Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

# Major Investment Themes for 2021

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We believe six key themes will influence returns in 2021: 1) economic strengthening 2) rotation into Value, 3) an ongoing M&A boom, 4) private equity putting its money to work, 5) China tensions, and 6) the exuberance of the individual investor. If we were to combine all of these themes into one phrase, it might simply be "The reopening trade has room to run."

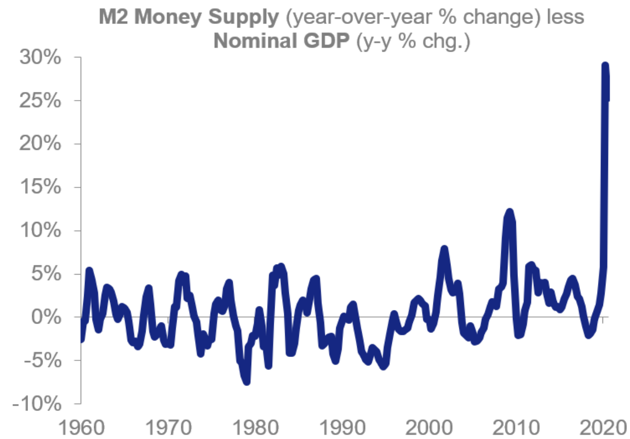
## THEME #1: STRONGER ECONOMY, UNINSPIRING INDEX RETURNS

In light of all the unusual factors influencing markets in 2020, we return to the basics that have influenced our thinking for many years: an analysis of GDP and money supply.

Essentially, the more the real economy grows, the more money gets siphoned away from financial assets (e.g. stocks, bonds) and vice versa. The last few years were almost textbook examples of this. Spurred by corporate tax cuts, the economy strengthened in 2018 (especially in the form of capital spending) while the Federal Reserve tightened and money growth slowed.

The process then reversed in 2019 as concerns about a trade war slowed the economy, the Fed eased, and long-term interest rates fell. We were poised for a more normal business cycle in 2020, but the COVID-19 pandemic had other ideas. Facing widespread lockdowns and a historic recession, the Fed unleashed another round of unprecedented monetary stimulus.

Investors, in turn, sought higher returns in financial assets and got them. Almost everything – stocks, bonds, gold, etc. – appreciated in price. This year, however, could unfold a bit differently: Widespread vaccinations should allow the economy to reopen at the same time the effects of fiscal and monetary stimulus course through the economy. One would expect economic growth to surge, long-term interest rates to rise, and returns on risk assets to fall this year.




Pandemic-related monetary and fiscal policy increased the supply of money in the U.S. in 2020 which helped cause assets to increase in price. As economic growth surges in 2021, returns are likely to be less heady.

## THEME #2: RELATIVE OUTPERFORMANCE BY VALUE, INTERNATIONAL, AND SMALL-CAPS

In the second half of 2020, we were on the fence on Growth vs. Value. We remained overweight Technology, Communications, and Health Care and held a positive view of Industrials and Materials, though we eventually took Communications down to Neutral based on the fact that Facebook and Alphabet make up about 50% of the sector.

We are now more seriously considering overweighting Financials and Energy – both traditional Value sectors – due to our expectation of a much stronger global economy next year. This strength, predicated on widespread vaccination and economic reopening, should also lead interest rates higher, a negative for more Growth-oriented sectors. The Russell 1000 Growth Index outperformed the Russell 1000 Value Index by the greatest margin on record in 2020 – some mean reversion may finally be in the cards. Elsewhere, sector composition has also informed our call for International over US shares this year. International stocks tend to be more Value-centric, and these trades often go hand-in-hand. Getting a bit more granular, we would have a bias toward commodity-exporting Emerging Market nations over manufacturing and production-oriented ones.

Finally, though the recent outperformance of small caps over large may suggest that a pause in this trade is possible in the short-term, we remain bullish on small caps for the coming year. Furthermore, small caps have greatly outperformed large caps during periods of high government budget deficits, and it is no secret the direction that our deficit is headed in today.

The Growth component of the Russell 1000 index has outperformed the index's Value component for several years. Conditions of economic re-opening and rising interest rates could spur a shift in this trend in 2021.


### THEME #3: THE M&A BOOM CONTINUES

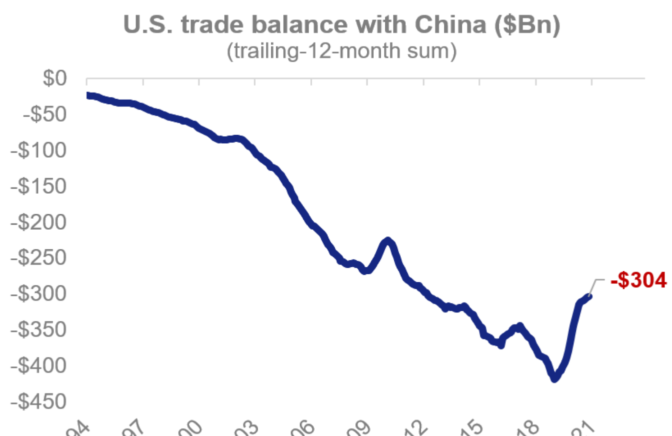
The current environment appears to be set up well for a continuation in Merger and Acquisition activity in 2021. Corporate cash levels are exceptionally high, interest rates are at historically low levels, political uncertainty is elevated, and the COVID-induced recession revealed the importance of scale and easy access to capital. While many target company valuations are not cheap, neither are share repurchases at these levels.

