MJM INVESTMENT ADVISORS, INC.

2021 Investment Outlook

The Elephants In The Room

“The one reality that you can never change is that a higher-priced asset will produce a lower return than a lower-priced asset. You can’t have your cake and eat it. You can enjoy it now, or you can enjoy it steadily in the distant future, but not both – and the price we pay for having this market go higher and higher is a lower 10-year return from the peak.”

– Jeremy Grantham

"It is necessary to spend the money now. It will be in the trillions of dollars, the entire package... in order to keep the economy from collapsing this year, getting much, much worse, we should be investing significant amounts of money right now to grow the economy."

– President-elect Joe Biden

In the trials and tribulations of investing, return and risk are joined at the hip. The old investment adage “there is no free lunch in investing” means that in order to generate outsized returns an investor must take on outsized risk to do so or conduct a tremendous amount of research and gain a level knowledge such that the risk taken may end up being rewarded (but never guaranteed) with an outsized return. At the extreme ends of the risk spectrum, an investor can keep money in cash and earn miniscule returns but have nearly 100% confidence the original investment value will be at least maintained over time. Alternatively, they can invest 100% in venture capital, where there is a high risk that the vast majority of the investment may end up being worth zero. However, if just a few companies succeed and end up winners in a VC fund, it could potentially generate returns 100% or much higher for a VC investor. Of course, the majority of investing takes place between these two extremes, in the realm of publicly traded stocks and bonds.

At the beginning of 2020, and after a quite robust year of investment returns across all financial assets in 2019 (the average balanced fund returned nearly 20%), investor sentiment was elevated, cash levels were low, financial asset valuations were high (U.S. stock PEs traded at the 95th percentile of their historical valuation range), and bond yields were near historical lows. The risk/reward setup at the start of the year was such that our 2020 Investment Outlook was titled Running on Empty? Little did we know the insidious COVID-19 (“C-19”) virus was already rapidly spreading in China and Europe and was about to engulf the entire world in a pandemic, the likes of which had not been seen in 100 years.

C-19 has had a devastating effect on the global economy, causing U.S. economic activity to initially drop 50%, the U.S. unemployment rate went from an all-time low to 16%, and global stock markets plummeted over 30%, all in just a matter of weeks. Credit markets also froze as riskier bonds experienced large declines and yields increased dramatically. The risk/reward setup going into the 2020 was quite poor, and a once in a century risk event like C-19 made investors pay dearly. Even if one had properly assessed that a more conservative risk posture was prudent coming into 2020, the magnitude of the negative effects caused by C-19 had a large negative impact even on more conservatively managed portfolios.

Unlike the 2008 Global Financial Crisis, when it took Congress and the Fed around six months to implement various monetary and fiscal programs to support the economy, the response to C-19 was rapid and unprecedented. Over the course of just a few weeks, the Fed cut interest rates to near zero and implemented massive programs to provide support to credit markets. At the same time, Congress quickly passed the CARES Act, a $1.8 trillion dollar fiscal package, which included support for small businesses, direct payments to taxpayers, and extended unemployment benefits to workers who were furloughed as businesses shut down. Late in the year, the very welcome news of two C-19 vaccines showing effectiveness and receiving rapid approval by the FDA and the immediate distribution of vaccines gave financial markets an added boost of confidence that global economy in 2021 would continue to recover. By the end of 2020, the U.S. stock market was hitting new all-time highs and the average balanced fund returned just over 10% for the year.

