First Quarter 2021 Outlook and Commentary

Our expectations for the U.S. economy have evolved considerably over the last six months. Last July we expressed concern that the recovery would be "prolonged and unsteady." In October, we discussed the possibility of a more optimistic scenario but saw it as one in a wide range of outcomes. Since then, with the approval and distribution of two highly effective vaccines and with $900 billion of Covid relief in place and perhaps more on the way, the economic outlook for 2021 is much improved.

While much of the country was learning more about election certification than it ever wanted to know, the stock market focused on the economy and continued to climb. The market likes certainty and it decided early on that Biden had won and that the Senate would be tight enough to keep it from veering sharply left or right. Even the shocking desecration of the U.S. Capitol on January 6th failed to rattle markets. That may seem strange, but when terrible things happen Wall Street asks two questions: Will the financial system be disrupted? Will corporate profits be impacted? Regardless of how disturbing the images of the assault were, the answer was no. In the meantime, highly safe and effective vaccines offer the prospect of a return to something approaching normal life later this year. In the summer or fall the economy may begin to accelerate and rapidly approach pre-Covid levels of activity.

To be sure, the economy is not home free. A full recovery requires a successful roll out of the Moderna and Pfizer vaccines, together with any others that may be approved in coming months. Experts believe that 70% to 85% of the population needs to be vaccinated to achieve "herd immunity." Only a month ago, Operation Warp Speed targeted 20 million vaccinations by the end of 2020. The actual number was around 4 million, so the initial rollout has not been confidence inspiring. New variants of the Covid virus, including those recently originating in the U.K. and in South Africa, may complicate matters. Although the vaccines are expected to be effective against these new strains[1], the mutated variants appear to be more transmissible. The more easily a virus is transmitted, the higher the threshold to achieve herd immunity.

Despite all of this, the experts we follow most closely anticipate that the vaccine rollout will gain momentum in coming months and expect that at some point over the summer, things will begin to look a lot closer to normal. In the meantime, thanks in part to the CARES Act that Congress passed last March, consumers have accumulated hundreds of billions of dollars that they would spend if they could and will when they can. When it's safe to travel and move about more freely—or even when it's starting to get close—consumer spending should accelerate. While that won't be of immediate help to the millions of Americans who have experienced permanent job loss or been evicted from their homes, it should give a huge boost to the overall economy.

[1] Experts are less certain of that with the South African variant; it is believed that if necessary, the vaccines could be relatively easily modified to become effective but that creates obvious complications.

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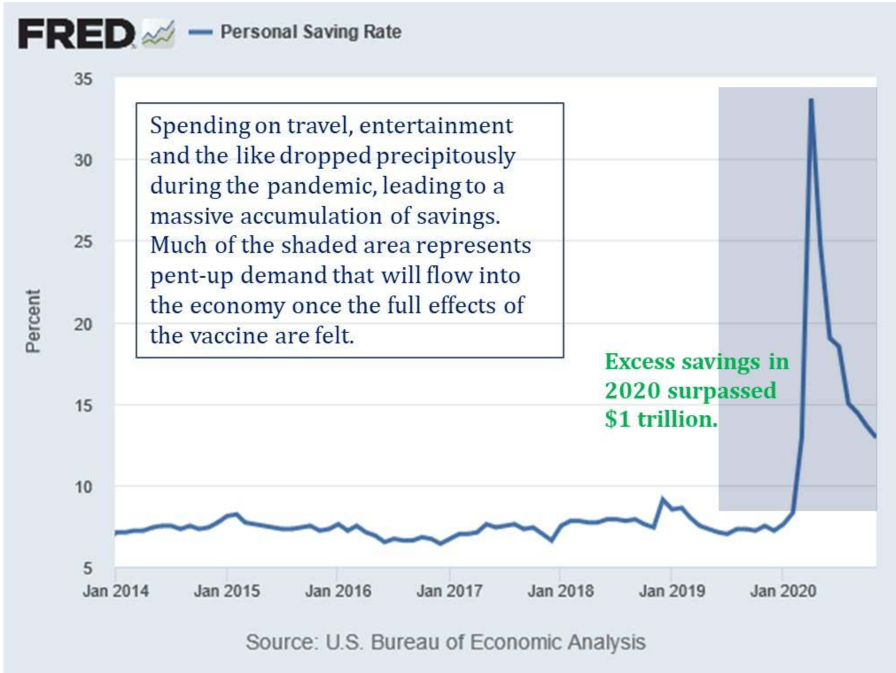

The chart above illustrates the surge in personal savings. Last November investment publication Barron's estimated this excess savings at $1.3 trillion. Not all of that will flow into the economy when life returns to normal, but much, perhaps even most of it, will.

