



Artemis

FINANCIAL ADVISORS LLC

Market Outlook & Strategy

Fourth Quarter of 2020

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Executive Summary

- Financial markets turned in a very strong fourth quarter almost across the board. Returns were boosted by continued stimulus from governments around the world, the arrival of COVID-19 vaccines, and the completion of the U.S. presidential election. Emerging market equities led the way at +17.5%, ahead of both the overall U.S. stock market (S&P 500 +12.2%) and international developed markets (+15.9%).
- Bond returns were more muted for the quarter but positive in most segments except U.S. Treasuries. The riskier segments of the bond market had a good quarter, increasing in the +5.0-6.0% range. Finally, commodities also rallied at +10.0%, again due to renewed optimism.
- Q4 capped a positive year overall, though an extremely volatile one due to the pandemic and its economic impact. Despite the volatility, the overall U.S. equity market posted a total return of +21% for the year. Emerging market equities finished up +15.5%, and developed international markets rose +8.0%.

Due largely to unprecedented central bank activity, many segments of the bond market had a stellar year overall. U.S. Treasuries (both nominal and inflation-protected) were the overall winners, both increasing by over +9.0% for the year.

- **2021 outlook.** Our outlook for 2021 is for continued momentum in global equities, albeit unlikely at the rate we achieved in 2020. Vaccine distribution, additional fiscal support, and continued easy money will all help to drive a global economic recovery.
- **Watching carefully.** While we do not believe the so-called FAANG and other growth stocks are in crazy bubble territory, we do expect some mean reversion into areas of the market that were most impaired during the pandemic. We also think it will be a positive year for international and emerging market equities, and they may even outperform for a change due to their relatively low valuations and prospects for a weakening dollar in 2021.
- **Artemis strategy.** Client portfolios performed very well in 2020 and our strategy for 2021 is to build on that success. We plan to modestly tilt away from large growth stocks to capture the expected upside in other sectors as the recovery takes hold. We are also fine tuning our technology disruptor lineup, boosting emerging market equities and adding some inflation protection to select portfolios.



Q4 and Year in Review

Financial markets turned in a very strong fourth quarter almost across the board. Returns were boosted by continued stimulus from the U.S. and other governments around the world, the announcement of several effective COVID-19 vaccines, and the completion of the U.S. presidential election. For the first time in a while, international stocks performed better than U.S. stocks during the quarter, with emerging markets leading the way at +17.5%. The overall U.S. stock market (as measured by the S&P 500) rose +12.2%. See Figure 1.

Figure 1. Asset Class Returns in USD for 2020 (%)*

Asset Class	2020				Q4	Total Year	Index
	Q1	Q2	Q3	Q4			
Equities							
All Markets - Global*	(22.4)	19.8	8.1	15.7	16.3	MSCI ACWI IMI (net)	
U.S. Large Companies	(19.6)	20.5	8.9	12.2	18.4	S&P 500	
U.S. Small Companies	(30.9)	25.4	4.9	31.4	20.0	Russell 2000	
Int'l Developed Markets	(23.3)	15.3	4.9	15.9	7.6	MSCI EAFE & Canada (net)	
Emerging Markets	(24.2)	19.0	9.0	17.5	15.5	FTSE EM All Cap China A Inclusion (net)	
Fixed Income							
All Segments - U.S.*	3.2	2.9	0.6	0.7	7.5	Barclay's U.S. Aggregate	
U.S. Treasuries	10.3	0.7	0.3	(1.3)	10.0	Merrill Lynch U.S. Treasuries, 7-10 Years	
U.S. Municipal Bonds*	(0.5)	2.7	1.2	1.3	4.7	Barclay's Municipal Bonds, 1-15 Years	
U.S. Corporate *	(3.8)	9.5	1.7	2.3	9.6	Merrill Lynch U.S. Corporate Bond, 5-7 Years	
U.S. High Yield	(13.1)	9.6	4.7	6.5	6.2	Merrill Lynch U.S. High Yield Bond	
Int'l Bonds	(1.0)	2.1	4.1	4.3	9.8	Merrill Lynch World Gov't Bond, Ex-U.S.	
EM Bonds*	(13.7)	12.9	8.0	6.1	5.8	J.P. Morgan USD Emerging Market Bonds	
Floating Rate Bonds	(9.9)	6.6	3.5	3.4	2.8	S&P.LSTA U.S. Leveraged Loan 100 Index	
Real Assets							
U.S. Tips	1.7	4.2	3.0	1.6	11.0	Barclays Capital U.S. TIPS	
Commodities	(23.3)	5.1	9.1	10.2	(3.1)	iPath Bloomberg Commodity	
U.S. Real Estate Income*	(16.6)	16.8	4.3	5.6	3.4	Fidelity Series Real Estate Income Composite	
Int'l Real Estate	(30.4)	9.0	4.1	16.2	(8.3)	Dow Jones Global Ex-US Select RESI	

