Annual Equity Market Outlook

Executive Summary

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Key themes

Reopening with Cyclicals

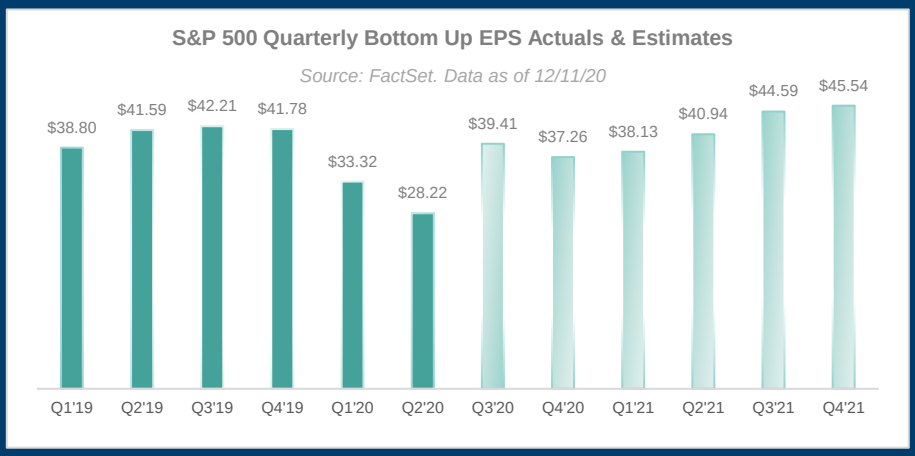
While it is difficult to look beyond the chasm of negative headlines from rising COVID-19 case counts and hospitalizations, we expect rapid vaccine deployment to help fuel improving economic activity as we progress through 2021. There will likely be setbacks along the way. Yet, we believe more cyclical areas of the economy offer an attractive risk/reward opportunity. A higher concentration of value names typically populates the cyclical sectors. However, this does not mean completely abandon solid growth companies with secular tailwinds. Accordingly, we believe a balanced approach with a tilt toward value and cyclical sectors could pave the way for healthy performance in 2021. As a reminder, investors typically view Technology, Communication Services, Consumer Discretionary, Materials, Industrials, Financials, and Energy as cyclical sectors. Defensive sectors include Health Care, Consumer Staples, Real Estate, and Utilities.

2020 was an unprecedented year for investors, fueled by rapidly changing behavior and marred by uncertainty. Investors rewarded sectors that capitalized on those shifts such as Information Technology and Consumer Discretionary while those caught in the crosshairs such as Energy and Financials suffered. The chart at the right depicting the year-to-date performance of the S&P 500 Growth and Value indices illustrates this bifurcation. Nearly every sector experienced outperformers and laggards at the industry level.

