Third Day Capital Management

Private Investment Advisers

"With great wealth comes great responsibility"

Global Economic and Markets Review

December 31, 2020

Happy New Year

Equity Indices:	12/31/20	Qtr Return	YTD Return
Dow Jones Industrial Average	30,606	10.7%	9.7%
S&P 500 Index	3,756	12.1%	18.4%
Nasdaq Composite Index	12,888	15.6%	44.9%
Russell 2000 Index	1,975	31.4%	20.0%
MSCI EAFE Index*	1,174	11.4%	1.3%
MSCI Emerging Markets Index	1,664	16.2%	19.6%
**Europe, Australiasia, Far East*			

We are hard pressed to identify another year in which "Happy New Year" salutations were exchanged with as much relief and gratitude as they were on December 31, 2020. Without question, the world was eager to kiss 2020 goodbye at midnight. This, despite the fact that most U.S. equity indices generated healthy double-digit returns and closed the year at all-time highs. But if 2020 was anything, it was unusual, and so, it's only fitting that such an unusual year end in such an unusual manner.

Consider, for example, that in 2020, inflation-adjusted after-tax personal incomes rose at the fastest pace in 6 years, household debt as a percentage of income fell to 25-year lows, and household net worth set an all-time record high, while, at the same time, unemployment rose to multi-year highs and the U.S. economy contracted 3.5%. Small business optimism remains above its 15-year average when most small businesses are either closed or operating at significantly reduced levels. Stocks' strong performance occurred against the backdrop of a 13% decline in corporate profits. Highly unusual indeed.

Currently, the consensus outlook for 2021, that economic extremes will give way to economic normality, is based on a return to a more "normal" social environment. As the general population is vaccinated and herd immunity is achieved, social restrictions will be lifted, freeing consumers to spend their accumulated savings on services that were severely restricted or entirely unavailable. This in turn should drive a declining unemployment rate which further perpetuates an acceleration in economic growth and another positive year for stocks. It's a logical outlook, and one we generally share.

That said, the real story of 2020 was the human story. Examples of bravery, courage, patience, charity, and heroic personal sacrifice on the one hand; fear, frustration, confusion, insecurity, and tremendous personal loss on the other. These experiences, as visceral as they were, will dictate our priorities and behaviors starting in 2021 for decades to come.

In this regard, we note the generally negative perception of 2020 despite the very strong gains in overall material wealth as the first green shoots in society's collective perspective and priorities – that our non-financial wealth, comprised of our family and friends, is far more valuable than our financial wealth. To that end, like the rest of the world, we look forward to 2021, in which we are able to reconnect with, nurture, appreciate, and enjoy our non-financial wealth. Happy New Year.

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The Global Economy

Foreign Currency:	**12/31/20**	**Qtr Change***	**YTD Change***
European Euro	1.22	-4.2%	-8.9%
British Pound	1.37	-5.8%	-3.1%
Canadian Dollar	1.27	-4.5%	-2.1%
Japanese Yen	103.32	-2.0%	-4.9%
Chinese Yuan	6.53	-3.8%	-6.2%

** US Dollar performance versus the Foreign Currency*

Global economic activity during the fourth quarter continued to improve, albeit at a much slower pace than in the third quarter. A limited resurgence of Covid in a number of Asian countries, coupled with a widespread resurgence of Covid in Europe and the U.S. motivated governments to increase social and business restrictions, which weighed on economic activity, especially in the services sector.

For the year, global economic activity was roughly 4% lower than it was for 2019. China was the only major country to post year over year growth in 2020 (just under 2%). However, as a region, Asian economies, with the exception of India, fared better than the western world, a fact attributed to their experience handling periodic outbreaks of SARS and their cultural preferences for compliance. We would also note that a rebound in global trade, which has almost completely recovered, provides a tailwind for most Asian economies' due to their heavy export orientation.

Europe has not been as lucky. A Covid resurgence in multiple major cities across the continent forced governments to impose lockdowns, which ended the economic rebound. Fourth quarter GDP in the eurozone contracted, marking the third quarter of the previous four in which economic activity in Europe declined. German manufacturing was the sole bright spot, benefitting from the sector's global competitive advantage, but it wasn't enough to offset weakness across the rest of Europe, plagued by inefficient manufacturers, rigid labor and business regulations, a crippled banking system, political discord that limits the potential fiscal response, and a meaningful orientation towards the services sector.

