CMH Wealth Management, LLC

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The Year That Was

Looking back at 2020, we see a stock market that soared more than 60% off March lows and a 10-year government note with a yield that remained below 1% most of the year. Certain segments of the market embraced three to five years of technology advancements in less than a year, while other segments slowed or came to a halt.

We remain in an investment cycle fully supported by the Federal Reserve (Fed) through excess liquidity and low rates, also called the "Goldilocks Stage". Excess liquidity boosts asset prices since investors know the Fed is supporting the market. This is often called the "Fed put". Low rates increase the present value of future cash flows, which in turn lifts both equity and bond prices past what many consider expensive valuations relative to history.

A stock market is not necessarily expensive considering only a price-to-earnings level that is higher than its historical average. Above-average valuations can persist for an extended period. This common valuation measure is driven by both fundamentals and sentiment. Investors should acknowledge and adjust for this, but also understand it is not a firm indicator determining the future direction of the stock market.

We view valuation measures as important indicators and add the following additional context:

- Over the past two decades, companies have been required to report earnings that reflect more short-term noise, such as accounting practice changes.
- Retirement accounts, with automatic contributions, bring constant liquidity and disciplined buying into the financial system.
- Trading costs are significantly reduced.
- Most valuation measures reflect historical earnings or estimated growth over a short horizon rather than capturing long-term growth.

"Excess liquidity boosts asset prices since investors know the Federal Reserve is supporting the market."

In early February of last year, Jeremy Siegel, a well-known Wharton School finance professor, was presenting at an analyst seminar. He posed the question; "What do you think will end this bull market?" He provided six or seven choices, one of which was a pandemic. Out of 100 analysts, only one thought a pandemic would end the bull market. The lesson being, the triggering event is usually a surprise. The unexpected pandemic event happened and, as usual, the markets swiftly priced in the worst possible outcome.

Looking ahead to 2021 and beyond, we still see investment themes that will be impacted from trends created or accelerated by the COVID pandemic, such as e-commerce, payment networks, remote work, re-imagined office space, reduced business travel, and a bio-pharma/technology revolution. We also see a stock market with broad strength, as most companies are finally contributing to this rally. Companies that fit these trends, coupled with other quality cyclical stocks, should be key ingredients to a properly structured and diversified portfolio.

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Asset Class	Current Tactical View
Fixed Income Investment Grade High Yield	Remain underweight & defensive: We remain underweight direct high yield (higher risk) exposure and have moved up in bond quality. Our interest rate sensitivity is neutral in order to lock in income for our portfolios. We have also increased our allocation in treasury bonds to add liquidity.
Equity Large-Cap Small & Mid-Cap International	Remain overweight: Our portfolios are overweight U.S. large cap and small/mid cap equities, while underweight international equities. Within international equities, we are overweight emerging markets.

Tactical views are focused on the shorter-term market cycle defined as the next three years. Strategic views are the underlying investment discipline focused on longer-term market cycles up to 10 years.

Asset Allocation

Heading into 2021, our asset allocation remains overweight equities relative to fixed income. We favor high quality large cap companies. Outside of the U.S., emerging markets remain our favored asset class to garner diversification and structural growth.

There have been daily winners and losers, as headlines vacillate between growth and value stocks. More recently, this broad market strength has resulted in a larger number of companies participating in the rally. The breadth of stock market participation has not been at this level since 2011. While this can be a short-term sign of weakness to come, it is a better long-term indicator of strength.

We also see small- and mid-cap stocks participating in the stock market rally in a manner not seen during the first three-quarters of 2020. There is a saying that when the "privates (small caps) join the generals (large caps) on the front line, it is strong validation of the rally".

Shifting to bonds, we continue to emphasize income, quality, and liquidity for our core investment grade bond portfolios. Our fixed income portfolios are positioned very strategically, with neutral interest rate sensitivity. This means if rates go down, the portfolios will have locked in a higher yield relative to the current rate environment. If rates go up, we will buy into higher yields with each new purchase as existing bonds mature.

We do not believe bond yields will rise swiftly in the short-term. While yields may gradually rise from current levels, the economic system is still heavily reliant on debt. Global economies could struggle with materially higher rates at these elevated debt levels. Until either debt levels are more sustainable and productive, or substantial inflation occurs, rates should remain well below historical averages.

