FINANCIAL MARKETS COMMENTARY

4TH QUARTER, 2020

TELEMUS®

Matt Dmytryszyn, *Director, Investments*

Direct: (248)827-1800 mdmytryszyn@telemus.com

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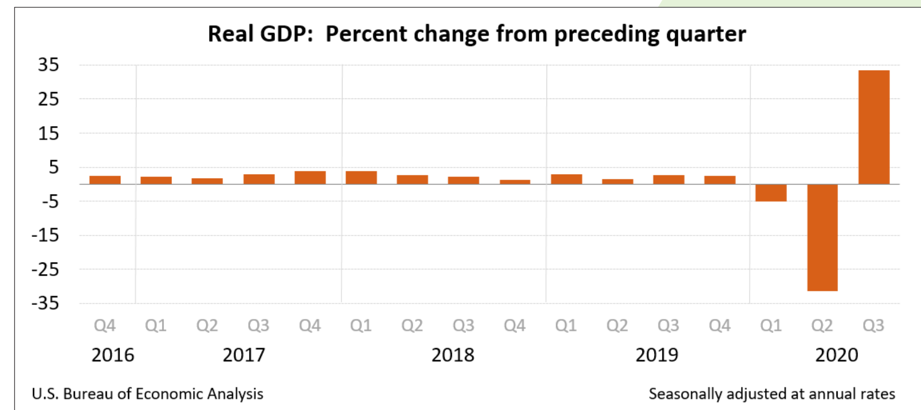
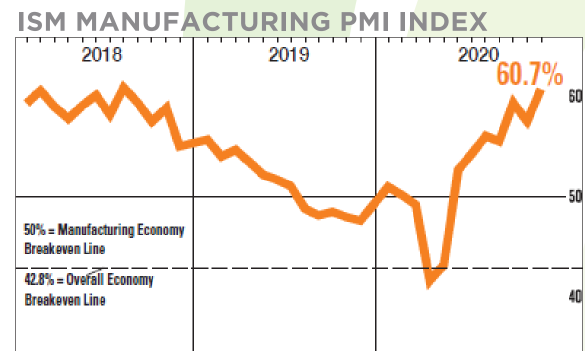
ECONOMY

Economic conditions generally improved during the fourth quarter as industrial activity accelerated and consumer spending remained strong. Improving employment trends, however, began to reverse. During the quarter, the Gross Domestic Product (GDP) for Q3 was released, showing an astounding +33.4% annualized growth rate. This comes after GDP contracted by an annualized rate of -31.4% in Q2. Current expectations are for a +4.6% GDP expansion for Q4 of 2020 and +2.5% in Q1 of 2021.



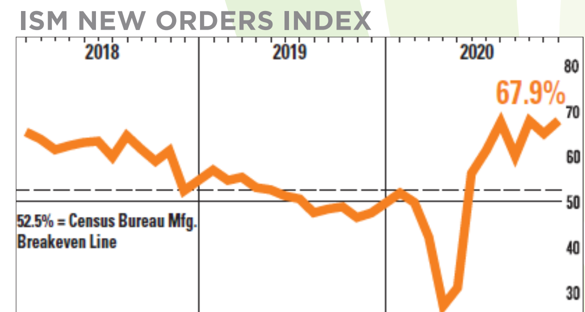
Industrial activity remains strong. Robust new order growth and backlogs from growing supply chain challenges are likely to fuel strength in manufacturing for some time. More recently transportation has become a greater challenge as an increase in COVID-19 cases and greater travel restrictions have impacted the logistics infrastructure.

ISM MANUFACTURING PMI INDEX



A continued bright spot for the U.S. economy has been the health of the consumer. Consumer spending did slow during the 4th quarter, however for the year consumer spending has been stronger than many expected. What transpired with spending habits was a substitution effect, as Americans have shifted from spending on services, such as lodging, entertainment and transportation, and increased their consumption of goods. This has led to outsized growth in durable good items such as appliances and sporting goods.

ISM NEW ORDERS INDEX



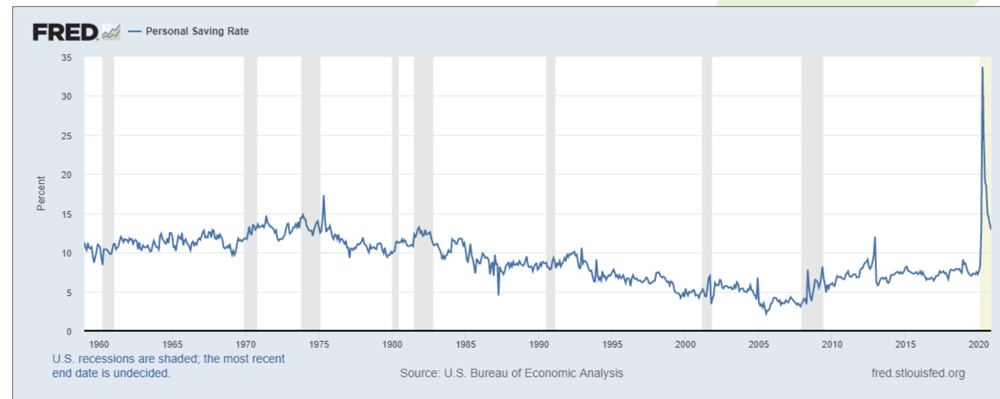
Source: Institute of Supply Management

What leaves us optimistic is the continued strength in consumer savings. As evidenced by the chart below, Americans have tended to save between 7-8% of their income. That statistic changed during the pandemic, exceeding 30% early on given generous benefits from the CARES act. Yet as benefits have fallen off, consumers continue to save at nearly twice the level they did coming into 2020. Given the fact that the consumer accounts for nearly 70% of economic output, the combination of higher savings rates and lower debt levels provide ample resources to sustain economic strength going forward.

