January 8, 2021

The dichotomy between the strong performance of the markets in 2020 (S&P 500 Index **18.4%**) and the hunkered down, pandemic economy was striking, but not completely surprising. For decades now, uncorrelated financial returns have so far outpaced growth, profits, and disposable incomes. And while portfolio results of 2020 left many of us with the uncomfortable optic of having profited in the face of a high human toll, we submit that financial markets are not moral actors but only a reflection of the supply and demand for current liquidity versus future expectations. In shuttering our Service Sector, economic activity fell and pushed up savings. The Federal Reserve's actions in March (lowering interest rates to zero and supporting Corporate and Municipal Credits) drove bank balances into stocks – and the rest is history. The lesson is that dark circumstances inevitably mean the future is what we have for better times and now valued highly even more.

Currently, this leaves us with a roll out of vaccinations far behind schedule, and a recovery dawdling as well. With recent modest fiscal action risking deeper economic damage, a new Administration is expected to push for "more" while the Federal Reserve is expected to keep rates low. If we are lucky, some portion of "more" will consist of infrastructure to fuel the productivity of future periods. If not, our definition of luck narrows to a brush with inflation.

For our summary outlook for 2021, we are currently sanguine that things are looking up:

- **Economic Growth:** With China and the U.S. both set on expansion, the relationship may change for the better with less Tariffs and new trade agreements. In addition, vaccinations should drive higher employment leading to a pick-up in household incomes and a curtail or shift in government assistance.
- **Dollar Exchange:** Weak exchange rates could strengthen earnings and add support to stock valuations, yet this will take longer than desired as the consequences of "renewing foreign alliances".
- **2021 Stimulus:** Monetary policy supporting low interest rates will hold in addition to more stabs at fiscal spending. These efforts most likely will continue in 2022 or 2023 before regaining to pre-pandemic economic levels.
- **Allocation:** Stocks remain a favored asset. Key alternatives face higher valuations with challenging prospects (Bonds and/or Commercial Real Estate). Minor shifts favor Small Cap; and a tug of war with Value, Cyclicals and International stocks has promise, but we think our "Quality Growth" part of the market keeps its legs.
- **Returns:** Stocks could perform consistent with Investment Plan expectations of 7% to 8% to score a third positive year. But overall, our Balanced Allocation Investment Plan expectations for the year are little changed from 2020 (5% to 6%).

Our firm has experienced many business cycles over the last 35 years and, while the current one may have its differences and challenges, we remain confident that our balanced portfolio management approach using quality securities will continue to be validated by the Market over the months and years to come. As always, we welcome the opportunity to discuss our expectations, your circumstances, and the track of your progress together during an Annual Review via Zoom Meeting or phone call.

Warmest Regards,

James W. Mersereau, CFA, CIC
President

Daniel A. Kane, CFA, CIC
Managing Director

In compliance with Rule 204-2(a) of the Investment Advisors Act of 1940, we hereby offer our current Form ADV Part II as filed with the Securities and Exchange Commission through notice of its public posting on our website (www.carderockcapital.com). The Securities Exchange Commission's Investment Adviser Public Disclosure database can be accessed at their website (www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_Search.aspx). With reference to Rule 206(4)-2 Carderock urges you to compare the information on your statement with the statements received from your custodian. Please call if you have any questions.

Random Gleanings

"Though this is the time of year when financial analysts figuratively gut the global economy to examine the entrails and divine what the next year might hold, the exercise looks particularly hopeless right now." Robin Wigglesworth, "*Contrarian Scenarios That Could Upset the Market Consensus*," **Financial Times**, November 30th.

"With the finalization of the Senate balance, the markets have repriced for a sunnier outlook. Adding more stimulus, help for small business and relief for renters – all should hit the market sooner rather than later, putting more money to work in the economy, and spurring sales in a wide variety of industries." "*Daily Market and Economic News*", **Zacks Advisor Insights**, January 7th.

"If you bought every company that lost money in 2019 with a market cap over $1 billion, you'd be up 65% this year. We know it's a frothy market when you hear, 'This company is going to be the next Google, Microsoft or Amazon.' Sure, there are hundreds of companies that rhyme with these, but we classify their growth looking stock by stock, and try to buy at a discount. We're looking for causation not correlation." Barry Ritholtz, "*Transcript: Joel Greenblatt*", **The Big Picture**, October 11th.

"Much as security analysts have wondered why earnings no longer call the tune of share-prices, we answer that Fed-sponsored interest rates have been in the driver's seat for the past decade. Noting that without QE, the NASDAQ and S&P500 would be roughly 50% lower, it's not surprising that large caps have benefited the most. So if you ask where risks lie in the year ahead, we submit they're in our fake interest rates and ever inflating balance sheets." James Grant, **Grant's Interest Rate Observer**, November 13th.

"Also a major concern for the US economy is commercial real estate. Even if vaccines normalize daily activities, our post-pandemic lives have been reshaped. Workers will do more work from home and shoppers will stick with the convenience of E-commerce. As the need for office and retail space falls, rents will drop as well. The eventual hit to the banking system remains unknown." "*Outlook 2021: A Brave New World*", **Bank Credit Analyst**, December 2020.

"Few fully comprehend how the internet and pandemic have accelerated the monetary revolution we're living through. Fewer still that Bitcoin rallied 139% this year. As recently as 2017, Noureil Roubini called Bitcoin's crash the 'biggest bubble (burst) in human history' and 'mother of all scams.' Fast forward to November 2020 as though the biggest conversion since St. Paul, Roubini's conceded 'it might prove a store of value and hard to debase.' Nial Ferguson, "*Bitcoin is Winning the Covid-19 Monetary Revolution*", **Bloomberg**, November 29th.

"With a market rally based on blind faith that vaccines will speed reversion to things as they were before, the risk that production and distribution aren't a walk in the park is real. The markets have held together because low rates have supported asset prices and suppressed costs. Moreover, government aid is keeping us afloat (but only just), and withdrawal is unthinkable. Likely the risk of mistakes is underestimated – especially how the hunt for yield is pushing investors to accept lower quality or bet that interest rates will remain low forever." Martin, Fletcher and Platt, "*What Can Go Wrong? Investors Views on the Big Risks to Markets in 2021*", **Financial Times**, December 26th.

"The ECB owns nearly 70% of Eurozone outstanding sovereign debt and buys all net issuances as there is no market. Then they respond to protests against the rising cost of living by telling us there is no inflation. Yet financial asset prices have soared. This is like driving a car at 300 mph on a highway, looking in the rearview mirror, and saying, 'We haven't killed ourselves yet, so accelerate!" Daniel Lacalle, "*The ECB's Latest and Biggest Mistake*", **Mises Institute**, December 31st.

"There's no doubt that COVID accelerated the "me here now" economy and its blisteringly bright future. While the prospect of its "total control" is irresistible, this perception is deeply flawed. In fact, we've become dependent and like "the Upstairs" of Downton Abbey, risk losing the ability to do anything ourselves. We're beholden to Uber drivers, UPS deliverymen and Instacart shoppers. A dig into last week's Labor Report figures shows that job growth was dominated by "couriers" and "warehouse workers." Peter Atwater, "*The Looming Problem with the On-Demand Economy*", **Financial Times**, December 10th.