*Used to create Artemis portfolio benchmarks

In the U.S., large value stocks rose by +16.3% for their best quarter since 2009. Even more impressive was the performance of smaller company equities, which returned +31.4%. These two segments of the market are more heavily composed of companies that have been most negatively affected by the pandemic and so are starting to benefit from renewed optimism following the COVID-19 vaccine rollout.

Bond returns were more muted for the quarter but positive in most segments, with the exception of U.S. Treasuries. The riskier segments of the bond market, including corporate



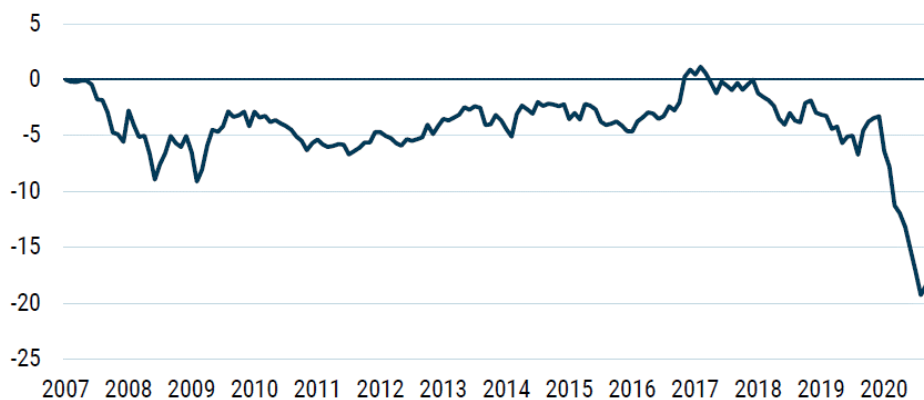
high yield, emerging market debt, and domestic (commercial) real estate debt had a good quarter, each increasing by over 5.0%. Finally, commodities also rallied at +10.0%, again due to renewed optimism.

Figure 1 on the previous page also shows how markets fared over the course of the entire year. Q4 capped a positive year overall but an extremely volatile one due to the pandemic and its economic impact. The swing was large by anyone’s standards, with the S&P 500 declining by -33.9% from February 19 through March 23, followed by a +67.9% rise over the rest of the year. This marks the shortest-ever bear market (33 days), and the third-fastest recovery to breakeven (about five months) in history. By the close of the year, the overall U.S. equity market had increased by just under +21%. Emerging market equities finished the year up +15.5%, and developed international markets gained +8.0%. There isn’t a person on the planet that predicted (or could have predicted) these results.

As is well known, the pandemic created clear winners and losers from a sector perspective, with companies in technology, online and food retail, and home improvement faring very well with about a +40% gain on average for the year. In contrast, the losers included airlines, retail, hospitality, energy, and real estate, which posted a -30% return on average.

Because many of the losing sectors overlap with value stocks, 2020 witnessed the worst 12-month relative performance of value investing in history, after already underperforming for more than a decade. See Figure 2. As noted earlier, only in Q4 of 2020, did we see value start to outperform growth.