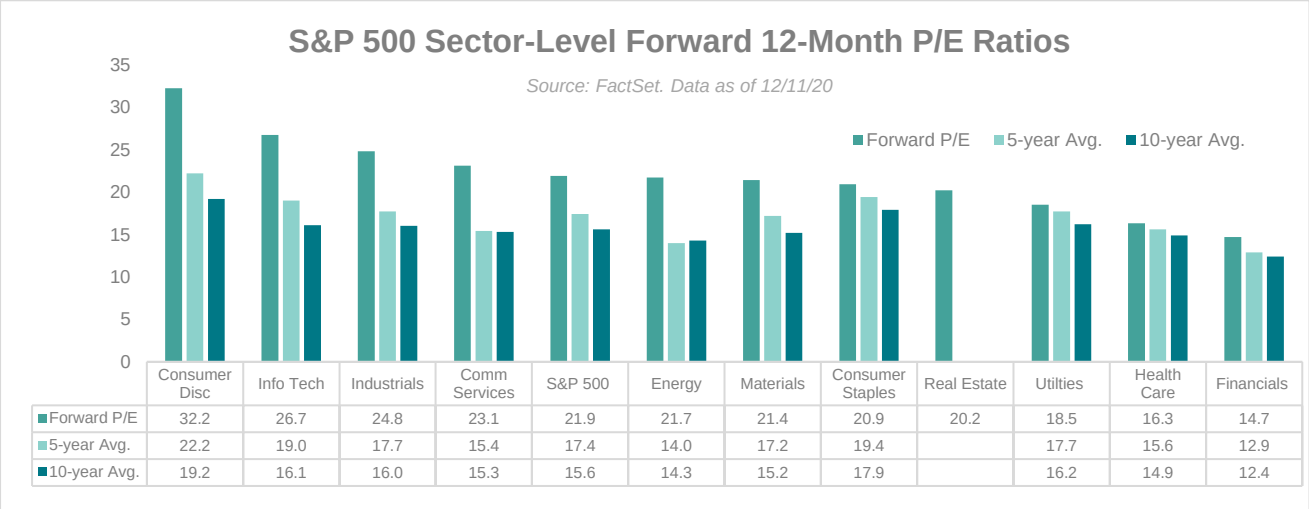
In our view, 2021's reopening could allow Financials and Energy to rebound gradually, as well as harder hit segments within Consumer Discretionary and Health Care. We also anticipate the Real Estate sector to benefit from the economic recovery. However, we believe some recent behavioral shifts could become permanent, resulting in supply/demand imbalances in sub-sectors such as retail, hospitality, office, and residential. In our view, some pandemic-driven technology shifts, such as video conferencing, could evolve into "business as usual" trends. However, we believe outsized valuation levels, strong growth expectations, and more normalized Technology spending (at both the corporate and consumer level) could result in modest gains for the Tech sector. For the Industrial and Materials sectors, a possible rotation from growth to value is unlikely to derail growth drivers, in our view. We expect growth drivers related to the content growth for automation and sensing for manufacturing and transportation, demand for high-density glass for data transfer, TVs and smartphones, or cyberwarfare equipment to persist.

Valuations High, But EPS Estimates Rising

The price-to-earnings (P/E) multiple on 2021 estimate earnings for the S&P 500 is 21.6x, which is well above the respective 5- and 10-year averages of 17.4x and 15.7x. Moreover, S&P 500 earnings for 2020 are expected to be down 15% from 2019 levels. While this combination seems at odds with indices hitting new highs, we remind investors that stocks are forward-looking assets, and earnings estimates for future years (both 2021 and 2022) have been steadily improving. In fact, 2021 EPS estimates for the broad market have moved from $163 at their low in July to approximately $170



following a solid Q3'20 earnings season. While $170 per share for S&P 500 earnings may appear tepid at just +4% versus 2019, if it holds, $170 would be a record earnings level for the broad index. As the year progresses, we anticipate continued improvement in earnings growth, which likely brings the forward P/E multiple back to more normalized levels. The graph on page 2 sourced from FactSet illustrates a three-year quarterly progression of S&P 500 EPS estimates, with 2021 estimates strengthening sequentially throughout the year.



	Consumer Disc	Info Tech	Industrials	Comm Services	S&P 500	Energy	Materials	Consumer Staples	Real Estate	Utilties	Health Care	Financials
Forward P/E	32.2	26.7	24.8	23.1	21.9	21.7	21.4	20.9	20.2	18.5	16.3	14.7
5-year Avg.	22.2	19.0	17.7	15.4	17.4	14.0	17.2	19.4		17.7	15.6	12.9
10-year Avg.	19.2	16.1	16.0	15.3	15.6	14.3	15.2	17.9		16.2	14.9	12.4

At a sector level, valuations reflect a combination of earnings trends in the pandemic and post-pandemic operating environments. The graph above sourced from FactSet illustrates the sector's current forward P/E multiple versus historical averages. Investors rewarded companies leveraged to technology and online shopping with expanding multiples, boosting the Information Technology and Consumer Discretionary sectors' premium valuations. In our view, Info Tech's earnings may need to play "catch-up" in 2021 to warrant the premium, while increasingly permanent changes in consumer behavior could support multiples for select names in Consumer Discretionary. Financials and Industrials investors rotated towards more defensive niches in the deeper cyclical sectors such as index providers, professional services, and insurance brokerage. We believe the premium valuations of these selected industries reflect a combination of earnings visibility as well as scarcity value. In our view, these attributes could persist in a recovery environment as well. In the Health Care sector, which encompasses both cyclical and defensive traits, valuations are trending in-line with historical averages. However, we believe the sector could re-rate higher in 2021 if successful vaccine deployment unleashes pent-up demand in med-tech.