Economic dislocation, an acceleration of key macro trends (e.g. the widespread digitization of commerce), and the shock that smaller companies felt last year due to COVID-19 would all seem to favor a pick-up in deal-making activity in 2021. By performance, M&A was among the best uses of corporate cash last year.

### THEME #4: PRIVATE EQUITY SEEKS LARGE-CAP LEVERAGED BUY-OUTS

In what can only be described as an embarrassment of riches, the private equity industry finds itself with more assets than it knows what to do with. The best estimates peg the private equity industry at more than $4.5 trillion in assets under management with approximately $1.5 trillion in "dry powder" (i.e. cash on the sidelines). With valuations for private assets rich and competition fierce, we believe the industry is now so big that it will have no choice but to seek relatively large public companies that it believes are underleveraged.

### THEME #5: CHINA AND THE EMERGENCE OF A NEW COLD WAR




A period in which Washington and Beijing compete as the two spheres of economic and geopolitical influence seems probable. Although the eurozone still seems interested in striking trade deals with China, we think populist sentiments and distrust will prevail in the US.

Whether one believes President Trump's tactics regarding China were effective, we think that popular opinion has changed about our trading relationship with China and the country's future geopolitical ambitions.

China's initial handling of the COVID crisis (and incredible economic rebound), human rights abuses, and conflict with democracy in Hong Kong are all likely to broaden skepticism of the Chinese Communist Party's long-term motives. It is almost impossible to imagine China being regarded as a mostly benign force for economic development and international cooperation – as it was seen by many just a few years ago.

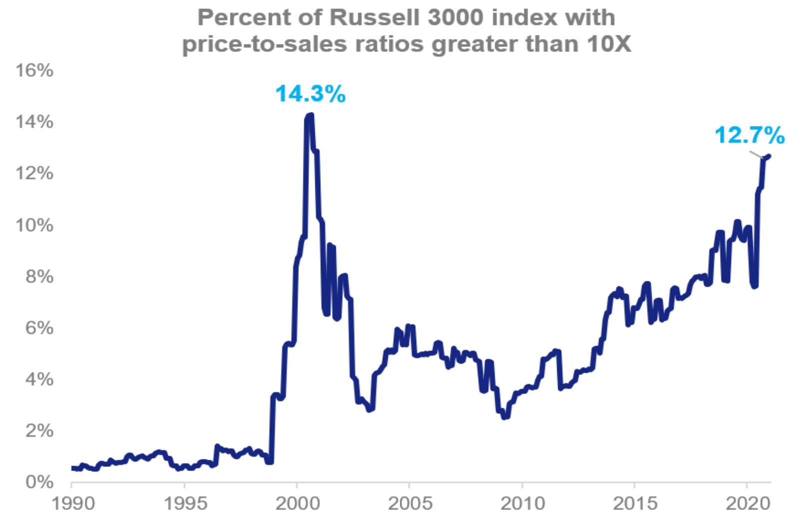
And yet, with the eurozone poised to sign its own trade deal with China, some still seem to believe that more engagement will bring about desired changes, both on economic and cultural fronts. Stateside, however, though the Biden Administration may take a different tack on international relations, it seems probable that US-China relations are now on a long-term path to more-permanent decoupling. Biden may slow the pace, but the wheels are in motion.

The net result may be somewhat slower economic growth and higher inflation over the long-term (particularly as companies seek to strengthen their supply chains, perhaps even by bringing some production back to the US). Geopolitically, a period in which both Washington and Beijing will compete as the two spheres of economic and geopolitical influence seems probable. Populist tendencies in the West are likely to persist.

## **THEME #6 (LONGSHOT THEME):** THE “BLOW OFF TOP”; ROBINHOOD INVESTORS REJOICE

Although some believe we are in the middle of a bubble in stock prices, the average forecast for the S&P 500 at the end of the year is still for a gain of 7.4% (4,035), with no forecast lower than the current level of the Index. It would be difficult to describe the price of any asset in the world as particularly cheap today, and yet we believe there is a distinct possibility that we may only be at half-time of this cycle.

It's one thing for stock prices to go up as interest rates fall, but it is quite another to see them go up as interest rates rise, a normal occurrence in times of "irrational exuberance." In 1987, the S&P 500 went up roughly 40% January through August as 10-year Treasury yields increased from 7% at the start of the year to 9% in May. Rates would eventually need to peak at roughly 10.3% in October to quell the stock market advance. Similarly, in 1999, the NASDAQ increased by 85% as long rates rose from 4.7% to 6.4%, and the Fed raised rates three times from 4.75% to 5.5%. In such episodes, "new era" thinking allows both the professional and individual investor alike to believe that the old rules no longer apply.




Share prices have moved higher much more quickly than revenue numbers for the underlying companies have grown, creating the sensation that the stock market may be in a bubble. But with plenty of cash still coming off the sidelines and the Fed holding interest rates low, this rally could have room to run.

Free commissions, free money, and presumably more free time provided the impetus for individual investors to open an estimated 10 million new brokerage accounts in 2020, a record. Incidentally, my barber made a strong case for Bitcoin this past Sunday (not kidding). But with the Fed Funds rate likely to be pegged near zero until 2023, the "wow" finish may be yet to come. With that in mind, we’ll be watching interest rates closely over the coming year – few are forecasting 10-year yields to rise significantly, though many anticipate blockbuster economic growth. This will be a critical dynamic to balance as we march forward into 2021.

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