TERRA NOVA
ASSET MANAGEMENT

U.S. Financial Markets
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Stock Market Development

The first wave of the pandemic at the beginning of the year had triggered a market correction of 30.4% YTD on 03/23/20. However, fiscal and monetary stimulus buffered the economic downturn triggered by the pandemic, and when the spread of the virus diminished and the hope of a vaccine, the market anticipated a swift economic recovery and rallied 61% from its bottom in March boosting the S&P 500 up about 16% for the year. The technology sector took the lead (40%) followed by consumer discretionary (31%), communication services (21%), materials (17%). Utilities, real estate, financials, and energy (-36%) finished the year in the red.

Fixed Income Markets

The Federal Reserve Bank has manipulated bond markets since the financial crisis in 2008. It is curbing Treasury yields at levels that no longer fully reflect market sentiment of the economy, it suppressed volatility, adding fuel to a record-setting advance in stocks, leaving credit markets priced to perfection.

Economy

After a dramatic swing in GDP growth from -31% in March to +33.1% in the Q3, the virus resurged and the economy is expected to slow down to a 2% growth in Q4. Vaccines are being rolled out fast, and the end of the pandemic is expected by the end of 2021. Ongoing monetary and fiscal stimulus to shore up the economy, particularly small businesses, will be critical to secure a smooth transition period for the economy. We expect this scenario to unfold and GDP growth to not only trend back to normal in Q 2, but accelerate during the course of the year to grow a robust 5% in 2021.

Inflation outlook

Overall inflation alarmism in 2021 is unwarranted in our opinion. Although a weak dollar will put some pressure on imports and goods prices, a pronounced disinflation trend for household rents, other consumer services, as well as spare economic capacity, and tepid wage growth will offset this trend, in our opinion, until we see a full economic recovery. Inflation may pick up slightly by mid-year in certain segments of the economy where lingering supply disruption may allow companies to raise prices to meet pent-up demand. We expect inflation to remain weak until the economy will have fully recovered from the pandemic, which is unlikely to happen before 2022. Until then, we expect core inflation not to exceed 1.75% to 2%.

Federal Reserve Policy

The Fed expects sizeable economic downside risks over the medium term, and stressed policy should be maximized to mitigate lasting damage. Constrained at the zero bound, the Federal Reserve Bank's toolkit at this point includes enhanced forward guidance, continued quantitative easing and tailored emergency lending facilities to serve businesses, as well as state and local governments. The Fed is unlikely to signal QE tapering until the pandemic no longer poses considerable risks to the outlook for economic activity, labor market, and inflation. Interest rate increases will only occur in the final phase of monetary normalization. The Fed's new average inflation target is unlikely to trigger a change in policy in 2021.

Corporate Earnings Outlook

With earnings of the companies of the S&P 500 reported, the Index is set to post a 6.5% decline in Q3, a vast improvement over the 21% decline that had been projected on Oct. 1st. Q4 earnings are projected to decline 11% due to the resurgence of the virus, and the lack of fiscal stimulus. However, if a swift rollout of the vaccines allows normal business activity to resume in 2021, we expect a recovery of 23% in corporate earnings in 2021, after a decline of 15% in 2020.

Outlook

Treasury yields did not react to the change, or trend in the pandemic compared to equities, which moved strongly at peaks in Corona virus cases in part because equities were supported by fiscal stimulus, and more recently by optimism over a potential vaccine. The question for longer-term yields now is how the economy will develop in 2H21 and 2022. We recommend to stay on the sidelines, and/or to keep duration short. The yield curve is likely to steepen and yield to adjust once the Federal Reserve Bank starts to normalize its monetary policy which is likely to happen earlier than broadly expected.

Furthermore, during a year when the global pandemic put many companies out of business, the four biggest U.S. technology companies thrived, raking in profits that sent their stock prices soaring, and dominating the overall performance of the stock market. These companies are likely to face considerable risks on several fronts, from mounting antitrust and regulatory issues to high valuations, and a volatile economy. We do not expect this performance to be repeated in 2021. Overall, the technology sector benefited from a so-called safety premium trade to avoid solvency risks found in other traditional sectors such as travel, energy, and retail. Any gains from this allocation shift may dissipate should the economy, once stabilize, start to improve rapidly, which is expected to happen in the second half of 2021. If so, some rebalancing in portfolios towards undervalued sectors will be necessary, in our opinion. Also, a diversification away from the market leaders in technology towards companies with a lower market capitalization in technology segments, with promising futures, developed during the pandemic, is warranted. Sectors which are most promising, in our opinion, include biosciences, with their new CRISPR techniques, that allow scientists to create a new smart phone based diagnostic test that would detect viruses within half an hour, artificial intelligence with its GPT-3 technology, a major step toward the creation of robots that react in very human ways, advances in cloud computing and internet access to spread globally provided satellite -based, progress in transportation- driverless vehicles to be used by Walmart, and alike, for truck delivery, the change to electric cars driven by major progress on batteries; progress in solar-power will prove a boon for the environment. The notion of a mostly green energy future no longer appears utopian. Advances in energy and transportation typically have brought further technological advances by enabling people to reshape their physical environments in new and unexpected ways.

We also expect remote work to be a breakthrough, as it is likely to improve productivity significantly, and save costs for both, employers and employees. It will make it easier to attract the best talent from all over the world, and provide mobility for people to choose their preferred place of living.

The markets are likely to continue to surf on liquidity, thrive on strong technicals, and trade on a “goldilocks” outlook. To reverse this setting it would probably take a U-turn (unlikely) of monetary politics, a massive accident in one segment of the market, which is also unlikely as financial conditions remain to be loose, and lastly, a wave of bankruptcies which would be the most possible of all scenarios, in our opinion. The question is, how long will technicals remain disconnected from fundamentals? Since we do not know the timeframe, we suggest that this scenario does not apply to all sectors and companies. It is warranted for sectors, as described prior, but most importantly for companies that have strong balance sheets and/or a strong revenue growth outlook due to promising markets.

We continue to remain invested, while expecting more sector rotation from overvalued sectors, like technology, to undervalued sectors, a rotation from large growth stocks to smaller-cap growth stocks, some value and small cap stocks, as confidence about a strong economic recovery rises. We expect a finishing line under the pandemic by the end of 2021, and the new administration to restore stability to global trade, as well as sufficient fiscal and monetary stimulus to bridge the gap back to normality.

We wish you all a Happier 2021. May the bells ring again for all of us and the sun warm our hearts.

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