2020 Benchmark Index Performance

Asset Class	2020	As Measured By
Fixed Income		
Investment Grade Municipal	5.1%	BB Muni Bond 7 Year
Investment Grade Taxable	7.5%	BB U.S. Aggregate Bond
High Yield Bond	7.1%	BB U.S. Corp High Yield
Equity		
Large Capitalization	18.4%	S&P 500
Large Capitalization Growth	33.5%	S&P 500 Growth
Large Capitalization Value	1.4%	S&P 500 Value
Small & Mid Cap (SMID)	20.0%	Russell 2500
International Developed	7.8%	MSCI EAFE
International Emerging	18.3%	MSCI Emerging Markets

Data Source: Tamarac and providers to Tamarac. Total returns.

S&P 500 ANNUAL RETURNS LAST 25 YEARS	
Year Ending	Total Return Change
2020	18.4%
2019	31.5%
2018	-4.4%
2017	21.8%
2016	12.0%
2015	1.4%
2014	13.7%
2013	32.4%
2012	16.0%
2011	2.1%
2010	15.1%
2009	26.5%
2008	-37.0%
2007	5.5%
2006	15.8%
2005	4.9%
2004	10.9%
2003	28.7%
2002	-22.1%
2001	-11.9%
2000	-9.1%
1999	21.0%
1998	28.6%
1997	33.4%
1996	23.0%
Avg. Annualized	9.6%

Table Source: S&P Dow Jones Indices

Equity Sector

Our investment philosophy has always focused on a search for growing companies with reasonable valuations. Growth rates are an extremely important quantitative variable during periods of low economic activity. While many believe this style tilts towards growth over value stocks, it is not as clear cut as that broad distinction. We own many stocks in our portfolio that are easily characterized as value stocks, but we believe the market is mispricing their growth opportunity and/or intrinsic valuation.

While we have seen underlying changes occur within the market for years now, 2020 certainly brought forward a number of structural trends. It was only in 2017 that the technology sector's weight in the S&P 500 was under 20%. The technology sector is now 28%, not including Google, Facebook, and Amazon. This tends to ring alarm bells of a tech crisis, when technology's weight was 34% at its peak. Instead of focusing on the sector weight, we would emphasize the earnings per share (EPS) contribution of 24% today vs 16% in 2000. Technology companies are in a much stronger financial position, with an ability to grow market share and profits by rapidly spending more than their fragmented competition. This is a dramatic change that is expected to continue.

Over a similar time frame, we have also seen the weight of the financial sector reduced dramatically from 15% in 2017 to 10% in 2020. We emphasize caution when viewing the banks. Bank earnings power is dramatically reduced, not just because of low interest rates, but also due to fintech competition and government regulation. Banks remain heavily regulated, resulting in a lower growth trajectory. We do believe they offer SIRP (safety and income at a reasonable price), so there is still a place for banks in a diversified portfolio.

Our portfolios remain biased to growing companies, specifically technology, communications, consumer, and health care companies. Many of these are now defensive growth. There is a renewed emphasis on value stocks because of their cheaper characteristics. Some consider this growth phase to be over. We believe we are still in the early innings of a secular and defensive growth story.

To summarize, we believe one should not over-emphasize just one sector or a handful of companies with attractive growth rates and strong historical returns. Equities are most risky when one holds a concentrated portfolio. Instead, investors should own a diversified basket which can increase the probability of success, even during heightened volatility.

Tipping the Balance of Power in Asia

In the early 1970's, China and the United States seemed like an unlikely match. No formal communication or diplomatic ties had existed for 25 years. Henry Kissinger laid the groundwork for formal ties with a series of secret meetings in 1971. Richard Nixon then formally ended the public silence with a historic visit to China in 1972.

The two countries were driven together by a shared unease with the growing strength of the Soviet Union. It was a delicate balance to avoid offending Moscow while still leveraging the direct relations. The payoff was almost immediate. Both China and the U.S. received concessions from the Soviet Union. Ultimately, the direct relations allowed the U.S. to pressure China and the Soviet Union to limit their support to North Vietnam.

China benefits from a large population and low production costs for goods that the United States and other developed markets seek. As China's economic power has increased, so has their consumption of U.S. goods and technology. Both sides are sensitive to their reliance on the other.

The relationship between China and the U.S. has not been perfect, but it has significantly benefited both countries. In fact, it has been so successful that the two countries are now uneasy with the other's global influence. China has used its expanding wealth to flex its economic muscles and look to expand its military influence, particularly in Asia.

