Westshore Wealth *Insights*

The Great Rotation

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WESTSHORE WEALTH

The Great Rotation

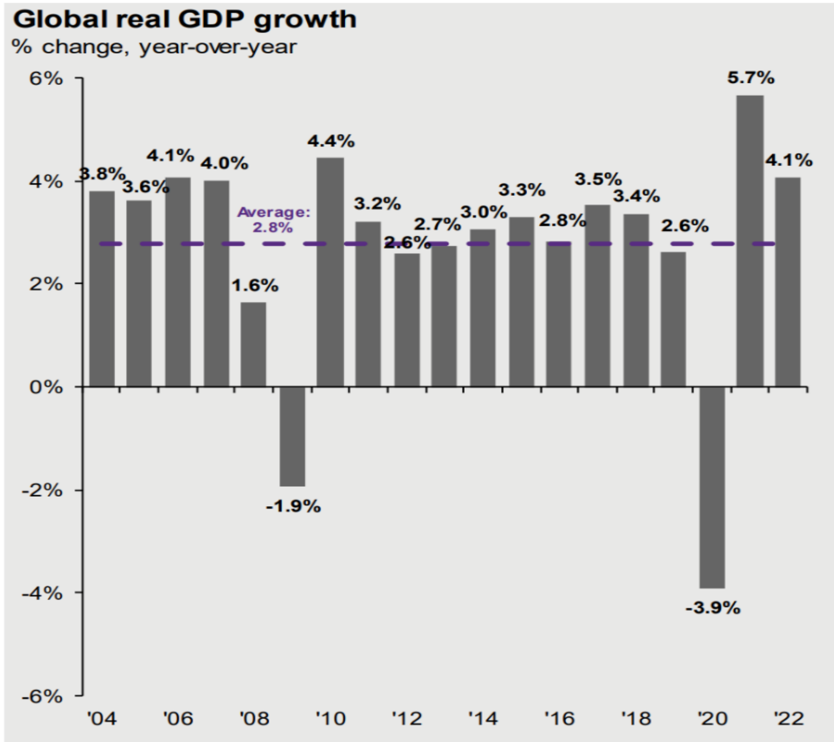
If the stock market were a song, Bob Dylan's, *The Times They are a Changing,* is the tune that it would be singing. Just as Dylan's lyrics foreshadow a cultural passing of the baton, current action in markets is signaling a powerful sector and stylistic transition ahead in 2021, something that we have thematically begun to call, "The Great Rotation." From our vantage point, we believe long-tailed outperformance trades of large capitalization stocks over small cap, growth over value, US over International/Emerging Market equities, and finally long duration bonds over short duration bonds are all showing signs of reversal. While a "set it and forget it" investing strategy has prevailed for many years, we think we are entering a compositional change.

Before we fast forward to the changes we foresee, let's first examine the prevailing trend of the last ten years. The conclusion of the Global Financial Crisis was pivotal in setting the stage for much of the investor tilt that we have observed over that period. Specifically, the collapse of the housing market stressed our banking system to the point of failure. While catastrophe was averted with the implementation of the Troubled Asset Relief Program (TARP), it set the stage for a dramatic behavioral shift. Banks were forced to shrink the size of their lending book at the same time that regulatory changes compelled them to set aside additional buffer capital. Lending standards became much more stringent and credit extension slowed dramatically. At the same time, US consumers, significantly over-indebted, started to save more and retire some of their debt obligations. When combined, the result was one of the most anemic post-recessionary growth periods in history.

