STOKES CAPITAL ADVISORS, LLC

Market Commentary
December 31, 2020

Quarterly Market Review

So long 2020……and good riddance! A year marked by a global pandemic, historic unemployment, social unrest, political uncertainty, and extreme market volatility. There are many ways to describe the year, but clearly 2020 was a bear market for humans but a bull market for investors. Equities finished the year at or near record highs with the S&P 500 rising over 12% during the quarter to finish the year at an all-time high of 3,756 and an 18.4% total return. The rally from the March 23rd low is one for the record books for sure. In just over 9 months, the S&P 500 index managed to gain an unprecedented 70% as investors looked beyond the pandemic and snapped up equities on expectations of a strong recovery and massive fiscal and monetary stimulus.

But it was the technology heavy NASDAQ composite that stole the show in 2020 with the "FANMAGs" (FB, AMZN, NFLX, MSFT, AAPL, GOOGL) driving the index up more than 44% for the year and to record highs. The margin of outperformance between growth and value stocks has now eclipsed the heady days of 1999 when the dot.com bubble pushed the NASDAQ to record highs and to such extreme valuations that the famous "irrational exuberance" call was made by then Federal Reserve chairman, Alan Greenspan. The six stocks or FANMAG now represent more than 25% of the S&P Index and 40% of the NASDAQ composite Index. FYI, Tesla was added to the S&P 500 in Q4 and represents 5.0% of the index. I guess we will need a new acronym for 2021, FATMAG? (FB, AMZN, TSLA, MSFT, AAPL, GOOGL)

Small cap equities, as measured by the Russell 2000, gained over 31% for the quarter the best result since the index was established in 1978 as investors widened their bets on a rapid post-COVID-19 recovery. Small cap stocks, recording a gain of 20%, outperformed their large cap counter parts in 2020 for the first time since 2016.

The energy patch enjoyed a strong rally during the final quarter of the year gaining over 30% as investors look for value and position for a post-COVID-19 economy where demand for oil is expected to return in the back half of 2021. However, energy remains significantly in negative territory and was the worst performing sector for 2020. Energy now represents just 2.3% of the S&P 500 Index, an all-time low.

Turning to the bond market, bonds took a breather during the final quarter of the year as global investors piled into equities and the risk on mood and concerns over inflation paused the bond market rally for 2020. At year end, there was more than $17 trillion of negative yielding debt. However, high yield bonds or "junk credits" did participate in the year-end risk on rally as the quest for real yield leaves very few options for bond investors.

Global markets finished in positive territory for 2020 except for the U.K. The FTSE 100, on a local currency basis, declined 11% as a new COVID-19 strain emerged and forced the Government to take additional measures to contain the virus. In addition, the looming Brexit agreement over trade with the E.U continues to cast a shadow on the outlook for the economy in the post-COVID-19 world.

Global Economic Outlook *

United States: For 2021, GDP should rebound on the back of ample monetary and fiscal stimulus and as the impact of the pandemic fades. A lower unemployment rate and rising consumer confidence levels should support household spending next year. U.S.–China trade tensions and renewed lockdown measures are key downside risks to the outlook, however. Analysis see GDP growing 3.8% in 2021. In 2022, our panel sees the economy expanding 2.9%

Eurozone: The economy should recover most of its lost output next year, supported by EU funding, ultra-loose monetary and fiscal stances, and strengthening external demand as the global economy reopens. That said, further restrictions, global trade tensions, a no-deal Brexit and rising levels of public debt pose downside risks. The economy is seen expanding 5.3% in 2021 and 2.9% in 2022.

Japan: GDP is forecast to rebound in 2021 from the sharp downturn this year. Sustained government spending should bolster the recovery in domestic demand, while improving external demand should drive higher exports. However, persistent rates of new Covid-19 infections and a potential worsening of the China-U.S. trade conflict cloud the outlook. Analysts see the economy expanding 2.7% in 2021 and 1.6% in 2022.

China: Economic growth is expected to accelerate sharply in 2021. Next year, private consumption should be the main growth driver as it recovers from the coronavirus-induced slump. Despite the new Democrat-led administration in the U.S., uncertainty over the China-U.S. relationship will likely persist and affect investment decisions. Analysts expect GDP to expand 7.9% in 2021 and 5.2% in 2022.

