1Q 2021 Asset Allocator's Guide

MarketDesk Research

Quarterly Report

December 18, 2020

Missed the Roaring 1920s? 2021 Looks Promising

Vaccine Trials Unleash Risk Asset Rotation; Biden Wins Presidency

4Q 2020 Market Recap — U.S. Election & Vaccine Trials

A COVID-19 resurgence, positive vaccine trial results, fiscal stimulus negotiations, and the U.S. presidential election defined 4Q20. The most impactful theme was Pfizer's and Moderna's positive trial results. The vaccine breakthrough allowed the market to overlook a surge in European and U.S. COVID-19 cases and the reimposition of restrictions in Europe. Fiscal stimulus negotiations dominated the U.S. policy environment, but the headline volatility ultimately amounted to noise. Projections for a 'blue wave' election scenario kept hopes alive for a big stimulus package. However, a split Congress (pending GA elections) and lack of progress in Washington are now dashing fiscal stimulus hopes.

Positive vaccine trial results released a pro-cyclical rotation. The rally powered beaten up sectors, factors, and countries higher as investors rushed to adjust their portfolios. The Dow, S&P 500, Nasdaq, and Russell 2000 all hit record closing highs in 4Q20. Energy, Financials, Industrials, and Materials outperformed, while Cons Stpls, Health Care, Utilities, and Tech lagged. Small Caps outperformed Large Caps, and High Yield outperformed both Investment Grade and Treasuries. USD weakened as safe-haven assets lost their appeal, while oil prices jumped above $45/barrel after hovering around $40 since June.

1Q 2021 Investment Outlook — Vaccine Distribution & the Reopening Phase

We expect the reopening narrative to carry into 1Q21. Vaccine distribution, accommodative monetary policy mixed with fiscal stimulus, and corporate operating leverage are all catalysts. The key risks are a COVID-19 resurgence before vaccine distribution is ramped up and/or a sudden market correction due to euphoric market sentiment and speculative activity. (Refer to page 3 for an expanded list of catalysts and headwinds.) While we remain wary of the pandemic's longer-term consequences, our near-term view is the positives outweigh the negatives.

From a macroeconomic perspective, we believe (1) interest rates will drift higher and the yield curve will steepen; (2) oil demand will improve, and supply constraints will pressure prices higher; (3) inflation will tick higher but remain in check; and (4) economic growth will be strong in 2021 as consumer and business demand from 2020 works through the system. We do not expect large moves, but we anticipate the overall market narrative to remain focused on the economy opening back up.

Positioning Calls: Moving Ahead to the Reopening Phase

- **Size & Style:** We favor Small over Large (page 7) and Growth over Value (page 8).
- **International:** Biden's multilateral trade approach and USD weakening should both support international assets. We continue to favor Emerging over Developed (page 10) and would increase overall international exposure. Page 11 offers tactical country ideas.
- **Duration vs Quality:** We view Duration (page 12) as a bigger risk than Quality (page 13).

What We're Watching

- **Investor sentiment remains exuberant.** DoorDash and Airbnb IPOs in December were both well received by the market. Tesla announced a $5Bn share offering and will be added to the S&P 500 Index. An endless parade of SPAC IPOs is coming to market as recently launched SPACs announce a rush of deals. If investors are nervous about the future, their actions are not showing it. We believe investor sentiment will remain positive in 1Q21. We expect FOMO (fear of missing out), BTD (buy the dip), and TINA (there is no alternative) to remain relevant acronyms in the coming months.
- **What will U.S. policymaking look like in 2021 and 2022?** If history is a guide, we expect lots of Congressional noise and executive actions (Figure 6). The number of introduced bills generally spikes in the first six months of a new Congress. In contrast, the number of enacted laws is weighted to the end of the first and second years. The difference maker will be if Democrats win both Georgia Senate seats in January.

Table of Contents

Report Overview

Welcome to the MarketDesk Research *Asset Allocator's Guide* . The goal of this report is to simplify the asset allocation process, ask targeted questions to understand key drivers, and build investment conviction. The analysis is designed to break down a complicated market narrative and focus on what matters. A summary of our current asset allocation views is listed on page 2. Up/down arrows indicate a positive (▲) or negative (▼) change in view since the last edition of the *Asset Allocator's Guide* .

Research Portal →

Asset Allocation Ratings

This page provides a summary of our asset allocation views. Up/down arrows indicate a positive (▲) or negative (▼) change in view since the last *Asset Allocator's Guide* .

● Underweight (UW) ● Neutral (N) ● Overweight (OW)

Asset Class	Allocation View				Rationale
	Chg.	UW	N	OW	
U.S. Equities					
U.S. Large Caps	▼	•	●	•	Stronger fundamentals than Smalls, but Big Tech OW is a risk; Potential to underperform in reopening trade
U.S. Mid Caps		•	●	•	Cheapest on NTM P/E basis; Nice mix of small-caps' higher growth & large-caps' business model stability
U.S. Small Caps	▲	•	•	●	More cyclically exposed = Benefits from COVID-19 vaccine & fiscal stimulus; Emphasize quality via S&P 600
International Equities					
Europe		•	•	●	Significantly exposed to global growth/trade; Brexit path remains murky; Improving EU member relations
Emerging	▲	•	•	●	Benefits from increased global stimulus, strong mfg. rebound & USD weakening; China potential headwind
Developed	▼	•	●	•	Central banks responded more aggressively with stimulus; More defensive sector exposure than EM
Asia-Pacific		•	●	•	U.S.-China relations undergoing seismic shift & not finished; Emerging economies = increasing consumption
Latin America		●	•	•	Favor near-term tactical position (Fig.26); Lingering COVID-19 & domestic policy uncertainty
Fixed Income					
Quality (IG vs HY)		•	•	●	Corporate health weakening before the COVID-19 outbreak; Credit risk elevated over next 12 months
High Yield		•	•	●	OW conviction shrinking with junk bond yields at record lows & spread tightening fading; Downgrade Watch
U.S. Treasuries		•	●	•	Favor shortening duration due to interest rates sitting near historic low & potential upward pressure on rates
Investment Grade		•	●	•	Increasing duration remains key risk in IG bonds; Limited potential for addtl spread tightening
Duration		●	•	•	Expect more of credit's return to come from yield than duration; Interest rates not likely to move before 2023
Alternatives					
REITs		•	●	•	Faces post-pandemic demand & rent uncertainty; Firm N rating due to yield & diversification benefits
Commodities		•	●	•	USD weakening, rising inflation expectations and rebounding global growth all positives
U.S. Sectors					
Communication Services		•	•	●	Above average 2021 EPS & sales growth; Social media industry faces antitrust headline risk
Technology		•	•	●	Expensive valuations are a headwind, but Tech is essential to businesses and leveraged to secular trends
Health Care		•	•	●	Lowest OW conviction; Potential Medicaid rate cuts & Biden admin push for price controls = headwinds
Consumer Discretionary		•	●	•	Benefits from vaccine rollout; Online retailers driving sector higher; Above average 2021 EPS & sales growth
Industrials		•	●	•	Strong 4Q20 performance classifies it as momentum; Highest NTM EPS growth across sectors (ex Energy)
Utilities		•	●	•	Attractive dividend yield; Prefer Utilities over Cons Staples if looking for a defensive play
Consumer Staples	▲	•	●	•	Downgrade Watch; Margins expanded during the pandemic but low beta likely to underperform in rally
Energy	▼	●	•	•	Expect oil demand to gradually recover but remain volatile; Asset write-downs are still material risks
Financials		●	•	•	Upgrade Watch; Vaccine distro, resilient earnings, & more stimulus could lead to 2021 reserves releases
Materials		●	•	•	Ability to raise prices if production costs increase; Stimulus could lead to inflation & sector provides hedge
U.S. Equity Factors					
Growth		•	•	●	We continue to OW Growth despite stretched valuations due to its superior operating metrics
High Beta	▲	•	•	●	Use to gain targeted exposure to reopening themes; Refer to 12/11/2020 *Friday Strategist* for full report
Momentum		•	•	●	Remains leveraged to Large Cap Tech and secular trends; Watch for trend change in reopening
Low Volatility		•	•	●	Downside protection against a selloff with markets trading near record highs; Good offset to above factors
Quality	▼	•	●	•	Similar exposure to S&P 500 means not making an active sector bet; Use in place of broad market exposure
Value		•	●	•	Low valuations provide a buffer late cycle, but Value ETFs do not provide good "Value" exposure

Dissecting the Narrative

This page dissects the current Bull and Bear market narratives. The catalysts and headwinds are listed in the order of most impactful to least impactful based on our views and include a brief discussion of the current narrative.

Bull Case / Catalysts

+ **COVID Vaccine Distribution**: Successful distribution of the Pfizer and Moderna COVID-19 vaccines will allow countries, cities, and businesses to reopen. As more individuals are vaccinated and herd immunity builds, public health officials will need to rely less on blunt restrictions, such as closing indoor dining and issuing stay-at-home advisories, to combat the virus's spread. A quicker, more efficient distribution phase will let the economy heal sooner.

+ **Accommodative Fed:** The Fed and global central banks are expected to maintain their highly accommodative monetary policy programs to support the recovery. As an example, the Fed's own dot plot indicates FOMC members expect rates to remain near zero into 2023. In addition, the Fed recently committed to maintaining its asset purchase program until the economy reaches full employment and inflation stays above 2%. Historically low interest rates, plus significant asset purchases, are positive for risk assets and economic growth.

+ **Janet Yellen as U.S. Treasury Secretary:** Janet Yellen brings a wealth of experience to the role of U.S. Treasury Secretary. Yellen, the former Federal Reserve Chairwoman during the Obama administration, will be an ally for the Fed in the Biden administration and is particularly focused on labor markets. The Fed and U.S. Treasury being coordinated is important to keep the economy moving forward.

+ **Operating Leverage:** Companies cut expenses during COVID-19 shutdowns. This allowed corporate profits to hold up better than expected. Operating leverage is forecasted to kick in during 2021 so long as expenses remain in check.

+ **Corporate Cash Reserves**: Companies rushed to issue debt in 2020 to bridge themselves through the pandemic. Cash reserves are strong, and boards and shareholders will want to put the cash to work if the economy improves. Potential uses include share buybacks and M&A.

+ **Pent-Up Consumer Demand**: The personal savings rate surged during the pandemic as consumers spent less money on eating out, traveling, and attending live events. Similar to corporations, the elevated savings rate could unleash a wave of pent-up consumer demand as the economy reopens in 2021.

+ **Biden's Trade Agenda:** The incoming administration is expected to pursue a multilateral trade agenda that focuses less on tariffs and threats to get trading partners to the negotiation table. A less erratic trade agenda provides businesses more confidence to make investment decisions and removes a headwind to global trade.

Bear Case / Headwinds

— **COVID-19 Resurgence / Restrictions**: Public health officials warn the gap between vaccine production and vaccine distribution will be a dark period. COVID-19 cases are surging in the U.S. and Europe, and the travel-heavy Christmas and New Year's holidays could quicken the spread. Public health officials are resorting to blunt containment efforts to slow the spread. Governor Cuomo closed indoor dining in New York City, and most of California is under a stay-at-home advisory. The biggest risk is case counts continue to climb and restrictions stall the economic recovery.

