February 2021

Economic Comment and Market Outlook

In a year whose number is synonymous with "perfect vision," all of humanity discovered how imperfect our ability to see the future is. 2020 was simultaneously dramatic, stressful, calamitous, intense, and ultimately, even rewarding from an investment standpoint. Most of us are still coming to terms with the events we have experienced. The appearance of the novel coronavirus created economic and market upheaval beginning in February, triggering a steep decline in the financial markets. Resulting lockdowns and "social distancing" behavior forced an equally dramatic decline in economic activity and employment, ending the longest expansion on record. Then, as quickly as the downturn began, the aggressive actions of governments and central bankers engineered an amazing, powerful response in the markets, leading a shift from meltdown conditions to robust recovery as the S&P 500 Index repeatedly set new all-time highs later in the year. Shockingly, in spite of registering a decline of 34% from February 19 to March 23, the S&P 500 Index finished the year with a positive total return of 18.4%. Fayez Sarofim & Co. portfolios also experienced an excellent outcome, participating in the strong advance after offering downside protection during the first quarter's volatile downturn.

A normal recession impacts most companies in a fairly consistent fashion as overall demand weakens; however, our recent economic experience has been far less uniform. In fact, the bifurcated situation of various industries led to the creation of a new term to describe the economy's recovery from the pandemic—the "K-shaped recovery." Normally, economists or market participants discuss the shape of a recovery and whether it will appear like a "V" or a "U," mainly considering the path and the speed of recovery. However, with the onset of the pandemic, some industries rebounded extremely quickly or even saw their demand rise exponentially as the world shifted to new routines and new necessities. For example, consider many of the technology companies, grocery stores, home-improvement retailers, and delivery companies. These businesses occupied the upper portion of the K. On the other hand, some industries—like airlines, hotels, restaurants, oil and gas, office buildings, and many retail stores—experienced a dramatic drop in demand and minimal rebound, occupying the bottom portion of the K. Many of these negatively-impacted businesses represent large sources of service-sector employment, so the economy has experienced significant job losses. Fortunately, a typical Sarofim portfolio began with more exposure to the top part of the K than the bottom, and the firm strove to identify changes throughout the year that would improve the portfolio's positioning.

Although some industries continue to face difficult conditions, earnings for the companies in the S&P 500 have been surprisingly resilient. Using figures from David Bianco at DWS Investment Management, it appears that the pandemic will have caused a 15.5% decline in S&P profits to approximately $138 per share. The second quarter of 2020 represented the worst period as profits fell more than 30% while many businesses were closed or halted some of their operations. Over the rest of the year, the profit picture improved as businesses re-opened and adapted to the new conditions. In addition, those companies on the "upper part of the K" experienced enhanced demand and strong growth. Now, it appears that an overall profit rebound in 2021 will return the S&P to record levels of profitability, with profits expected to increase 21% to an estimated $170 per share in 2021. The US economy and corporate sector are extremely dynamic, so it should not be too surprising to see this outcome. A typical Sarofim portfolio experienced a much shallower decline in earnings of only approximately 7% in 2020; therefore, we expect a quicker rebound to record levels of profitability. In addition, many balance sheets are highly liquid as businesses capitalized on record low interest rates and high demand to issue a record amount of investment-grade corporate debt in 2020. Data from Bloomberg show $1.9 trillion of new bond offerings, which was $500 billion more than the previous record of $1.4 trillion in 2017.

Reinforcing the strength emanating from the corporate sector, both the consumer and government sectors should further support a robust economic recovery. Employment is rebounding, and household net worth sits at an all-time high near $128 trillion, buoyed by the stock market and home price appreciation. There should be significant pent-up demand in some sectors of the economy, especially for travel, entertainment, restaurants, and other businesses that have been mostly off-limits to consumers during the pandemic. The recently-elected Biden administration is currently proposing an additional $1.9 trillion in fiscal stimulus. With regard to monetary policy, the participants on the Federal Reserve's Open Market Committee have communicated that they do not expect short-term interest rates to rise from effectively zero before 2023. Fed Chair Jerome Powell also recently reiterated the central bank's commitment to its large asset purchases, or quantitative easing programs, that have helped to lower 10-year Treasury yields to current levels near 1.0%. As a result, the economy and the corporate sector appear to be poised for a substantial rebound in 2021 with both fiscal and monetary policy set in a firmly accommodative stance.

Of course, the speed of the recovery is still governed by the prevalence of the virus and the corresponding worldwide vaccination effort. The rapid development of multiple effective vaccines to combat the coronavirus offers great hope for a re-opening of the economy and a dramatic improvement in public health in 2021. Recently, several mutated forms of the virus have appeared; these variants may be more difficult for the vaccines to neutralize, so it will remain important for society to persist in fighting the spread of the virus with all available techniques for some time to come. It is far too early to declare victory on the health front, but we remain confident that 2021 will witness significant progress after the health challenges of 2020.

While no one at FS & Co. forecast the occurrence of a global pandemic in 2020, our firm's experience provided an excellent reminder of the importance of two key elements of our investment philosophy. First, we invest for the long term, as owners of businesses, and do not try to time the market. The speed of both the downturn and the recovery in the market surprised most participants, including us. Had we attempted to "trade" the market in the midst of these violent movements, it is quite likely that we could have outsmarted ourselves and missed out on significant portions of the powerful recovery. Of course, it is much easier to stay the course of investing for the long-term when one is also following the second element—focusing on high quality companies. To our firm, those businesses are financially-strong, competitively-advantaged, and operating in attractive industries. Knowing that our companies' balance sheets and cash flows were secure and resilient, the firm could afford to remain patient and confident that our portfolios would weather a more challenging period. As a result, the nature of our portfolio reinforces our ability to focus on a longer time horizon. Therefore, while not explicitly designed for a pandemic scenario, our strategy's long-term focus on dominant companies in structurally-attractive industries again delivered superior risk-adjusted results for 2020. Finally, we want to recognize that the trust and confidence that our clients place in our firm is another critical component of ensuring that we can focus on the long-term. Thank you for entrusting your assets to our management.

We sincerely hope that you and your families remain safe and healthy during this unusual and stressful era, and, as always, please contact us if you have any questions or feedback for our firm.

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