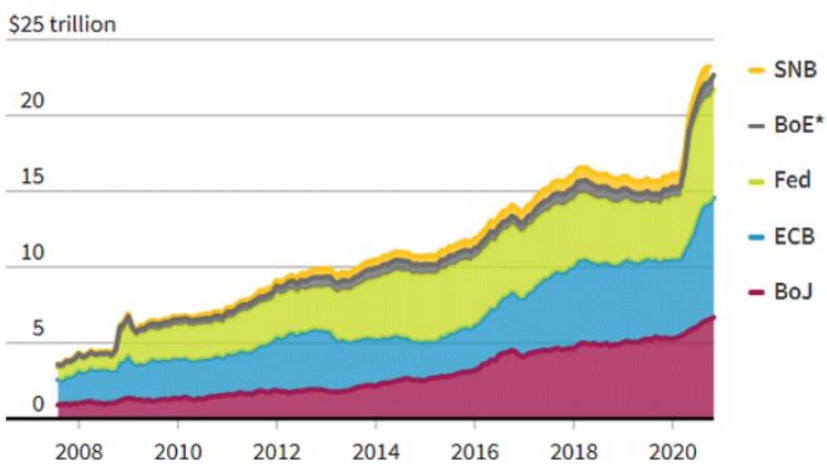
Monetary and fiscal policy actions saved investors from sizable financial losses in 2020. The fastest decline in financial markets history was followed by one of the largest and fastest price recoveries in financial markets history. From the stock market low on March 23rd, the U.S. stock market returned 75% for the rest of 2020 and finished the year up nearly 21% as measured by the Russell 3000 Index. Considering the U.S. stock market returned 31% in 2020, and valuations were rich coming into 2020, these results are quite astounding. A highly unexpected and strong year of investment returns occurred despite the fact that the U.S. economy has yet to fully recover and is now in the throes of a dreaded second wave of C-19 cases and deaths. Global economic activity is once again slowing, as governments are forced to limit mobility and restrict businesses to try and control the spread of the virus and until such time as vaccines get more widely distributed and herd immunity develops to the point that normal economic activity can resume.

With financial markets worldwide having more than fully recovered and after two straight years of outsized investment returns, where does that leave us for 2021? With risk levels still elevated and financial markets highly dependent on the most positive of outcomes occurring, especially the successful deployment of the C-19 vaccines, which would lead to a reversal of many of the pandemic's negative effects.

Adding to the above average risk setup is a new Administration. Some of the policies of the Trump administration that were investor friendly and positive for financial market returns the past four years are at risk of being reversed, including lower personal and corporate tax rates. The sweep of the Democrats in the Georgia Senate run-off elections in early January created a blue wave Federal government. Initially, the U.S. stock market has reacted positively, as it increases the likelihood of even more fiscal spending to support the economy. In fact, President-elect Biden recently indicated his Administration will request an additional $2 trillion of fiscal spending shortly after taking the oath of office. While that news may get stock investors even more giddy in the short-term, it remains to be seen if this will create a sugar high effect, but followed by an eventual payback period of higher taxes to pay for trillions of unexpected spending forced on the Federal government and which has created unprecedented fiscal deficits and debt levels.

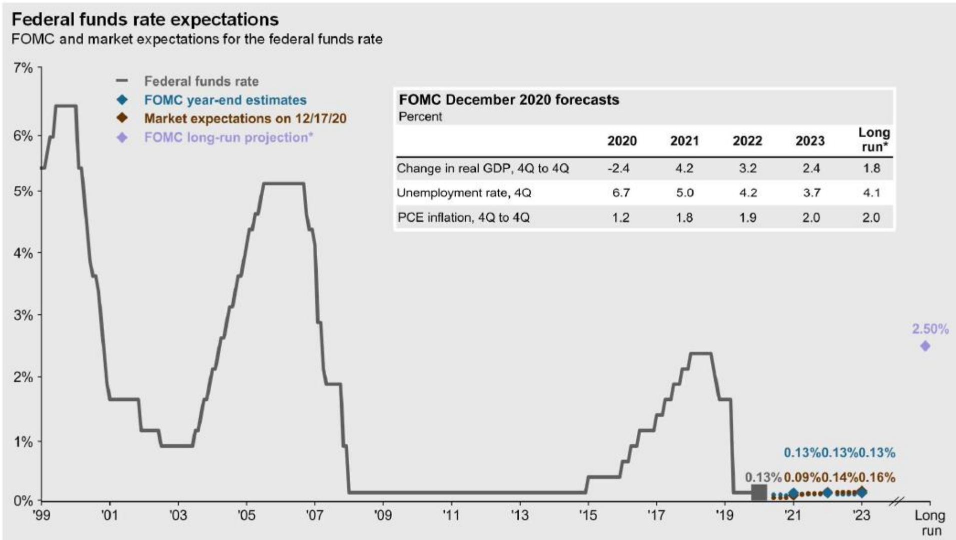
The elephants in a room represent issues that everyone knows exist, but no one wants to talk about and are more than happy to conveniently ignore. Like Uncle Bob, who's the life of every party, but should be at an AA meeting instead or the company not doing so well and on the verge of downsizing, but everyone looks sharp and is on time for the weekly Zoom meeting because they think someone else is getting the axe. There are several elephants in the room that will have a material impact on investment returns over the next decade.

