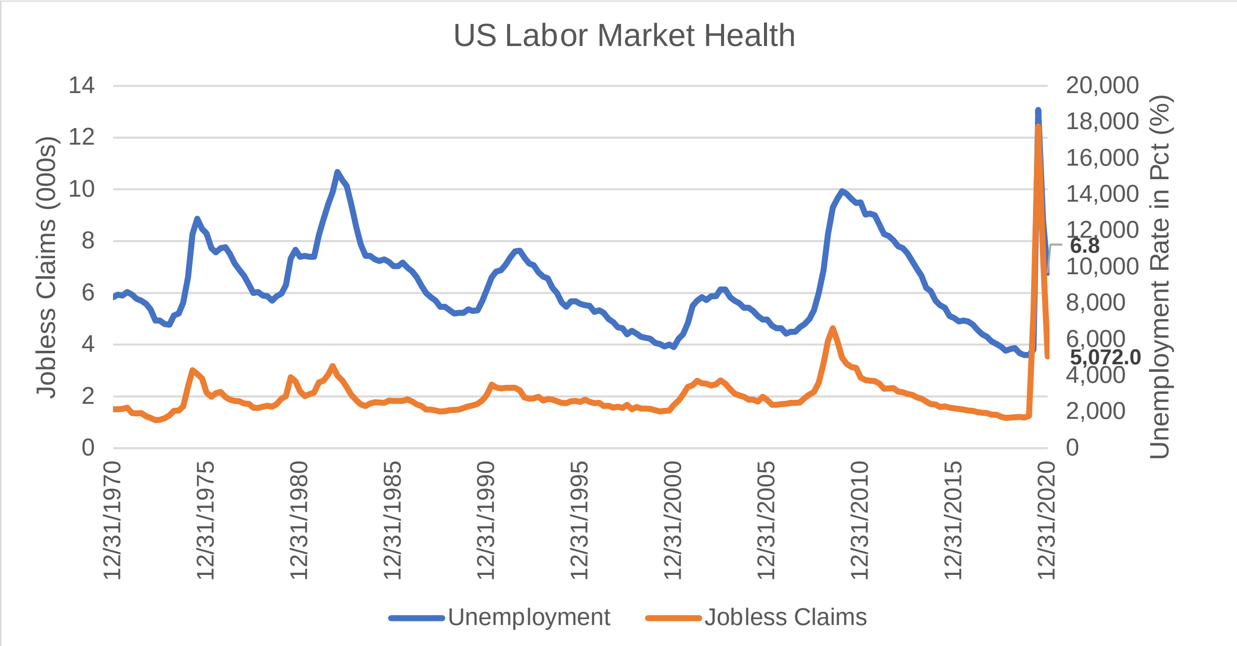
AndCo's Monthly Market Update

January 2021

THE ECONOMY

Looking back on 2020, it would be trivial for us to equate anything experienced from an economic perspective to those who experienced personal loss related to the pandemic. The shared experiences of this year will most likely shape future generations in ways that we cannot yet imagine. In terms of the economy and capital markets, the year can be viewed in three distinct, uneven time periods. The first being the leadup to the onset of the pandemic in late-March, followed by a dramatic drawdown during the second quarter, and finally an unprecedented market recovery during the remainder of the year. The shock and subsequent recovery experienced by the economy was unlike anything we have observed in recent history. While most markets closed the year at, or near, new highs, millions of Americans remain either out of work or underemployed and many businesses and schools remain closed. We would be remiss if we did not mention this all took place amid a hotly contested presidential election. It is safe to say that regardless of your experience with the pandemic, political persuasion, or perspective, we are all hoping for a better year in 2021.