ECONOMY

Employment was the one element of economic progress that reversed during the 4th quarter. Renewed restrictions to prevent further spread of the virus lead to both a reduction in job creation as well as an uptick in unemployment. The unemployment rate ended the year at 6.3%, a stark improvement from 14.7% back in March. However, this number is understated given the lower size of the workforce, with many choosing to stop looking for work due to concerns associated with COVID. In fact, the reduction of 4 million workers has left the labor force participation rate at its lowest level since the 1970's.

US PERSONAL SAVINGS RATE



MONETARY POLICY

The Federal Reserve remains highly stimulative seeking to provide sufficient liquidity to support the economic recovery. In September, the Fed altered its objective to target an average inflation rate of 2%, wherein they are presently looking for inflation to exceed 2% for a period of time before considering any interest rate increases. This has led many, including most Fed Governors, to conclude that interest rates will not begin to rise until 2023 at the earliest.

The Fed remains active with its Quantitative Easing (QE) program, seeking to purchase $80 billion of Treasuries and $40 billion of agency mortgage backed securities each month. At the conclusion of the 4th quarter the Fed had $6.9 trillion of securities on its balance sheet, up from $3.8 trillion at the beginning of the year. During the quarter, assets increased by approximately $275 billion, as currency swaps with other central banks continued to decline given improved stability in foreign exchange markets.

In 2021, a series of new questions will face the Fed. First, as happens every year, the voting membership of the Federal Open Market Committee (FOMC) will rotate among regional bank Presidents. A change in voting members could influence how the Fed acts or communicates. Second, the Fed will be faced with a decision on when to slow or cease its pace of asset purchases as part of its QE program. A few regional Presidents have

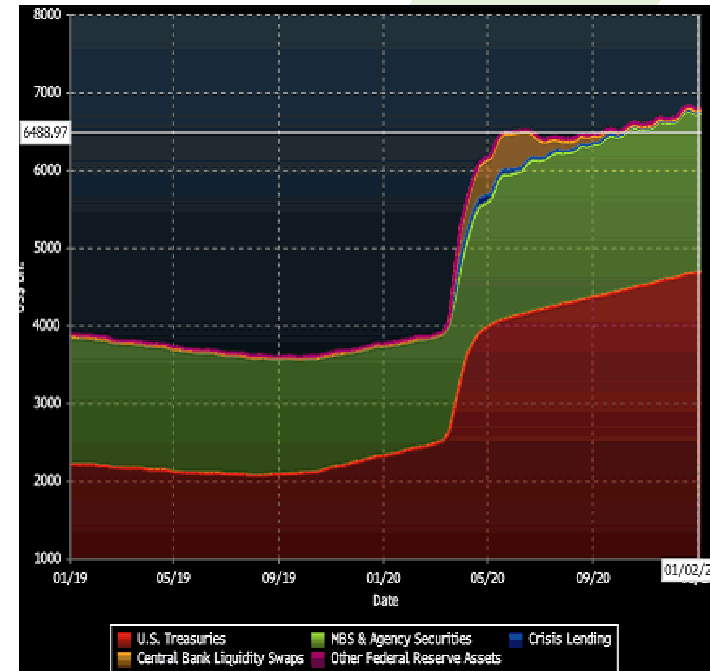
ECONOMY

already publicly stated they could see a reduction in QE activity in the later half of 2021. Finally, Jerome Powell's term is set to expire in February of 2022. As the year progresses, increased speculation will be placed on whether the Biden administration will support another term for the Fed Chairman.

FISCAL POLICY

The $2.2 Trillion CARES Act that was passed in March provided a helpful boost by injecting money into the economy and essentially offsetting demand that was lost due to the coronavirus and associated mitigation measures. Most of the benefits that came from the CARES act expired over the summer, with many hoping that Congress would pass a second package in August or September. The debate around added stimulus became more politicized as the election neared, and as result, added stimulus was not passed until just before year end.

SECURITIES ON FEDERAL RESERVE BALANCE SHEET



Source: Bloomberg

The recently passed $900 fiscal stimulus package will renew extra unemployment benefits, provide another round of Payment Protection Program (PPP) loans to businesses impacted by the virus, and deliver direct payments of $600 to most Americans. The U.S. economy is in a unique position where economic conditions are improving, and optimism awaits as COVID-19 vaccines are in the early stages of being distributed. However, it will take time for the country, and the globe, to be inoculated. Moreover, an upsurge in cases and hospitalizations is putting another round of strain on businesses, particularly those in service industries. We see the added stimulus as a positive, providing some relief to the economy and helping to bridge toward a post pandemic environment.