Figure 2. U.S. Value’s 2007-2020 Relative Returns (As of 9/30/2020)



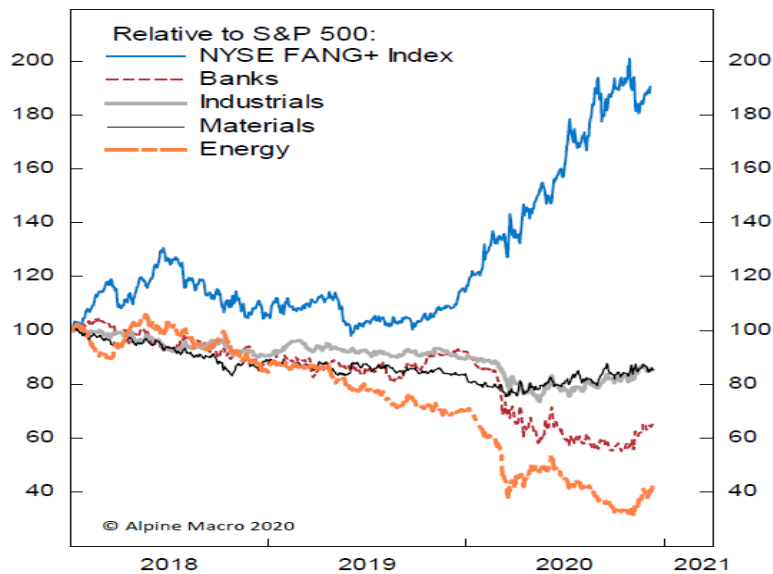
Source: GMO. U.S. Value defined as the cheap half of market cap within the U.S., including financials.



The year was also another one of extraordinary technology sector outperformance, driven in large part by the FAANG stocks: Facebook, Amazon, Apple, Netflix, Google. See Figure 3.

Apple again led the pack this year by generating a total return of +80%. Amazon was not far behind at +73.7% for the year, and Netflix posted a return of +65.9%. Yet all of these returns were eclipsed by Tesla, whose stock traded up +740% in 2020, landing the company a spot in the S&P 500 by year end. These results helped the overall U.S. market to maintain its outperformance versus the rest of the world, a divergence that got underway after the Trump tax cuts started showing their impact in 2018.

Figure 3. Relative Stock Market Performance in the U.S.



Finally, due largely to unprecedented central bank activity, many segments of the bond market had a stellar year overall. (See Figure 1 again.) U.S. Treasuries (both nominal and inflation-protected) were the overall winners, increasing by over +9.0% for the year. U.S. investment-grade corporate bonds were not far behind.

In short, 2020 turned out to be a very good year for stock and bond market investors. The only losing bets in the public markets were energy and real estate. It was also one for the record books!



2021 Outlook

The first quarter of 2021 is going to remain challenging as COVID-19 cases increase and many restrictions remain in place. But markets are anticipatory, and investors seem to be looking beyond current realities to the expectation that once the majority of folks are vaccinated, an economic recovery will take hold.

News out of China, where control of the virus has been more successful than in the U.S. to date, supports this conclusion. Chinese activity data shows that domestic air travel has returned to 90% of its pre-COVID levels, as have theater and restaurant bookings. China announced last week that its December 2020 economic growth was at an annual rate of 6.5%, which carried its full-year economic growth to 2.3%, making it the only major economy in the world with a positive growth rate last year.

U.S. economic growth is also expected to be supported by additional fiscal measures, most notably the \$1.9 trillion package proposed by President Joe Biden a few days before he took office on January 20. Biden also has promised to put forth an equally large infrastructure and “green energy” bill in a few months. While the bills’ price tags are highly likely to be trimmed before passage, Biden’s razor-thin control of the Senate ensures that major budgetary initiatives can get passed if he can get all Democrats on board. (In a 50-50 Senate, Vice President Kamala Harris can cast the tie-breaking vote on any spending bill.)