A New Partnership?

While China and the U.S. struggle to manage their relationship, they both seem to be eyeing a new partnership elsewhere. The recipient of this search may well be India. Based on their size and proximity to China, they have the potential to sway the economic and political balance of power in the region.

What's the appeal from the U.S. perspective?

- India has the population and potential to replace the manufacturing output of China.
- A shared foundation of democracy.
- A younger, highly educated population. The median age in India is 28, compared to 38 in China.
- With 1.4 billion residents, they are projected to pass China as the most populous nation within a decade.
- A young, educated, growing population is an ideal market for both the U.S. and China.

What's the appeal from India's perspective?

- An ally that can offer security against China's growing military strength.
- Elevated international standing.
- Continued investment in technology and infrastructure.
- Access to a wealthy consumer base for its goods and services.

While relations with China required significant thawing in the 1970's, current U.S. relations with India stand on more stable ground. The last two decades have brought strategic partnerships including food, technology, financial investment, and defense. It helps that both countries are established democracies and such a large portion of the population in India speaks English.

With all the positives, India still has its challenges. The development of the banking system has not kept pace with population growth. A weak banking system slows the flow of money, inhibiting reinvestment by business owners. This only complicates commerce in a country known for weak legal protections and an unwieldy bureaucracy. Fortunately, the challenges for India are areas of strength in the U.S. If the U.S. can continue assisting with investment and financial infrastructure, the economic growth potential for a young country of that size far surpasses the potential for growth in either the U.S. or China.

A Path Forward

For this to work, both sides will need to bend on their current protectionist mindsets. There are also delicate topics to address, such as different policy approaches to relations with China and Pakistan. The potential benefits of the relationship should allow for collaborative discussions on these sticking points.

Fifty years ago, the U.S. needed China to counterbalance the Soviet Union. Now the U.S. may need India to counterbalance China. The foundation for relations has been laid by prior administrations. Continued progress will take time and the results are not guaranteed, but the potential is there to sway the balance of power in Asia.

Key Market Themes

The Economic Growth Stage

- Market levels and earnings ratios suggest late stage economic growth
- Most other indicators point to early stage:
  - accommodative Fed
  - continued fiscal policy support
  - low interest rates
- Expect highly volatile GDP reports during economic recovery
- Liquidity-driven rally supports continued growth
- Demographics and productivity suggests structural economic growth below 2%

Monetary/Fiscal Policy and Interest Rates

- Fed accommodation lasts longer than expected, maintaining "Goldilocks Economy" (low growth/inflation)
- Fed sets bar higher for future bond purchase programs with the recent corporate bond purchases
- Monetary/Fiscal policy nominal figures dwarf 2008 levels
- Budget deficit temporarily overlooked to support impacted consumers and businesses
- Risk that higher future rates, with current debt levels, will harm long-term growth

Profits vs Valuations

- Low interest rates support higher valuations
- Equity valuations more attractive than bonds
- Emerging markets remain an opportunity
- Global supply chain disruption cost weighs on profits
- Debt levels limit productive growth potential
- Priority turns to strong balance sheets with higher default risks

It is a challenge to predict broad market movements. The year 2020 was a powerful reminder. How many experts were predicting a pandemic-driven recession? The market retreat and following recovery was unprecedented in its scale and speed. Attempting to time the top or the bottom would have been a dangerous task. A diversified portfolio and a disciplined approach to opportunities proved to be a much more appropriate response.

Please feel free to reach out with any questions or comments. We would love to hear your thoughts.

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All portfolios have the same core discipline but may be impacted by the views above to different degrees. Some use individual stocks, individual bonds, mutual funds, exchange traded funds, or are a combination of all of these security types. We customize each portfolio by considering other holdings, liquidity needs, different tax brackets, risk tolerance, financial goals, etc. The views expressed in this newsletter accurately reflect CMH Wealth Management's opinions about the investments and/or economic subjects discussed. This publication is designed to provide general information about economics, asset classes and strategies. It is for discussion purposes only since the availability and effectiveness of any strategy is dependent upon individual facts and circumstances. The information contained herein has been obtained from sources believed to be reliable, but we cannot guarantee its accuracy or completeness. Opinions and estimates expressed herein are as of the date of the report or the date referenced and are subject to change at any time.