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2021 Outlook
Williams

Chris Schildz:
Welcome to Conversations with Commerce Trust. Today, we have Chief Investment Strategist, Joe Williams. Joe, welcome. How are you today?

Joe Williams:
I'm doing great.

Chris Schildz:
Joe, did you ever think in your lifetime that ... You've been doing this a long time, that we'd see a 30,000 level in the Dow?

Joe Williams:
I sure didn't. Well, I knew we would eventually get here, but it came a little sooner than I would've thought.

Chris Schildz:
Well, let's lead you off in that direction. Despite a 2020 that everyone would like to forget for many different reasons, we're probably looking at double-digit equity market returns for the past year and maybe a promising 2021. What should equity investors be thinking about for the new year?

Joe Williams:
Well, there's no doubt the rally from the lows in late March has truly been historic. I've sensed the skepticism about the longevity of this rally though is still very high. Until just recently, money flows have been out of equities and into fixed income investments and that's been occurring over the last several years. So, here is the investment landscape for financial assets in 2021, as I see it. First, money market funds yield nothing and the Fed has said, short rates are not going up for the foreseeable future. So, 2021, (it looks like) 0% rate of return. We all are aware that interest rates collapsed as the economy declined in 2020. As we end the year, the 10-Year Treasury is hovering around 0.9%, still 1% lower than it was just a year ago.

But we believe the pressure will be on interest rates to slowly increase in 2021 as the economy reopens, which will limit fixed income returns for bond funds in the zero to 3% range. And there is a possibility of slightly negative returns in 2021. So, that brings us to equities, and they beat a 3% return. And our answer is yes, valuation levels are high, but earnings are making a strong rebound. Companies have coped much better than we would have thought under these pandemic operating conditions. Dividends also look attractive. Dividend yield on the S&P 500 is 1.8%, and we think this could cause a shift from bonds back to stocks in 2021.

Chris Schildz:
Joe, you've been pretty consistent in recommending an overweight to stocks versus bonds, and still favor growth to value over the short-term. Give us some more insight about your rationale on this and a possible catch-up of value stocks that is developing in the market.

Joe Williams:
Yes, well, we recently just went overweight stock. We've been fairly neutral weighting in stocks over the last six months, but in early November with the election results, finally known and the announcement of a viable vaccine, or maybe more than one or two, the window now was open for the economy to fully recover sometime in 2021. Granted, the next several months are going to be painful with growing coronavirus cases and unfortunately deaths, but it's very important to remember the stocks are a discounting mechanism and what will happen six months from now is what is being priced in currently.

Fortunately, the outlook looks much brighter than before the vaccine news. We feel comfortable with a slight overweight now of equities to fixed income. We have long also over-weighted growth to value stocks. And in 2020, that was a very profitable tilt as large-cap growth stocks through the end of November, were up 32% versus value stocks, which actually declined 1%.

So, growth stocks, why have they done so well? Well, growth stocks are typically heavily concentrated in certain sectors, namely technology, healthcare and consumer discretionary, which is led by Amazon. Value is heavily weighted toward economically sensitive sectors, namely financials, industrials, energy, real estate, and utilities. Most of these sectors have been hit hard by the dramatic decline in the economy in 2020. But with the news of the vaccine, all of a sudden value stocks see a window of opportunity and started performing better, as was the case in November of 2020.

So, before the vaccine news was announced in November, we tilted (our)portfolio 60% growth stocks versus 40% value stocks. But as we enter 2021, we want to narrow that difference to 55% growth and 45% in value, at least for the first half of 2021. We do expect value stocks to perform now in line or possibly better in growth over the short-term.

Chris Schildz:
Joe, let's turn to international investing for just a moment. It's certainly underperformed domestic equities for quite a while now. With a falling dollar as a tailwind are international stocks finally improving as an option for your portfolio?

Joe Williams:
We are becoming a little more optimistic on international investments. The EAFE, Europe, Australia, and the Far East, underperform U.S. stocks by about 10% so far in 2020. We do think the under-performance (will continue) and we still want to keep underweighted to our long-term target, which in a normal portfolio is about 30% international stocks. But we do have to admit, there are finally some tailwinds instead of headwinds for international stocks as we enter 2021. First, international investments have a large tilt, just the way the indexes are built toward value stocks. And as I commented before, with the reopening of the economies around the world, this should favor value, which should translate into better international returns.

