

January 18, 2021

Dear O'Brien Client,

What a whirlwind the past 12 months have been! This time a year ago the coronavirus was just a pneumonia-like health scare in Wuhan, China. There was only one confirmed death from the virus globally<sup>1</sup>. President Trump was yet to face his first impeachment trial and was experiencing his high-water job approval mark of roughly 50%. Former Vice President Biden was still one of a dozen candidates for the Democratic nomination. The economy was humming along with the unemployment rate at a mere 3.5% -- the lowest rate since the 1960s.

Today the coronavirus is a worldwide pandemic. Roughly 2 million people are estimated to have died from the virus. President Trump is now facing a second impeachment trial and Biden is now President-elect. The economy has experienced a historically sharp healthcare-induced recession, the after-effects of which are expected to linger well into the future. The unemployment rate is roughly double what it was entering 2020 – and that doesn't account for millions more underemployed workers and people who have left the workforce entirely.

Needless to say, 2020 unfolded quite a bit differently from how it started, and we don't think many were sad to mark its ceremonial passing this New Year's.

And yet global stocks rose 16% and U.S. fixed income was up 7.5%. To be sure, policymaker response, particularly the Federal Reserve (Fed), was a significant driving force behind this performance dichotomy. Although the economy and corporate profitability have started to recover, they are still well-below their pre-COVID crisis levels. As a result, financial markets are historically expensive entering 2021.

So where do we go from here?

We begin thinking about the future by considering opportunities and risks over multiple time horizons. More often than not, when there is a difference of opinion about an economy or asset market that difference comes down to the time horizon under consideration.

Let us start with the secular (think next decade) outlook. From an economic standpoint, growth – on average – will likely be slower because population growth is slowing. This, along with high valuations today, suggests market returns will generally be more challenged as well. Our biggest concern is higher inflation, as the diversification benefits from owning stocks and bonds together tend to diminish when inflation is rising sustainably. Finally, we note that policy and political risks – be they anti-globalization pressures, rising populism, larger deficits, and/or greater regulatory intervention are probably here to stay.

At the same time, we are more positive about the cyclical (think 3-5 years) outlook. For much of last year we referenced the six signposts we were watching on the path to recovery. The table and comments below provide an update of our outlook on each of those signposts. The high-level takeaway is that we are seeing some light at the end of the tunnel.

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<sup>1</sup> <https://www.thinkglobalhealth.org/article/updated-timeline-coronavirus>

Six Signposts on the Path to Recovery	Current Situation
Stabilization of coronavirus infection rate	New cases rising; vaccines have begun
Clarity on depth & duration of economic disruption	Economy softening; vaccine boost looming
Sufficiently large global stimulus	Fiscal headwinds; monetary tailwind shrinking
End of funding/liquidity stresses in markets	Fed actions mean hopefully past this signpost
Cheap asset markets	Markets expensive but technicals still positive
No other Black Swan events	Nine months since last event (negative oil)

Source: Goldman Sachs, O'Brien Wealth Partners, as of 1/5/2021.

From a healthcare standpoint, new cases, hospitalization rates, and the estimated reproduction rate of COVID are rising. That's the bad news. But that rise in cases has led to estimates that roughly a quarter of the U.S. population have now been exposed to the virus – which, if nothing else, is also a step closer toward herd immunity. That's the mixed news. Finally, the long-awaited vaccine rollout has begun. That's the good news. Put it all together and the situation still is not great, but it is better than it used to be.

From an economic standpoint, the rise in new cases is weighing on growth. In fact, the economy may stall in the first quarter. However, there is also significant pent-up demand in sectors where COVID has had the greatest impact – such as travel – that could boost growth if a successful vaccination rollout occurs. That said, it will still take years to fully offset the damage caused from COVID.

Global stimulus has been massive and rapid. But the tailwind is slowing. Absent another fiscal stimulus package, fiscal policy will become an outright headwind for growth as spending from previous fiscal packages winds down. And while quantitative easing by major central banks will continue into 2021, the pace of their asset purchases are expected to slow by half.

Encouragingly, recent stock market pullbacks have not seen a return of the illiquidity issues that plagued fixed income markets back in March. Hopefully this means that Fed actions taken during the depths of the crisis, and its promise to do whatever it takes if more is needed, have moved us past this signpost.

Asset markets are expensive. If we compare starting valuations to one-year forward returns we find that there is no correlation historically. Put differently, you are just as likely to get a positive forward return as a negative forward return on a one-year basis from a high starting valuation. But starting valuations compared with 10-year forward returns show a positive correlation. In other words, over long periods of time valuations tend to revert toward their long-term average. This is why expensive markets today are a headwind for longer-term return potential.

The last signpost has to do with the lack of additional Black Swan – or unforeseeable extreme negative - events which cause a sharp market sell off. When the environment is changing rapidly, the potential for other things to unexpectedly go wrong rises, such as negative oil prices nine months ago. Since that time, however, no other Black Swans have occurred.

These signposts lead us to anticipate a relatively sanguine backdrop as a base case for 2021. Against that backdrop stocks will likely outperform bonds, but by a more modest pace than has been experienced the past nine months. Since we are still not fully out of the proverbial tunnel, markets could also remain choppy.

Given that we also had sanguine expectations for 2020 entering the year it is also worth exploring what could challenge that expectation. Perhaps the biggest risk is that not enough people are willing to inoculate themselves. A recent YouGov survey indicates just 40% of Americans would be willing to vaccinate when the vaccine becomes available to them and another 30% are not yet sure whether they will do so<sup>2</sup>. A lack of herd immunity may prevent a full return to normalcy.

Other risks worth monitoring vary from uncertainty about what Democrats will do with control of the legislative agenda, to potential anti-trust legislation for large technology companies, to the risk of a sharper-than-expected rise in inflation and interest rates. All of these risks represent potential downsides of varying magnitudes to our base case outlook.

Finally, it is worth noting that traditional “safe” assets, such as bonds, have provided less downside protection during the market pullbacks that have occurred since March. We have been concerned about this for a while now, and have been looking to add other diversifiers such as the JPMorgan Hedged Equity Strategy mutual fund in portfolios, as that fund does not rely on interest rates falling further to provide some downside protection if markets decline significantly.

We wish you and your families all the best for 2021, and we hope you are all taking care and staying healthy. If you have questions, or would like to talk, please call us at 617-547-6717.

Your O’Brien Team

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<sup>2</sup> Source: Pew Research Center, Gallup, Goldman Sachs, O’Brien Wealth Partners, as of 12/15/20.