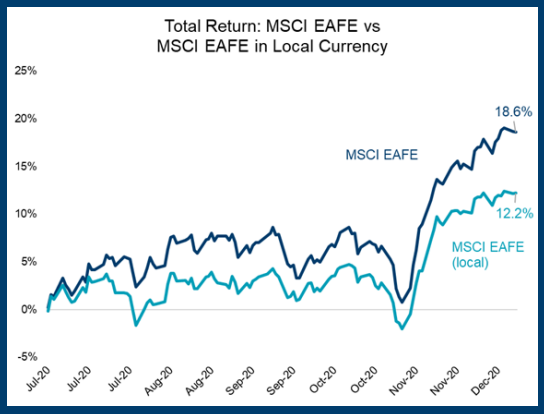
Small-Cap, Big Returns?

In early 2019 and continuing through early October 2020, small-cap stocks have underperformed their large-cap brethren by a wide margin. However, as investors started to price in an economic recovery in the U.S., including a shift to more cyclical industries, the group has handily beaten its large-cap peers. We believe this theme has the potential to continue in 2021 as the economy gradually reopens, cyclical areas of the economy rebound, and domestic business activity improves. We also believe the longer-term underperformance in small-caps (vs. large-caps) stems from the dominance of a handful of large technology companies and their outsized influence on index performance. Moreover, small-cap indices typically consist of more cyclical (excluding Tech) companies that could disproportionately benefit from stronger domestic growth. Although our expectation for a weaker U.S. dollar and its potential impact on smaller companies with limited international revenue bears watching, we believe this headwind could be offset with improving demand at home.

Cyclical sectors (excluding-technology) make up nearly 60% of the S&P 600 Small Cap Index versus just over one-third for the broader market, with Industrials representing the largest sector weight at just under 20%. In our view, industries such as aerospace &

defense, machinery, and instrumentation are well-positioned as domestic demand rebounds. Also, the Health Care sector includes smaller and innovative biotech and medtech companies that are often acquisition targets for larger strategic acquirers. Thus far in 2020, there have been several multi-billion dollar acquisitions of small-cap biotechnology companies. At the consumer level, while retail-oriented small-caps came under significant pressure during the peak of shelter-in-place mandates, many enjoyed improving demand due to strong growth in e-commerce.

International Back in Vogue?



International stock indices have been underperforming their U.S. counterparts for several years. However, 2021 may provide an environment that is more friendly for international companies as well as U.S. multi-nationals with high exposure to foreign markets. In our view, factors such as a potentially weaker US dollar and overall improved trade relations could provide an attractive operating environment for international companies. Additionally, valuation metrics for overseas markets are more attractive versus major US indices.

Stimulus from the European Central Bank, meaningful progress in Brexit negotiations, and positive developments surrounding Covid-19 vaccines could fuel investor optimism and extend the positive momentum for foreign developed market equities in 2021. The improving sentiment has prompted investors to buy assets outside the U.S., driving gains for foreign equities while pushing the dollar lower in recent weeks. The euro, despite massive stimulus from the region's central bankers and politicians, is up more than 8% against the U.S. dollar this year as it nears its highest level since April 2018.

At a sector level, we believe rebounding cyclicals and value outperformance could manifest outside the U.S. as well, particularly in the Financial sector. One key driver of bank-stock performance could be the potential reinstatement of dividends after payouts were effectively frozen by regulators in March in exchange for regulatory relief and government loan guarantees amid the onset of the global pandemic. We note that earnings expectations for the Financials sector have improved significantly since mid-year as banks reported solid third-quarter revenues, a drop in loan provisions, and healthier capital ratios. The Financials sector inside the Stoxx 600 is expected to generate 2021 earnings growth of over 31% y/y.

In the U.S., sectors with increased exposure to international markets also could be better positioned in 2021. Specifically, the Technology and Materials sectors each generate ~55% of sales outside the U.S., and could benefit from a weaker U.S. dollar as well as a more rational trade environment. Finally, Health Care is another sector that could benefit from multi-national companies with exposure to foreign markets.

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