

Year-In-Review – Before we start discussing the markets and financial issues, all of us at Gemmer want to extend our best wishes to everyone during these trying times. We hope you and your family have stayed healthy and safe the last few months. Generally, when we write these pieces we go back to past letters to assess how accurate our views at the time were and analyze what we missed. This is as much an exercise in humility as anything else as it generally shows how cloudy our (and everyone else’s) crystal ball typically is. Well, nobody’s crystal ball was working this time last year as hints of a new virus were starting to trickle out. Actually, looking back on 2020 brings to mind Mike Tyson’s quip that ‘everyone has a plan until they get punched in the mouth.’ And 2020 took a solid swing at everyone. I think most of us, if told at the end of 2019 what would unfold last year and were asked to predict what the markets would do, would not have penciled in numbers shown in the box to the right. Global pandemic, deepest recession in living memory, the fastest bear market in history, a contested U.S. election...and the S&P finished the year with a +18.2% gain? An all-round crazy year. But in our mind the key to 2020 wasn’t about predicting the future, but more about adapting to a changing landscape. There’s something to the idea that ‘it is not the strongest or the most intelligent who will survive, but those who can best manage change.’

Markets Position for a Post-COVID World – In terms of market performance, up until about August it was all about who the winners were in the new COVID world. Investors rewarded companies that would win in the new order (Amazon, Netflix, DocuSign, etc.) or firms dominating emerging industries (think Tesla). These are all larger-cap growth types of stocks. The typical value stock (energy or financial company for example) or small-capitalization company was almost left for dead. As you can see below, up until the end of August only growth was making money.

Asset Class	Jan -August	Sept-December
S&P 500 Growth	+26.3%	+5.4%
S&P 500 Value	-9.4%	+11.7%
Russell 2000	-5.5%	+27.0%
Emerging Mkts	-0.2%	+17.2%
Commodity Index	-9.4%	+6.5%

Source: Bloomberg

However, the dynamic changed rather dramatically in September. During July and August, the details on the

Market Benchmarks			
Market Indices	4th Qtr 2020	YTD	3-Yr An
S&P 500 Index	+12.1%	+18.2%	+14.0%
Russell 2000	+31.3%	+20.0%	+10.2%
Global Equities	+15.5%	+16.6%	+10.1%
Int'l Index (EAFE)	+15.7%	+7.6%	+4.2%
Emerging Mkts	+16.8%	+15.1%	+5.6%
Other Indicators	12/31/20	9/30/20	12/31/19
Fed Funds Rate	0%-0.25%	0%-0.25%	1.5%-1.75%
2-Year Treasury	0.12%	0.13%	1.57%
10-Year Treasury	0.92%	0.68%	1.92%
S&P 500 P/E Ratio*	22.3	21.5	18.2
Crude Oil	\$48.45	\$40.22	\$61.16
Core Inflation	1.4%	1.6%	1.6%

*Forward 12-month operating earnings per S&P

various vaccines started to emerge and the possibility that they might actually work began to sink in. Additionally, the betting markets started to point towards a relatively clear election outcome. As a result, the markets started to try to price in a post-COVID world. This did not necessarily mean dumping the winners, but money began to rotate into sectors that stood to benefit from reopening. Energy stocks, banks, and especially economically sensitive small-caps kicked into gear. The small-cap Russell 2000 had its best month *ever* in November. Even Japanese and European stocks found interest. It is the same story for interest rates. Up until early August longer-term interest rates were in a steep downtrend, with the yield on the 10-year Treasury hitting a low of 0.51% on August 3rd. However, slowly but surely yields started to rise, finishing the year at 0.92%. While much is made of rising inflation expectations, certainly much of the move higher in yields in the fourth quarter was simply pricing in a more normal environment. After all, yields started 2020 at close to 2% and were considered unusually low even then!!