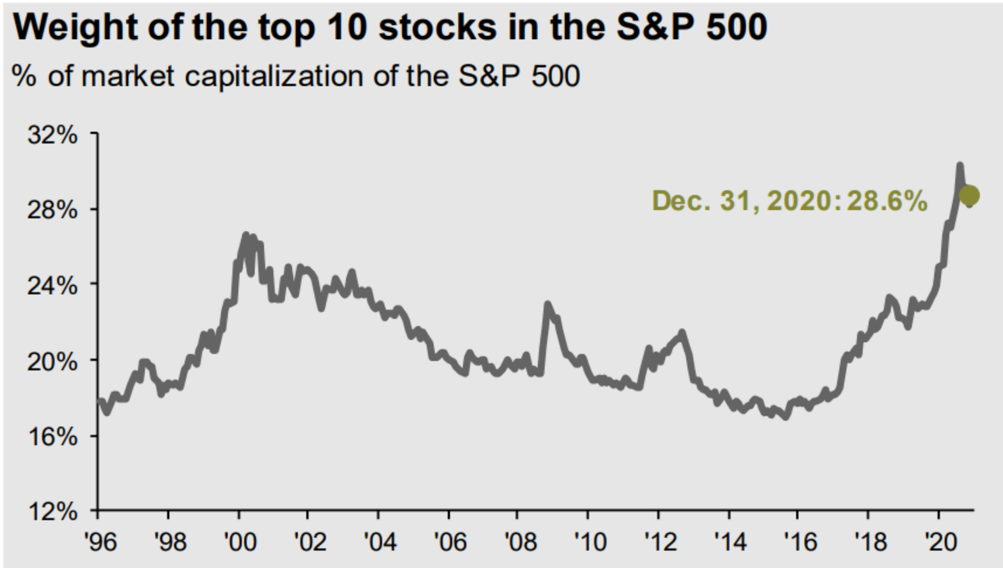
Now let's explore how that reinforced some of the outperformance trades that we outlined above. First, large, well-capitalized companies, feasted on their small, under-funded competitors who had trouble accessing lending markets. Large companies were able to take market share and grow their earnings at a faster rate than peers. Voila, the large versus small cap trade was born. With anemic economic growth, there was a scarcity of stocks that were able to produce positive earnings momentum. Investors gravitated to those stocks that could deliver growth at the expense of cheap stocks whose financials remained stagnant, reinforcing the growth over value theme. With US consumers retrenching, and the US representing roughly 25% of world economic output, export markets slowed for foreign and emerging market companies. Once again, investors sought out companies with outperforming financials and that lead them to dramatically overweight US companies relative to foreign peers. Finally, sluggish economic conditions allowed interest rates to continue to move lower, favoring long dated Treasuries over shorter maturities.

With that backdrop, what are the forces in place that would drive a reversal of these trends? We believe there are three major thematic changes on the horizon. First, sustained government spending coupled together with aggressive monetary policies across the globe will accelerate economic growth meaningfully. Second, falling unemployment, substantial accumulated savings, rising wealth, and considerable pent-up demand will unleash a powerful consumer spending boom. Third, we believe we are on the cusp of a structural increase in interest rates. The disinflationary trend of the past generation may give way to a surprising resurgence of inflation by mid-year.

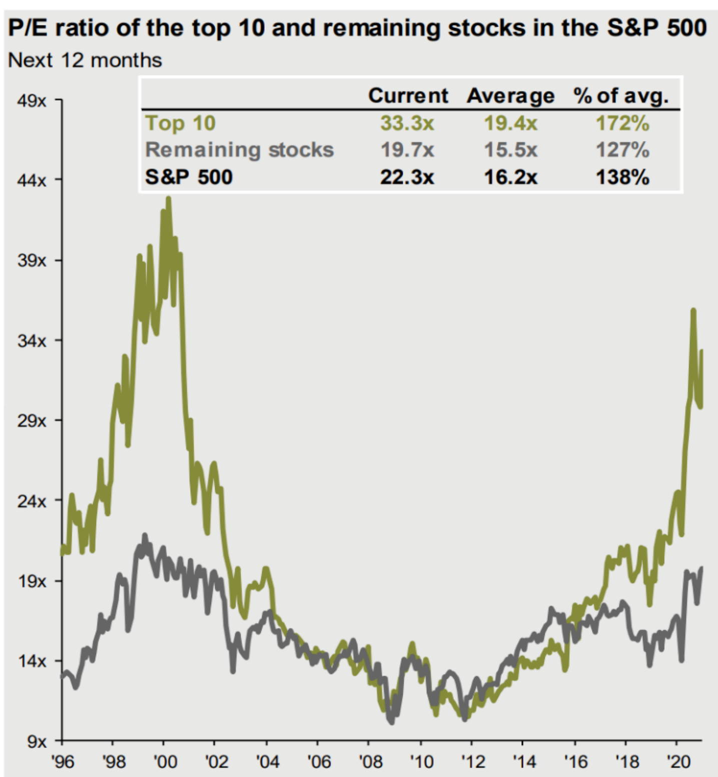
The fiscal response to the COVID-19 pandemic was massive in all respects. Globally, nearly $30 trillion was spent by sovereign governments to avert a depression outcome, with the US at the top of the list. The injection was so large that it offset contractionary effects that are typical of such downturns. The result should set the table for growth to meaningfully inflect higher once broad scale vaccination has taken place. Consensus growth estimates for Global GDP now project that 2021 and 2022 will grow 5.7% and 4.1%, respectively. That will represent the fastest pace in the last decade.