At least the fourth quarter delivered a Brexit resolution, avoiding a scenario where Britain would "crash out" of the European Union without a trade deal. Just before Christmas, both sides agreed to a framework that would avoid the imposition of draconian trade barriers, a welcome breakthrough that will eliminate what would have been an additional factor weighing on European economic activity. For its part, the European Central Bank expanded its efforts to prop up the European economy, but thus far, its efforts have delivered very little, if any, success.

In the U.S., fourth quarter economic activity improved when compared to the third quarter, but the pace of recovery has slowed. Covid cases rose in October, and then surged in November and December, as people, including the politicians who imposed them, largely ignored social restrictions for the holidays. In the labor market, goods-producing employment has almost fully recovered thanks to an inventory restocking cycle, but the recovery in the services sector has stalled; only 11 million of the 18 million jobs lost in March and April have been regained. Enhanced unemployment benefits expired in October, leaving many former service-sector workers in a difficult financial position. As a result of all of the above, consumer spending tapered off in November and declined in December, although early indications suggest consumer spending over the holidays grew modestly when compared to 2019.

Slower consumer spending has not impacted residential real estate, however. Companies are finding remote working arrangements to be productivity enhancing, and as such, the vast majority of companies expect to extend some degree of work from home flexibility to many, if not most, of their employees going forward. Working from home expands the home's role and the needs it must fulfill, but also opens the door to larger homes in suburban areas that were previously too far from city centers to justify the time required for the daily commute. To complicate the situation, household formation is currently running at roughly two times the pace of new residential construction and ultra-low mortgage rates increase the amount buyers can pay for a property. It all adds up to supply unable to meet demand and strong home price appreciation.

All told, economic growth for the fourth quarter is like to be 4.5% higher than the third quarter on an annualized basis but roughly 3.5% lower when compared to 2019, good enough to land the U.S. in the top 5 worldwide for recovery. Which is why the Federal Reserve, at its final meeting of the year in December, opted not to adjust its policy stance, but only reaffirmed its commitment to maintain monetary accommodation until the U.S. economy achieves "substantial further progress" towards full employment and higher inflation.

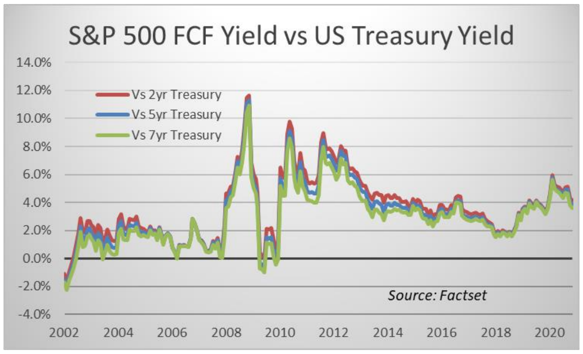
Equities

U.S. equities performed exceptionally well during the quarter, finishing the year at all-time highs. An October swoon heading into November elections was not enough to derail the advance that began in the third quarter. Investors cheered the split result, expecting that the likely GOP majority in the Senate would blunt any major taxation policy changes. Energy and Financial Services led the advances during the quarter, but still ended the year in negative territory, along with Real Estate and Utilities. Once again, the U.S. equity markets were the best performing among major stock markets.

S&P 500 Index Sectors	Qtr Change	2020 Change
Communication Services	13.5%	22.2%
Consumer Discretionary	7.9%	32.1%
Consumer Staples	5.6%	7.6%
Energy	25.8%	-37.3%
Financial Services	22.5%	-4.1%
Health Care	7.6%	11.4%
Industrials	15.2%	9.0%
Information Technology	11.5%	42.2%
Materials	13.9%	18.1%
Real Estate	4.1%	-5.2%
Utilities	5.7%	-2.8%

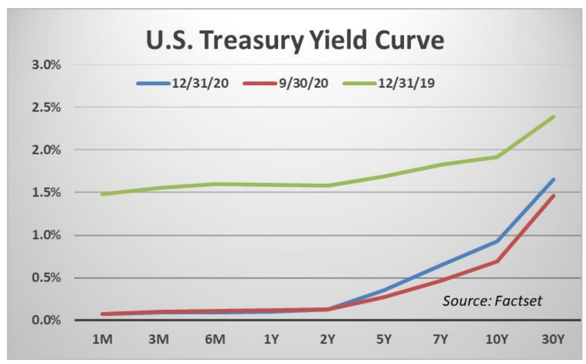
U.S. stocks had good reason to rally. Third quarter earnings fell 6% compared to last year, but when the weakest three industries (out of 63 total) are excluded, earnings *rose* 4% year over year. Outside of the Oil & Gas, Airlines, and Hotels, Restaurants & Leisure industries, companies have shown remarkable resilience, flexibility, and cost control this year. Operating margins have modestly declined from historic highs, but Free Cash Flow margin *rose* this year, from 10% to 12%, as companies successfully focused on improving cash flow generation. This flexibility and resilience produced best-in-class earnings results when compared to the other major regions around the world. To wit, Europe's Stoxx 600 index earnings declined 26% in the third quarter and are slated to decline 20% in the fourth quarter for a total decline in 2020 of 37%. Compare that to the U.S. S&P 500, where earnings are slated to decline 9% in the fourth quarter, and 13% for all of 2020.