Another tailwind is the weakness in the U.S. dollar, for foreign currencies. Every percent the dollar declines, it actually adds about 1% onto your international fund returns as it's translated back to US dollars. So, if the dollar declines another 5% in 2021, this could be a nice tailwind for returns for international funds.

Chris Schildz:
So, I asked your good colleague, Scott Colbert, our chief economist, yesterday, this same question. I guess, this one has a little drama to it. Wall Street seems to anticipate a gridlocked Congress for the next four years, but there's still much uncertainty in the eventual Congressional makeup, depending upon the January 5th Georgia run-off. As we approach that date, Joe, anything you want to pass on to investors?

Joe Williams:
Well, the equity market I think expects the Republicans to win one or two of the Georgia seats, and that will mean they maintain majority within the Senate. If they lose two, that means it's going to be a 50/50, and the vice-president will have the winning vote. So, the market ... If they do lose two, the market could drop 5%. But I think the decline will be short in duration, as the odds of passing detrimental tax reform for corporations and personal tax rates still looks very low, even with a 50/50 Senate.

Chris Schildz:
Are you recommending any repositioning for tax purposes at this time?

Joe Williams:
Well, as we're closing into the end of the year, we're not proposing any repositioning in 2020 based on any expected tax law changes being proposed in 2021. And of course, the ones that would have a negative (impact) would be increasing your capital gains tax and your dividend tax rates. But as I said earlier, we think the odds of something like that happening are low and not worth trying to change your portfolio in 2020 for 2021 changes.

Chris Schildz:
Joe, let's conclude with this, any predictions for the end of the year? A lot of pundits out there try to guess what the indexes look like toward the end of the year. What do you foresee at the end of 2021?

Joe Williams:
Well, as we've said, we're positive on the outlook for 2021. I guess the question is, what would change that outlook and make us more negative and say, this bull market is coming to an end. Over my years of doing this, I've observed a lot of bull markets and they typically run out of steam when all four of the following areas that affect the market turn negative. So, the first of the four is valuation. And I commented earlier that no doubt the valuation levels for the market are extremely high as earnings collapsed in the mid part of 2020 and are trying to rebound. Valuation levels are back to highs that we saw back in the low for earnings in 2009 and also 1999. So, we need earnings to continue to recover, to drive those valuation levels down, but that's still a negative right now for the market.

Second is the economy, and what concerns us is kind of a contrary thinking, a real strong economy causes problems for the stock market because when the economy is very strong, the Fed is usually close to following up... trying to slow down the economy and raising interest rates. We're right now, coming off the third-worst recession we've had since 1920, and we don't have to worry about the economy overheating. So, that's still a positive.

Also, then we look at the direction of interest rates and we've found in the past when interest rates are rising, that's not a good sign for stocks, it causes problems. And when interest rates are falling or remaining about the same level, that is very positive and a nice tailwind for stock returns.

So, we know interest rates have been declining this year and they've kind of stabilized and slowly starting to creep up. But right now it still remains a real positive for stocks, makes stocks very competitive to other investments.

So, until we see a really strong ... much stronger move up in interest rates, that's a positive for stocks.

Last off is sentiment, investor sentiment. And I will have to say we are currently seeing some short-term sentiment indicators suggesting there is a lot of speculation in the market. We've seen that in several new initial public offerings, Airbnb and DoorDash, that just recently have come out, that all of a sudden doubled on the first trade.

Certainly, there is some speculation there, but when we look at some of the longer-term sentiment indicators, they still show that investors are surprisingly still cautious. So, we would still rank sentiment as a positive, maybe neutral.

So, all in all, as we enter 2021, three of the four are positive, and I think the surprise for returns, at least in the first half of the year, could be on the upside and hopefully for the entire year of 2021.

Chris Schildz:
Thank you, Joe. That was Joe Williams, Chief Investment Strategist for Commerce Trust Company.

Chris Schildz:

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