By far the biggest elephant in the room is financial markets dependency on central bank policy support. The $64,000 question is when (or will) the Fed eventually reverses its current policy course and starts to withdraw monetary and credit support programs that have helped financial markets generate robust investment returns since 2008 and especially over the past two years. The next chart shows the balance sheet growth of the Big 5 global central banks since the 2008 Global Financial Crisis. The large uptick that occurred starting in 2009 was when the Fed lead all global central banks with the implementation of its Quantitative Easing ("QE") programs. QE is the purchase of Treasury and mortgage-backed securities (some of the Big 5 have expanded QE to include corporate bonds and stocks) in the open market by the Fed to infuse the financial system with excess liquidity and to encourage banks to lend and help the economy recover. Over the course of the next 10 years, the balance sheets of these five central banks increased 300%, from $5 trillion to $15 trillion by 2018. Sadly, it is an indictment of the Fed's QE policy, as U.S. economic growth was never strong enough that the Fed had enough conviction to withdraw its QE policy support and let the U.S. economy stand on its own two feet. As shown on the far right side of the chart, central banks were forced to go all-in after C-19 hit, as the aggregate balance sheets of the Big 5 increased another $7 trillion over the past year. Since 2008, the Big 5 central banks have infused the global economy with approximately $17 trillion of monetary stimulus from QE related programs.



Source: Thomson Reuters

A second component of monetary stimulus has been the Zero Interest Rate Policy (ZIRP) used by central banks to support economic activity and encourage borrowing by corporations and individuals. As shown in the next chart of the Fed Funds rate, the Fed was raising interest rates from early 2016 through 2018 until the economy went through a rough patch brought on by the China / US trade war started by the Trump Administration. As the economy started to slow from the negative effects of the trade war, the Fed announced in early 2019 that it was ending its interest rate normalization policy path and it began to cut interest rates again. When C-19 hit, the Fed was forced to cut rates more aggressively and revert back to ZIRP again, as it had done starting in late 2008 and for seven years through 2015.

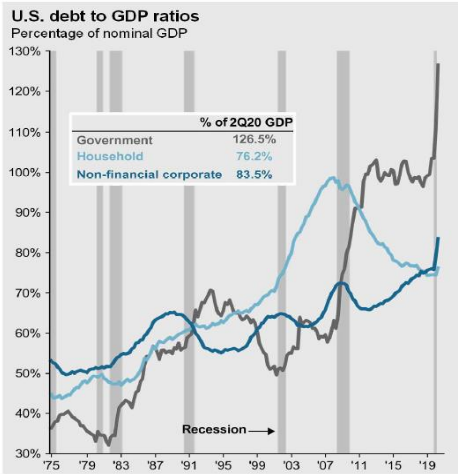


Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management.

The lower the cost of debt, the greater the incentive to borrow, which is key goal of the Fed during weak economic times since borrowing drives economic activity. In the case of individuals, it may be borrowing to buy a new car or a higher priced home or using home equity loans to upgrade a home. In the case of businesses, it may be to expand production or increase efficiency by building new plants or buying new machinery. For governments, debt can be used to invest in infrastructure projects or in the case of the C-19 response, used to implement large sized fiscal stimulus plans to provide businesses and individuals with extra money to spend. While cheap debt may deliver short term benefits, growing and excessive levels of debt create headwinds to future economic growth as that debt eventually needs to be repaid.