Also of note is the fact that consumers have saved quite a bit during the pandemic, as incomes have not dropped to the degree normally associated with economic recessions (thanks to the CARES Act, Paycheck Protection Program, and other government programs), and because consumers haven’t been able to spend on travel, dining, and other leisure activities. By one estimate, there is over \$1.3 trillion “dry powder” waiting to be spent when the services sector is back up and running. See Figure 4 (next page).

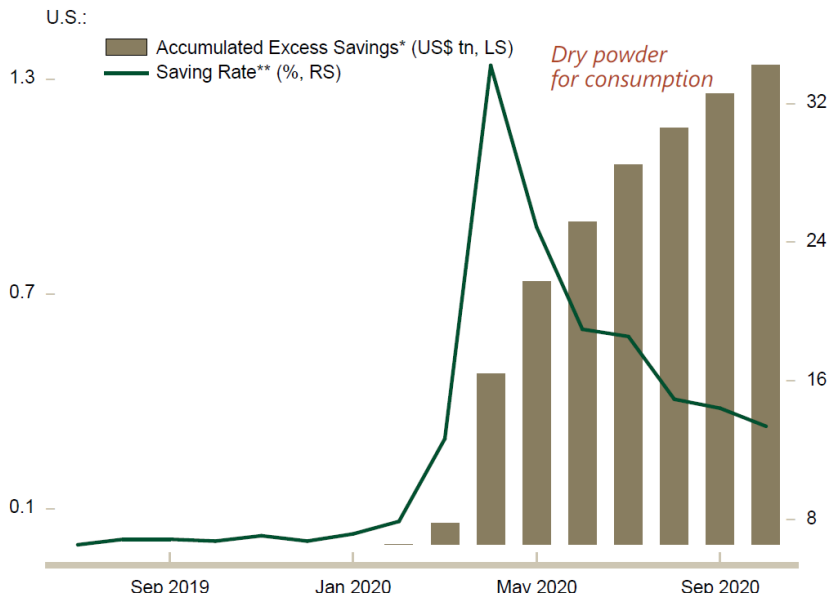
With the prospect of solid government spending, continued low interest rates, and the unleashing of pent-up demand, expectations for corporate profits are high for 2021. Consensus forecasts for earnings growth in the U.S. are at nearly +22% and revenue growth expected to increase by 8%.

But there’s a risk to watch. With the S&P 500 closing out 2020 trading at 22.3 times forward earnings (nearing a level not seen since the tech bubble), underwhelming earnings in 2021 would likely send the stock market lower. See Figure 5 (next page).



However, we see at least three key differences between today's valuations and those in 2000. First, corporate earnings are low currently and are not expected to stage a full recovery in the next 12 months, whereas the U.S. corporate sector was at peak earnings during the technology boom 20 years ago. (Hence, the E in the forward P/E ratio is lower today.)