Much like a rising tide lifts all boats, accelerating global growth should lend a powerful tailwind to unloved companies and geographies that have languished relative to concentrated bets that investors have made on US, large capitalization, growth names. The following charts depict how extreme that positioning has become. Presently, 10 stocks in the S&P 500 account for 28.6% of the market capitalization of the index. That is above the extremes achieved during the Dot.com bubble of 2000.



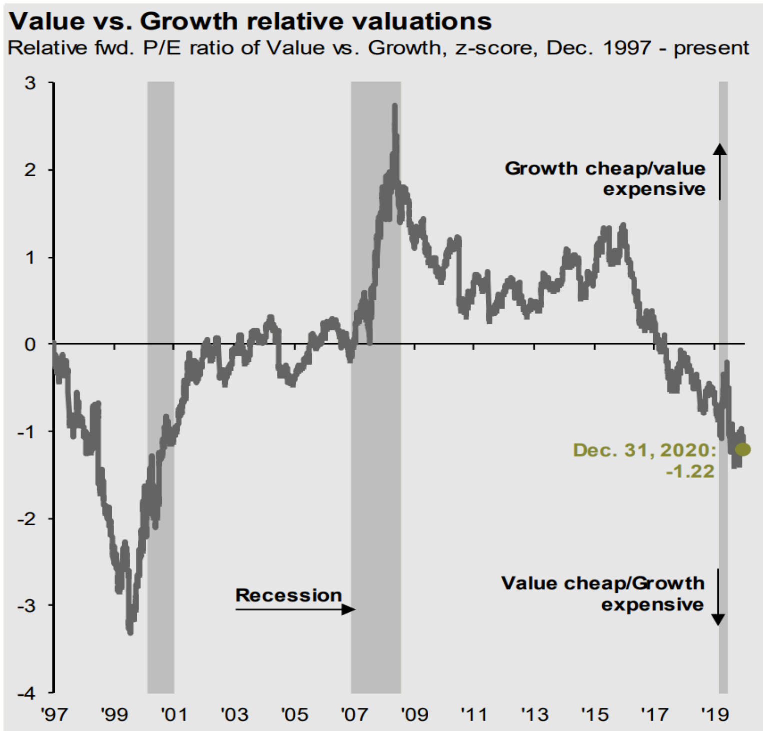
Additionally, the top 10 names trade at a 70% premium valuation relative to the bottom 490 when measured by their price/earnings multiples. The average premium is closer to 25%.