Excessive global debt is another elephant in the room. The next chart on the left shows how U.S. debt has grown relative to GDP over the past 45 years as interest rate levels have declined to historical lows. Note that U.S. government debt is the largest segment of U.S. debt and the recent large uptick on the far right of the chart represents debt issued to cover the fiscal spending packages that were passed in response to C-19. Companies have also continued to issue more debt, as low interest rates give them the incentive to refinance existing debt at lower interest rates or to use additional debt to make capital expenditures or as means to buyback company stock. Many new companies have been funded since 2008 using cheap debt, another reason corporate debt has continued to climb to record levels. Like government debt, corporate debt saw a large uptick in 2020 as many companies had to issue debt to offset the negative effects of C-19 on business operations. Since 2007, individuals have been paying down debt, which peaked in 2007 when the housing bubble peaked.

The table on the right shows that debt is not just a U.S. problem. 2020 saw a substantial increase in sovereign debt globally, mostly from fiscal responses to address C-19 economic declines. The U.S. government issued the most debt on a per capita basis, and mostly due to the fact that the U.S. has the largest economy in the world.



Debt levels and increases in major economies

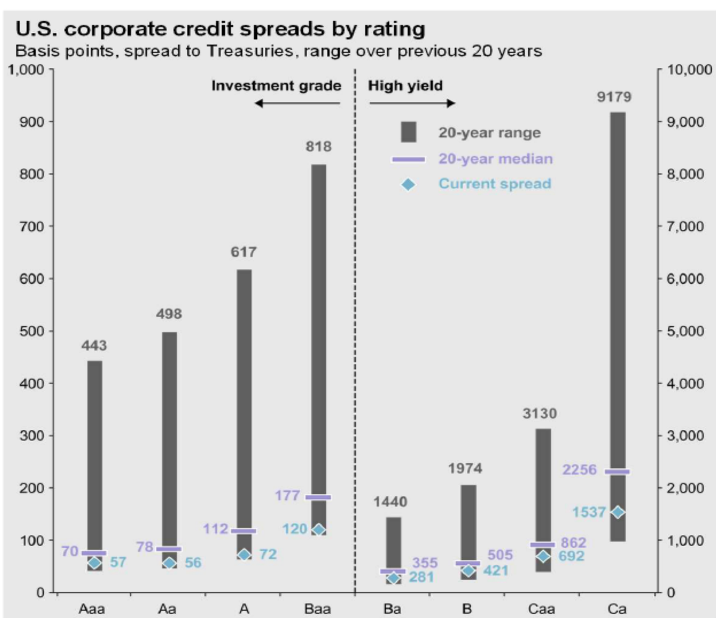
	2020 gov't debt (US$ trn)	2020 rise in gov't debt (US$trn)	Population (mn)	2020 gov't debt per capita (US$)	2020 rise in gov't debt per capita (US$)
USA	22.21	4.20	328.2	67,672	12,797
Canada	0.76	0.31	37.6	20,300	8,202
UK	2.68	0.46	66.6	40,176	6,961
Japan	9.01	0.72	126.5	71,192	5,690
Germany	2.12	0.44	83	25,571	5,286
France	2.92	0.34	66.9	43,552	5,063
Italy	2.85	0.24	60.3	47,157	4,048
China	9.65	1.66	1,393.00	6,931	1,191

As long as interest rates and bond yields stay at low absolute levels, and the global economy recovers and grows such that the level of debt to GDP ratio declines, then this excessive debt situation may resolve itself over time. However, if bond yields start to rise and with it the cost of debt, and the global economy does not begin to grow at a higher level after all the debt that has been issued to offset C-19 effects, then Houston, we have a problem. Governments will have to pay out more in interest, putting greater pressure on fiscal deficits and requiring even more debt. If this were to happen, governments will eventually be forced to raise taxes, putting a dampener on future economic growth. Businesses overly dependent on debt to fund operations may find the higher cost of capital to be too much and may have to seek bankruptcy protection as a result. Normally, in a recession, corporate yield spreads widen, and it creates a broad reset as distressed companies file for Ch. 11 bankruptcy. This time around, the Fed stepped in and provided support programs to credit markets and the natural process of capitalism was usurped, allowing highly indebted companies that should have gone bankrupt to continue to live another day. This is known as moral hazard and highly indebted companies are called zombie companies.