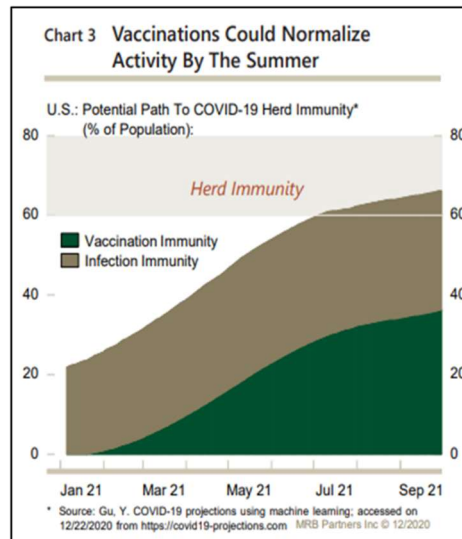
Policy Was Key in 2020 – What About 2021? – The markets may be pricing in a post-COVID future, but how realistic is such an outlook? After all, there are few signs that the latest wave of infections in the U.S. has crested, and vaccine distribution seems to be moving at a glacial pace. Just because markets are forward-looking doesn’t mean they have 20/20 vision. And to a much greater extent than normal, the markets are driving the real economy, rather than the other way around. Generally, the outlook for the economy is taken as the fixed variable in any outlook piece. The economy is going to do X so this implies doing Y with your portfolio. But the world is more

complex than that. Feedback loops are ever present. For example, stocks going up can make the cost of capital cheaper. This might mean companies issue stock to fund expansion plans which then drives economic growth. In a sense, a rising stock market can drive the economy, which in turn drives a rising stock market. Of course, it also works in reverse, such as in 2008. Falling stock and corporate bond prices meant much tighter liquidity conditions for the real economy. Tighter liquidity resulted in the failure of some high-profile banks (Lehman, Bear Stearns, etc), which cut off credit to large portions of the real economy. This only exacerbated the economic downturn, which led to even tighter liquidity conditions. And so, the wheel turned.

This cycle played out in 2020, but the pace was so much faster and an order of magnitude bigger than anything we have ever seen before. Shelter-in-place orders crippled large parts of the travel, leisure, and entertainment sectors and job losses were enormous around the world. Businesses of all stripes grappled with how to work remotely, and in many cases once thriving industries were teetering on the verge of bankruptcy. The viability of everything from airlines to oil companies were called into question. The global economy felt like it hit a brick wall in late March and U.S. GDP declined by more than -31% in the second quarter – a once unthinkable large number. What ultimately stopped the spiral in 2008 and 2009 was the monetary and fiscal response from governments. But where it took many months to cobble together a plan eleven years ago, it took only weeks in 2020. Congress passed three fiscal packages in quick succession that acted as disaster relief for both consumers and businesses. Just as importantly, the Federal Reserve moved quickly to ensure liquidity conditions didn't tighten. Additionally, both the fiscal and monetary bazookas were enormous! In retrospect, the key to getting the markets right in 2020 was not forecasting COVID trends but anticipating that policy initiatives would fill the hole left by the pandemic.

What about 2021? Again, we doubt it will be about getting 2021's corporate earnings number right or guessing where consumer spending goes, but more about three big questions; 1) how quickly are the various vaccines distributed, 2) how does fiscal policy evolve, especially in the U.S. under the new Biden administration, and 3) will inflation force the monetary authorities to shift gears, thus changing the liquidity backdrop?