The size and scale of the added benefits is likely to support strong consumer spending and improve consumer confidence during 2021. In addition, we would expect personal savings to benefit as well. According to a survey by the New York Federal Reserve, 45% of respondents surveyed indicated they would save any future stimulus payments. A higher savings rate will have the added benefit of supporting the economy for a longer period, versus offering merely a short-term jolt of liquidity.

ECONOMY

TAXES AND INFLATION

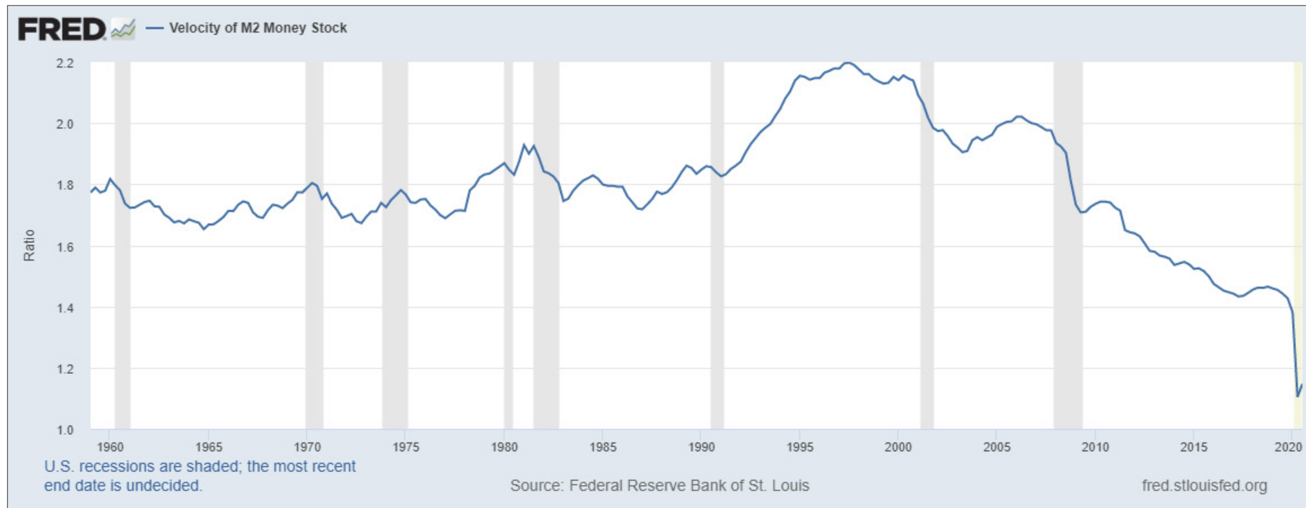
Looking back on 2020, we applaud both lawmakers and the Fed for providing ample liquidity to the point where the U.S. economy was able to adequately weather the worst contraction in recorded history. As we look ahead, one has to acknowledge there may be consequences that arise from the actions taken. Eventually, taxes will need to rise to pay for the unprecedented stimulus. At a minimum, the higher debt burden taken on from 2020's stimulus efforts is going to lead to higher interest expense on government debt. This could be a more acute concern in a higher interest rate environment. The economy will need to first be at a point where it can stand on its own two feet before higher taxes can be part of a policy agenda. As such, we believe it is more likely that tax increases will be not be considered until 2022 or 2023.

The other consequence the economy may be forced to grapple with is the prospect of higher inflation. Inflation is derived by a combination of a growing economy that also sees growth in money supply and the velocity of money. The amount of money in circulation increased by over 25% in 2020 alone (see chart below). A record year, by far. The velocity of money, evidenced below, has trended down as consumers have chosen to save more money. However, the risk comes if there is an increase in spending that leads to greater velocity. We think the potential for this outcome exists once vaccine inoculations have been completed and pent-up demand potentially leads to outsized spending. This outcome would likely become more evident in inflation data later in 2021.

ECONOMY

CHANGE IN MONEY SUPPLY (M2)

VELOCITY OF MONEY



ECONOMY

PERSPECTIVE

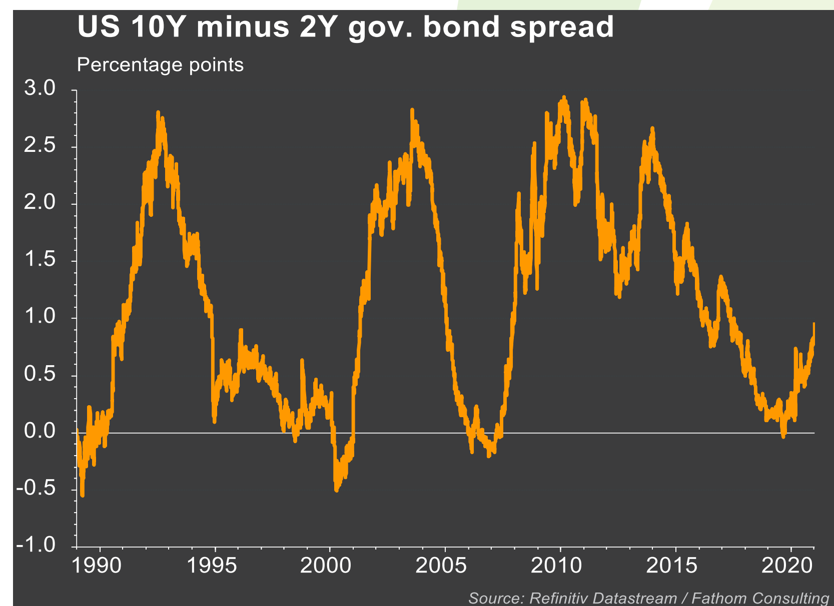
As we enter 2021 we have a constructive view on the economy. Strong consumer savings rates provide ample dry powder for the economy. Industrial activity is robust and strong new order growth provides an indication that activity will remain strong into 2021. Trade has been a challenge, as the U.S. has recorded its worst trade deficit, ever. A reset of supply chains and less restrictions on the economy should ease this to some degree going forward. Intermediate term concerns, such as inflation, higher taxes and changing demographics, remain risks. However, we do not expect these to be noteworthy factors in the year ahead.