Not only has the absolute level of global debt increased, but the quality of the debt outstanding has deteriorated over time. The next chart shows the amount of Baa rated debt outstanding in the U.S. going back to 1990. Baa represents the lowest rung of investment grade debt. Any bonds rated below Baa are considered high yield or junk bonds. The chart shows the continued growth of Baa rated investment grade debt, now at the highest level of the past 30 years. As interest rates and bond yields have declined to record lows, companies that in the past would not have qualified for an investment grade rating due to the higher cost of debt have instead been placed in the lowest category of investment grade bonds because the interest rates and cost of debt today are well below normal. So, an investor buying an investment grade bond fund that has corporate debt exposure is actually assuming more credit risk in today's low interest rate environment. If bond yields start to rise, then potential losses in some investment grade bonds could be more than investors expect due to the lower quality profile of corporate credits.

Source: Bloomberg Barclays, JPM Asset Management

The next chart shows a historical snapshot of corporate bond yield spreads across the credit rating spectrum. The right side of the chart shows the riskiest of corporate credits (Ba to Ca) are well below the 20-year median and sitting at the low end of yield spread range. The same is true for all corporate credit ratings Baa or higher. Also note the number of bond issues for each category of credit rating and how the number of junk bond issues, especially the lowest rated Caa (9,179!), dominate the number of investment grade credit issues (15,723 vs. 2,376). This situation is a direct result of the ZIRP implemented by the U.S. Federal Reserve. It is a great time to be the CFO of a company where cheap credit is readily available, but not such a great setup for bond investors in a world where higher rated credits and cash pay very little yield and the yields on many investment grade credits barely exceed the rate of inflation. By now, it should be obvious the return setup for bond investors is quite challenged and the global bond market is laden with outsized risks, both interest rate and credit related. The poor risk/return setup of cash and bond markets also help to explain why investors have been forced into stocks to seek higher returns.



Source: Bloomberg Barclays, Factset, JPM Asset Management

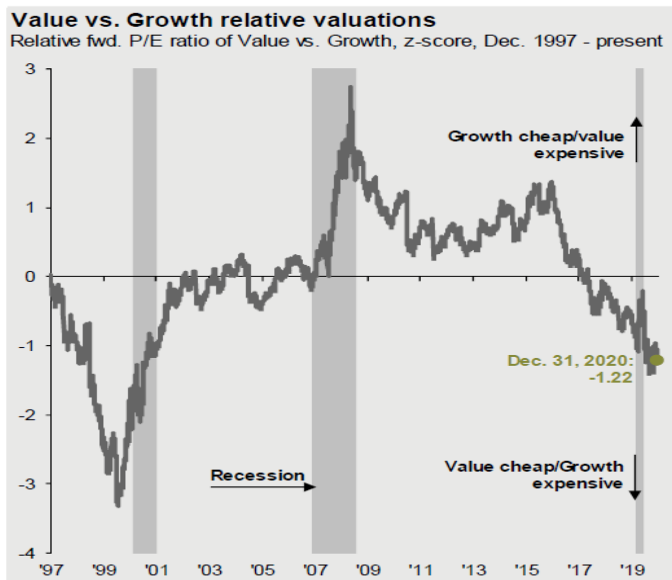
When assessing the global stock market landscape, the most expensively valued stocks reside in the U.S. The next table on the left breaks down the current price/earnings valuation profile of various segments of the U.S. stock market by market capitalization and style categories. It compares the current valuation to the 20-year average and the bottom grid shows how each segment of U.S. stocks is currently valued relative to its 20-year average PE. The most egregious overvaluations exist in U.S. small cap growth stocks, which are trading at nearly 2X their 20-year current PE average. 36% of small cap growth stocks have no earnings, the highest level in history. All segments of the U.S. stock market are currently valued well above their 20-year average, it is just question of the degree of overvaluation. Currently, small cap value stocks are the least overpriced. The chart on the right shows the relative PE relationship between the Russell 1000 Growth and Russell 1000 Value indices going back to 1997. The current valuation relationship is not as extended as it was at the Tech Bubble peak of 2000, but it is still very extended today and shows value stocks are trading at a wide discount to growth stocks in today's low interest rate world.