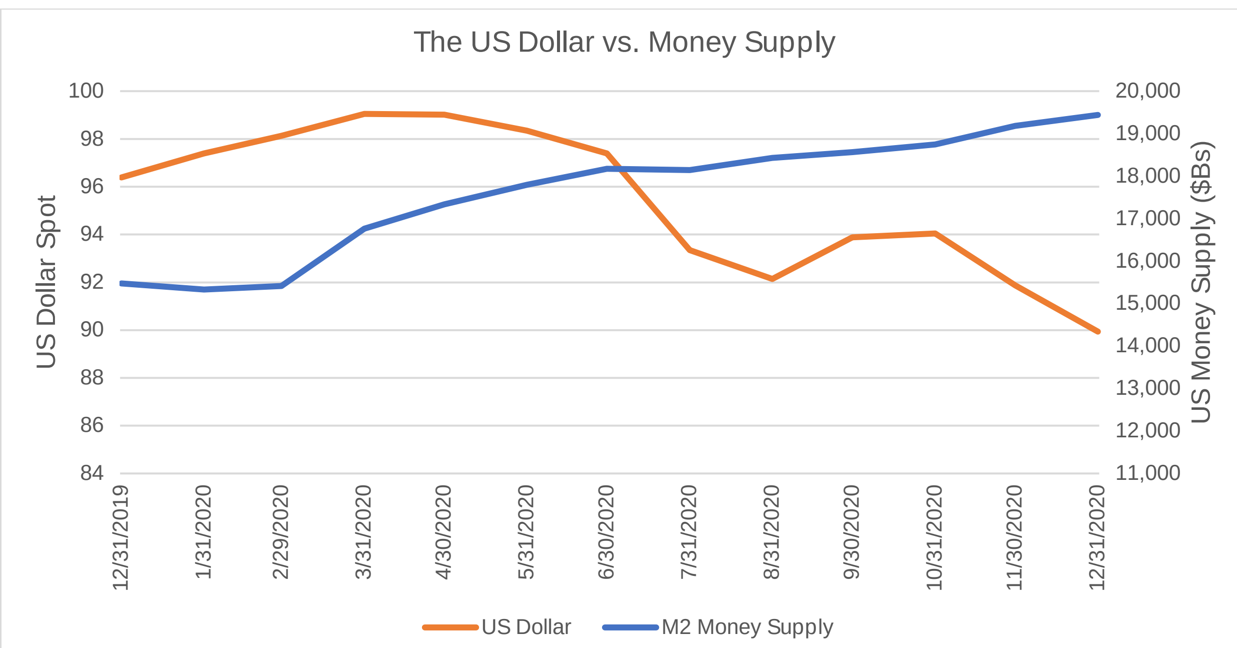
From an economic perspective, we have discussed in previous updates that there have been signs of weakness in several keys data points while still maintaining the belief that the broader recovery remains in place. We continue to watch the health of the US labor market closely for confirmation of our thesis. As seen in the chart below, the dramatic deterioration in the labor market in the first quarter of 2020 was followed by an equally impressive recovery. Even in the throes of the Great Financial Crisis, the unemployment rate never exceeded 10.0%.[1] In April this year, the unemployment rate measured 14.8%.[2] Following the initial shock, the labor market steadily improved with the unemployment rate ending the year at 6.7%.[3] More recently, initial claims have come in above the market's expectations due primarily to increased restrictions related to the holiday resurgence of the pandemic.[4] That said, with the rollout of vaccines and therapeutics, we are of the belief that jobless claims and the unemployment should continue to trend lower in the future.