The path towards Herd Immunity – The first big question for the coming year is what happens with global COVID infection rates and vaccine distribution. We won't pretend to have any great insights here, and in reality, few people



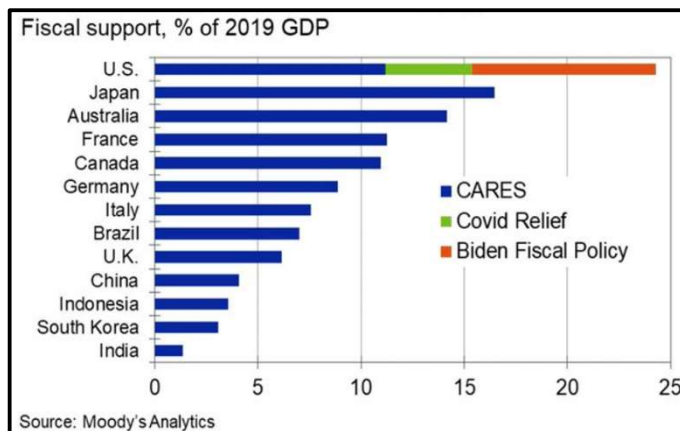
do. Clearly infection rates are on the upswing again after the holidays, but vaccine distribution is slowly ramping up in most countries, and it doesn't seem unreasonable to expect that by the spring all essential workers and people at high risk should have been vaccinated if they wish to. Hopefully, distribution then ramps up significantly so that everyone else can be immunized. The chart to the left seems like a reasonable guess of the future based on what we know now. Herd immunity, either through vaccination immunity or infection immunity should be reached sometime in the late

summer or early fall in the U.S., depending on how you define herd immunity. This is clearly what the markets are looking forward to. As we noted earlier, the market rotation we saw from September on was towards companies who stand to benefit from a return to normal. To the extent the immunity timeline is extended into 2022 you'd expect market turbulence, and conversely, if it is shortened then that is clearly good news.

Given a Chance Consumers Will Spend – While the timing of vaccinations and herd immunity is open to debate, the direction seems clear. At some point in 2021 consumers and businesses will be operating in a much more welcoming environment. Seeing family and friends, attending weddings and graduations, taking vacations. The impact on mental health alone will be a significant positive. From an economic standpoint people are going to spend!! Just consider that between March and November 2020 disposable incomes increased by over \$1tn in the U.S. while spending fell by over \$500bn. This means that at the macro level savings increased by close to \$1.6tn. And we should remember that this is before the latest round of support checks went out in late December and early January and before whatever the incoming Biden administration aims to add. It doesn't seem unreasonable to expect that consumer spending in the second half of 2021 could be robust to say the least.

Fiscal Policy - Go Big or Go Home – A major variable in the coming months is what happens with fiscal policy in the U.S. President-Elect Biden takes office on January 20th with a slim majority in both the House and now the Senate after the Georgia Senate run-offs. Clearly the last few weeks have been tumultuous on the political front, and there are competing interests even in the Democratic party pulling Biden in divergent directions. So far there is no clear consensus on social policy changes, how to handle relations with China, how to address climate change, etc. It is clear, though, that Biden will try to pass another stimulus/support bill in late January or February. The

details are a moving target, but another round of checks for individuals, help for state and local governments, and money for vaccine distributions appear to be areas of agreement. Estimates of what can pass range from \$750bn on up to \$2tn. We think Biden has the votes for such a package in the House and he will use reconciliation, if necessary, to pass it in the Senate. The chart to the right shows fiscal support in various countries. These are enormous numbers, and another \$2tn would mean the U.S. would have spent roughly 25% of GDP to address the COVID crisis. You simply do not see these numbers outside of war time.