— **Elevated Unemployment**: Unemployment is dropping as more employees are called back. However, Figure 12 shows temporary layoffs are turning into permanent layoffs. The risk is employees lose valuable skills the longer they are unemployed. Retraining individuals for new jobs will be important in order to reduce unemployment and keep the recovery strong.

— **The Fed Gives In:** Fed Chairman Jerome Powell publicly stated the Fed will continue its asset purchases until the economy reaches full employment and inflation stays above 2%. The Fed's dot plot indicates most FOMC members expect interest rates to remain near zero through 2023. A lot can happen between now and 2023. If the economy and inflation run hot in 2021, or even 2022, it will be difficult for the Fed to maintain its resolve. The risk is they react prematurely by raising rates, which could pressure equity valuations and cause another taper tantrum.

— **Weakened Corporate Health**: Corporate cash reserves may be high, but the impact from the pandemic will be felt for a long-time. Companies cannot go back in time to earn the revenue they missed out on during shutdowns. Corporate balance sheets are less robust than before the pandemic. Figure 15 in the monthly *Credit Strategy* report highlights the rise in debt / EBITDA and corresponding decline in interest coverage. This risk is probably longer in duration, but it is worth monitoring.

— **Global Protectionist Mentality**: The Trump administration may be ending, but the impact from its protectionist trade policy is likely to stick around. Governments around the world are increasingly erecting capital barriers, such as enhanced reviews of foreign M&A. The headline risk may be gone, but remnants will remain.

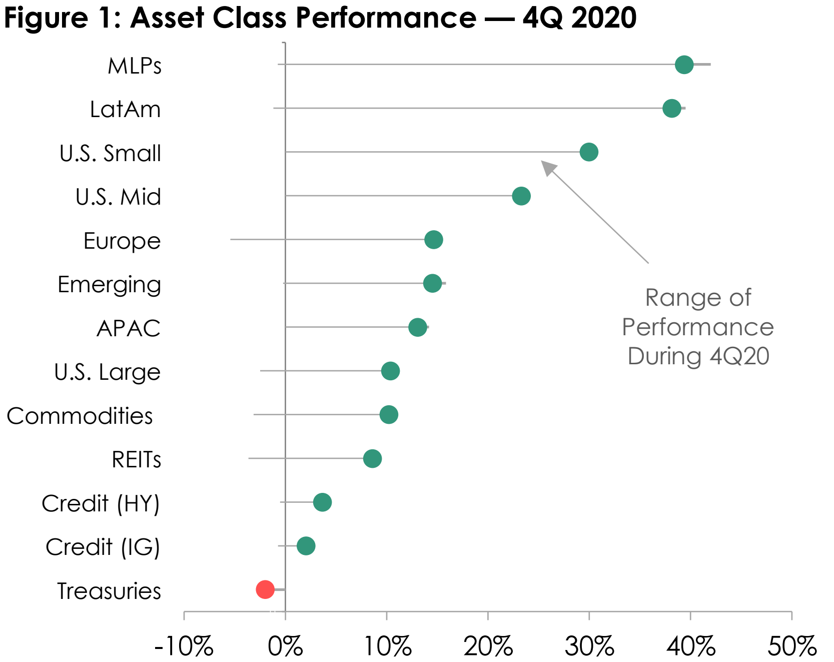
Asset Class Performance

This page provides a recap of total returns and asset flows across various asset classes since the last edition of the *Asset Allocator's Guide* . It also includes current valuation metrics (NTM P/E & P/B) and dividend yields.

Asset Class	Total Return (%)			Valuation & Yield			Asset Flows[1]		Price Chart
Global Equities	**4Q'20**	**1Yr**	**3Yr**	**NTM P/E**	**P/B**	**Div Yld**	**4Q'20**	**Last 2Yrs**	**Last 2Yrs**
U.S. Large Caps	10.4	16.5	45.9	21.9x	3.9x	1.54%	↑ 3%		
U.S. Mid Caps	23.3	12.5	25.6	19.7x	2.5x	1.13%	0%		
U.S. Small Caps	30.4	19.2	32.8	30.4x	2.3x	1.05%	↑ 4%		
Europe	14.6	4.5	11.0	15.8x	1.5x	2.04%	↓ -4%		
Asia-Pacific	13.9	20.1	20.3	16.1x	2.1x	1.09%	↑ 9%		
Latin America	39.5	-12.5	-7.3	14.1x	2.2x	1.90%	↑ 2%		
Developed	14.6	6.6	12.1	17.6x	1.8x	2.15%	↑ 1%		
Emerging	15.7	14.3	14.5	15.2x	2.1x	1.48%	↑ 1%		
U.S. Sectors									
Comm Svcs	17.6	28.4	36.8	24.7x	3.4x	0.79%	↑ 2%		
Cons Disc	7.9	27.7	66.5	27.6x	9.6x	0.90%	↑ 4%		
Cons Stpls	4.9	8.9	27.5	20.6x	6.2x	2.44%	↓ -4%		
Energy	35.1	-28.9	-35.0	20.7x	1.4x	5.45%	↑ 15%		
Financials	18.9	-5.1	8.9	14.6x	1.3x	2.10%	↑ 7%		
Health	6.2	11.5	42.7	16.5x	4.7x	1.47%	↓ -1%		
Industrials	15.4	10.9	24.2	24.8x	5.2x	1.59%	↑ 19%		
Materials	12.0	18.1	24.8	21.2x	3.1x	1.71%	↑ 34%		
Tech	8.7	39.8	106.0	26.5x	10.1x	0.94%	↓ -1%		
Utilities	6.3	0.4	31.4	18.6x	2.1x	3.09%	↓ -5%		
Fixed Income									
Treasuries	-0.9	7.8	16.0	-	-	1.34%	↓ -5%		
Invest. Grade	2.7	10.2	24.4	-	-	2.71%	↑ 5%		
High Yield	5.0	3.7	15.9	-	-	4.85%	↓ -9%		
Alternatives									
REITs	8.6	-5.3	14.7	17.1x	2.3x	3.44%	↑ 3%		
MLPs	43.7	-26.4	-31.9	7.3x	1.3x	11.35%	↑ 2%		
Commodities	10.2	-9.8	-10.8	-	-	1.77%	↓ -7%		

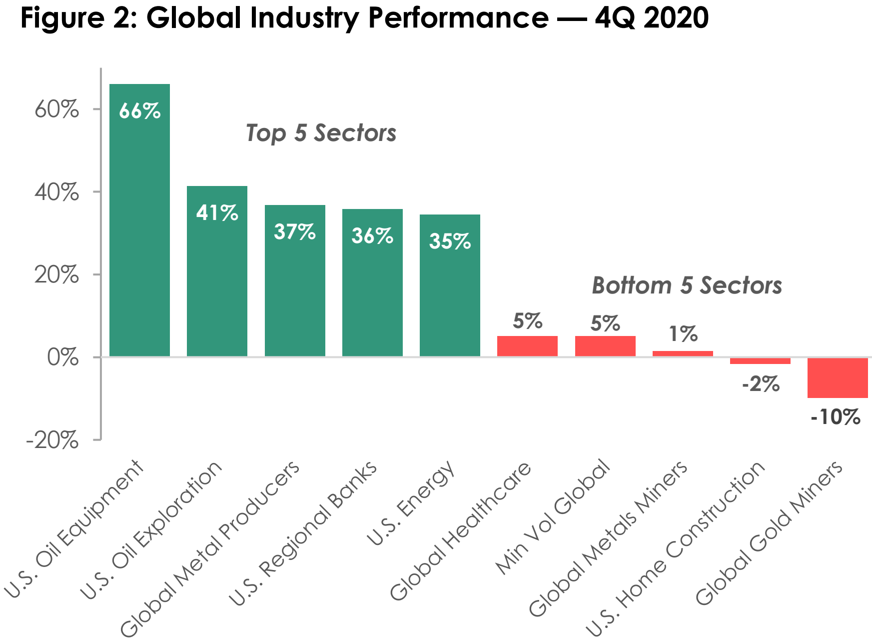
[1] *Asset Flows are calculated using 5 largest ETFs for each category.*

Figure 1: Asset Class Performance — 4Q 2020



Source: MarketDesk Research

Figure 2: Global Industry Performance — 4Q 2020

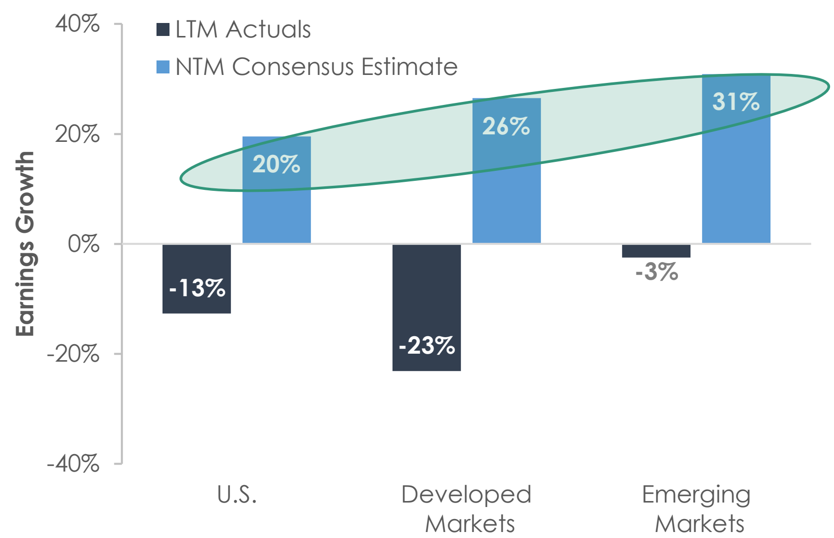


Source: MarketDesk Research

Charts That Will Shape 1Q 2021

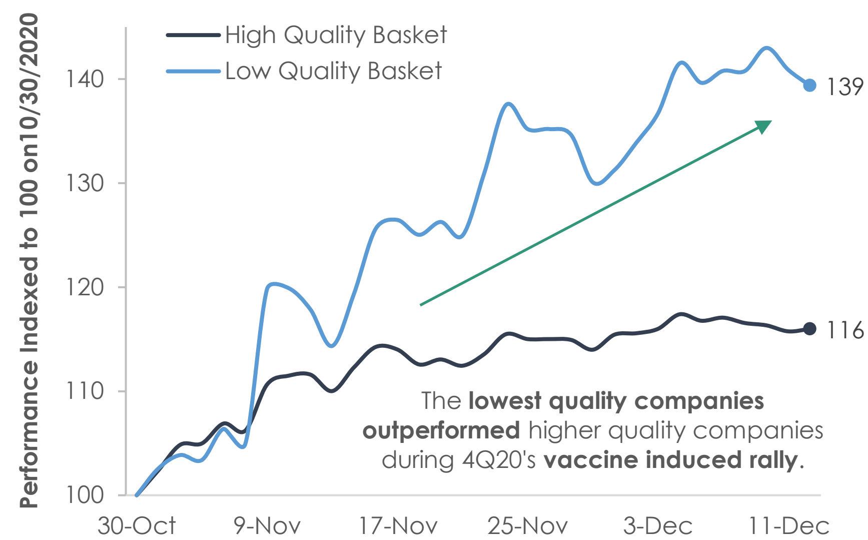
Below are six charts we think will shape the market narrative during the upcoming quarter.