Of course, we're still six months or more away from having enough of the population vaccinated to start thinking about life returning to normal. That's why the recently passed $900 billion Covid relief package was so important. With encouragement from President Trump, Democrats pushed to have checks to individuals increased from $600 to $2,000, but that effort died in the Republican-controlled Senate. When the new Georgia senators are seated, giving Democrats tenuous control of the Senate, the additional $1,400 as well as help for badly impacted states and municipalities may be approved. While it's not clear how much of this relief will get to those who need it most, the economy seems likely to muddle through until consumers feel safe enough to splurge.

In a best-case legislative scenario, President-elect Biden and Congress will find a way to forge a bipartisan infrastructure package. Sustained investment in repairing the country's crumbling bridges and roads could provide a long-term economic boost and do a lot to address the festering problem of stagnant middle-class wages. It's possible but not something we would count on. Even so, as the vaccines allow life to return to some semblance of normalcy later this year, the prospects for robust economic growth are strong.

Investment Implications

If the economic outlook is positive, does that mean it's time to increase stock allocations? Not necessarily. For one thing, it's not a sure bet that the vaccines will save the day. Perhaps new and dangerous side effects will be discovered. Perhaps the rollout will continue to be rocky. Maybe the vaccines won't be effective against new strains of the virus after all. Even if vaccines are as effective as hoped, economic prospects outside the U.S. are spottier. China and some other Asian countries seem to have been successful in getting control of the pandemic, but

Europe has been devastated and has not responded as aggressively with stimulus and relief measures. It could take several years for the global economy to fully heal.

Perhaps the most important reason for caution, though, is eye-popping 2020 stock market returns. Shaking off the deep Covid triggered recession, the S&P 500 Index returned over eighteen percent on the year. That's on top of a very strong 2019; putting the two years together the S&P 500 is up fifty percent since December 31, 2018. It's hard not to believe that the U.S. market has gotten ahead of itself and taken away from future returns.

If 2020's strong performance lowers future stock returns, investors may be in a bind because the outlook for bonds is downright depressing. In a normal environment, bond yields are the best predictor of future returns. The yield on the benchmark 10-year U.S. Treasury is around 1%. Corporate bonds offer a bit more yield, as do emerging market bonds. But those come with additional risk. To make matters worse, if the economy does pick up steam, that will put pressure on interest rates, and bond prices go down when rates go up. It's critical to have bond strategies in a portfolio to provide a stable source for short- and medium-term cash flow needs. But at the current level of interest rates, you can't rely on bonds to deliver more than low single digit returns.

Fortunately, most of the stock market strength over the last two years has been concentrated in a small number of companies. The FAANG stocks (Facebook, Apple, Amazon, Netflix and Google) are up anywhere from 69% (Google/Alphabet) to 236% (Apple). This has created a huge discrepancy between growth stocks and value stocks. Growth stocks have done so well that returns over the next ten years may not be much better than bonds. Value stocks have done well also, but more reasonable valuations should support respectable future returns. Vanguard's Investment Strategy Group recently projected annualized returns from U.S. growth stocks over the next ten years from 1% to 3%. U.S. value stocks are projected to return a more attractive 5% to 7%. Better returns will likely come from overseas where foreign and emerging markets stocks are projected to generate high single-digit returns given their lower starting valuations and higher dividend yields.

In the near term, the whole U.S. market may be due for a pause. At this writing, the S&P 500 is up over seventy percent from the March 23rd low. While value stocks haven't bounced as sharply, they are still up over fifty percent. Periodic retrenchment is a normal part of the investment cycle, so it would hardly be surprising if the market pulled back a bit some time over the next few months.

Our optimism about the economy is also tempered by a mounting litany of long-term problems facing the country. The pandemic will leave deep financial, physical and emotional scars on millions of Americans. Massive government spending, no matter how critical and well justified, adds to the nation's debt. And political divisions seem to be tearing at the fabric of the nation. Eventually these issues could have systemic effects that negatively impact companies and their financial results. Whether and how is difficult to know.

January 17, 2021
Boston, MA

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