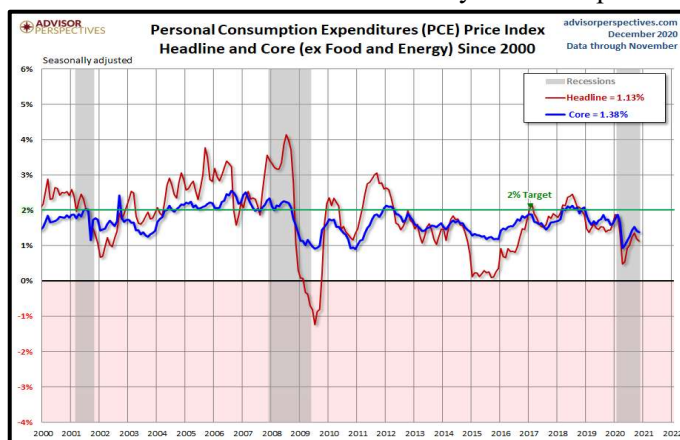


After this next package things may get more contentious. Rumors of a multi-trillion-dollar infrastructure plan are circulating, but this may be a tough sell for more conservative Democratic Senators. However, the big picture is that the hyper-stimulative policies of the last few months will continue, at least through the mid-term elections. Unlike the post-financial crisis period where austerity came into vogue very quickly (remember, the Tea Party movement started in February 2009), there is no similar champion today.

Is Inflation Inevitable? – In a word - no - nothing is inevitable when it comes to the markets and the economy. Maybe a more pertinent question is whether there is a combination of macro policies and initiatives that could create inflation in the quarters and years to come. On this we think the answer is ‘almost certainly.’

Ever since the financial crisis, core inflation has pretty much stayed well below the Fed’s target of 2%, as you can see from the chart below. There are a whole host of reasons why, but demographics, technology, and high debt burdens all rank high on the list of culprits. Even when unemployment fell solidly below 4% in 2018 inflation remained muted. The COVID crisis is nothing if it’s not a deflationary shock, and to counteract such an event has taken unprecedented stimulus – both monetary and fiscal.

But can such stimulus go too far? Theoretically, yes. If the government sent everyone \$1m dollars tomorrow it’s quite likely price inflation would shoot higher, at least temporarily. But in reality, inflation doesn’t work like an on/off switch, but more as a continuum from deflation on



the left to inflation on the right. We are currently deeply embedded on the deflation side with a lot of underutilized resources. People still need to return to work and many businesses aren’t even close to operating at full capacity. But given enough time they could be. If our scenario about herd immunity and consumers returning to form in the fall proves close to the mark, we

could see full employment and capacity constraints come into play sometime in 2022. The other key question is what happens with policy. Does fiscal spending continue to grow leaps and bounds? Just as importantly, does the Fed basically continue to monetize most if not all of the debt issuance? As you can see from the chart at the top of the next page, over the last year the Treasury has issued \$3.2bn of new debt while the Fed has bought \$2.4bn. This serves to suppress rates and allows Congress to think that fiscal policy is a ‘free lunch.’

The policies of the last few months have been important, but can they be taken too far? Without question. But we don’t think we are at that point yet. We think we are moving along the continuum from deflation to reflation. The reflation theme probably persists throughout 2021 before we transition to worrying about inflation. Our best guess is inflation runs hot for a while (say 2.5% to 3.0%) because both the fiscal and monetary policy makers are rowing in the same direction. But to the extent this means more wage growth, particularly at the lower end, it could be a net positive. The bottom line is we do not think global central banks will be forced to reverse course in 2021 through rate increases or reduced asset purchases. Rather than tightening proactively before inflation picks up, they are likely to err on the side of accommodation. This means the liquidity backdrop should remain favorable for the markets over the coming months.

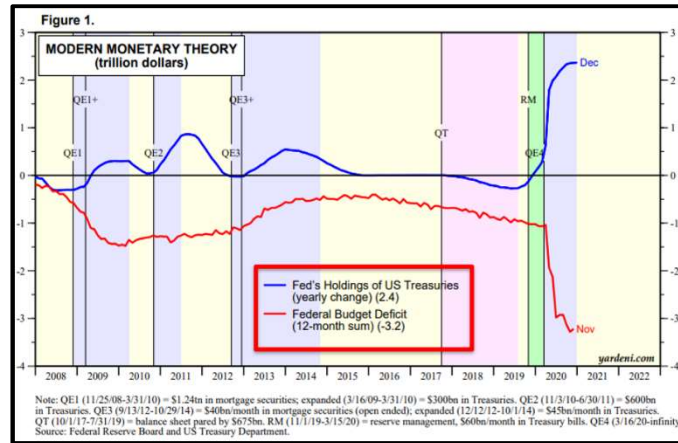
The Battle between Liquidity and Market Valuations –