FIXED INCOME

Bonds had a strong showing in the fourth quarter as falling yields on corporate bonds helped to drive a +0.7% return for the Bloomberg Barclays U.S. Aggregate index. For the year, the bond market gained +7.5%, driven predominantly by lower interest rates.

During the quarter, returns from Treasury bonds were influenced by a steepening of the yield curve, as the 10-year Treasury yield rose 23 basis points, while 2-year Treasury yields fell 1 basis point. With an 80 basis point, or 0.80%, difference between 10-year and 2-year Treasuries, the yield curve is the steepest it has been since October of 2017. As evidenced by the chart below, this level of steepness in the curve remains below levels typically experienced during expansionary economies.

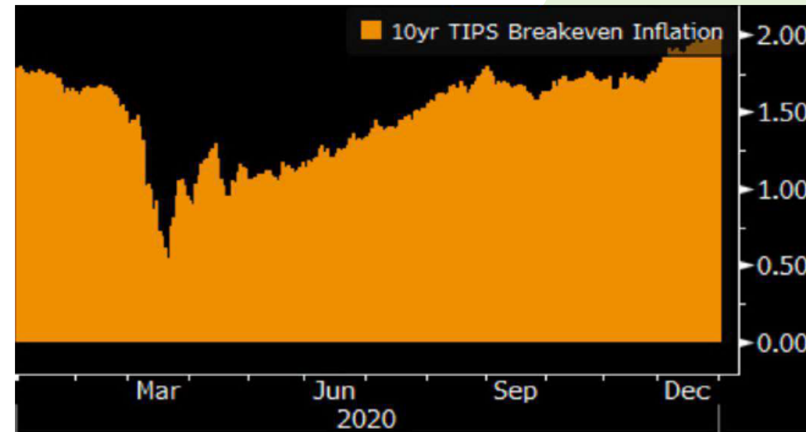
INDEX	Q4 2020	YTD
Bloomberg Barclays U.S. Aggregate	0.7%	7.5%
Bloomberg Barclays Intermediate Corporate	1.8%	7.5%
Bloomberg Barclays High Yield	6.5%	7.1%
Bloomberg Barclays US Mortgage Backed Securities	0.2%	3.9%
FTSE World Government Bond	2.8%	10.1%
Bloomberg Barclays Municipal Bond Index	1.8%	5.2%



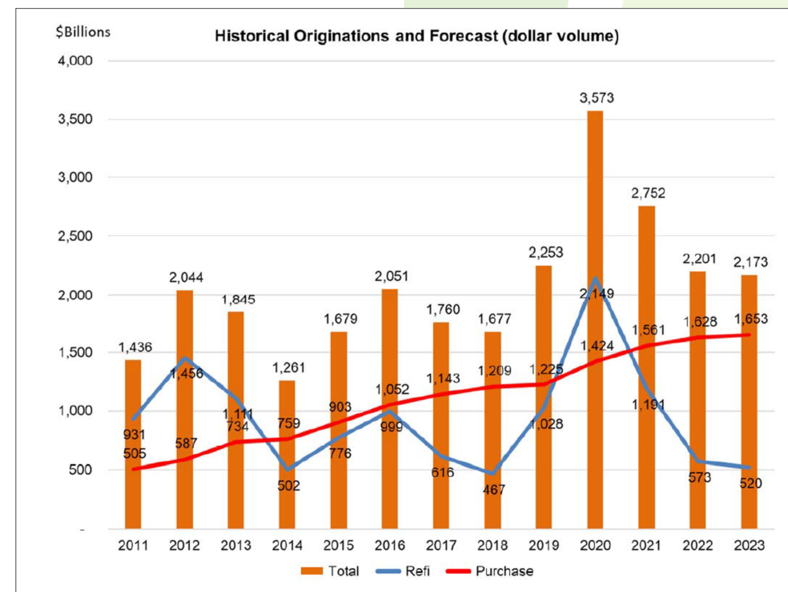
FIXED INCOME

A subset of the Treasury bond market is Treasury Inflation Protected Securities, often referred to as TIPS. Inflation expectations have shifted higher following the Federal Reserve's statement in September that they were willing to let inflation drift above their 2% long-term target. The fourth quarter saw breakeven inflation rates on TIPS go from roughly 1.5% to 2%, after having fallen well below 1% back in March.