We attribute the strong fourth quarter performance in U.S. equities to the relatively strong fundamental performance so far this year, but more importantly, to the 2021 outlook. With that said, strong stock price performance amidst declining earnings translates into higher valuations. Using the traditional but flawed Price / Earnings ratio, stocks currently trade at a 60% premium to their 20-year average. Using the superior Inflation-adjusted Free Cash Flow Margin valuation metric, stock valuations moved from slightly inexpensive to moderately expensive during the quarter, now trading at a 16% premium to their 20-year average. Compared to other asset classes, however, stocks remain one of the least "overvalued". For example, stocks' current dividend yield exceeds the yield on US Treasuries by 4%, well above the average since 2014, and historically speaking, signals positive performance for stocks over the next few years. The same can be said when comparing stocks' dividend yield to the yields on Investment Grade, Non-Financial corporate debt. We would also note that, in addition to providing higher current income, stock dividends tend to rise over time, whereas bond interest payments do not. Which is why we continue to be comfortable with the outlook for stocks over the next few years.



Fixed Income

For all the chatter about elevated stock prices, we continue to focus our concerns on the Fixed Income asset class, where Fed actions have pushed yields down and prices up even more dramatically. With the exception of the 30-year maturity, the entire U.S. Treasury yield curve is below last year's yield on the 1-month U.S. Treasury Bill. With short-term rates firmly anchored at 0% by the Fed for the next two years at least, investor concerns that inflation could accelerate starting next year drove yields on medium- and long-term bonds modestly higher. The fact that the U.S. must issue a significant amount of debt next year, an increasing portion of which will be longer-term in nature, only adds to bond investors' anxiety.



The paltry, below-inflation yields currently offered in the U.S. Treasury market make corporate bonds more attractive, and companies are capitalizing on it. In the fourth quarter, corporations rated 'BBB', the second-lowest investment grade rating, issued a record amount of debt at average yields lower, and average maturities longer, than what 'AA' rated companies were issuing debt at in the fourth quarter of 2019. From the Fed's perspective, their efforts have accomplished exactly what they intended; to alleviate short-term liquidity risks. However, in the process, they increased long-term solvency risks by allowing mediocre companies to borrow large sums at very low rates. For corporate bond investors, the risk / reward profile has turned decidedly negative as risks have risen at the same time reward has fallen.

In the tax-free municipal bond market, yields on tax-free municipal bonds remain above those available in comparable U.S. Treasuries, an anomaly to be sure (their tax-free status would logically argue for lower pre-tax yields than U.S. Treasuries). But even here, investors have to commit capital to 'BBB' rated municipalities for at least 13 years in order to earn a yield that exceeds the likely inflation rate of 2%, an unattractive risk / reward profile in our view.

Commodities

Commodities:	12/31/20	Qtr Change	YTD Change
Gold	$ 1,893	0.3%	24.6%
Crude Oil	$ 48.52	21.1%	-20.6%
Natural Gas	$ 2.54	0.5%	16.0%
Gasoline	$ 1.56	18.7%	-10.5%
Copper	$ 7,742	17.1%	25.8%
Wheat	$ 6.41	10.8%	14.6%

Commodities also performed well during the quarter. Gold paused, as the prospect for higher long-term interest rates, coupled with rising risk appetite limited its gains during the quarter, but the precious metal still finished 2020 with a strong performance. If the Fed exerts downward pressure on long-term interest rates, gold becomes an attractive inflation hedge (although, not as attractive as stocks, in our view). Crude oil had a strong rebound in the quarter, as investors anticipated a Democratic "blue wave" would usher in a deluge of fiscal spending and rapid economic expansion. While that scenario failed to materialize, escalating negotiations between OPEC and Russia were enough to give oil investors hope that OPEC's price war would draw to a close in 2021.

Conclusion

As we turn the page on 2020, investors have much more clarity on two key factors that will influence whether 2021 is indeed a Happy New Year. Election results are known, and, as sad as it is to state, the fact that neither political party can implement their agenda as desired is good news for investors (even with the Democrats winning both Georgia Senate seats). Operation Warp Speed has already delivered two vaccines, the initial doses are being administered, and a handful of other vaccines are on the way. It appears that 2021 will be the year in which the developed world moves past Covid. These two key factors underpin the optimistic outlook for 2021, and in general, we think the consensus outlook is the right outlook.