Current P/E vs. 20-year avg. P/E

	Value	Blend	Growth
Large	17.9 / 13.7	22.3 / 15.4	31.2 / 18.5
Mid	18.2 / 14.3	22.6 / 16.2	39.3 / 20.2
Small	18.0 / 16.8	30.1 / 20.9	76.2 / 38.4

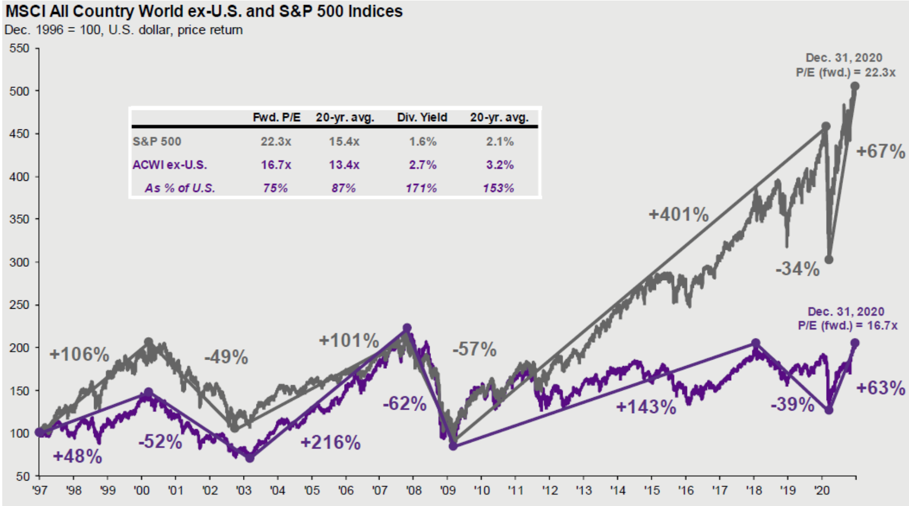
Current P/E as % of 20-year avg. P/E

	Value	Blend	Growth
Large	130.6%	144.8%	168.5%
Mid	127.1%	139.4%	194.6%
Small	107.2%	143.6%	198.5%



Source: FactSet, FTSE Russell, NBER, J.P. Morgan Asset Management.