Figure 4. U.S. Excess Savings Due to COVID

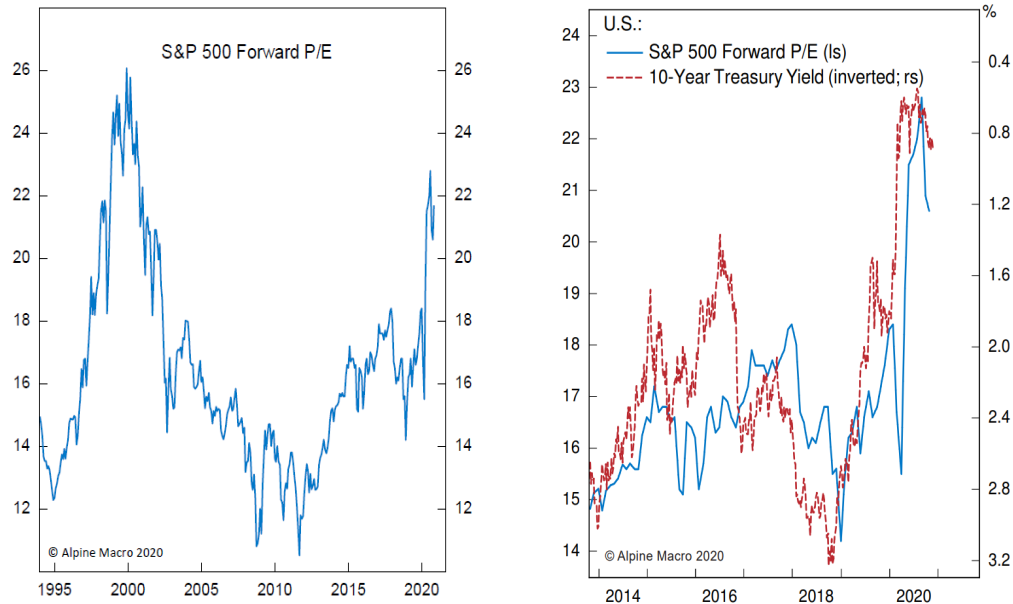


Source: MRB

Second, the tech high flyers, which now comprise over 25% of the S&P 500, don't look so overvalued when compared to their PEG ratios. The PEG ratio is the forward P/E divided by its expected earnings growth over a fixed period of time. The lower the PEG ratio, the more undervalued company's stock is given its future earnings expectations. Adding a company's expected growth into the ratio helps to adjust the result for companies that have a high growth rate and a high P/E ratio. Amazon is a good example as it currently sports a forward P/E of 58.5, but its PEG (based on 5-year expected growth) is only 1.2, which is lower than the current PEG of the entire S&P 500 of about 2.2.



Figure 5. S&P 500 Forward P/E versus 10-Year Treasury Yield



Third, we also believe that the market (and tech stocks) will continue to be supported by low interest rates in 2021, whereas interest rates during the technology boom era were much higher. As has been said by many, with interest rates so low, the stock market is the place to be. We know that the short end of the yield curve is going to remain low because Fed Chairman Jerome Powell has reiterated his commitment to this policy on numerous occasions. Few analysts are predicting yields to increase at the long end any time soon (although there is some risk here if the economy overheats.) As such, fixed income is not predicted to offer much in the way of compensation for investors in 2021.

To summarize, if the COVID-19 vaccine takes hold in 2021 and President Biden gets some of his spending plans through Congress, it should be an up year for U.S. equities. International equities are expected to perform similarly as a global recovery ensues. Indeed, some say international equities may outperform U.S. equities in 2021, due to their lower valuations and prospects for more dollar weakening in the year ahead. (The U.S. dollar typically weakens in economic recoveries because it is considered a safe-haven asset that is less important when the global economy is thriving.)



Risks

There are always risks to any forecast, and this one is no exception. COVID could simply linger for longer if, for example, we encounter worsening vaccine distribution bottlenecks or, worse still, current vaccines are ineffective against some of the new COVID strains being discovered. If this happens, the global recession could linger.

Another risk is that China pulls back on its stimulus measures too quickly, and/or Europe and the U.S. fail to implement additional fiscal packages. This seems to be a bigger risk in Europe, where all member countries have yet to ratify the EC's currently proposed recovery deal.

On the other hand, too much of a good thing also can have negative repercussions. For example, large stimulus packages, huge pent-up demand for services, and lingering supply chain disruptions could lead to an inflation spike, which would likely cause bond yields to rise and the stock market to correct.

Artemis Portfolio Strategy

I must confess that we are very pleased with how client portfolios performed in 2020 following the pivots we introduced in May of last year, and our strategy for 2021 is to build on that success.

We agree with the consensus view for a positive year for equities in 2021. We are unlikely to see the +20% increase we saw in 2020 for U.S. equities, as some of this optimism has surely already been priced in.

With this in mind, our thoughts for 2021 portfolio positioning are as follows:

Trim large-cap growth stocks in the U.S. in favor of smaller companies and cyclicals. We have already seen investors rotate in this direction in Q4. Given the sharp fall in these sectors in 2020, we believe there is room for more. (Have another look at Figure 3.) This does not mean we are going to rush back into overweighting value vs. growth as we have done historically. Our goal is more modest – to take a bit of profit in our large, growth company allocation and redistribute it to ride the recovery in other parts of the market.