Figure 3: Vaccine Rollout Pushes EPS Estimates Higher



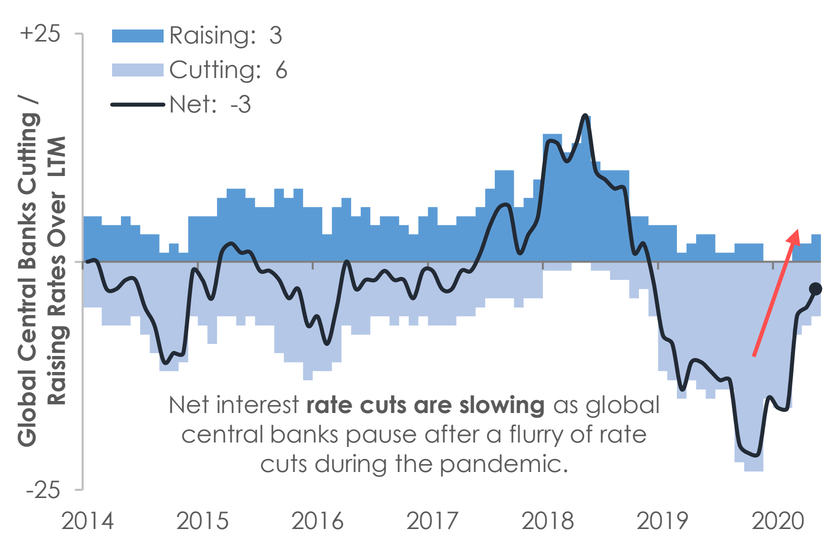
Source: MarketDesk Research

Figure 4: Low Quality Led During the 4Q20 Recovery



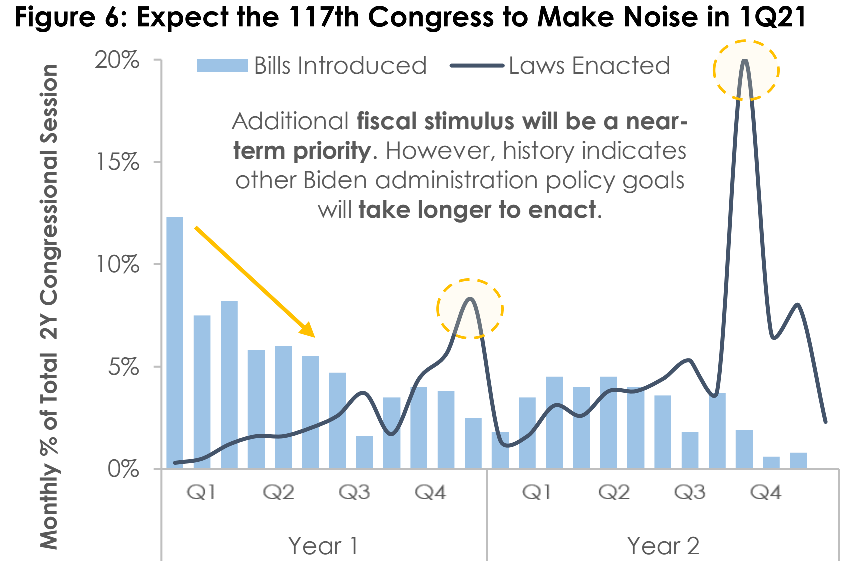
Source: MarketDesk Research. ***Note:*** *High (Low) Quality Basket is average performance of S&P 500 Stocks with 7-9 (1-3) Piotroski F-score.*

Figure 5: Pace of Central Bank Interest Rate Cuts is Slowing



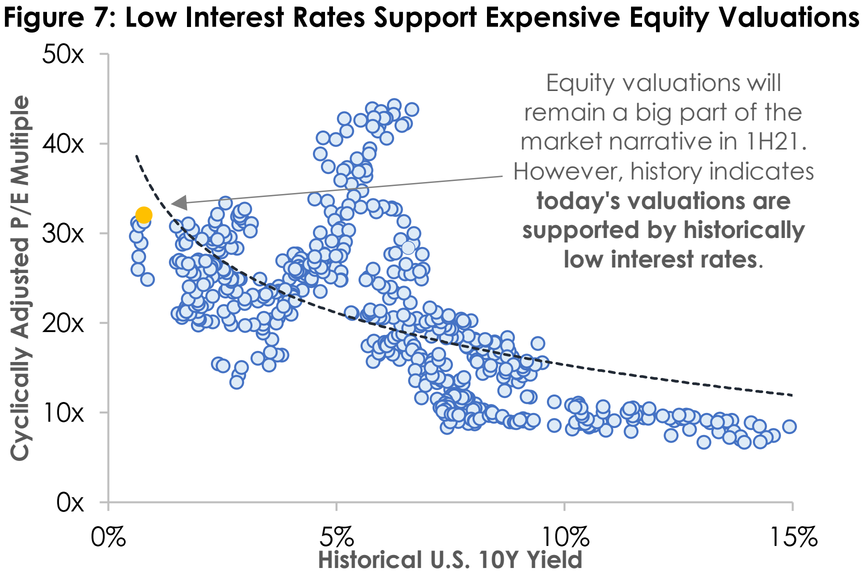
Source: MarketDesk Research, Various central banks

Figure 6: Expect the 117th Congress to Make Noise in 1Q21



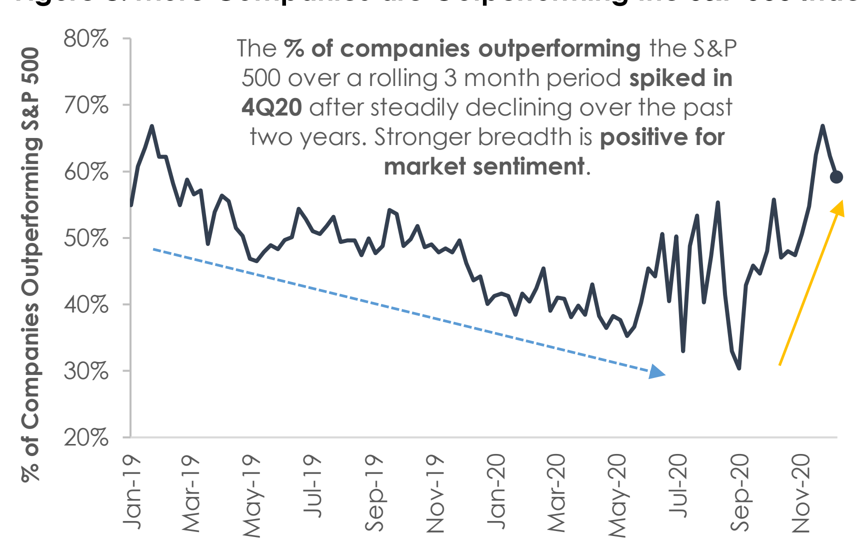
Source: MarketDesk Research, www.govtrack.us

Figure 7: Low Interest Rates Support Expensive Equity Valuations



Source: MarketDesk Research, Yale / Robert Shiller

Figure 8: More Companies are Outperforming the S&P 500 Index



Source: MarketDesk Research

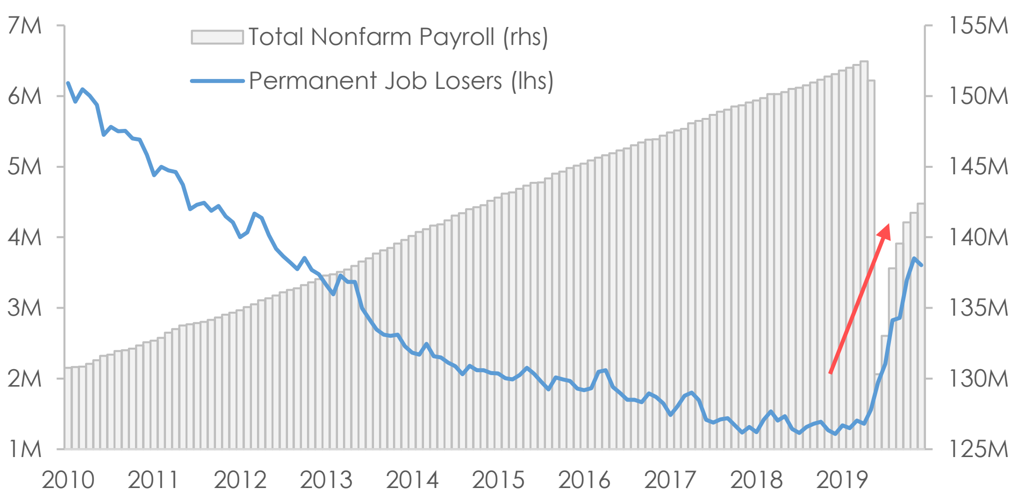
Unfolding Economic Stories

► **Labor Market:** The unemployment rate is trending lower, but temporary layoffs are increasingly becoming permanent. While nonfarm payrolls should continue trending higher, it will take time to reabsorb displaced workers.

► **Consumer:** Household net worth, retail sales, and housing starts are all rebounding. However, there is a widening gap between higher income and lower income households, which sets the economy up for a K-shaped recovery.

► **Business:** Core durable goods orders are up 4% y/y, while industrial production remains down 5% y/y. ISM data indicates service businesses are expanding. We expect the business recovery to lag the consumer recovery.

Figure 9: Unemployment Permanent Job Losers vs Total Nonfarm Payrolls



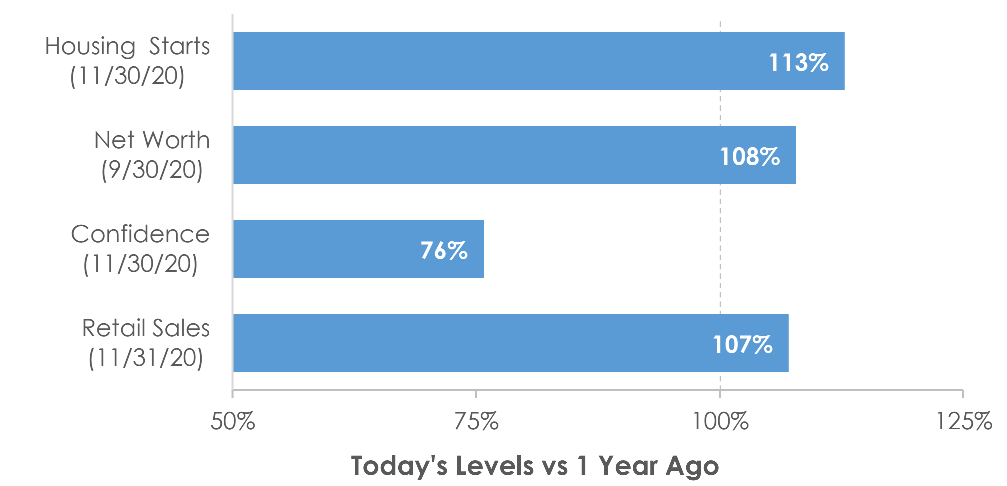
Source: MarketDesk Research. U.S. Department of Labor

Temporary Layoffs are Turning into Permanent Layoffs …

● Nonfarm payrolls plunged as the country shut down in March 2020. November's total nonfarm payrolls remain down 5.6% compared to March despite seven consecutive m/m increases.