Mortgage backed securities gained a modest +0.2% in the fourth quarter as a wave of prepayments influenced returns. As mortgage rates hit record low levels this fall, mortgage brokers were especially busy with refinance activity. As higher rate mortgages were paid off, investors had to accept reinvesting those principal repayments into lower coupon mortgage bonds. As evidenced by the chart below, mortgage activity was up nearly 60% in 2020. The Federal Reserve remains an active buyer of new issue agency (Fannie Mae and Freddie Mac) mortgage backed securities, providing support to the pricing of these bonds. Due to its aggressive quantitative easing program in 2020, the Fed now owns over 30% of outstanding agency mortgage backed securities.



Source: Bloomberg



Source: Mortgage Bankers Association forecast

FIXED INCOME

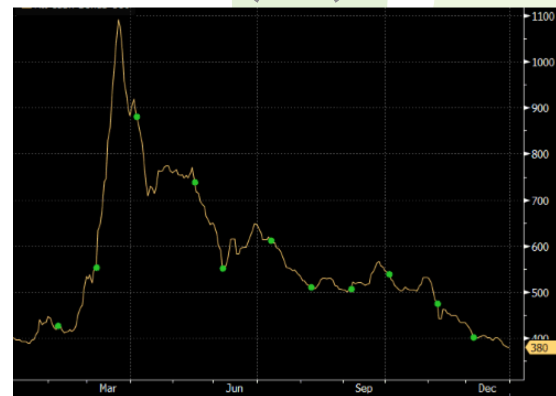
Investment grade corporate bonds outpaced the broader bond market as the spread, or difference in yield between corporate bonds and Treasuries, narrowed by roughly 40 basis points during the quarter. The inverse relationship between yields and prices resulted in lower corporate bond yields driving prices higher. As depicted in the chart below, investment grade corporate bond spreads finished 2020 in line with where they began the year as investors increased exposure to the sector in search of higher yields. This made for a remarkable year for investment grade corporates, as spreads had been 3.5x current levels back in March.

High yield bonds had a banner quarter as spreads tightened from roughly 550 basis points to 380 basis points, a change of 170 basis points. This 1.7% decline in yields led to robust price appreciation as the Bloomberg Barclay's High Yield Composite was up +6.5% for the quarter. This quarter accounted for a vast majority of the +7.1% return for high yield on the year. Most of the decline in high yield spreads came in November following the presidential election and positive data announcements on coronavirus vaccines. Spreads on high yield bonds also ended 2020 in line with where they began, a surprising outcome given the higher degree of economic uncertainty.

A noteworthy element of corporate market is that spreads were flat despite record new bond issuance. Investment grade corporate bond issuance of $1.7 trillion in 2020 was a record high, up 54% from the amount of bonds issued in 2019. High yield issuance of $275 billion was also at record levels. Given that yields remained at low levels despite record supply is indicative of investors' willingness to accept greater risk in an ultra-low interest rate environment where there is a desperate search for yield. Going forward corporate bonds

INVESTMENT GRADE BOND SPREADS (2020)

HIGH YIELD BOND SPREADS (2020)



Source: Bloomberg

FIXED INCOME

face both credit and interest rate risk. The investment grade portion of the Bloomberg Barclay's index has seen its average quality tick down over the years, as BBB rated bonds make up over 50% of the investment grade allocation. With spreads at below average levels, and greater exposure to lower rated credits, the corporate bond market faces price risk should spreads widen. In addition, the average maturity of corporate bonds continues to extend. Longer maturity bonds are more sensitive to changes in interest rates and hence in aggregate the corporate bond market has greater interest rate risk than in the past. We have attempted to manage these risks in client accounts by maintaining a shorter maturity profile within the corporate bond allocation.

Municipal bonds had a steady fourth quarter as the Bloomberg Barclay's Municipal Bond index gained +1.8%. Similar to the taxable market, municipal bonds saw record issuance. For the year, $457 billion worth of municipal bonds were issued, topping the previous record of $428 billion set in 2016. Strong demand for tax free income not only helped to keep yields stable but pushed them lower throughout the third and fourth quarters. While yields on intermediate and long-term Treasury bonds rose in the fourth quarter, the municipal bond market saw a divergence as yields on these maturities declined.

Looking ahead, investors will be challenged by the need to manage portfolio risks while earning yields that are at record lows. The yield to maturity of the Bloomberg Barclays U.S. Aggregate index finished 2020 at 1.1%. This compares to 2.3% and 3.3% at the end of 2019 and 2018 respectively. A lower portfolio yield means less income that is available to offset any negative impacts that could arise from higher interest rates or wider credit spreads. We expect an uneventful bond market in 2021 as aggressive quantitative easing is likely to keep interest rates range bound. Moreover, significant fiscal stimulus and improving economic conditions should support credit spreads. However, markets never move in a linear fashion and hiccups can occur along the way. Given that we don't believe investors are compensated with a sufficient yield to take on interest rate risk, we have a bias toward shorter and intermediate maturities. In addition, we believe bond selection will play a more important role in the present climate.