Source: Bloomberg as December 31, 2020

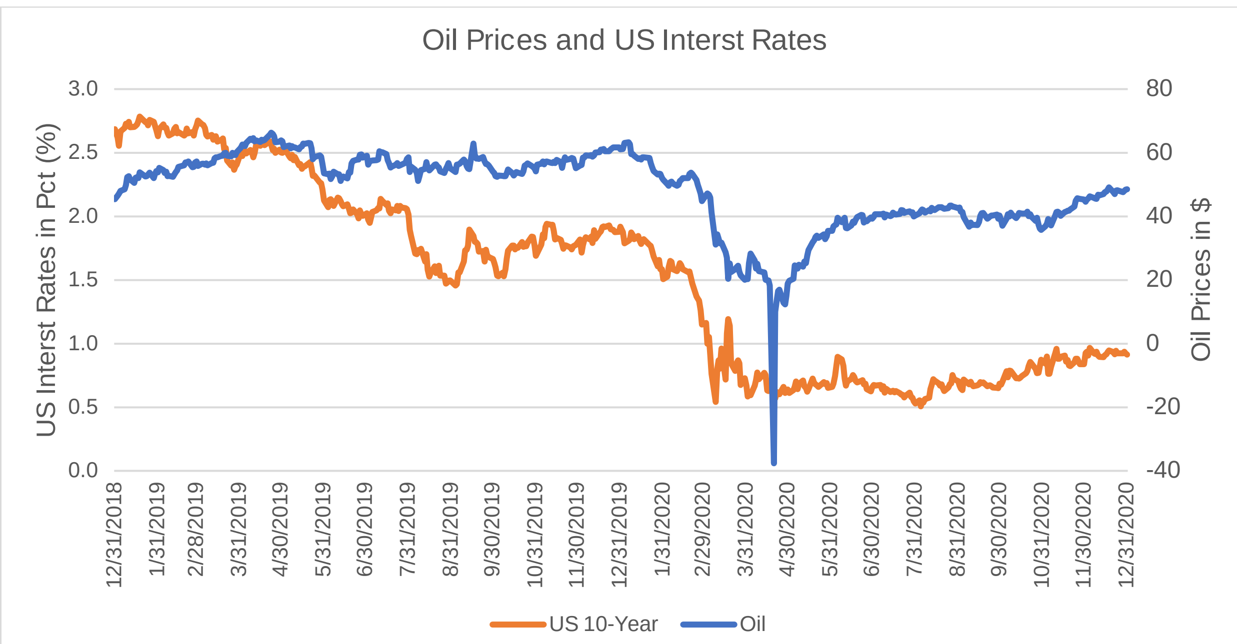
While the labor market will take time to recover, other parts of the US economy have seen significant growth. The ISM Manufacturing Index registered 60.7 in December, the highest level since late-2018.[5] Similarly, the US Services PMI Index rose to 54.8 in December, quickly recovering all of the losses from April, signaling an expanding economy.[6] With manufacturing and skilled labor jobs in demand, it is not surprising that the US Average Hourly Earnings grew by roughly 5.1% year-over-year in 2020.[7] Importantly, as the economy expands and wages rise, sectors like the housing market have historically benefited, and 2020 was no exception. While 5.3 million existing homes were sold in 2019, more than 6.6 million homes were sold in 2020.[8,9] There was a combination of potential effects that led to the rise in home sales in 2020 including record-low US interest rates, outward migration from urban population centers like New York and Los Angeles and improving consumer sentiment. While the University of Michigan Consumer Sentiment Index has not fully recovered to its previous February 2020 highs, the trend has been positive with the index registering in at 80.7 in December, up from 71.8 in March.[10] While there will likely be bumps in the road, there are several other positive economic data points that suggest the recovery is continuing to progress.

One area that we are watching closely is inflation. Since the beginning of 2020, the Federal Reserve Bank (Fed) has grown the US money supply by more than 25% in its efforts to stimulate the economy.[11] Much of this liquidity injection never made it into the market as evidenced by cash deposits with the Fed increasing to more than $1.5 trillion, the US Personal Savings Rate closing at the highest level on record, and US CPI remaining below the Fed's target of 2.0%.[12,13] The massive deflationary wave that hit the world economy as a result of the pandemic, combined with structural changes in the economy such as increased reliance on technology, have largely kept inflation in check in recent months. What gives us pause is the expected surge in economic growth once the pandemic subsides. The liquidity that has been on the sidelines in cash will eventually be put to work as the economy recovers. While nominal US GDP remains below the peak it reached prior to the pandemic, the Atlanta Fed GDP model is forecasting that real GDP growth in the 4th quarter will be 8.7%.[14] Importantly, there is a high likelihood of additional fiscal stimulus as the new Biden administration seeks to ensure the economy is on solid footing. The combination of growth in the money supply and stimulus has resulted in the US dollar trending lower against most major currencies in recent months. The chart below illustrates a semi-strong inverse correlation exists between growth in the money supply and the value of the US dollar. With the Fed signaling it will continue to buy bonds and grow the money supply, the US dollar will likely continue to trend lower which could eventually result in higher US inflation.