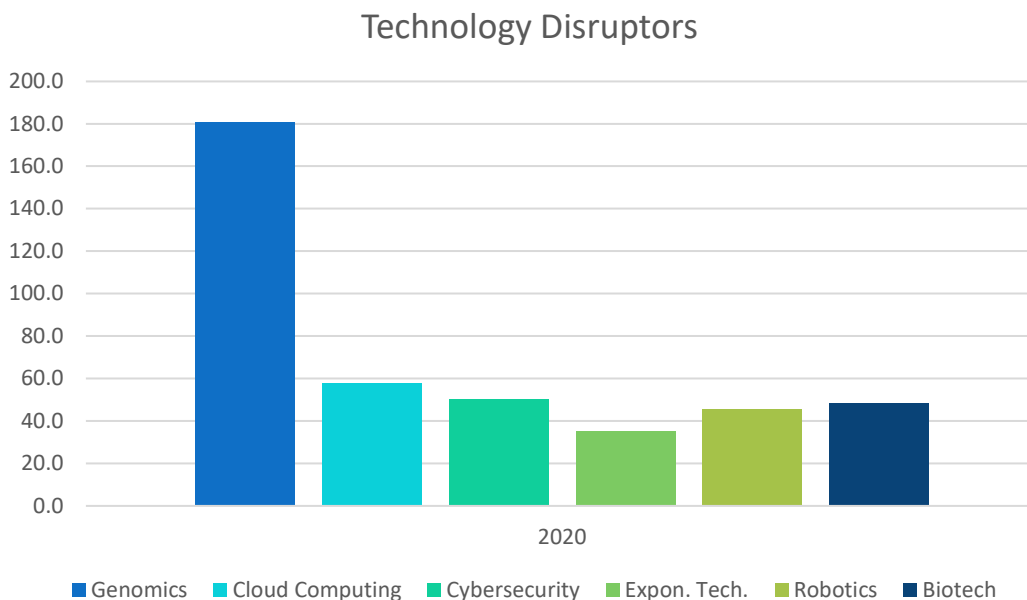
Fine tune our technology disruptors lineup. We continue to hold a strong conviction that the post-COVID landscape is going to engender and reward innovation and adaptability, building on trends spurred by the crisis itself. For example, the pandemic has created new



incentives to automate in manufacturing to reduce human exposure. And opportunities in cloud computing and genetics abound. We are also increasingly convinced that active stock selection (versus indexed-based) investing has a positive role to play in evaluating specific technologies and their potential. As such, we are planning to swap out of at least one of our current funds for a more active alternative. We also plan to rebalance our lineup, which has gotten somewhat out of whack due to the outsized performance of our genomics allocation. See Figure 6.

In addition, we plan to initiate an allocation to clean energy. With Biden committed to rejoining the Paris climate accord and rolling out a multi-trillion-dollar green initiative, and Europe and China committing similarly, green tech investment opportunities are multiplying. Investors (and some governments) are expressing increased optimism that technology can meaningfully get us out the climate mess we have created.

Figure 6. 2020 Returns in Select Technology Innovation Investments



Increase emerging market exposure. Emerging market equities performed well in 2020, primarily due to China and other emerging Asian countries' success in controlling COVID. Indeed, China is the only major economy that ended the year with GDP on the plus side, growing by +2.3%. This momentum is expected to continue in 2021 as the global recovery takes hold and other parts of the emerging market world (e.g., Latin America) start to normalize. In addition, emerging market equities will find support from a weakening dollar.



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Play it safe in fixed income. As noted earlier, fixed income is not expected to offer much in the way of compensation to investors in 2021, unless one starts to chase yield again in areas such as high yield and emerging market debt. But we all know what happened to these segments of the bond market when the market collapsed last March. As such, our view is that it's better to take less risk in fixed income by focusing on very high-quality corporates, (federally insured) mortgage-backed securities, municipal bonds, and inflation-protected securities, and to inch up client's equity exposure instead. Hence, we are maintaining a modest overweight to equity in general and keeping bond duration on the low side.