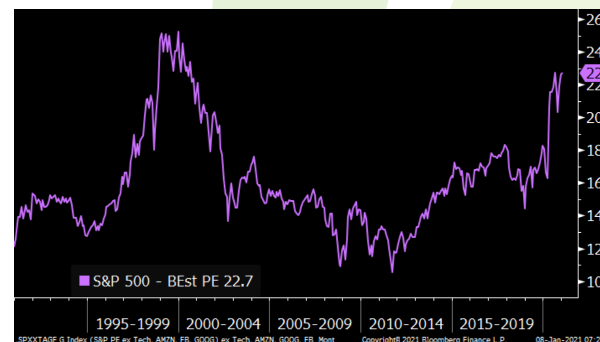
EQUITIES

Stocks experienced a robust fourth quarter as uncertainties around the presidential election, additional fiscal stimulus and a timeline around a vaccine saw resolution. This greater clarity around future conditions, combined with low interest rates and a high level of available cash, collectively led to continued multiple expansion. As 2020 concluded, the price to earnings ratio of the S&P 500, depicted in the chart below, was at its highest level since the technology bubble of the late 1990's.

For the quarter, the S&P 500 advanced +12.2%. The tech heavy NASDAQ composite outpaced the S&P, with flows on the year into NASDAQ ETFs being the largest since 2020. International stocks outpaced domestic with particular strength in emerging markets.

Energy and financial stocks bucked the trend from prior quarters and led the pack up +25.8% and+22.5% respectively. Technology stocks, which were by far the best performing sector on the year, had quarterly gains that were in line with the broader market. Returns to lower volatility sectors, such as real estate, consumer staples and utilities advanced the least. On a more granular level, stocks with weaker balance sheets did particularly well, having their best quarter since 2009.

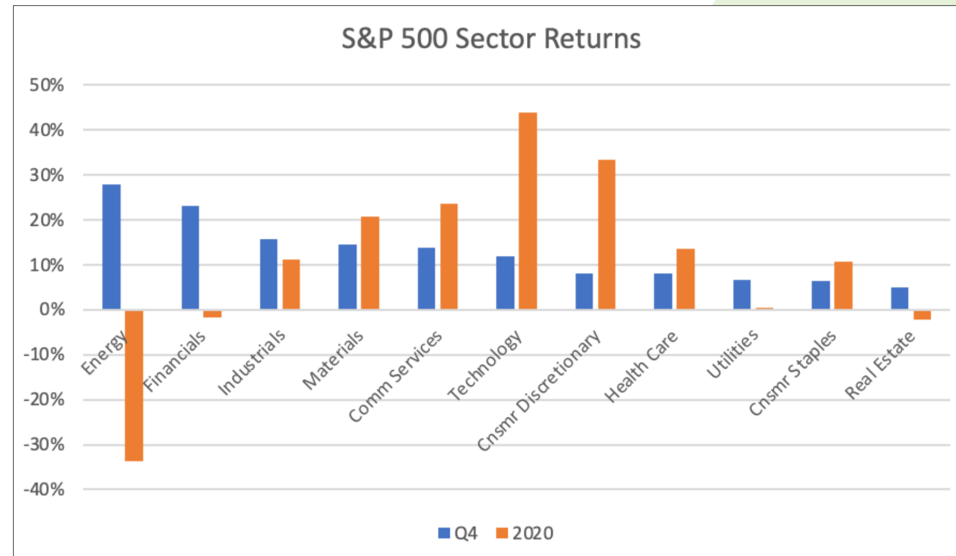
	Q4 2020	YTD
S&P 500	12.2%	18.4%
NASDAQ	15.6%	44.9%
Dow Jones Industrial Average	10.7%	9.7%
Russell 2000	31.4%	20.0%
Russell 1000 Growth	11.4%	38.5%
Russell 1000 Value	16.3%	2.8%
MSCI EAFE	16.1%	7.8%
MSCI Emerging Markets	19.7%	18.3%

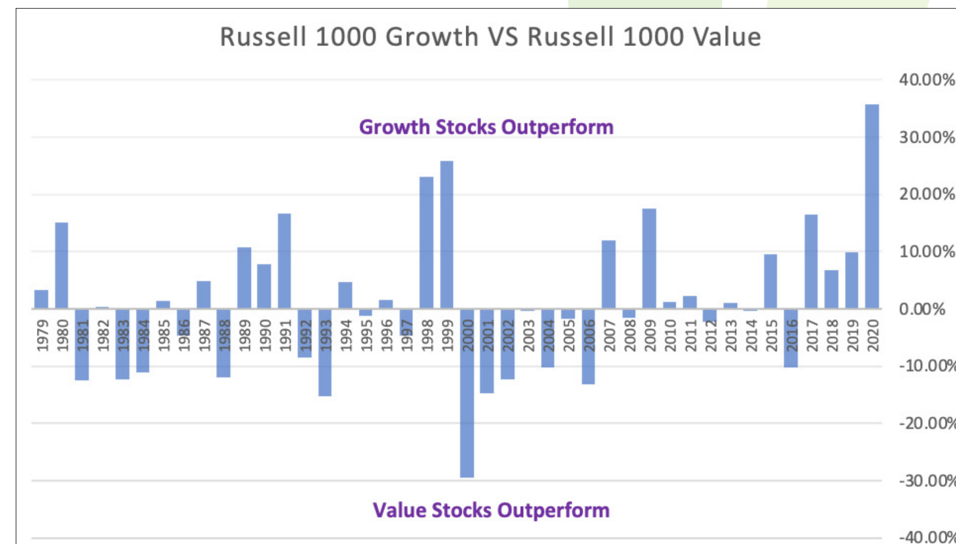


Source: Bloomberg

EQUITIES

The fourth quarter witnessed a shift in sentiment with value stocks outpacing growth. This was a notable swing as growth stocks outpaced value by nearly 36 percentage points on the year. This marked the greatest divergence in return between growth and value stocks dating back to the 1979 inception of the Russell style indices. As depicted in the chart below, the preference for growth and value socks tends to go through cycles over time. Whereas value stocks tended to lead during much of the 2000's, the last 10-years have witnessed a more dominant trend toward growth stocks.