EQUITIES

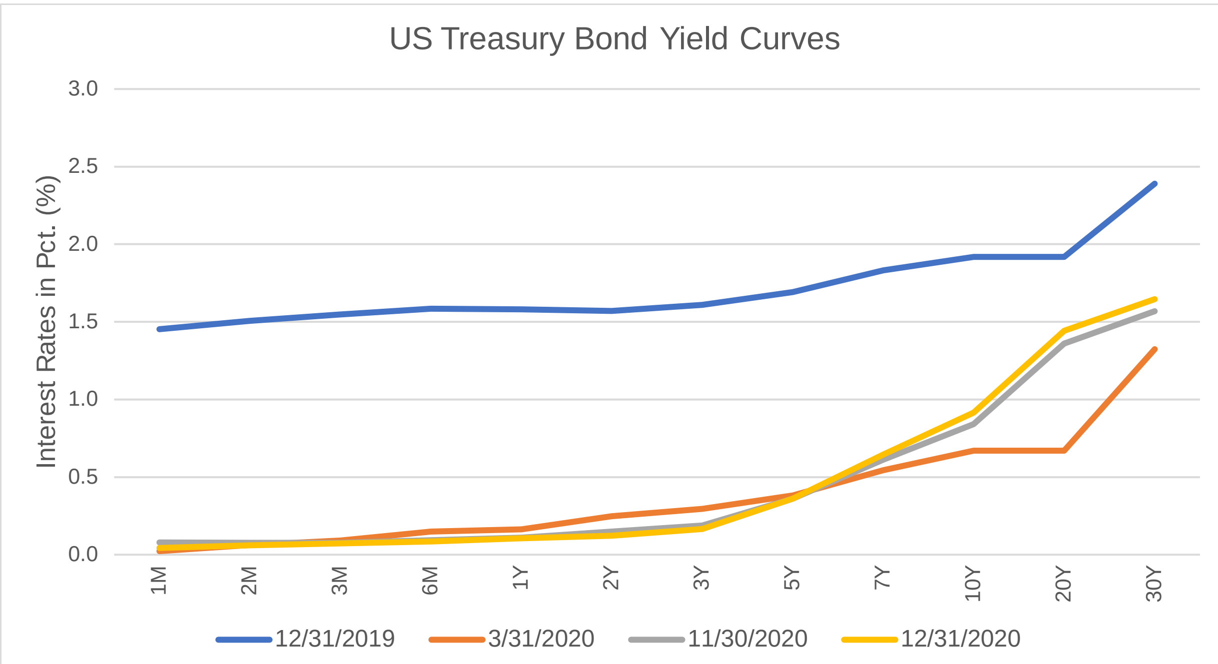
US stocks finished the year on a high note with the S&P 500 Total Return Index returning 3.8% for the month of December and 18.4% for the full year.[15] The best performing sectors during the month were financials, information technology, and energy stocks.[16] Much of these returns can be attributed to the reflation trade associated with the recovery in the economy and the increased reliance on technology due to pandemic-related restrictions. More specifically, oil prices continued their steady climb higher, with crude oil prices rising by more than 7% during the month[17] Rising oil prices are generally good for those energy companies who have hedged their exposures at lower prices and can profit from the increase. Similarly, US interest rates rose during the month with the US 10-Year Treasury bond closing at roughly 0.9%.[18] Higher interest rates are generally good for banks as they can borrow short-term at lower interest rates and lend longer-term to capture the spread. Historically, both rising energy prices and interest rates are associated with periods of economic recovery. However, our concern is while the economy is showing signs of improvement, rising input costs, in the form of higher energy prices, combined with higher financing costs associated with rising interest rates, we believe could put a damper on the pace of recovery should these measures move too far too fast. Importantly, data is readily available from the mid-1970s that illustrates the impact inflation, or even stagflation, can have on the economy. While we are nowhere near those levels in terms of energy prices or interest rates, they both act as implicit taxes on the economy and bear watching in the future.



