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Test Your Knowledge: What's Your 2021 Forecast IQ?

Regardless of whether you know the answers to this pop quiz, consider our outlook as you participate in the economic recovery and continued stock market strength. From an investment planning perspective, 2020 served as an important reminder of some key principles that we believe bear repeating:

- **Invest for the long term, look past near-term volatility, and stay invested.** Volatility will return at some point but exiting the stock market in times of turbulence is one of the biggest mistakes you can make.
- **Stress test your portfolio** (wealth and liquidity readiness) periodically to help ensure it's in sync with your risk appetite and keep you on track to achieve your goals.
- **Let rebalancing work its magic.** While it can be hard to take some chips off the table when the market is strong, or buy in during periods of weakness, even modest portfolio changes can have a compounding effect over time.

1

Which statements contribute to our view on U.S. small-cap equities?

A. A global recovery should bode well for U.S. small caps

B. Small businesses have been hard hit by the pandemic, and it will take a long time to recover

C. Small-cap equity indices have a larger allocation to defensive industries

D. Soaring cash levels on corporate ledgers could whet an appetite to acquire other firms

2

Given our expectation of higher, but not runaway, inflation over the next 12–24 months in the context of a steadily improving economy, which of the following asset classes did we recently increase our allocation to?

A. Gold

B. Bitcoins

C. Treasury inflation-protected securities

D. Real estate investment trusts

Continued

3. 

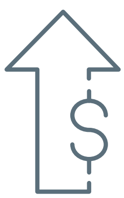
Where do we feel investors are best positioned to capitalize on technology opportunities? (Check all that apply.)

A. U.S.
B. International developed nations
C. Emerging markets
D. Global overall

4. 

The often-overlooked Rodney Dangerfield of investing is fixed income, it can be an important component of a well-diversified portfolio. Which sub-asset class did we recently move from underweight to neutral?

A. Investment-grade bonds
B. High-yield tax-exempt muni bonds
C. Treasuries
D. Certificates of deposit

5. 

The current high valuations in large-cap equities mean there must be a correction coming soon.

A. True
B. False

ANSWERS:

1. A and D
We are overweight U.S. small caps, as we believe we are in the early stages of a global recovery and new economic cycle, which should generally provide a positive backdrop for these companies. There are record cash levels on corporate balance sheets, some of which we expect to be deployed for mergers and acquisitions (M&A) and strategic partnerships. Small-cap equities could benefit from a flurry of M&A activity, as they tend to be more frequent acquisition targets. Such activity could result in disruption and selective investment opportunities over the next 12 months. Additionally, small-cap equity indices also have a larger allocation to cyclical industries, that see higher revenue growth when the economy is growing (as opposed to defensive equities—companies considered essential, such as utilities, and are less subject to the economic winds of growth or contraction).

2. C
This is a bit of a trick question. Although we are neutral to real estate investment trusts (REITs) and remain underweight Treasury inflation-protected securities (TIPS), we recently increased our allocation to the latter, and expect it may provide better risk-adjusted returns than some other hedging strategies going forward. Commodities such as gold are expected to perform well in an environment of continued global economic growth. However, the case for our gold position—taken before the election and the positive development of vaccines—is diminished in the stronger environment. We have thus eliminated our modest position, with some of that allocation going to TIPS and commodities. Additionally, we also suspect that gold may be experiencing some cannibalization from bitcoin as investors flock to the cryptocurrency.

Continued

3. A and C

U.S. Large-cap firms should benefit from technology advancements, but we are not overweight this space due to other considerations, including current valuations. We do have high conviction on emerging markets (EM) equities in 2021. First, from a supply-side standpoint, EM continues to be the "factory to the world." Much of the technology that supports services, like semiconductors and the cloud, are developed and sourced from EM (China, in particular).

Second, from a demand-side standpoint, EM societies, particularly those of Asia, are in many cases ahead of the rest of the world in adopting these new technologies, such as a cashless society and forthcoming augmented and virtual reality.

Third, China—which comprises roughly 40% of the MSCI Emerging Market Equity Index—is ahead of the game in terms of overcoming the public health crisis, spurring economic growth, and achieving post-COVID normalization. Lastly, EM equities are still cheap relative to historic metrics and other parts of the world, including the U.S. A weakening dollar, which we would expect to coincide with a global economic recovery, would be supportive of EM equities as well.

4. B

The pandemic has deeply cut into returns for this asset class, but successful vaccinations also increase the probability of a return to a more normal pre-pandemic environment. This would be supportive of certain high-yield tax-exempt muni bond market that have underperformed up to now, such as hospitals, transportation, airports, industrials, and other revenue bonds. Fiscal stimulus to states is a possible support, too.

5. False

While current valuations merit monitoring and certain equities have become expensive, valuations in and of themselves tend to be a poor short-term market timing tool. U.S. large-cap technology companies, for example, are pricing in very optimistic growth rates far into the future. These valuations could be sustained, particularly given low interest rates, but also suggest more muted equity returns over a three- to five-year time horizon.

Three factors are now coalescing to bridge that divide in a direction that favors risk assets (where the return is uncertain): the prognosis for vaccines, the $900 billion stimulus package that was recently approved—with the potential for more assistance for individuals and businesses whose income has been affected by COVID; and easy monetary policy. These forces all provide support for an economic recovery and returns of riskier assets over a 9- to 12-month investment horizon and see the outlook for equities as the most constructive in almost a year, and expect further upside despite what has already been a strong fourth quarter for stocks. We are modestly increasing risk in portfolios to take advantage of expectations for higher equity returns.

Still, we note the potential risks to our outlook, e.g., the continued path of the virus and stumbling blocks with vaccine distribution, uncertainty around the ability for Congress to compromise and make legislative strides, and a persistent dearth of yield, given the Fed's assurance that it will allow inflation to run above 2% to "make up" for years of low inflation. We will continue to remain vigilant and watch developments closely.

Continued

	Positioning	Tactical Tilts	-			N			+
Equities	**Overweight**	• U.S. Large Cap	□	□	□	■	□	□	□
		• U.S. Small Cap	□	□	□	□	■	□	□
		• International Developed	□	□	□	■	□	□	□
		• Emerging Markets	□	□	□	□	□	■	□
Fixed Income	**Underweight**	• Investment Grade	□	□	■	□	□	□	□
		• High Yield	□	□	□	■	□	□	□
Real Assets	**Underweight**	• Inflation-linked Bonds	□	□	■	□	□	□	□
		• Global REITS	□	□	□	■	□	□	□
		• Other/Commodities	□	□	□	■	□	□	□
Alternatives	**Neutral**	• Equity Long / Short Hedge	□	□	□	■	□	□	□
Cash	**Neutral**		□	□	□	■	□	□	□

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