EQUITIES

The fourth quarter not only marked a halt to growth's dominance, but smaller capitalization stocks had an outsized quarter, appreciating +31.4%. Small Caps handily lagged their large cap brethren throughout the first three quarters of the year. After their sizable 4Q, the full year return for the Russell 2000 ended up finishing ahead of the S&P 500.

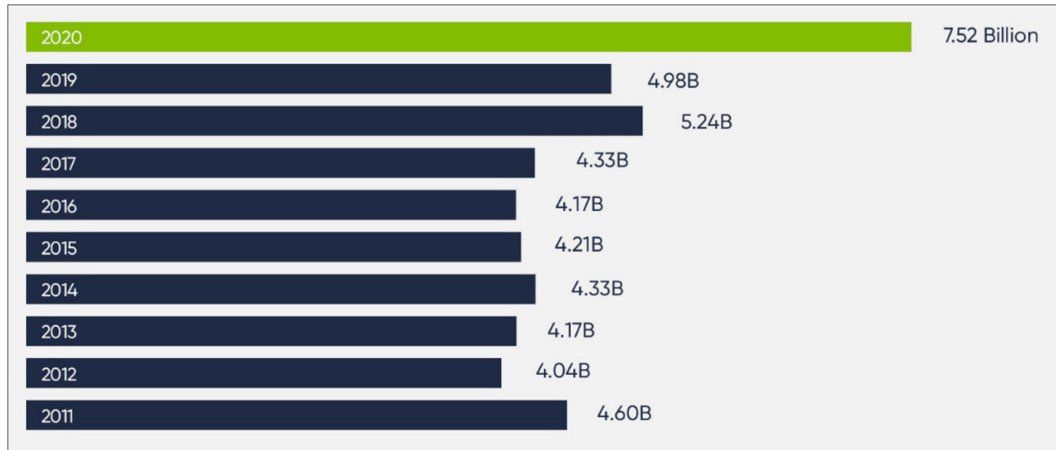
One factor that has supported such strong performance for stocks in 2020 was the lower interest rate environment. Lower rates can lead to a lower discount rate used in pricing stocks; effectively leading to a higher price/earnings multiple. In addition, the Fed's aggressive quantitative easing program has resulted in fewer Treasury and agency bonds available for sale in the market. This has had the secondary impact of pushing investors into allocating more capital to corporate bonds or into accepting more risk and allocating additional capital to equities in search of return. The chart below depicts the direct relationship between the price/earnings ratio of the S&P 500 (pictured in orange) and the size of the Fed's balance sheet (highlighted in blue).

An additional driver of equity market exuberance has been option activity. Total call option volume was up over 50% from year ago levels. The spike in option activity has been a notable factor in supporting the overall stock market rally. As evidenced by the chart below, volumes in the option and futures markets has been fairly consistent over the past decade. A combination of an increase in retail trading activity, along with greater demands to hedge risk through options, has led to this increase. A reversion back to previous volumes could be a destabilizing factor around equity demand and is worth monitoring going forward.

Source: Bloomberg

EQUITIES

ANNUAL OPTIONS AND FUTURES CONTRACT VOLUME



Source: OCC

As we look ahead, we see the favorable interest rate environment and continued stimulus programs to be supportive of stocks. A balance between growth and value stocks is prudent given the expectation for a recovery in the second half of the year for those segments hardest hit by the pandemic. In addition, we believe that dislocations in share prices remain, and active security selection can be an added source of return.

REAL ASSETS

Real assets generally produced positive returns during the 4th quarter. Commodities stood out as positive performers, while the price of natural gas and the dollar fell.

	Q4 2020	YTD
Bloomberg Commodity	10.2%	-3.1%
ICE U.S. Dollar Spot Index	-4.2%	-6.7%
Alerian MLP	32.5%	-28.7%
Philadelphia Stock Exchange Gold/Silver	0.8%	34.9%
MSCI World Real Estate	8.6%	-5.0%

COMMODITIES

Commodities were a bright spot as prices of industrial commodities, notably iron ore and copper, soared. Continued momentum in manufacturing activity, combined with supply chain disruptions and general optimism around the economy, helped to drive prices higher. As the year came to an end, iron ore was priced at multi-year highs. Copper hit its highest level since 2012.