Source: Bloomberg as December 31, 2020

FIXED INCOME

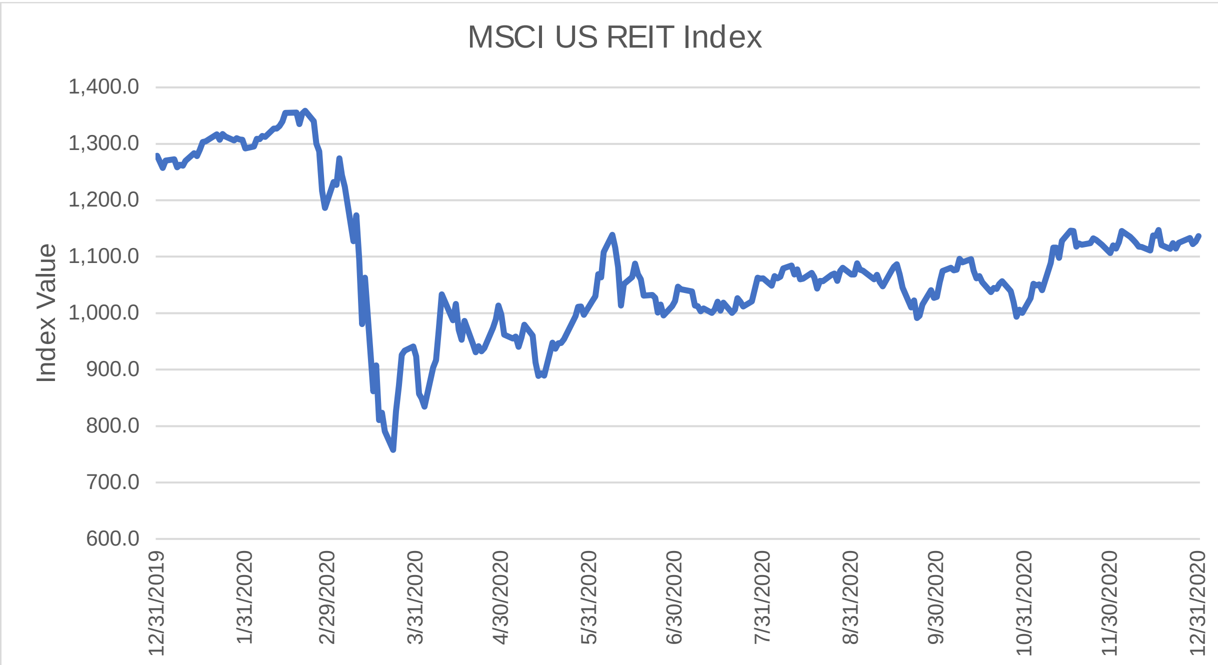
Fixed income market returns were broadly higher during December with lower quality corporate bonds outperforming higher quality US Treasury and government agency bonds. For the month, the Bloomberg Barclays US Corporate High Yield Bond Index returned roughly 1.9% while the Bloomberg Barclays US Aggregate Bond Index returned 0.1%.[19] As seen in the chart below, the US Treasury yield curve steepened slightly beyond 10 years during the month of December. [20] Despite this, US interest rates remain well below where they were one year ago. Historically, rising long-term US interest rates have acted as a headwind for fixed income investors and have been associated with accelerating economic activity and investors' expectations of rising inflation. Not surprisingly, the Bloomberg Barclays US TIPS Index rose 1.1% during December.[21]



Source: Bloomberg as of December 31, 2020

REAL ESTATE (YEAR IN REVIEW)

Pre-pandemic, the fundamentals of supply and demand within the real estate asset category were relatively balanced. However, due to the unprecedented response to the pandemic, including the closing of non-essential businesses, implementation of work-from-home policies, and severe reductions of business travel, existing trends within the real estate sector were accelerated. These factors bifurcated property-types into distinct winners and losers. As seen in the chart below, while the MCSI US REIT index gained roughly 2.7% for the month of December, the index was down -11.1% for the full year.[22]



Source: Bloomberg as of December 31, 2020

Digging deeper into property-types and expanding beyond December, retail-oriented properties continued to underperform as operations suffered further deterioration due to closures of businesses or reduced operating capacity due to the pandemic. The collection of rents from retailers was impacted by the closure and in some cases, bankruptcies represented by household names including Neiman Marcus, J.C. Penney, Lord & Taylor, and Brooks Brothers. On average, rents collected from retail tenants were 50.3% in April 2020, however, collections have recovered to 80.2% as of August 2020.[23] Similar to retail, properties exposed to leisure and hospitality have been negatively impacted by the near-complete halt of business-related travel.