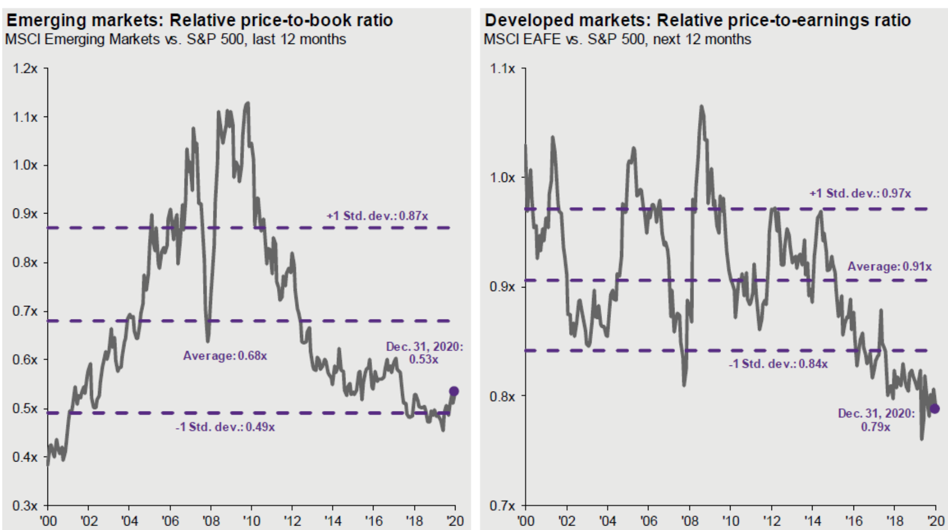
The next chart shows the returns of U.S. vs. non-U.S. stocks going back to 1997. There are several important points to highlight in this chart. First, note how stocks have experienced a substantial rally since the lows hit right after the 2008 Global Financial Crisis. Keep in mind the Fed's response to the GFC was to implement QE and keep short-term interest rates near zero for the vast majority of the period since 2008. Extremely low rates and ongoing liquidity support, most recently in March after C-19 hit, provided a tremendous tailwind to all financial assets, but most especially to stocks. Second, note how more richly valued U.S. stocks are compared to non-U.S. stocks. For example, based on the forward price earnings ("PE") multiple, non-U.S. stocks are trading at 75% of the forward PE valuation level of U.S. stocks. The 20-year average is 87% so at 75% today, non-U.S. stocks are at a cheaper relative valuation level. At the same time, the current dividend yield on non-U.S. stocks is 71% higher than U.S. stocks and compared to the 20-year average of 53% higher. So, for non-U.S. stocks, the setup is lower valuations combined with higher yields when compared to U.S. stocks.



	Fwd. P/E	20-yr. avg.	Div. Yield	20-yr. avg.
S&P 500	22.3x	15.4x	1.6%	2.1%
ACWI ex-U.S.	16.7x	13.4x	2.7%	3.2%
As % of U.S.	*75%*	*87%*	*171%*	*153%*

Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.

When evaluating the two main components of non-U.S. stocks, emerging markets equities and developed markets equities, and comparing both to the S&P 500 Index, the next two charts show that the relative valuation profile of both of these asset classes trade at their cheapest levels in 30 years. In other words, in a world where all financial assets including stocks trade at rich valuations, U.S. stocks are trading at extremely rich relative valuations when compared to non-U.S. stocks.



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of December 31, 2020.

A major factor behind this valuation disparity is that the U.S. stock market has the largest tech companies and a larger tech sector weight compared to non-U.S. markets. The next chart shows how global tech valuations since the beginning of 2020 have increased dramatically when compared to the underlying earnings growth of these companies. Global investors have crowded into tech stocks, and with the S&P 500 Index tech sector weight hitting 27%, the valuation profile of U.S. stocks relative to non-U.S. stocks has hit extremes.

BCA Research

U.S. stocks, which are richly valued by historical standards, are highly dependent upon the high valuation levels of and continued investor enthusiasm towards technology stocks, and those same tech stocks are highly dependent upon the continuation of a low interest rate regime in order for the current valuation disparity to continue. Ignore that elephant in the room at your own risk.

Summary

After C-19 caused global financial markets to plummet by the greatest amount over the shortest time in history, investors experienced an unprecedented recovery rally from the March 2020 lows. Rapid and aggressive policy actions by central banks combined with outsized fiscal spending responses by global governments were the primary reasons investors did not experience a more disastrous return outcome in 2020. What has this setup left us for 2021? A room full of elephants. Due to the fallout effects of the C-19 pandemic, debt levels are hitting new highs (and the tab is still open and growing), bond yields are near all-time lows, and stock valuations are rich, especially in the U.S. 2020 was the worst year in the lives of most people (but not Day Traders and Robinhooders!), yet it ended up surprisingly positive for most investors. However, there was a tremendous pull forward of returns in 2020 and this just creates a more challenging forward return outlook and a higher risk setup for 2021 and beyond.

Mark J. Majka, CFA
Chief Investment Officer

January 14, 2021

IMPORTANT DISCLAIMER: