Bitterroot
CAPITAL ADVISORS

Memorandum

To: BCA Clients and Friends
From: Sid Nadkarni, BCA CIO
Date: January 18, 2021
Subject: Recent Market Events – and Looking Forward

UPDATE OF MARKET DEVELOPMENTS AND OUR VIEWS

Dear BCA Clients and Friends,

Happy New Year! We hope everyone enjoyed the holiday season and are staying safe and healthy. 2020 was an unprecedented year in terms of a global health pandemic and financial markets' reaction to the pandemic and other global events. The end of 2020 has brought a simultaneous dose of elevated near-term COVID-related pain and suffering (due to the virus' aggressive resurgence) as well as hope (in terms of extremely positive vaccine trial data and expectation of worldwide mass rollout by the second half of 2021). Equity markets rallied significantly to close the year following the positive vaccine trial announcements (beginning Nov. 9, 2020) and the US presidential election. As we begin 2021, we want to brief you on market and economic developments, highlight the political and health backdrop, and update you on our views going forward.

Equity Markets Performance

In 2020, global markets appreciated 16.3%, with US equites outperforming international developed markets (17.7% vs. 7.7%) and emerging markets also performing strongly (+18.2%), mainly led by high returns in Asian markets. On the one hand, this is hard to believe given that 2020 corporate earnings were 20%-35% lower than those achieved in 2019 (originally forecast to grow 8%-10%). However, markets are forward-looking in nature and have viewed the earnings decline as a short-term event completely brought on by the global pandemic. Since the March 23rd lows, global markets have steadily appreciated 60%-70% with an especially strong rally to close the year. Several events drove the highly positive risk-on sentiment to close the year including:

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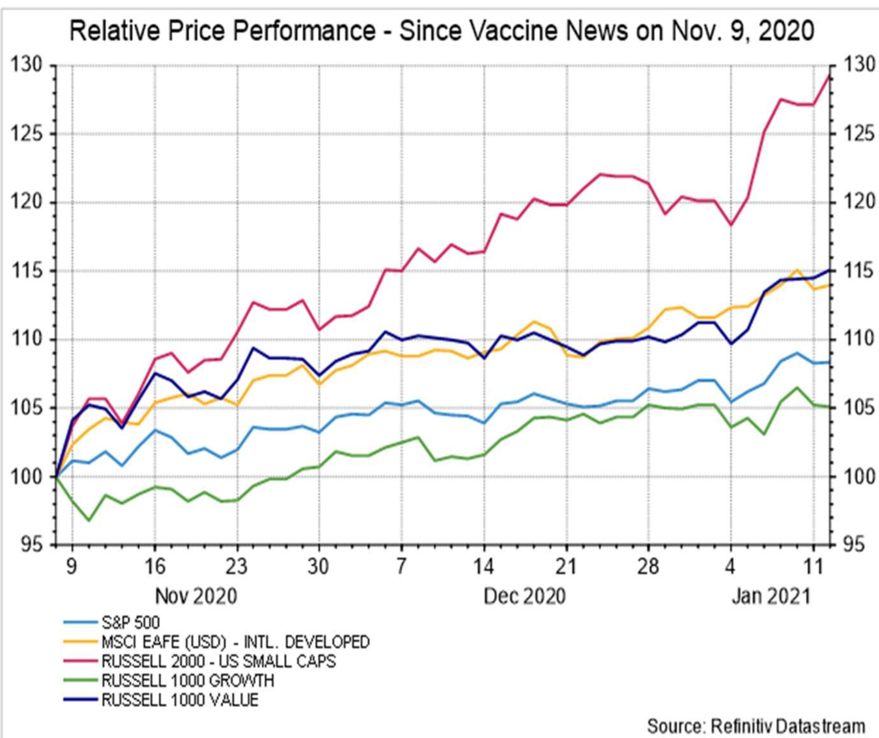
- Vaccine trial data: Beginning on Nov. 9th, 2020, several vaccine developers (Pfizer, Moderna, and Astra Zeneca) released significantly positive vaccine trial data. The efficacy profile of these vaccines proved much higher than initially expected and rollouts for tiered distribution began prior to year-end. It is widely expected that most of the population in the US and Europe will have vaccine availability by the fall of 2021. As such, markets have begun to price in a sharp return to economic and behavior normalcy by the back half of 2021 and continuing into 2022.
- Economic data and corporate earnings: Economic data for the most part continued to surprise to the upside through Q4, especially in terms of manufacturing data. Companies generally easily beat Q3 earnings expectations and their outlooks for Q4 also surpassed analyst forecasts as well. This positive economic and corporate earnings data occurred despite rising COVID cases and hospitalization and death rates.
- Favorable political outcomes: The US presidential and senate elections resulted in a potential "Goldilocks" scenario with a Joe Biden presidential victory coupled with a high likelihood for either a split congress or a Democratic sweep accompanied by significant increases in fiscal stimulus. Market consensus appears to be, for either scenario, large-scale policy actions perceived as unfriendly to business (increased regulation and a rise in corporate tax rates) were unlikely to pass. Ultimately, the Democrats emerged with control of both houses of Congress following the Georgia elections. Additionally, the UK and Europe reached a Brexit deal thus avoiding a chaotic no-deal scenario.
- Continued fiscal stimulus and easy monetary policy: Governments across the world continued to deploy additional fiscal stimulus to combat further COVID-resurgence and disruption. The US recently passed another $900B in stimulus with additional outlays highly likely in the new year, especially given the recent Democratic Senate majority in Congress. Central banks have committed to maintaining lower-for-longer interest rates and continuing to repurchase fixed income securities.
- Positive China recovery trajectory – Economic data continued to improve throughout the year in China. Consumption growth is now beginning to catch up to manufacturing growth within China, and thus far China has not experienced a significant flare-up in COVID cases.

For most of 2020, the trends of the past three years continued and even accelerated. US stocks outperformed international stocks and growth stocks meaningfully outperformed value stocks.



However, since the highly positive vaccine news beginning Nov. 9, 2020, equity markets have witnessed geographic and style rotations. Intl. stocks have outperformed US stocks and US Small Caps have sharply outperformed US Large Caps.

Although there has been reasonably high outperformance over a short time period, we believe that the value / cyclical rotation still has further legs given the current macroeconomic backdrop.

Equity Market Valuations and Outlook Going Forward

As seen below, consensus earnings estimates forecast sharp recoveries in 2021 (still disrupted by the pandemic) and 2022 (likely to be the first full-year post wide-scale vaccine distribution). Based upon significant consumer pent-up demand, likely business inventory restocking, and natural operating leverage that tends to manifest itself at corporations immediately post recessions, the earnings estimates seem plausible (especially in the US, whereas EM and European estimates may appear more optimistic). That being said, several risks to achieving these estimates remain including: a) increasing severity of the virus with new strains potentially requiring large-scale lockdowns, b) longer-than-expected timeframe for mass vaccine availability, c) lower-than-expected vaccine adoption rate, and d) unexpected policy changes such as increases in corporate tax rates.

	Consensus - Equity Market Earnings Est.					Equity Markets Valuation Multiples				
	1/13/2021 Index Price	Pre-Covid "Trend"* Earnings	Cons 2020 Earnings	Cons. 2021 Earnings*	Cons. 2022 Earnings*	Trailing 2020 P/E	2021 P/E	2022 P/E	Last 20 Yr Avg. NTM P/E	Last 10 Yr Avg. NTM P/E
US Large Cap (USD)	3,810	180	140	164	191	27.3x	23.2x	19.9x	16.0x	15.9x
Stoxx 600 Europe	409	27	17	23	26	23.4x	18.1x	15.5x	13.0x	13.7x
MSCI Japan	1,144	75	48	63	74	23.7x	18.2x	15.4x	14.0x	13.6x
MSCI EM (USD)	1,354	78	63	83	97	21.5x	16.3x	14.0x	11.3x	11.4x
US Small Cap **	1,215	56	33	50	67	36.7x	24.4x	18.1x	17.2x	18.4x
Russell 1000 Growth	2,434	76	69	76	86	35.3x	31.9x	28.3x	18.8x	19.2x
Russell 1000 Value	1,394	85	59	72	85	23.8x	19.2x	16.4x	14.1x	14.4x

** Trend Earnings based on 2020 est. pre-COVID. 2020, 2021, and 2022 EPS estimates are based on current consensus forecasts*
*** We have used the S&P 600 Small Cap rather than the Russell 2000 given the high % of Russell 2000 companies with negative earnings*

2021 equity valuation multiples are well above recent historical averages as investors understand that COVID will continue to hamper full economic recovery and corporate earnings are not yet "normalized". However, even based on 2022 earnings forecasts which do largely project a post-vaccine earnings trajectory, valuations still remain above historical averages. That being said, low interest rates and high levels of fiscal stimulus could support these elevated valuations.

Consensus Earnings Forecasts as % of Pre-Covid Trend Earnings

	Cons. 2020 Earnings*	Cons. 2021 Earnings*	Cons. 2022 Earnings*
US Large Cap (USD)	77.5%	91.1%	106.4%
Stoxx 600 Europe	64.6%	83.5%	98.0%
MSCI Japan	64.8%	84.2%	99.5%
MSCI EM (USD)	80.8%	106.4%	124.4%

Based on current valuations, markets seem to have already priced in a lot of positive news.

- Consensus earnings forecasts for 2021 project significant YOY growth over 2020 (the resurgence of Covid may render these forecasts as overly optimistic.)

- Forecasts for 2022 earnings are well above the pre-Covid 2020 expected results and valuations are elevated across all markets (even on 2022 earnings) vs. historical levels.
- However, the combination of low short-term and still-low long-term interest rates coupled with increasing stimulus may result in higher valuations persisting over the next couple of years. On the other hand, if inflation increases faster than people expect and 10-year yields rise rapidly, valuation multiples may contract.

Shorter-Term (12-18 months view)

In the US, politics play in important role in our short-term view. With the democratic sweep post the Georgia senate elections, we believe that increased fiscal stimulus is highly probable and potentially a bi-partisan infrastructure spending bill is possible as well. At the same time, the extremely narrow Democratic Senate majority makes it less likely that ultra-progressive policies favored by the progressive wing of the Democratic Party are enacted in the short-term. We will continue to monitor potential policy developments going forward.

Amidst this backdrop, *we continue to expect cyclical, value stocks (financials, industrials, materials, and energy) to continue outperforming high quality and structural growth stocks*, as these cyclical stocks should experience sharper earnings recoveries. The market has certainly already priced in some of this dynamic (given the strong outperformance of value and small-caps stocks post vaccine news on Nov 9th). As such, the outperformance may not be linear and will likely be subject to periodic bouts of volatility and performance reversals.

We also expect that international developed stock markets (Europe and Japan) may outperform the US as both markets have greater exposure to cyclical sectors and to an expected uptick in world trade. Within emerging markets, we may see a rotation from 2020 where laggards such as Latin America and Russia (greater exposure to cyclical companies) outperform the Asian stock markets (China, Korea and Taiwan's 2020 stock performance was well above the overall EM index).

Over the next 12-18 months, we believe equity markets have a reasonably wide range of outcomes as seen in the following matrix for the S&P 500.

- Our base case forecast is for mid-to-high SD returns in 2021 as strong earnings growth is offset by modest multiple contraction.
- Mid-teens appreciation is possible if high levels of stimulus coupled with faster-than-expected vaccine distribution unleashes significant pent-up demand. Under this scenario, earnings may continue to sharply exceed expectations and analysts ratchet 2022 earnings projections upwards.
- On the other hand, 10%+ declines are possible if large-scale lockdowns are re-instituted for long time periods, vaccine distribution and vaccine adoption take longer

and comes in below expectations, and if government pursues business-unfriendly policies. (For reference, the S&P500 is now at 3800.)

		S&P 500 - Forward P/E Multiple				
		18.0x	19.0x	20.0x	21.0x	22.0x
	180	3,240	3,420	3,600	3,780	3,960
	185	3,330	3,515	3,700	3,885	4,070
S&P 500	190	3,420	3,610	3,800	3,990	4,180
2022	195	3,510	3,705	3,900	4,095	4,290
Earnings	200	3,600	3,800	4,000	4,200	4,400
	205	3,690	3,895	4,100	4,305	4,510
	210	3,780	3,990	4,200	4,410	4,620

		S&P 500 - Forward P/E Multiple				
		18.0x	19.0x	20.0x	21.0x	22.0x
	180	-15.0%	-10.2%	-5.5%	-0.8%	3.9%
	185	-12.6%	-7.7%	-2.9%	2.0%	6.8%
S&P 500	190	-10.2%	-5.2%	-0.3%	4.7%	9.7%
2022	195	-7.9%	-2.8%	2.4%	7.5%	12.6%
Earnings	200	-5.5%	-0.3%	5.0%	10.2%	15.5%
	205	-3.1%	2.2%	7.6%	13.0%	18.4%
	210	-0.8%	4.7%	10.2%	15.8%	21.3%

Mid-term (7 Year views)

Given the elevated valuation levels relative to history, our mid-term equity market return expectations (7-year forecast) are muted. We presently forecast pre-tax average annual nominal returns of 5.0%-7.0% for equity markets over this period, below the high single-digit returns historically achieved.

- *We believe that risk factors are higher than normal* given the unprecedented level of fiscal debt, the potential for unforeseen effects such as faster-than-expected inflation, historically low interest rates with limited scope for reduction, rising income inequality and potential corrective policy actions, and elevated equity valuations.
- Overall, we *generally forecast mid-to-high-single digit annual earnings growth offset by valuation multiple contraction* (we still assume modestly higher than historical multiples at the end of our forecast period to account for structural changes in market composition towards higher quality companies and because we believe interest rates will remain below historical norms).
- We continue to *expect convergence between US and international equity returns* (unlike the prior seven-year period which was characterized by sharp US relative outperformance).
- Finally, we still *advocate a general bias towards higher-quality companies* with above-average structural growth potential. We believe these companies will continue to deliver low-to-mid-teens annual earnings growth (superior to that expected for lower-quality more cyclical companies) over the forecast period. This “earnings growth spread” should offset potential valuation multiple compression over the forecast period.

Suggested Actions

While execution of these actions remains client-specific and individual considerations such as tax implications and liquidity considerations need to be taken into account, we continue to advocate the following:

Public Equities

- Potentially reduce overall public equity allocation and add to private market exposure
- Add international developed and reduce US exposure if warranted
- Add cyclical and value exposure and reduce quality / growth exposure
- Selectively add best-in-class active managers
- Balance mid-term perspective with shorter-term tactical outlook in terms of weighting

Private Markets

We believe that the return potential for private equity (13%-15%) and private credit (high-SD to low DD) is far higher over the next seven years than that for public equities and publicly traded credit. As such, we recommend the following:

- Commit to implementing multi-year annual private equity and private credit programs with goal of increasing “steady-state” asset allocation targets.
- Overcommit in early years to take advantage of positive near-term vintage year dynamics (since commitments will be drawn over multiple years).
- Diversify across various PE strategies (buyout, secondaries, and co-investment) and Private Credit strategies (direct lending and stressed / distressed credit).

Lastly, our Q4-‘20 Quarterly Review, available in a few weeks, will cover these topics and other asset classes as well.

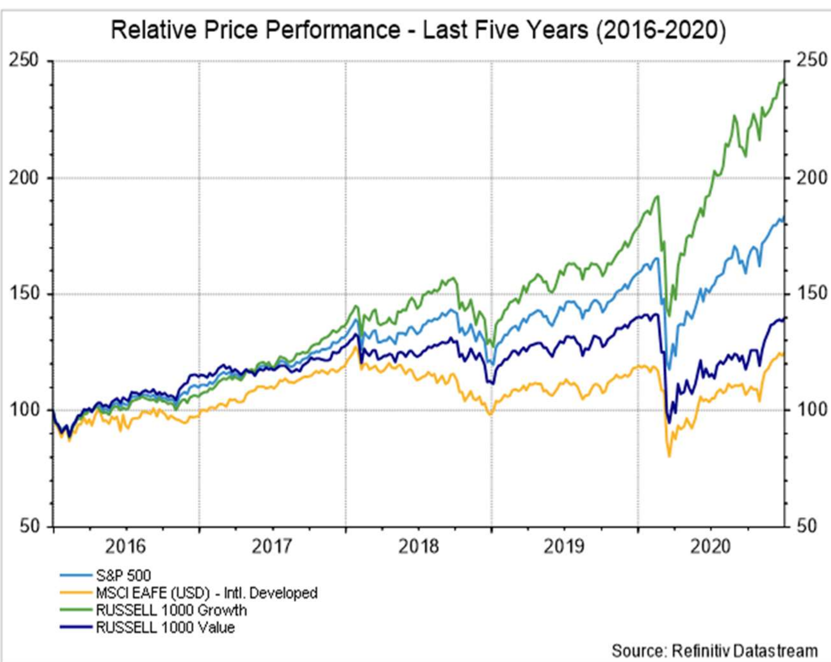
Appendix

Equity Market Performance (USD)

	2020 Full-year	2/19/20 3/23/20	23-Mar 12/31/20	11/9/20 1/12/21
MSCI ACWI	16.3%	-33.6%	70.5%	11.5%
US Large Cap	17.8%	-33.8%	69.5%	8.6%
MSCI EAFE (Intl. Dev.)	7.8%	-32.7%	61.4%	14.2%
MSCI Emerging Mkt.	18.3%	-31.2%	73.5%	15.3%
Russell 1000 Growth	38.5%	-31.5%	84.9%	5.2%
Russell 1000 Value	2.8%	-38.1%	64.2%	15.7%
US Large Cap	17.8%	-33.8%	84.9%	8.6%
US Small Cap	20.0%	-40.7%	99.1%	29.7%

Overall, in 2020, US large caps outperformed international developed markets and growth stocks (Russell 1000 Growth) dominated Value stocks (Russell 1000 Value), largely continuing themes witnessed over the past three years.

However, post the highly positve vaccine news beginning Nov. 9th, international developed markets have outperformed US large caps, Value stocks have outpeformed growth and US small caps have sharply outperformed large caps. As we have flagged since earlier in the fall, markets are increasingly rotating towards cyclical, value stocks whose operating fundamentals inflect positively during early periods of economic recovery.



Over the past five years, US markets have substantially outperformed international markets and Growth stocks have sharply outperformed Value stocks.

During this period, global growth has been slower than historical standards and uneven geographically, interest rates have remained near historical lows and geopolitical tensions (Brexit, China trade war) have increased. This backdrop paved the way for the substantial US and growth stock outperformance.