While there have been disappointments, there have been several "winners" coming out of the pandemic including warehouses and data center properties. Investors in warehouses have benefited from the consumers' ever-increasing use of e-commerce and last-mile delivery. This trend accelerated significantly in 2020 as consumers adhered to new social-distancing policies and desire for goods that could no longer be obtained through traditional retail outlets. This dynamic caused an increase in demand for warehouse assets by on-line retailers and grocers that offered home delivery services. The increase in demand resulted in Q3 2020 valuations exceeding pre-COVID levels.[24] The implementation of broad ranging work-from-home policies and the resulting increase in the use of on-line video conferencing services, heightened the demands for datacenters. These facilities house the servers and memory storage devices servicing this technology. Evan as companies evaluate the cost/benefits of continuing to conduct their business in this manner once vaccines become more widely available, it is anticipated that demand for datacenters will continue to rise.

The real wildcard in the real estate sector at this point are office properties. Corporate decision-makers have been rationalizing physical space requirements for decades in order to reduce the fixed costs associated with their business models. While the percentage of rent collected through the COVID pandemic remained relatively high compared to pre-pandemic levels, the perseverance of work-from-home policies may result in further declines in the demand for office space. The successful implementation of COVID-19 vaccine protocols and business managements' requirements of its employees to return to the office could be deciding factors on the relative performance of this property-type going forward.

PRIVATE EQUITY (YEAR IN REVIEW)

While full-year valuations are still being determined, the past year saw increased volatility in valuations, changes in business practices, and an increase in the dispersion of returns across Private Equity (PE). While the broad PE market saw negative returns during the first quarter, they were disparate depending on the geographic focus of a strategy's holdings. In the US, valuations fell the least as the response to the pandemic was muted when compared to either Europe or Asia. However, with the rapid recovery in public equity markets beginning in the 2nd quarter, many PE managers saw their portfolios recover, and in some cases, surpass their previous high-water marks by the end of the 3rd quarter. While final valuations are still being determined for the 4th quarter, it is reasonable to expect that most managers ended 2020 with a positive return given the strong performance of public markets during this period.

Aside from the recovery in public markets after the pandemic drawdown, PE valuations grew primarily through a rapid adjustment of firm investment, strategy, liquidity, EBITDA growth, and multiple expansion in portfolio companies. Similar to past periods of economic stress, PE was able to bring its strategic and institutional resources to bear as the crisis unfolded by renegotiating debt terms, right sizing cost structures, and ensuring sufficient liquidity before pivoting to acquire smaller competitors in an effort to gain market share. In terms of sector performance, technology-focused, asset-light companies with high recurring revenues fared better than their asset-laden peers. These results have accelerated a structural shift that was already occurring in the market where PE managers began treating technology-related companies less as a sector and more as a desired attribute of business models within other traditional sectors such as industrials, healthcare, and business services. Not surprisingly, deal flow during the 2nd quarter declined to levels not seen since 2012 as managers focused primarily on current exposures and tight capital markets reduced the availability of financing. Fortunately, deal flow quickly recovered in the 3rd and 4th quarter to a near all-time highs. Assuming markets remain stable and capital available, there is the potential for an increase in exit activity as PE managers attempt to realize their holdings at current high multiples.

Information provided herein based on AndCo's observations.

APPENDIX

1. Bloomberg, April 2010
2. Bloomberg, April 2020
3. Bloomberg, December 2020
4. Bloomberg, January 2021
5. Bloomberg, December 2020
6. Bloomberg, December 2020
7. Bloomberg, December 2020
8. National Association of Realtors, December 2019
9. Bloomberg, December 2020
10. Bloomberg, December 2020
11. Bloomberg, December 2020
12. Blackrock, December 2020
13. Bloomberg, December 2020
14. https://www.frbatlanta.org/cqer/research/gdpnow
15. Morningstar, December 2020
16. Morningstar, December 2020
17. Bloomberg, December 2020
18. Bloomberg, December 2020
19. Morningstar, December 2020
20. Bloomberg, December 2020
21. Bloomberg, December 2020
22. Bloomberg, December 2020
23. REIT Industry September 2020 Rent Collections | Nareit
24. US Ecommerce Growth Jumps to More than 30%, Accelerating Online Shopping Shift by Nearly 2 Years - Insider Intelligence Trends, Forecasts & Statistics (emarketer.com)

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