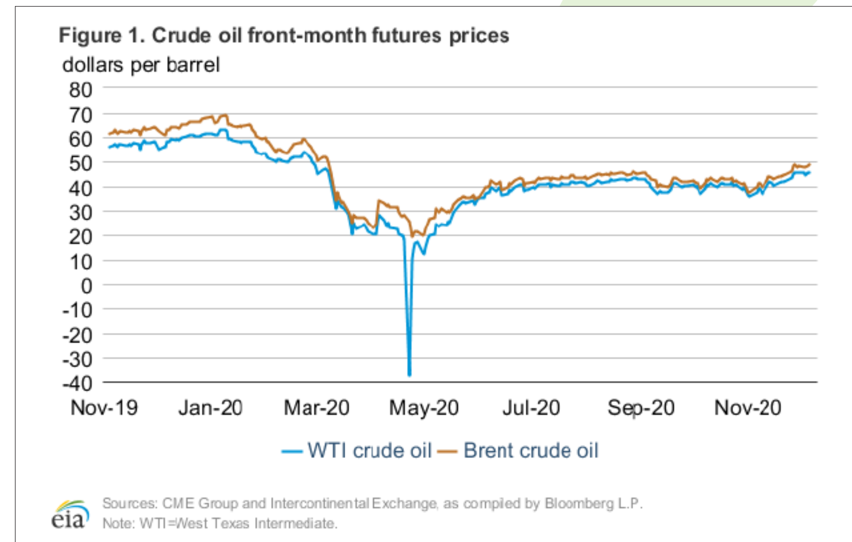
Prices of these commodities, along with others such as lumber, which increased 115% in 2020, are likely to lead to higher building and construction costs heading into 2021.

REAL ASSETS

OIL

Oil experienced a steady climb as West Texas Intermediate crude finished the fourth quarter up +20.6%. Oil had quite a ride during 2020, having begun the year near $60/barrel, cratering to an unfathomable -$38 in April, and gradually recovering back toward $50/barrel by year end. Crude inventories remain at above average levels, although they have been recovering from the heightened levels of this past spring.

Following the warmest November since 2001, demand for natural gas lessened, leading to higher than expected inventories. Concerns around high inventories heading into the winter heating season sent the price of natural gas lower in November and December. All told, the price of gas tumbled -26.2% during the quarter.



GOLD

After surging during the third quarter, the price of gold was range bound in the fourth, trading between $1,800 and $1,900 a troy ounce. The Philadelphia Gold/Silver index finished the quarter nearly flat with a +0.8% return.

For the year, the price of gold appreciated by +25%, driven by strong inflows into gold backed ETFs. Based on this return, gold was among the better performing asset classes in 2020. Gains did moderate later in the year, as gold ETF inflows shifted toward outflows, pressuring pricing.

REAL ASSETS

CURRENCY

The Dollar remained under pressure during the fourth quarter, depreciating by -4.2%. All G4 currencies finished the year at or near their 52-week highs versus the dollar. Earlier in the year the dollar was viewed as a safe haven currency. Over the last two quarters, sentiment has shifted away from the dollar toward other major currencies. While this led to a -6.7% decline in the dollar on the year, the currency has fallen by -13% from its March high.

Diverging from the dollar and price of gold was the price of Bitcoin, which rocketed +271% higher during the quarter. Known as being a particularly volatile asset, Bitcoin had fallen in half during March, before recovering by May. Pricing remained fairly stable for much of the summer before beginning to accelerate in October.

THE U.S. DOLLAR SPOT INDEX (TRAILING 1-YEAR)

BITCOIN (TRAILING 1- YEAR)

LOOKING AHEAD

The performance of stocks in 2020 surprised most market 'experts' given the onset of a global pandemic and the corresponding economic fallout. A key driver of stronger than expected returns has been the decline in interest rates. Adjusted for inflation, interest rates (real rates) are now negative across the globe. Lower real yields have pushed investors out of lower risk assets in search of higher returns. In exchange investors are having to accept greater risk to achieve those returns.

For the equity market, this translated into multiple expansion as money rotated into stocks, pushing prices higher. The price/earnings multiple on the S&P 500, which began 2020 at 18x, finished the year at a more elevated 23x.

As we look forward to 2021, we would expect the combination of highly accommodative monetary policies, the continued flow of fiscal stimulus support, and hopefully the inoculation for the coronavirus to result in favorable economic conditions. Although money supply has increased by 25% over the past year, we have yet to see broad based signs of higher inflation. Most market participants we talk to are not overly concerned about inflation. We have a slightly different stance in that we see a high consumer savings rate and a less restrictive economy as potential fuel for an acceleration in inflation.

Some have commented that 2020 saw a disconnect between the market and the economy. We would agree and believe that as the economy continues to gain steam, we will see it catch up with the market. The backdrop for the market appears favorable and therefore we believe returns can be positive, although they are likely to be more muted than what was experienced in 2020.

For bond investors, low interest rates and below average credit spreads lead us to expect fairly muted returns. Collecting the yield from the bond portfolio is a realistic return expectation.

Looking beyond 2021, our expectations are more measured. Rates will eventually rise and with that we will likely see stock market multiples compress. If they compress in line with earnings growth, there is opportunity for investors to garner return. However, given this dynamic we'd expect returns over the next 10 years to be lower than those experienced over the past 10 years (+13.9% for the S&P 500).

Over time, we see greater opportunity in specific segments of the market such as emerging market equities, global infrastructure, and value stocks. In addition, the events of 2020 have led to a greater dispersion in prices and valuation. We would expect both stock and bond selection decisions to have a greater influence on portfolio returns going forward.

On behalf of the entire team at Telemus, we want to express our gratitude to our clients. We look forward to interacting with you throughout 2021. To those of you that might not yet be clients of Telemus, please feel free to contact us.

Telemus Investment Committee

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