With that said, we differ in some respects as to how investors should position their portfolios, both in the near term, and in the longer-term. For example, investors concerned about a stock market correction may be accumulating cash, and while we will certainly take opportunities to trim concentrated positions at elevated valuations, raising a significant amount of cash is not an intelligent strategy. If 2020 taught investors one thing (we would argue it gave us a reminder not a new lesson), timing the market is futile. At the low point in March, investors had raised $4.5 trillion of cash, much of which is still sitting on the sidelines "waiting for a good entry point". Cash is a loser; it can't be effectively deployed to time the market, and in the meantime, inflation destroys its value at the rate of 2% or more per year.

Our perspective on fixed income is pretty straightforward.

Which leaves us with equities. Referring to stocks as the "least bad" option is not entirely fair, but it is a partially accurate statement. Elevated valuations concern us, but only in the sense that they contribute to and exacerbate the drawdown, not as a cause of it. On the contrary, we see the bigger risks to stocks as two-fold. First, that profit margins decline further as companies relent on rigorous cost controls and/or as the Biden administration imposes new and costly regulations and/or higher corporate taxes. Second, that the Fed chooses not to cap long-term interest rates, instead allowing them to rise in the face of accelerating inflation, making stocks in general, and growth stocks in particular, less attractive relatively speaking.

Aging demographics argue for investors to employ increasingly conservative investment strategies that include higher allocations to bonds, and while current yields make that unfeasible, if rates were to rise significantly (we think the 10-year Treasury yield would have reach or exceed 3%), investor re-allocation into bonds and out of stocks could create a material headwind for stocks. We think the first risk is more likely than the second, but if either risk takes shape, elevated valuations will compound investor losses.

In the absence of either of those scenarios, stocks represent the best option for long-term, inflation-adjusted wealth creation. Companies' ability to raise prices and dividends over time are inherently defensive during inflationary periods, not to mention their current yields already surpass bonds and cash. To us, the question isn't so much whether stocks continue to play the prominent role in most client portfolios, but rather, which stocks play that role. In this regard, again, we differ from the general consensus, at least looking beyond 2021.

Given the decade-long outperformance of "Growth" stocks versus "Value" stocks, and the likely above-trend economic growth rate in 2021, consensus investor sentiment is shifting towards a preference for Value stocks. While we allow for the probability that Value or cyclical stocks will outperform Growth stocks in 2021, the underlying factors driving the outperformance of Growth over the last 10 years have not abated. Namely, that long-term trend growth rates are low and declining, as low population growth and low productivity conspire to limit economic potential. Significant fiscal spending has ballooned government debt, which also weighs on economic growth. If Japan and Europe are any indication, low economic growth is naturally accompanied by low inflation, which allows the central bank to maintain very low interest rates.

As it turns out, this is exactly the same environment we've experienced the last 10 + years. It's also what we attribute the outperformance of Growth to. When overall economic growth is anemic, companies that can deliver above average growth are unique, highly sought after, command higher valuations, and deliver better performance. We see a clear cause and effect relationship behind Growth's outperformance and fail to see any argument for why that is going to change after 2021. If anything, we see it becoming more prevalent. The "reversion to the mean" argument, in which investors expect Value to outperform Growth simply because Growth has outperformed Value, has no logical or practical foundation.

It also means investors have to prepare for lower returns overall, in both stocks and bonds. Successful investors must be, now more than ever, selective in what they own and hold. Microsoft, Amazon, Apple, et al turned in exceptional performances this year for a reason, while hundreds of other stocks languished. Consumer behavior matters, and while we may not have all the answers when it comes to how the Corona crisis changed consumer behavior, we already know that some companies and their stocks will benefit, while others will struggle. In our opinion, the glory days of broadly diversified passive index investing have come and gone.

Finally, we think investors have to consider alternative investment options, and in particular, institutional real estate, which has many attractive features: investment returns are highly dependent on the individual properties in the portfolio and the manager's skill at identifying, developing, managing, and selling those properties, they have inherent inflation-hedging qualities, and in most cases, already offer yields that handily exceed stocks, bonds, and cash.

In the end, it comes down to the fundamentals of the underlying investment. Not all investments are created equal, and not all investment portfolios will perform equally. Those that recognize these axioms are more likely to have a Happy New Year. Those that don't may find themselves eager to kiss 2021 goodbye as well.