When you look at parts of the market you can’t help but be reminded of 1999. No, not the Prince song, but the inflating tech bubble. For example, the total amount of money raised through IPOs in 2020 was roughly double the amount raised in 1999. Many of the new IPOs are losing vast sums of money and the valuations on some companies such as Airbnb are tough to get your

head around. At \$110bn, Airbnb's market cap is higher than the six largest hotel chains...combined. Oh, and it lost \$697m in the first three quarters of 2020. But the liquidity backdrop is a powerful force. As we have noted above, both fiscal and monetary policy are likely to be supportive, at least through this fall.

At this market level it is hard to claim valuations are cheap. The S&P sells at 22.3 times forward earnings, more than one standard deviation higher than normal. Even looking at 2022 earnings (hopefully the first full year of normality) valuations are still over 19 times. But this isn't an unusual situation at economic low points. The chart below shows how the interaction of both earnings and valuations plays out in different economic environments. As you would expect, both profits and valuations fall during a bear market (the despair phase). However, when the markets turn, they are typically driven higher by multiple expansion, not earnings growth (the hope phase). That has certainly been the case since the March 2020 low. However, there comes a time where there is a handoff from multiple expansion to earnings growth (the growth phase). You see profit expansion during this long phase of the economic recovery that more than offsets the contraction in multiples. This is where we think we are.

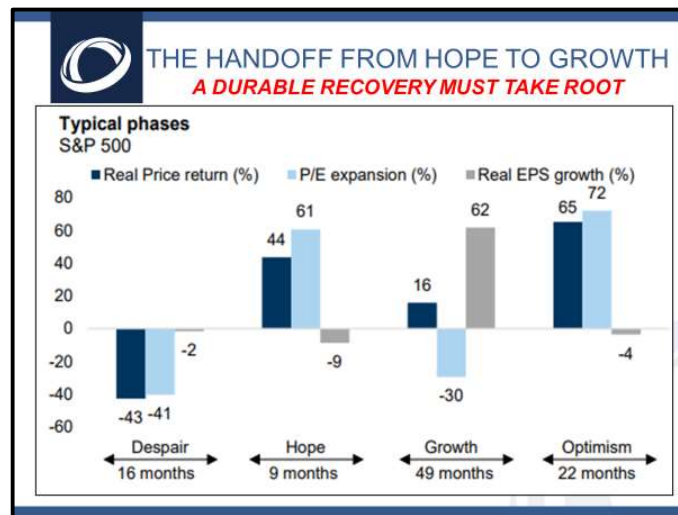
We are morphing from a market driven by expectations of better times to one where real earnings drive returns. Of course, this is ultimately taken too far, and the cycle starts again. And in our mind the trigger for the next cycle will be inflation. Anything that forces the Fed and fiscal authorities to change the liquidity backdrop will prove to be problematic for the markets. But we are not at that point yet.



remember prior vaccine development timelines were measured in years or decades. Just consider the following: *'Hamilton Bennett and her team (at Moderna) worked tirelessly to engineer a vaccine. Just two days after the first complete genome of the virus was mapped and publicly posted online in early January, Moderna's COVID-19 vaccine candidate, mRNA-1273, was finalized.'* Two days!!

This isn't to downplay the pain many have endured the last few months. These have been trying times, and the next few months will be fraught with uncertainty. But as an investor we have to take the long view, especially when no one's crystal ball is clear, even at the best of times. 2020 has taught us once again that making rash adjustments to one's portfolios during times of heightened economic or political uncertainty can be expensive. The next few months and years are likely to be equally uncertain. A

divisive political backdrop, unprecedented fiscal and monetary policies, the odds of higher inflation all rank high on our list of concerns. But we are focusing on adapting to changing times, and for now the outlook appears encouraging as people slowly get back to normal in 2021.



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