● The number of workers considered 'permanent job losers' is spiking as the U.S. labor market undergoes structural change. Leisure / hospitality was down 16.8% at the end of November compared to March, while air transportation was down 24.1%. The harsh reality is it will take years to reabsorb the lost jobs, which presents a recovery headwind.

Figure 10: Consumer Focused Recovery Dashboard



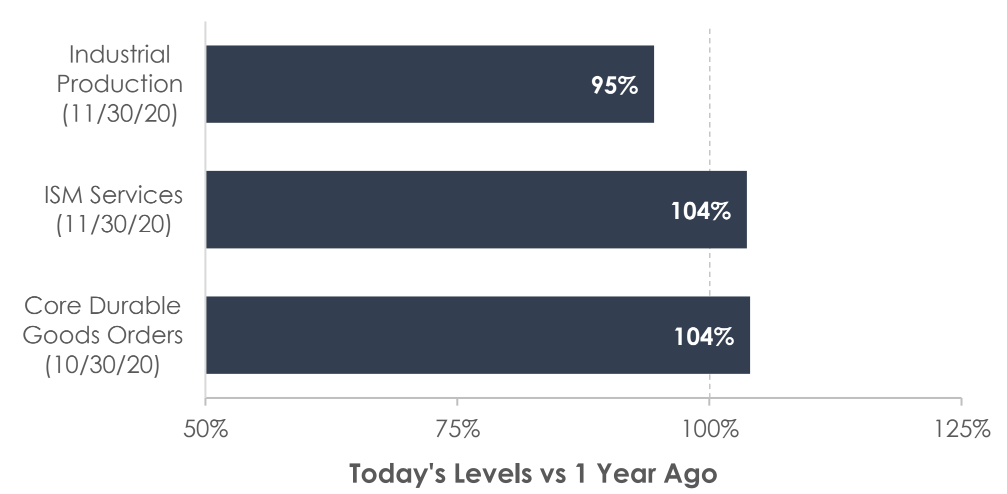
Source: MarketDesk Research, National Association of Realtors, Federal Reserve, U.S. Conference Board, U.S. Census Bureau

Consumer Spending Signals Recovery on Track, but Confidence Remains Weak …

● Figure 10 compares the latest readings for four consumer-focused datapoints against 1Y ago to create a consumer recovery dashboard. Household net worth is rising with the stock market, retail sales are strong, and housing starts are up thanks to low mortgage rates. The consumer recovery appears strong.

● The weak spot is consumer confidence, which highlights low-income households' struggles during the pandemic. The divergence creates significant headwinds for the durability and strength of the economic recovery.

Figure 11: Business Focused Recovery Dashboard



*Source: MarketDesk Research, Federal Reserve, Institute for Supply Management, U.S. Census Bureau. **Note:** Core Durable Goods Orders are calculated as durable goods orders less transportation equipment.*

Business Recovery Trending in Right Direction, but Less Robust than Consumer …

● Figure 11 compares the latest readings for three business-focused datapoints against 1Y ago to create a business recovery dashboard. The data is more mixed than consumer data. Core durable goods orders, which exclude transportation and are considered a proxy for business investment, were up nearly 4% y/y. However, industrial production remains down ~5% y/y despite increasing m/m in 6 out of the last 7 months.

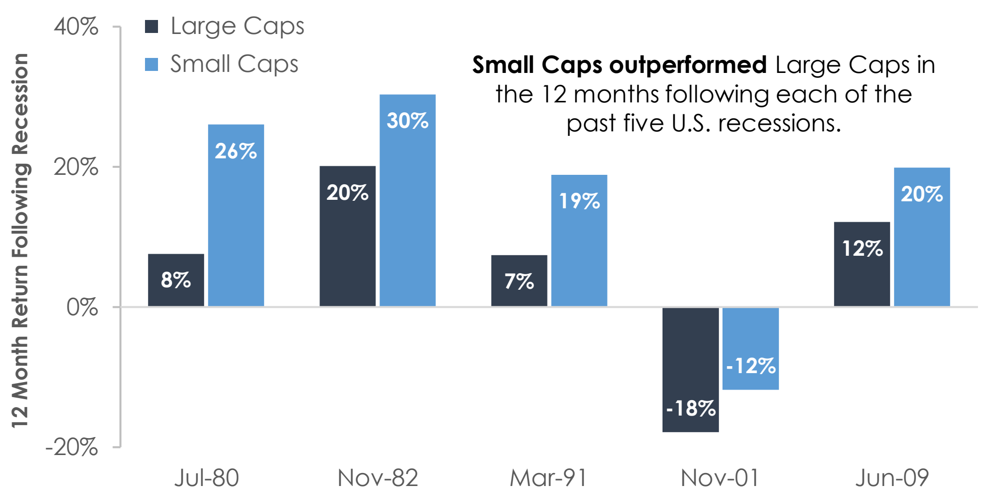
● Services are still an unknown despite the latest ISM Non-Mfg reading being up 4% y/y. We believe there is a risk respondents are comparing today to shutdowns and overstating the recovery.

Size — Large Caps vs Small Caps

► **Upgrade Small Caps to OW; Downgrade Large Caps to Neutral.** COVID-19 vaccine distribution will kick into high gear during 1Q21 and carry through into 2Q21. We expect the vaccine rollout to push economic growth and inflation expectations higher. The market narrative is likely to revolve around a continued risk asset rotation, which should benefit Small Caps. Small Caps' multi-year underperformance and NTM P/E discount vs Large Caps should also serve as catalysts.

► **Actionable Ideas**: We favor mixing quality into Small Cap exposure due to Small Caps' higher EPS volatility and higher percentage of money-losing companies. Consider the S&P 600, which has a 'financial viability' screen. ETFs: IJR, VIOO, SLY.

Figure 12: Performance Following Recessions - Large vs Small



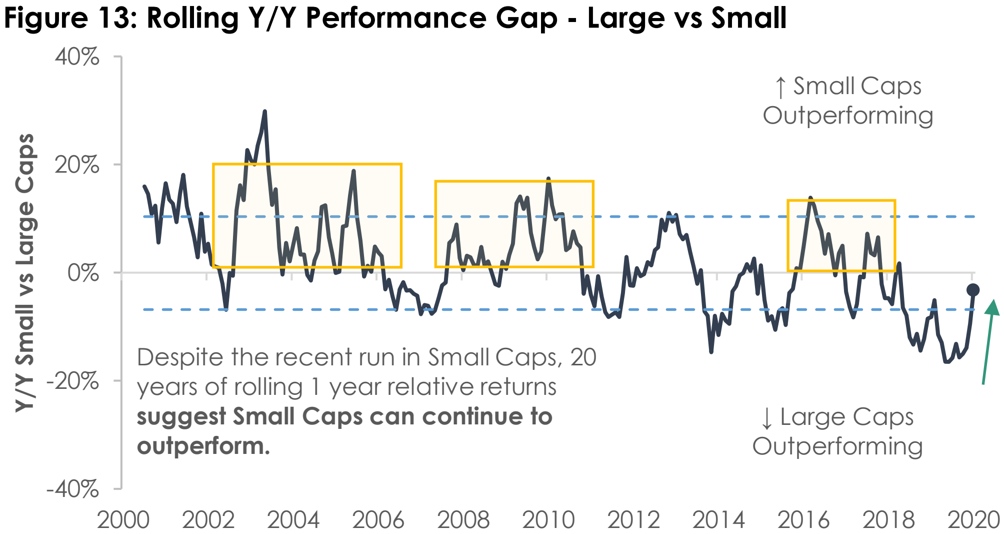
Source: MarketDesk Research, NBER

Investors Focus Likely to Remain on Small Cap Outperformance Exiting Recessions …

● Figure 12 compares Large Cap and Small Cap performance over the 12 month period following each of the last five recessions. Small Caps outperformed Large Caps 100% of the time with an average outperformance of 10.8%.

● Small Caps' outperformance following recessions is a widely known statistic. We expect investors to focus on Small Caps' ability to outperform Large Caps as the economy reopens. Strong economic growth projections and low interest rates should further tilt the market narrative toward Small Caps.

Figure 13: Rolling Y/Y Performance Gap - Large vs Small



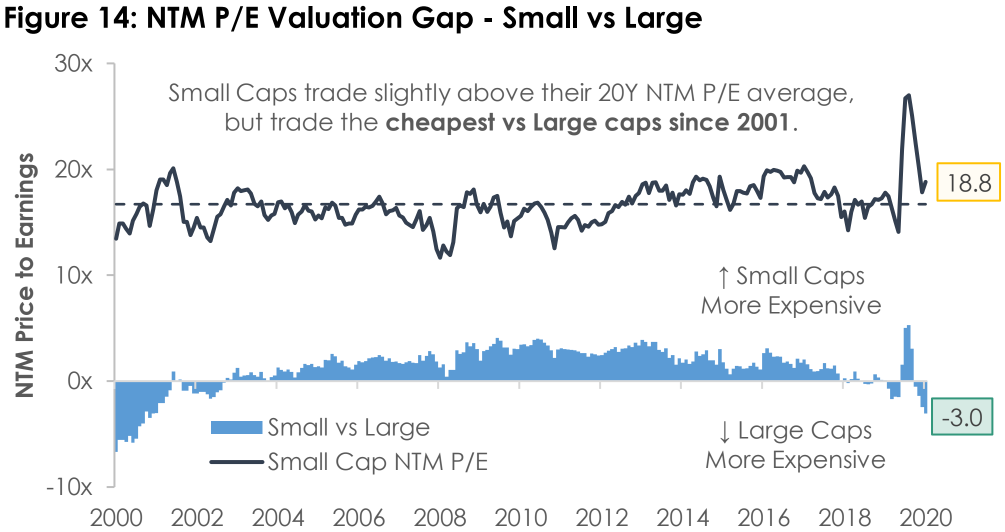
*Source: MarketDesk Research. **Note:** Russell 2000 used for Small Caps and S&P 500 used for Large Caps.*

Small Caps Can Still Outperform After November's Reopening Rally …

● Figure 13 charts the rolling y/y relative return gap between Small Caps and Large Caps. Small Caps underperformed in the pandemic due to their Tech UW and higher EPS volatility. More recently, the chart shows the y/y rolling return passed above the -1std line.