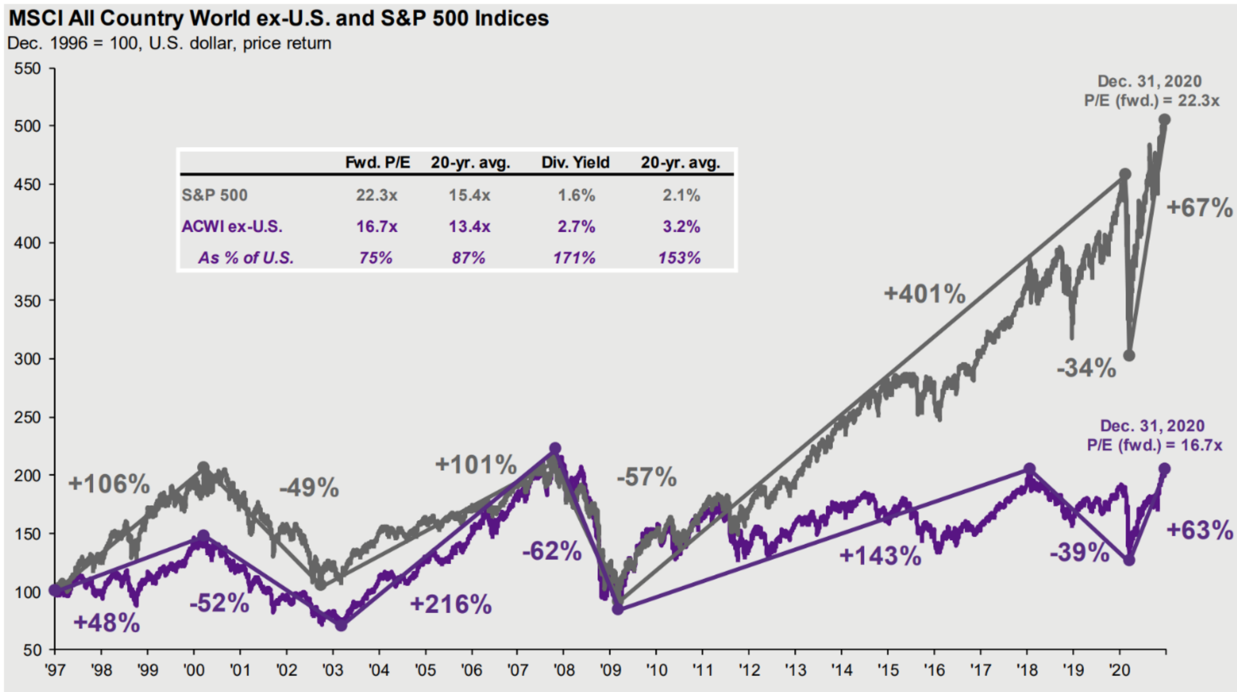
When we examine investment factor analysis, it confirms this dramatic investor tilt. Value and small cap factors have delivered some of the worst performance figures of the past fifteen years while momentum (following the winners) strategies have delivered the best (see the second to the column from the right).