Investment Strategy & Outlook

I was hoping that I would not see another "Black Swan" in my investment career but 2020 will most certainly join September 11, 2001 and the 2008-2009 Financial Crisis as a member of the notorious club.

2020 will also join the ranks of unprecedented fiscal and monetary policy support. In terms of scale, if the monetary policy response to the 2008-2009 Financial Crisis was a "bazooka" then the response to the COVID-19 Pandemic could be characterized as a "nuclear weapon". In addition to the tools used during the 2008-2009 financial crisis, the Federal Reserve expanded their balance sheet from $3 trillion to $7 trillion, created special purpose vehicles or SPVs to lend money to the U.S. Treasury which was then authorized to leverage these funds 10/1 and purchase junk bond ETFs and secondary corporate bonds deemed "fallen angels", bonds that lost their investment grade status. The Fed established a myriad of liquidity and lending facilities to shore up cash and credit markets as the Pandemic triggered a liquidity crisis. You combine all of this with unprecedented fiscal stimulus, negative real bond yields, and the arrival of a several vaccines and you get one heck of a stock market rally! 70% gain in 9 months to be exact.

So, where does this leave investors? In simple terms, the cash and credit markets have been stripped of their ability to generate a positive real return for the foreseeable future leaving equites as one of a few alternatives for long term investors to earn a positive return net taxes and inflation. To illustrate this fact in real time, I selected five (5) of our dividend growth stocks and compared the set to the corporate bonds each company offers. The average dividend yield for the equity set was 2.7% versus the average bond yield of 1.60%. If an investor took $100,000 and invested in these bonds today, they would receive $16,000 of income along with their original investment in 10 years. However, if inflation averages 2.5% for the next 10 years, you will receive only $90,618 for a cumulative real return of -9.4%. Hence the term, negative real yields.

Comparing the stock alternative, you start with a higher current yield of 2.7% and the compound annual dividend growth rate for the stock set over the last 10 years was 11.7%. If these companies continue their multi-decade discipline of raising their dividends, you will receive a total $47,230 in dividends for a cumulative real return of 15.0% (assuming inflation is 2.5%). Of course, stock prices could be higher or lower in 10 years and there is no guarantee the companies will raise their dividends, but the simple illustration highlights the dilemma investors are facing.

Clearly, each investment has unique risks and unknowns that should be carefully considered. An investor's time horizon, income needs, other sources of liquidity and their risk tolerance are among important factors to consider.

Finally, investing should be thought of as running a marathon. Just like the runner, investors should resist the temptation to "sprint or pause" and do not look for short cuts……there are none. A steady pace, careful planning, and a well thought out strategy will win! Additionally, it is more important than ever to differentiate signal from noise. The most important signals, in our view, are coming from the Central Bank. However, monetary policy will only carry the recovery so far. Washington will need to support the recovery with additional fiscal stimulus and investments are needed in infrastructure, manufacturing, and information technology.

Performance Scorecard

Benchmark Description	Q4	YTD	1 Year
U.S. Treasury 3 Month T-Bill	0.0%	0.7%	0.7%
Barclays Aggregate Bond Index	0.7%	7.5%	7.5%
Barclays US High Yield Corp Bond	6.5%	7.1%	7.1%
S&P 500 Index Total Return	12.2%	18.4%	18.4%
NASDAQ Composite	15.6%	44.9%	44.9%
NASDAQ Dividend Achievers Index	10.3%	15.4%	15.4%
Russell 2000 Index TR	31.4%	20.0%	20.0%
Alerian MLP Index TR	32.5%	-28.7%	-28.7%
U.K. FTSE 100 Index LC	10.9%	-11.6%	-11.6%
German DAX Index LC	7.5%	3.6%	3.6%
China SCI 300 Index LC	13.7%	29.9%	29.9%
Japan Nikkei 225 Index LC	18.5%	18.3%	18.3%
MSCI Emerging Markets USD	16.1%	19.5%	19.5%