● The yellow boxes highlight Small Caps' extended outperformance following the dot-com bubble, 2008 financial crisis, and 2015 industrial recession. While Small Caps closed the performance gap in November, we believe there is more room to run.

Figure 14: NTM P/E Valuation Gap - Small vs Large



*Source: MarketDesk Research. **Note:** S&P 600 (IJR) used for Small Caps and S&P 500 used for Large Caps. The S&P 600 is used for Small Caps because the index only includes companies that meet certain profit requirements.*

Small Caps Trade at Biggest Discount to Large Caps Since Dot-Com Bubble …

● Figure 14 charts the relative NTM P/E gap between Large Caps and Small Caps against the absolute NTM P/E for Small Caps. Small Caps trade at the largest NTM P/E discount to Large Caps since the dot-com bubble. However, Small Caps trade slightly above their 20Y NTM P/E average on an absolute basis.

● Large Cap Tech's performance during the pandemic drew comparisons to the dot-com bubble in the late 1990s. Small Caps' relative NTM P/E discount in Figure 14 serves as another datapoint that supports an upgrade to OW.

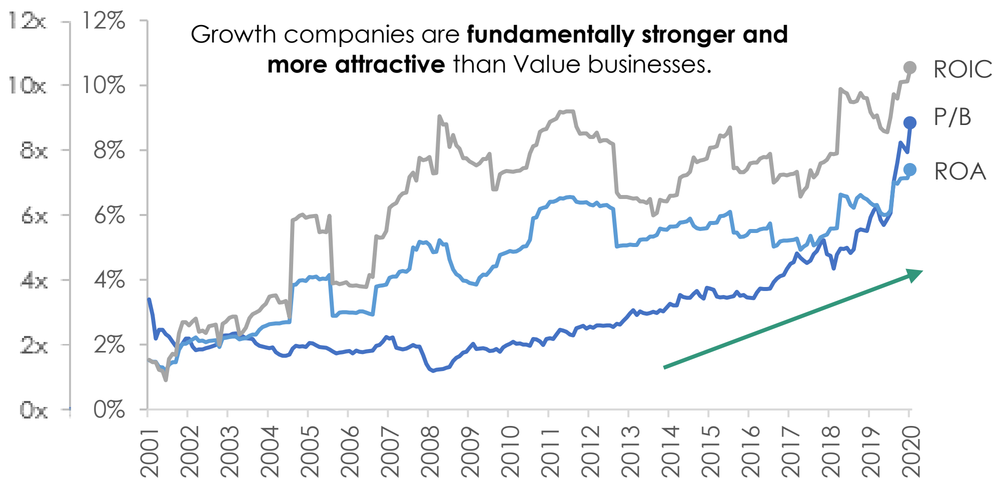
Factor Tilts — Growth, Momentum & High Beta

► **Favor Growth vs Value:** We continue to OW Growth despite stretched valuations due to its superior operating metrics.

► **Momentum vs Low Volatility:** We remain OW both factors. Momentum remains leveraged to Large Cap Tech and secular trends, while Low Volatility can protect against a selloff with markets trading near record highs.

► **High Beta:** While a mix of sector and industry ETFs (e.g. JETS, XLF, XLY, XLE, etc.) can be used to gain targeted exposure to reopening themes, we favor tactically using SPHB's high beta factor approach. Refer to the 12/11/2020 Friday Strategist.

Figure 15: Relative Fundamentals - Growth vs Value



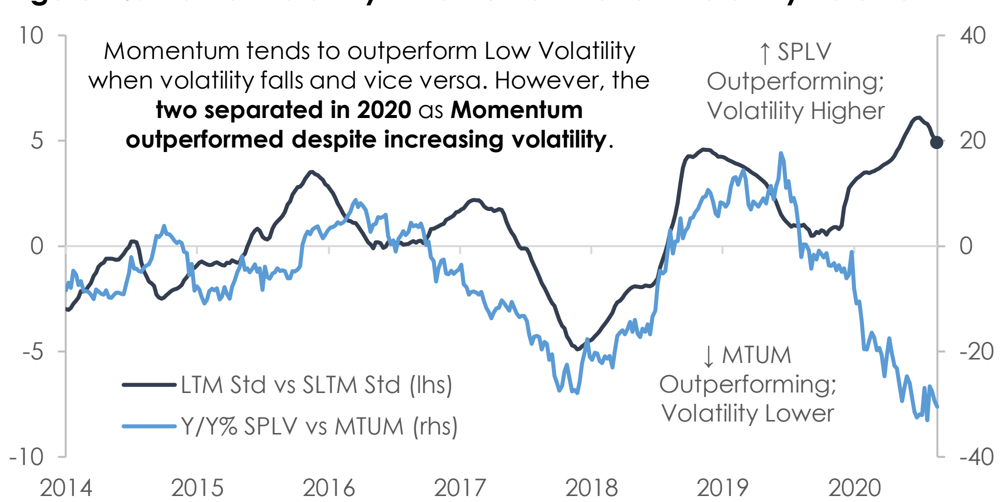
Source: MarketDesk Research

Growth Stocks are More Attractive Long-Term Businesses …

● Figure 15 compares three fundamental ratios for Growth vs Value: P/B, ROA, and ROIC. Growth's P/B ratio is 8.8x higher than Value's P/B ratio. However, we believe Growth's ROA and ROIC support the higher valuation. Growth's ROA is 7.4% higher than Value's ROA, while its ROIC is 10.5% higher than Value's ROIC.

● Growth businesses are fundamentally more attractive businesses than Value. With inflation in check and an uncertain economic environment following COVID-19, we continue to favor Growth over Value.

Figure 16: Market Volatility - Momentum vs Low Volatility Returns



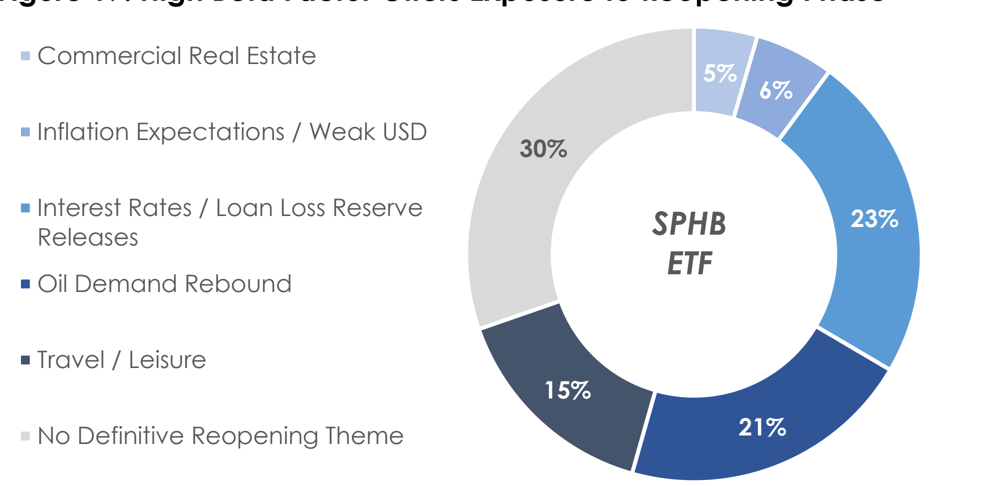
Source: MarketDesk Research. ***Note:*** *STLM corresponds to months -12 to -24*

Momentum Outperforming Low Volatility Despite Increasing Market Volatility …

● Figure 16 compares the y/y volatility change against the relative y/y Low Volatility-Momentum return gap (light blue line). The navy line represents the y/y volatility change, which is calculated as the std of the last 12 months' performance vs the std of the prior 12 months.

● The chart shows Momentum's performance and market volatility generally trend in the same direction. However, the two separated in 2020 as Momentum outperformed even as market volatility rose. We attribute Momentum's outperformance to its Tech sector OW.

Figure 17: High Beta Factor Offers Exposure to Reopening Phase



Source: MarketDesk Research

High Beta Factor Provides Exposure to Major Reopening Themes …

● We expect the vaccine rollout and reopening phase to drive the market narrative in 1Q21, which means portfolios should have exposure to the reopening narrative. We favor tactically using SPHB, which rotated into COVID-19 names during 2Q20.

● Our team sorted through SPHB's holdings and grouped them into reopening themes. The pie chart in Figure 17 shows the current breakdown. We estimate SPHB's reopening exposure at ~70%. Refer to the 12/11/2020 Friday Strategist for the full report.

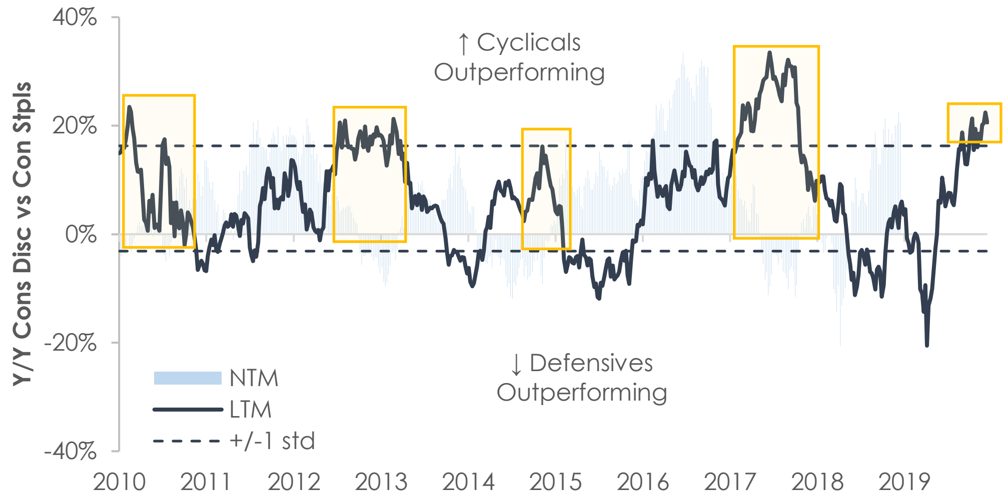
U.S. Sectors — Drivers of Risk & Return

► **Favor Cons Disc over Cons Stpls:** We prefer Cons Disc over Cons Stpls. In our view, accommodative monetary policy and low interest rates can support Cons Disc's continued outperformance against Cons Stpls.

► **Financials:** We remain UW Financials for now but believe there is an opportunity to upgrade the sector in 1H21 due to the potential for (1) continued yield curve steepening and (2) excess loan loss reserves to be released.

► **Sustainable Growth:** Investors will be hyper-focused on the reopening trade and relative earnings growth over the next six months. However, the focus should revert back to sustainable growth as the economy normalizes.

Figure 18: Performance Gap - Consumer Cyclicals vs Defensive



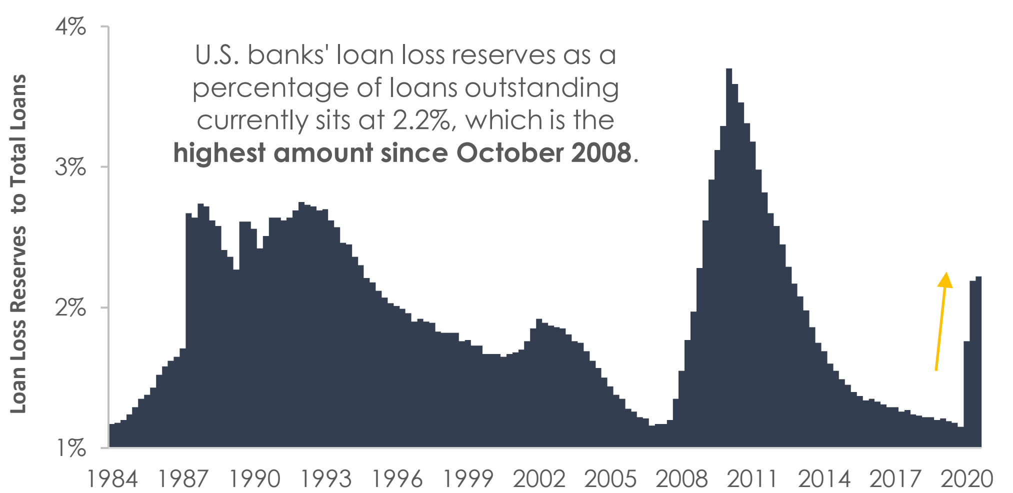
Source: MarketDesk Research

History Points to Muted NTM Cons Disc Returns; Favor Active Selection …

• Figure 18 charts the y/y rolling return gap between Cons Disc and Cons Stpls. Cons Disc's NTM returns tend to be muted when its outperformance bumps up against the +1 std line (see yellow boxes). The exception is late 2017 / early 2018 when the sector surged higher.

• Cons Disc's retail and services exposure made it vulnerable to COVID-19. However, online retail and homebuilding exposure bridged the gap and supported outperformance. We believe Cons Disc can continue to outperform but favor active stock selection.

Figure 19: % of Loan Loss Reserves to Total Loans for all U.S. Banks



Source: MarketDesk Research, Federal Reserve

Loan Loss Reserves Could be Released if Recovery Remains on Track …

• Figure 19 charts the percentage of loan loss reserves to total loans outstanding for all U.S. banks. Loan loss reserves spiked during the pandemic as banks set aside capital.

• The banking industry created its biggest collective reserve since 2010 this year. However, actual loan loss trends are more favorable than banks initially expected. Factor in a combination of promising vaccines, surprisingly resilient earnings, and the potential for another round of stimulus, we believe banks could start releasing excess reserves in the second half of 2021.

Figure 20: Sector EPS Estimates & Long-Term Growth Rates

Sector	NTM P/E	2021 Est	2022 Est	PEG	EPS LTG
Energy	20.4x	745%	103%	0.05	0%
Industrials	24.8x	78%	28%	0.47	7%
Cons Disc	27.8x	57%	30%	0.65	18%
Financials	14.7x	21%	18%	0.76	5%
Comm Svcs	24.7x	35%	25%	0.84	12%
Materials	21.3x	28%	12%	1.08	15%
Real Estate	17.1x	11%	10%	1.65	7%
Health	16.5x	11%	9%	1.67	10%
Tech	26.6x	14%	11%	2.13	14%
Cons Stpls	20.5x	6%	8%	2.86	6%
Utilities	18.5x	5%	6%	3.50	6%

*Source: MarketDesk Research. **PEG** is calculated as NTM P/E divided by the average consensus growth rate projection for 2021 and 2022. **EPS LTG** uses the consensus estimate for each sector's projected long-term growth rate.*

Balancing Reopening Exposure with Sustainable Growth Should be a Priority …

• The table in Figure 20 lists out NTM P/E, 2021 / 2022 EPS growth estimates, sector PEG, and the long-term EPS growth rate (LTG) for each sector. The COVID-19 EPS plunge and forecasted 2021 rebound following vaccine distribution are distorting estimates and PEGs.

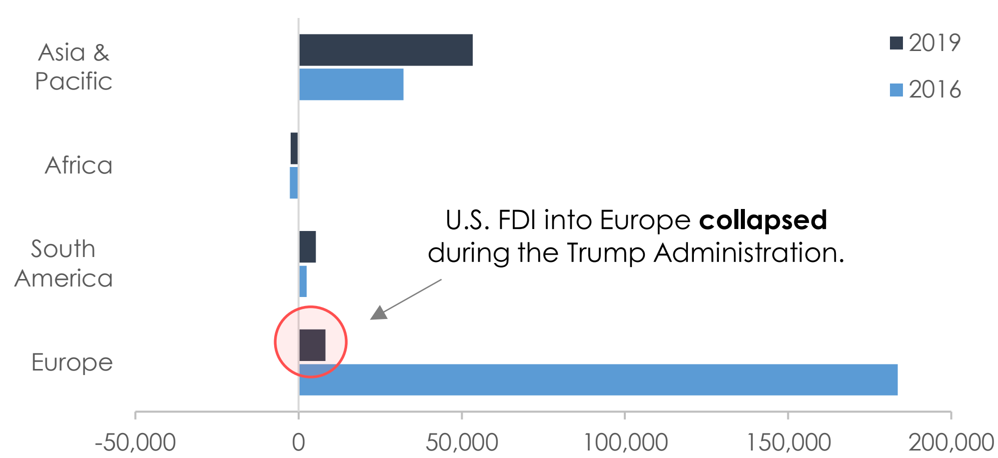
• Striking a balance between the one-time reopening boost and sustainable LTG is key. For example, Energy benefits from reopening, but the higher near-term growth rate appears unsustainable. In contrast, Industrials, Cons Disc, Financials, Comm Svcs, and Materials offer attractive PEGs with sustainable LTG.

International — Developed vs Emerging

► **Add to International Exposure; Favor EM over DM.** International equities are becoming more attractive as catalysts appear on the horizon. The incoming Biden administration is expected to pursue a more multilateral trade agenda with less emphasis on tariffs and threats. USD is weakening as the global economy enters the reopening phase and safe-haven assets lose their appeal. Both should be broadly supportive of international equities.

► **Actionable Ideas:** We continue to favor broad Emerging Market exposure. Consider EEM, VWO, and IEMG. Page 11 provides additional tactical country and region idea generation for both EM and DM.

Figure 21: U.S. Direct Investment Abroad - 2016 vs 2019

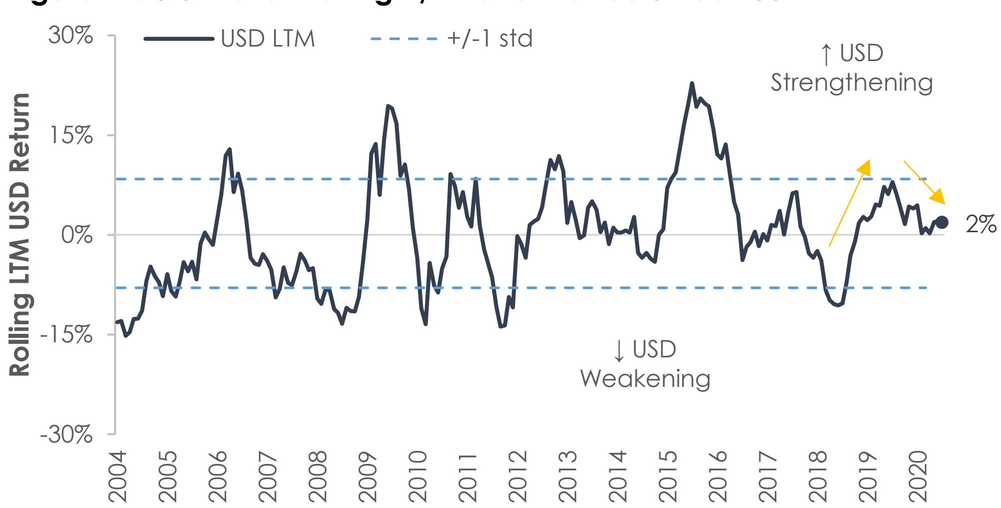


Source: MarketDesk Research, U.S. Bureau of Economic Analysis

Biden Trade Agenda Expected to be More Multilateral and Less Confrontational …

- Figure 21 compares U.S. outbound foreign direct investment (FDI) by region in 2016 against 2019. The Trump administration's protectionist trade policies and China trade war impeded global trade and business investment. As an example, U.S. FDI into Europe plunged in 2019.
- The Biden administration is expected to be more institutional and less erratic on trade policy. This should remove a barrier to business and cross border investment, which would be positive for global growth. International assets should benefit from a less combative approach.

Figure 22: U.S. Dollar Rolling Y/Y Performance Since 2004

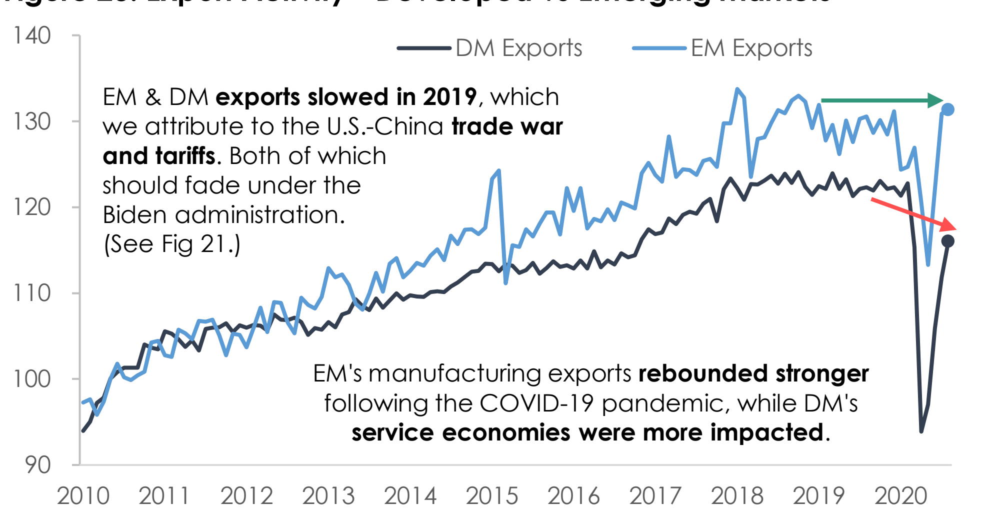


Source: MarketDesk Research

USD Strengthened During the Pandemic but is Now in a Weakening Trend …

- Figure 22 charts USD's y/y rolling performance since 2004. USD strengthened as the Fed raised interest rates twice in 2018 and Trump pursued protectionist policies via a trade war and tariffs.
- USD strengthened during the initial stages of the pandemic. It is now reversing course and weakening, which should make international assets more attractive. We expect USD to continue weakening as vaccine distribution causes investors to rotate out of safe-haven assets and low real yields send investors searching for yield outside the U.S.

Figure 23: Export Activity - Developed vs Emerging Markets



Source: MarketDesk Research, CPB Netherlands. ***Note:*** *Data indexed with 2010 = 100.*

Export Activity Highlights EM's Reopening While DM's Exports Remain Weak …

- Figure 23 compares EM export volumes against DM export volumes over the last decade. The data shows exports from EM's manufacturing-oriented economies held up stronger than DM's service-oriented economies during COVID-19.
- We favor EM's manufacturing economies during the reopening phase. Service businesses will continue to endure start and stop periods until vaccine distribution is far enough along to blunt the virus's spread. In addition, EM should benefit more than DM from a flood of stimulus washing up on its shores.

Allocations to Global Regions

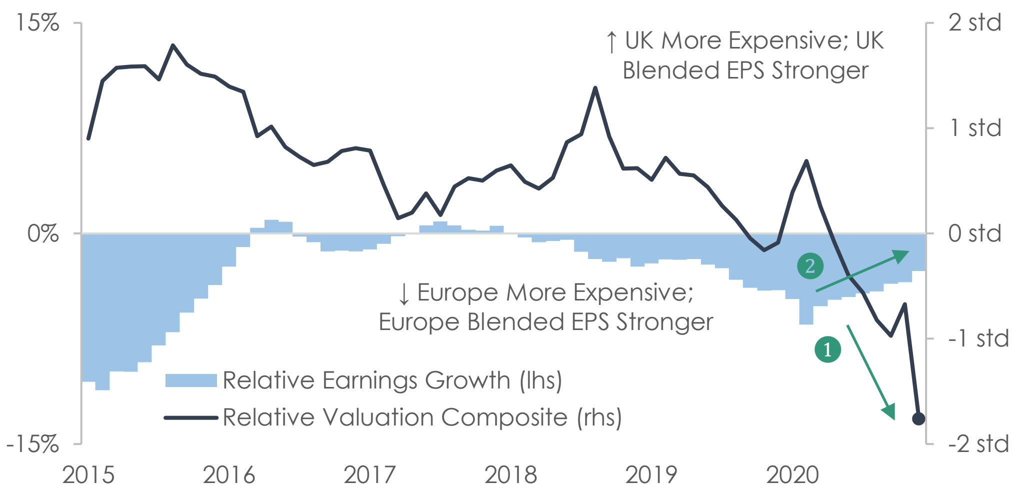
In 1Q21, we favor tactical exposure to regions and countries that underperformed during the COVID-19 pandemic. We view these as shorter-term tactical positions (3-6 months) tied to the reopening phase and idiosyncratic events, such as Brexit.

► **Europe**: Tactically OW the UK (Brexit resolution) vs Europe. Consider EWU or IEUS (Refer to 10/23/2020 Friday Strategist).

► **Asia:** Tactically OW Singapore (tourism economy, Financials & Real Estate sector OWs) vs Developed Asia. Consider EWS.

► **Latin America:** Tactically OW Latin America vs All World ex U.S. as global economy reopens. Consider ILF.

Figure 24: UK Valuation & Blended EPS Growth vs Europe



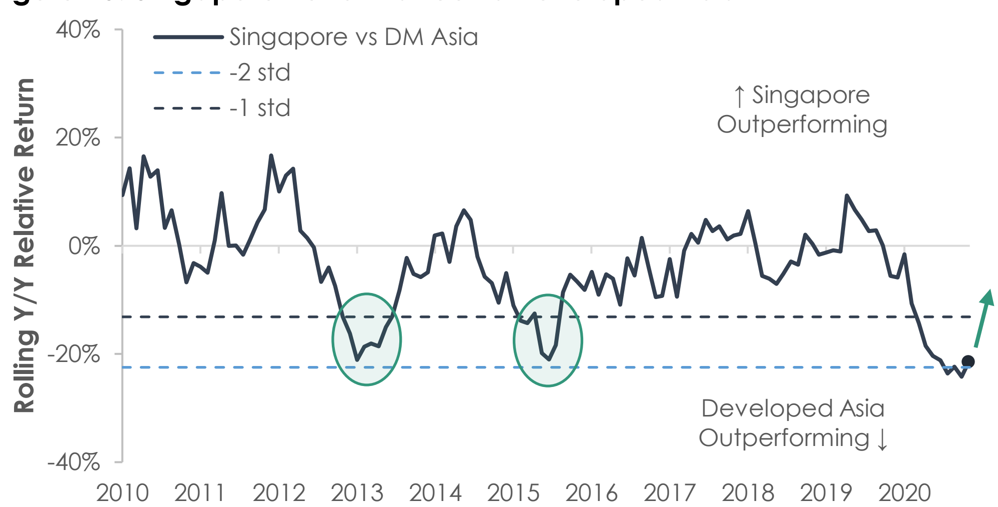
Source: MarketDesk Research. ***Earnings Growth*** *is an average of LTM and NTM EPS.*

UK Trades at a Valuation Discount to Europe Despite Improving Blended EPS Growth …

● Figure 24 charts the Europe-UK relative valuation composite and blended EPS growth gaps. The UK (1) trades at a nearly -2std valuation composite discount despite (2) its blended EPS growth rate rebounding.

● Brexit is a headwind for the UK as the group of countries faces an uncertain future. However, the transition period ends on 12/31/2020, which should provide at least some resolution. We favor tactically adding UK exposure in anticipation of the valuation discount reversing and blended EPS growth trending higher.

Figure 25: Singapore Performance vs Developed Asia



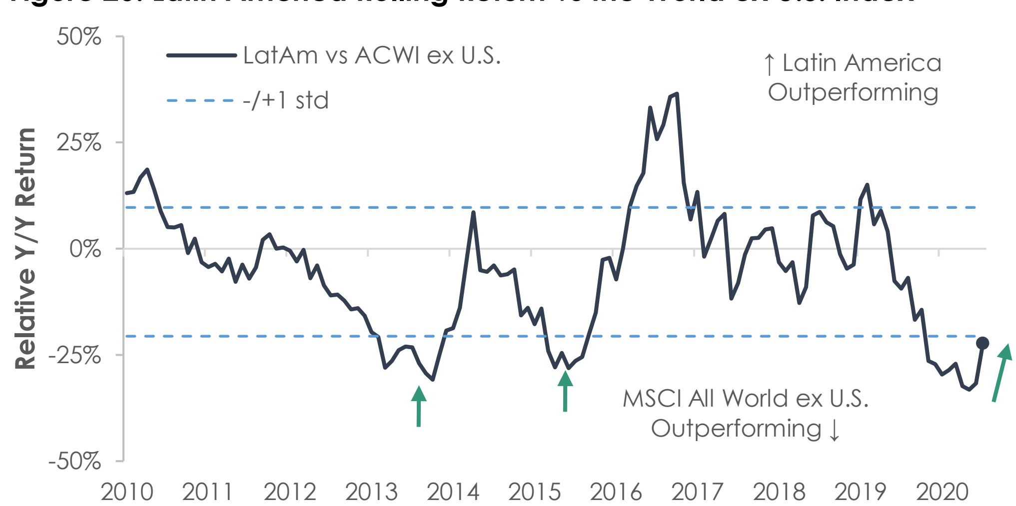
Source: MarketDesk Research

Singapore's Relative Return vs Developed Asia Creates a Tactical Opportunity …

● Figure 25 charts the rolling y/y performance gap between Singapore (represented by iShares' EWS) and Developed Asia (represented by Vanguard's VPL). The relative y/y return gap currently sits near the -2std line.

● Singapore's tourism dependent economy suffered as COVID-19 upended global travel. The economy contracted 5.8% y/y in 3Q20 after falling 13.3% y/y in 2Q20. In addition, EWS's Financials and Real Estate OWs led to significant underperformance. We favor a tactical Singapore OW vs DM Asia in 1H21.

Figure 26: Latin America Rolling Return vs the World ex U.S. Index



Source: MarketDesk Research

Latin America Relative Return vs All World ex U.S. Presents Mean Reversion Trade …

● Figure 26 charts the rolling y/y performance gap between Latin America (represented by iShares' ILF) and the MSCI All World ex U.S. Index (represented by iShares' ACWX). The relative y/y return gap currently sits near the -1std line after COVID-19 strained Latin American government budgets and healthcare systems.

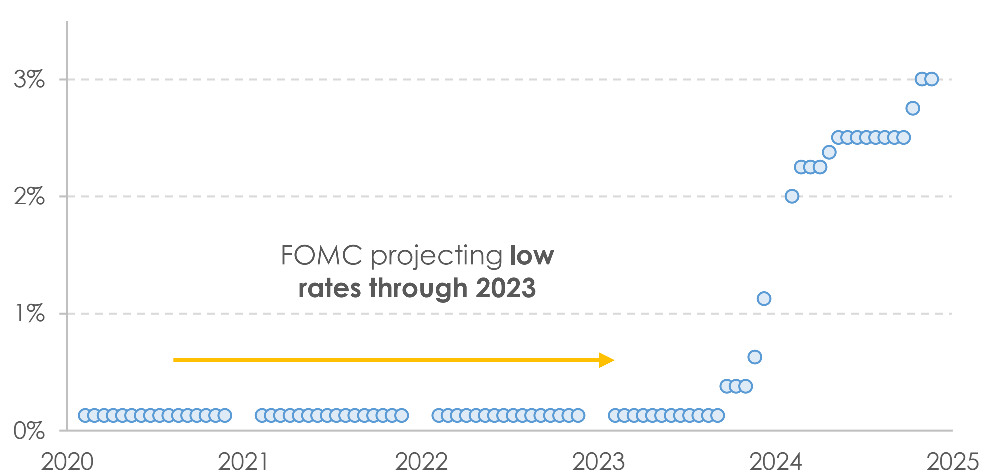
● Risk assets, such as Latin American equities, should benefit from the vaccine rollout. Similar to Singapore, we favor tactically gaining Latin America exposure during the reopening phase.

Credit Duration — Long vs Short

► **Shorten Duration.** The Fed is expected to keep interest rates near zero through 2023. However, we expect rising inflation expectations and a continued risk asset rotation to pressure interest rates higher. We favor shortening duration and adding exposure to floating rate debt to address interest rate risk. The near-term risk to this viewpoint is the current speculative market environment (e.g. SPACs, IPOs, etc.), which could lead to a sharp correction and rush to U.S. treasuries in 1Q21.

► **Actionable Ideas:** In Corp IG, we favor shortening duration (e.g. 5Y-10Y maturities). (Refer to the 10/16/2020 Strategy Snapshot for our short-duration IG ETFs.) In addition, consider adding floating exposure, such as FLOT, FLRN, VRIG, and FLTR.