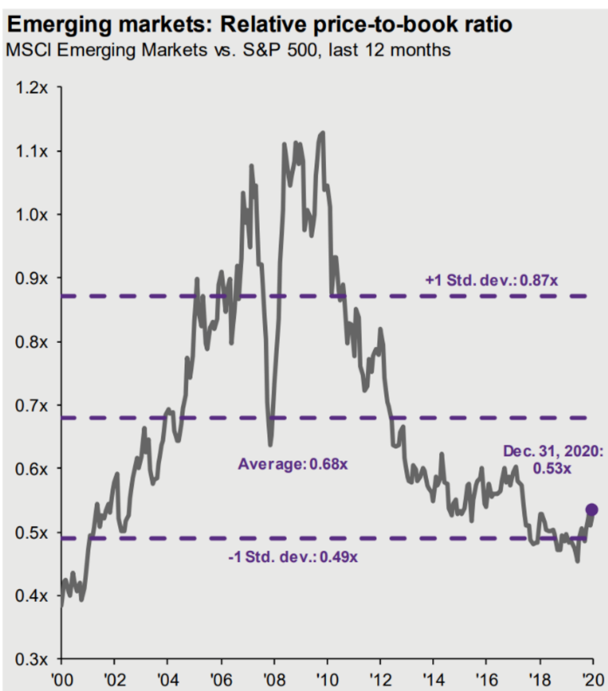
																2006 - 2020	
2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Ann.	Vol.
Momen. 19.3%	High Div. 21.1%	Momen. 17.8%	Min. Vol. -25.7%	Value 38.8%	Small Cap 26.9%	High Div. 14.3%	Cyclical 20.1%	Value 43.2%	Value 17.7%	Momen. 9.3%	Small Cap 21.3%	Momen. 37.8%	Min. Vol. 1.5%	Cyclical 36.3%	Momen. 29.6%	Momen. 11.7%	Small Cap 22.6%
Multi-Factor 15.7%	Value 19.7%	Defens. 17.7%	Defens. -26.7%	Cyclical 36.9%	Multi-Factor 18.3%	Min. Vol. 12.9%	Value 16.8%	Small Cap 38.8%	Min. Vol. 16.5%	Min. Vol. 5.6%	High Div. 16.3%	Cyclical 27.3%	Momen. -1.6%	Quality 34.4%	Cyclical 27.8%	Quality 10.7%	Value 20.3%
Value 13.2%	Small Cap 18.4%	Quality 10.1%	High Div. -27.6%	Multi-Factor 29.8%	Momen. 18.2%	Defens. 10.1%	Small Cap 16.3%	Multi-Factor 37.4%	High Div. 14.9%	Quality 4.6%	Value 15.9%	Quality 22.5%	High Div. -2.3%	Momen. 28.1%	Small Cap 20.0%	Cyclical 10.4%	Cyclical 19.8%
Defens. 11.1%	Multi-Factor 16.6%	Multi-Factor 5.5%	Quality -31.2%	Small Cap 27.2%	Cyclical 17.9%	Quality 7.5%	Multi-Factor 15.7%	Cyclical 35.0%	Multi-Factor 14.8%	Cyclical 2.6%	Cyclical 14.0%	Value 22.2%	Defens. -2.9%	Min. Vol. 28.0%	Quality 17.1%	Min. Vol. 10.1%	Momen. 17.9%
Min. Vol. 6.6%	Defens. 15.9%	Min. Vol. 4.3%	Small Cap -33.8%	Quality 24.9%	High Div. 15.9%	Multi-Factor 7.3%	Momen. 15.1%	Momen. 34.8%	Momen. 14.7%	High Div. 0.7%	Multi-Factor 13.7%	Multi-Factor 21.5%	Cyclical -5.3%	Value 27.7%	Multi-Factor 11.4%	Multi-Factor 9.6%	Multi-Factor 17.5%
Quality 5.4%	Cyclical 15.0%	Value 1.1%	Value -36.9%	High Div. 18.4%	Min. Vol. 14.7%	Momen. 6.1%	Quality 12.8%	Quality 34.3%	Cyclical 13.6%	Multi-Factor 0.4%	Min. Vol. 10.7%	High Div. 19.5%	Quality -5.6%	Multi-Factor 26.6%	Min. Vol. 5.8%	High Div. 9.4%	Quality 15.6%
Small Cap 4.6%	Min. Vol. 15.0%	High Div. 0.0%	Multi-Factor -39.3%	Min. Vol. 18.4%	Quality 14.2%	Value -2.7%	Min. Vol. 11.2%	High Div. 28.9%	Defens. 13.0%	Defens. -0.9%	Quality 9.4%	Min. Vol. 19.2%	Multi-Factor -9.7%	Small Cap 25.5%	Defens. 5.2%	Small Cap 8.9%	High Div. 15.0%
High Div. 3.7%	Quality 12.8%	Cyclical -0.8%	Momen. -40.9%	Momen. 17.6%	Value 12.7%	Cyclical -3.4%	Defens. 10.7%	Defens. 28.9%	Quality 10.7%	Small Cap -4.4%	Defens. 7.7%	Small Cap 14.6%	Small Cap -11.0%	High Div. 22.5%	High Div. 1.7%	Defens. 8.6%	Defens. 13.7%
Cyclical 2.5%	Momen. 10.7%	Small Cap -1.6%	Cyclical -44.8%	Defens. 16.5%	Defens. 12.0%	Small Cap -4.2%	High Div. 10.6%	Min. Vol. 25.3%	Small Cap 4.9%	Value -6.4%	Momen. 5.1%	Defens. 12.3%	Value -11.1%	Defens. 21.4%	Value -0.2%	Value 8.6%	Min. Vol. 13.1%

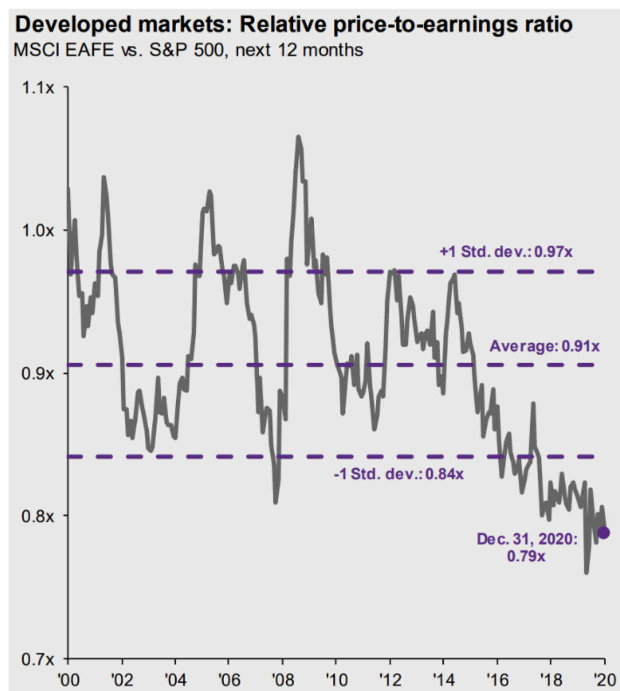
Again, this is borne out by the valuation disparity that has developed with ten years of growth over value outperformance.



