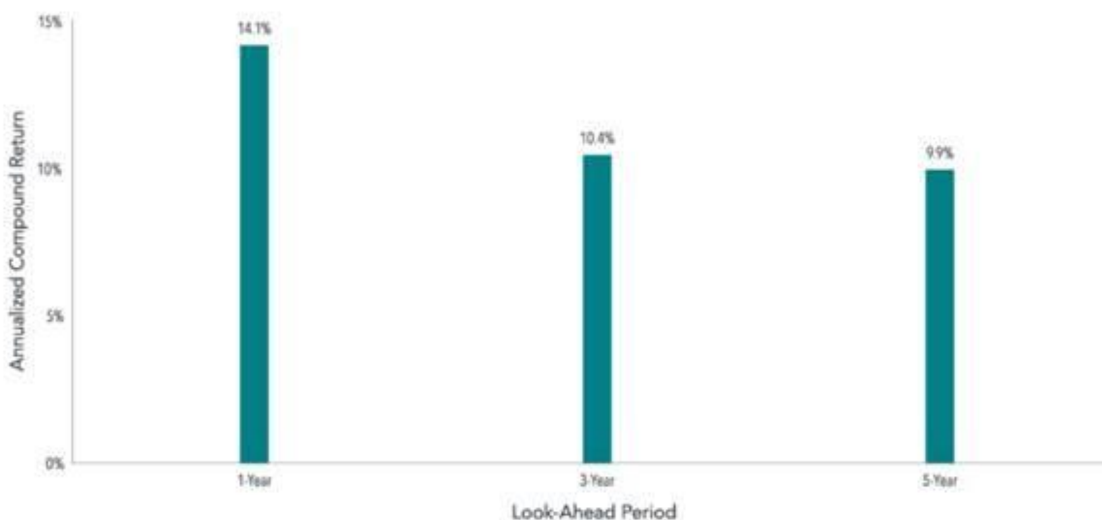


Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. All return values are MSCI Gross Index (official) data, except the U.S. which is the S&P 500. Cyclicals include the following sectors: Consumer Discretionary, Financials, Industrials, Energy, and Materials. Data are as of December 5, 2020.

Is Now a Good Time to Invest?

Earlier this year the S&P 500 Index hit an all-time high, closing at 3,386.15 as part of a historic bull run that started on March 9, 2009, and ended on February 19, 2020. Over the next 23 trading days the index fell nearly 34%, amidst the uncertainty stemming from the COVID-19 outbreak. Fast forward to August 18th and you'll see it only took 126 trading days for the S&P 500 Index to make the round trip from peak-to-trough-back-to-peak. For investors, the question many are asking is, "why invest when the market is at an all-time high?"

When markets hit all-time highs, investors may wonder whether they have already missed the rally and are better off waiting for a pullback rather than getting into the market. They may consider taking profits now, weary of an imminent downturn. Some investors may make tactical decisions that do not align with their initial investment plan based on their beliefs on what may happen next. More often than not, one major fear is driving similar reactions to these scenarios: what if I make an investment today and the price goes down tomorrow? The good news is the data makes a compelling case as to why investors should not do any of these things. The below exhibit suggests that new market highs have not been a harbinger of negative returns to come. In fact, following new market highs, the S&P 500 Index has historically gone on to provide positive average annualized returns over the subsequent one-, three-, and five-year periods.



New market highs are defined as months ending with the market above all previous levels for the sample period. Annualized compound returns are computed for the relevant time periods subsequent to new market highs and averaged across all new market high observations. There were 1,115 observation months in the sample. January 1990–Present: S&P 500 Total Returns Index. S&P data © 2019 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. January 1926–December 1989; S&P 500 Total Return Index, Stocks, Bonds, Bills and Inflation Yearbook™, Ibbotson Associates, Chicago.

Concluding Remarks

While on a personal level, many of us look forward to saying goodbye to a very unusual year, from a financial perspective, the markets have once again provided us with returns in-line or perhaps slightly ahead of our expectations. It is a good reminder that capitalism dictates that investors require a positive rate of return over and above inflation in exchange for risking their capital.

It is this belief that causes us to wake up every day expecting the market to go up just a little bit. But we are not surprised when it doesn't. We don't obsess over short-term ups and downs. Investing for the long run yet worrying about the daily market volatility is like a man walking up a big hill with a yo-yo in his hand and keeping his eyes on the yo-yo instead of on the hill. As we continue to shepherd your assets for your family and for future generations, we will always maintain a long-term disciplined approach to investing by recommending a globally diversified portfolio of stocks and bonds and helping identify areas of the market that are most likely to benefit across different phases of the economic cycle.

Wishing you all a safe and happy holiday season and a healthy new year,

Brian Luster	David Sivel	Trevor Hoffman
Chief Investment Officer	Chief Executive Officer	Chief Operating Officer

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