Figure 27: December 2020 Federal Reserve Dot Plot



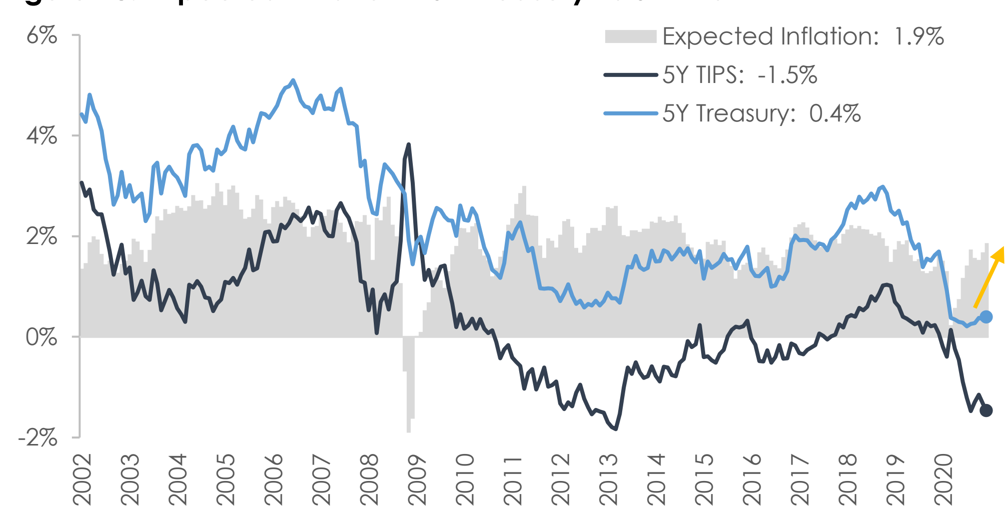
Source: MarketDesk Research, Federal Reserve

Fed Dot Plot Shows Interest Rates are Expected to Remain Low Through 2023 …

● Figure 27 shows the Federal Reserve's December 2020 dot plot. Each dot represents a FOMC member's future interest rate projection. The latest dot plot shows most FOMC members expect interest rates to remain near zero through 2023.

● The Fed's push to keep interest rates near zero means duration should theoretically not be a concern. At first glance, extending duration to earn slightly higher yields appears attractive given the low rate environment. However, we believe yields could be pressured due to rising inflation expectations and a risk asset rotation.

Figure 28: Expected Inflation - 5Y Treasury vs 5Y TIPs



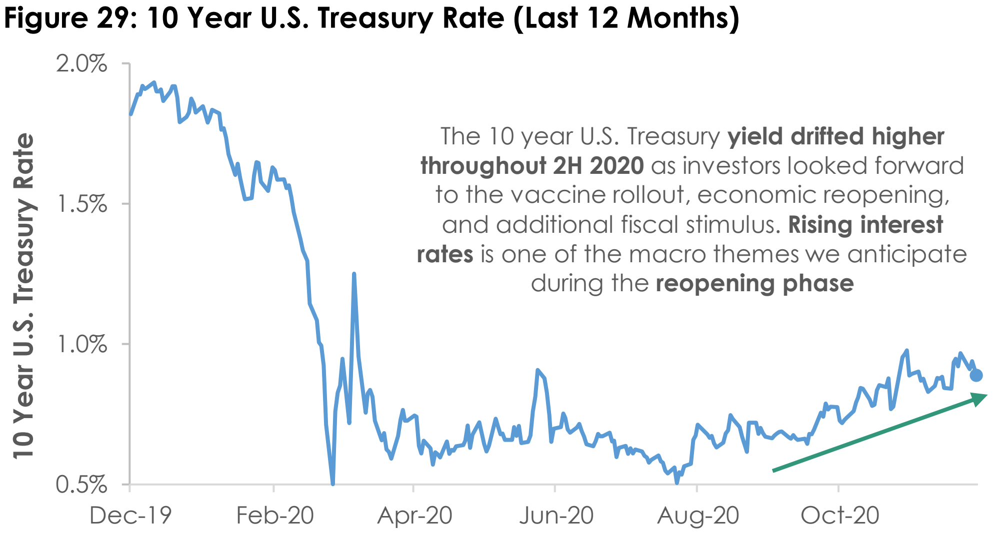
Source: MarketDesk Research, Department of the U.S. Treasury

Inflation Expectations Move Higher Due to Stimulus & Reopening …

● Figure 28 charts inflation expectations by measuring yields on 5Y Treasuries against 5Y TIPs. Inflation expectations are firming, which we attribute to stimulus measures and rising economic growth projections.

● Inflation expectations will likely remain elevated in 1Q21. Rising inflation expectations, combined with a risk asset rotation as the economy reopens, could put upward pressure on interest rates. Long-duration bonds would be vulnerable, which means extending duration is risky.

Figure 29: 10 Year U.S. Treasury Rate (Last 12 Months)



Source: MarketDesk Research, Department of the U.S. Treasury

10Y Interest Rate Moving Higher; Favor Shorter Duration & Floating Rate Debt …

● Figure 29 charts the 10Y U.S. Treasury (UST) yield over the last 12 months. The Federal Reserve cut the federal funds rate to 0-0.25% in March 2020 to support credit markets. The 10Y UST yield touched a low of 0.51% on 8/4/2020 but now sits at 0.92% after moving higher in recent months.

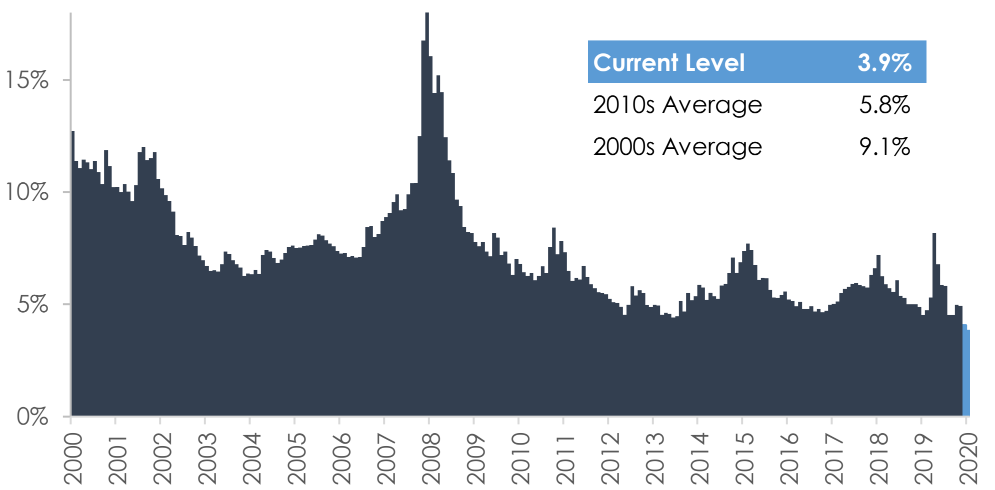
● We expect interest rates to continue drifting higher in 1Q21. The vaccine rollout and reopening phase should both remain dominant market narratives. We favor addressing the risk of rising interest rates by shortening duration in IG and adding floating rate exposure.

Credit Quality — IG vs HY

► **Maintain High Yield OW.** We maintain our HY OW as a way to generate higher income levels in the present yield-starved environment. However, our OW conviction is shrinking with junk bond yields sitting at record lows and the spread-tightening catalyst fading. There is an increasing likelihood we downgrade HY to Neutral in 1H21. For now, we remain hesitant to upgrade IG due to the segment's elevated duration. (Refer to page 12 for our duration views.)

► **Actionable Ideas:** In Corp HY, we favor emphasizing BB-rated bonds via FALN, ANGL, and HYBB. Refer to page 12 'Actionable Ideas' for our preferred Corp IG exposure.

Figure 30: ICE BofA High Yield Index — Yield to Worst



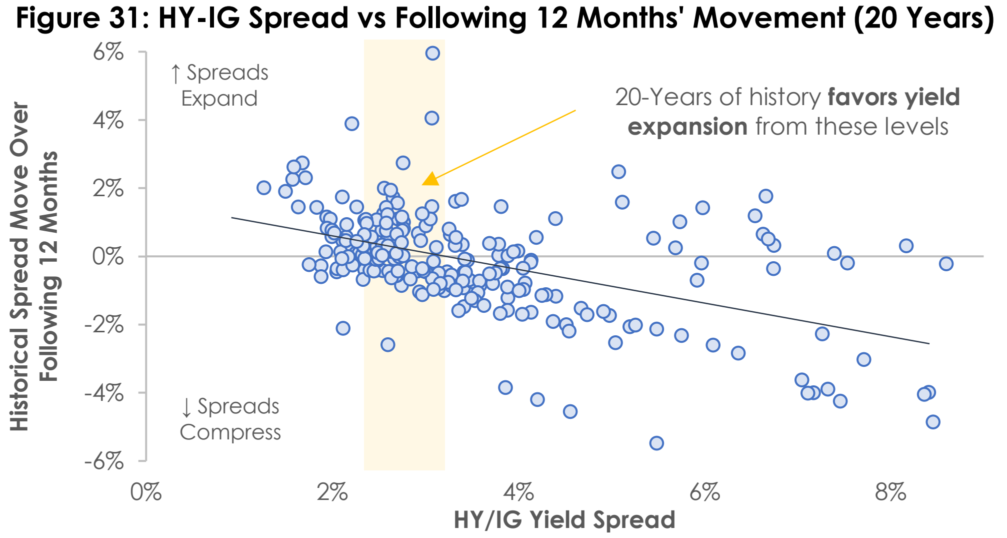
Source: MarketDesk Research

Yield on Corporate High Yield Index Hits Record Low Twice in 4Q20 …

● Figure 30 charts the yield to worst (YTW) on the ICE BofA HY Index over the past two decades. Junk bond yields hit a record low in November 2020 following the presidential election and a second record low in December 2020.

● Accommodative monetary policy continues to distort credit markets. The current 3.9% YTW compares to a 5.8% 2010s average YTW and a 9.1% 2000s average YTW. With yields expected to remain low and the Fed underwriting credit risk, HY offers a more attractive yield than IG.

Figure 31: HY-IG Spread vs Following 12 Months' Movement (20 Years)



Source: MarketDesk Research. ***Note:*** *IG includes AAA, AA, and A corporate bonds.*

History Indicates HY-IG Spread Likely to Widen Over Next 12 Months …

● Figure 31 is a scatter plot comparing historical HY-IG YTW spreads against HY-IG spread movement over the following 12 months. In general, wider HY-IG spreads signal a higher probability of spread compression, while tighter HY-IG spreads suggest spread expansion, or limited compression, is a higher probability event.

● The current HY-IG YTW spread is 2.3%. The HY-IG spread ended the month between 2.0-2.5% 44 times over the past 20 years. It widened an average of +0.2% in the following 12 months. HY's spread tightening catalyst is fading.

Figure 32: Credit Divide Spread - BB HY vs BBB IG (20 Years)

Source: MarketDesk Research

Favor BB HY Debt Over Lower Rated HY Debt in Order to Emphasize Quality …

● Figure 32 charts the BBB-BB YTW spread (e.g. credit divide spread), which shows the incremental yield earned by moving from the lowest rated IG debt (BBB) down to the highest rated HY debt (BB). The current BBB-BB spread is 1.3% compared to 0.7% on 12/31/2019.

● The risk / reward of owning HY is less attractive compared to May 2020 when we initially upgraded HY to OW. We favor addressing the less favorable risk / reward ratio by positioning in the highest rated HY segment (BB) in order to earn higher yields while still emphasizing quality.

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