Finally, the outperformance of US markets relative to international and emerging markets is staggering and has set up valuations that are statistically cheap relative to historical norms. Our bottom line is the following. If global growth re-accelerates meaningfully, many of these trends are set to reverse.

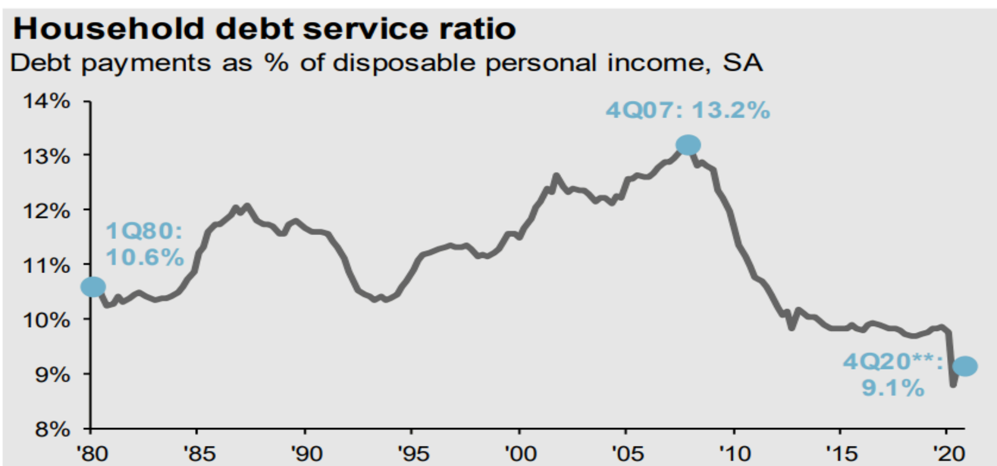


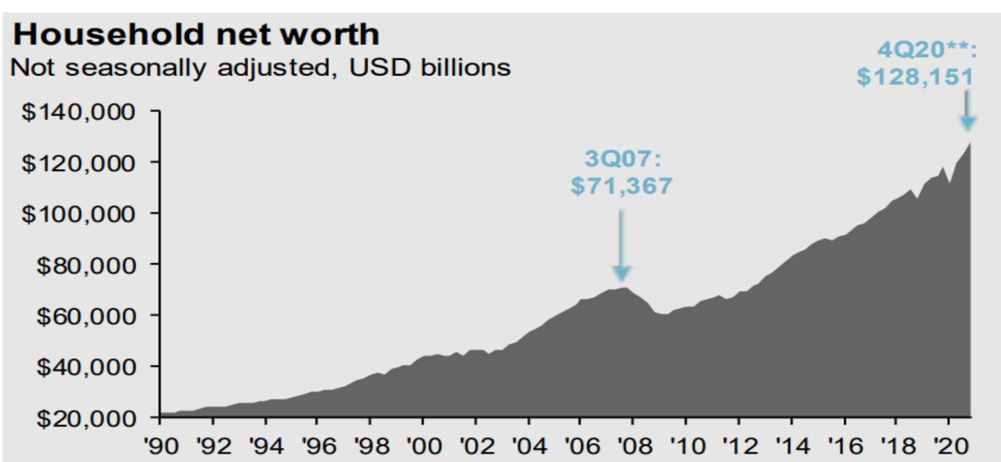




The second major structural change revolves around our thesis that consumer spending is poised to boom in 2021. While highly atypical following an economic downturn, we believe unprecedented fiscal stimulus (e.g. enhanced unemployment benefits, the Payroll Protection Plan, and direct payments) has bridged income shortfalls for many. As Federal Reserve Vice

Chairman Richard Clarida remarked recently, "never before has disposable income actually gone up in a deep recession," such as it has during this contraction. And the stage is set for this to improve further. Unemployment has already more than halved since the April peak (14.7% to 6.7%). Vaccinations should enable lost service jobs to come back online, furthering the trend. Meanwhile, by forcing parts of the service economy to close, consumer savings rates spiked from the low 7% range, pre-pandemic, to over 30% in April 2020. While moderating back down to the mid-teens, they still reside at generational highs. It is estimated that consumers have accumulated over $500 billion in excess savings since the beginning of the crisis. Finally, interest rates have been coming down and financial assets have been going up. The net result is that consumer debt service as a % of disposable income has plunged while household net worth has appreciated to record highs.





When we sum all these factors up, we believe there is going to be massive consumer spending from pent-up demand once people get comfortable that their safety risk has been reduced through vaccination. We expect to see burgeoning demand for air travel, leisure hotels, and cruising. We expect entertainment venues like theme parks, movie theaters, and concert halls to be overwhelmed. Restaurants, bars, and other service establishments should see their bookings accelerate to the point that they have to turn away traffic nightly. Finally, shopping malls and other retailers should start to see their traffic increase. Bottom line, this should once again reinforce the theme that the economic recovery will be broad. The earnings recovery that we project should be strong and not simply be confined to a few stay-at-home enablers.

The final thematic shift that we see on the horizon is the directionality of interest rates and the possibility that inflation starts to percolate in the 2nd half of 2021. Keep in mind, the Federal Reserve has been running at full speed with regard to monetary accommodation since the pandemic began. Not only have they reduced the Federal Funds rate effectively to 0%, but they have been aggressively buying back Treasuries, mortgages, municipals, and even corporate bonds. They have been extending loans under their Main Street Lending Program directly to small and mid-size corporations. All told, this has allowed the money supply (defined as M2), to grow at a 25.9% year over year pace. While that figure probably is a bit meaningless to most, as a frame of reference, this is nearly 2x the previous high (+13.8%), encountered in the 1970s. For those old enough to recall, that was the last time the US encountered a hyperinflation event. <u>To be sure, that is not what we are calling for at this point</u>. We simply believe that strong economic growth, coupled together with a consumer spending boom, could prove to be a trigger to cause prices to directionally inflect higher. This is simple to understand when you think about it in terms of a real-life example. If everyone feels safe again and decides to take their family to ______ (fill in the blank here with your favorite pastime or destination….Disney, Hawaii, a movie, a concert, a restaurant), it is going to overwhelm supply. Disneyland can only hold so many patrons at once. The same applies for movies theaters, concerts halls, restaurants, etc. Economics 101 tells us that when demand overwhelms supply, vendors generally raise price. We think that is a likely scenario in the 2nd half of 2021 once broad vaccination is complete and consumers' pent up demand for services in unleashed. Given that interest rates generally follow prices, if we get a bit of inflation, rates are likely to go higher. If this plays out, longer maturity bonds will likely suffer capital depreciation and as such we will need to be careful how we compose the ballast portion of our portfolios.

Our anticipation is that this essay will likely initiate a few questions. Some of the more obvious probably include the following. What are we doing at Westshore to prepare our clients for this transition? Does this mean I should expect massive changes in my portfolio? What if Westshore Wealth is wrong and these themes don't play out? First and foremost, please understand that most of what we described above will be accomplished by letting the winners run. Our portfolio allocation already includes all equity market capitalizations, all stylistic tilts, including growth and value, as well as exposure to international and emerging markets. Most of the themes described above started to exert themselves in 4Q20, and as such, their weightings in your respective portfolios has increased. We will simply allow that to climb. If we continue to be correct, that means the portfolio will naturally tilt to favor our viewpoint. If we are proven wrong, we have exposure on the other side of the barbell. With regard to fixed income, we expect that theme to play out by mid-2021. That said, we have already made most of the transition. We are generally devoid of longer-term Treasuries and long on adjustable-rate instruments. We do have exposure to municipal and corporate bonds, but those maturities are generally in the 5-7 year range. We anticipate they could be impacted by an interest rate rise, but that should, at least partially, be offset by an improvement in their credit worthiness if growth accelerates as we expect. All told, we are taking measured steps with the goal of continuing to deliver solid, risk-adjusted returns. Should you have follow-up questions, please let us know.

Important Disclosures

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