COLONIAL TRUST *Quarterly*

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In The Spotlight

James C. Fiske, CFP®,
Portfolio Manager & Investment Analyst

Jimmy Fiske joined Colonial Trust as an Analyst and Portfolio Manager in 2019. Before joining the firm, Jimmy had roles with Brown Advisory in Washington, D.C. and Scott & Stringfellow. He graduated with an Economics degree from the University of South Carolina in 2009 and is a Certified Financial Planner™.

As a member of our investment committee, Jimmy provides insight into economic trends and evaluates investment opportunities. Jimmy supports our other portfolio managers in reviewing the asset allocation and holdings of client accounts and making trades. He also works directly with clients to review their accounts to develop financial plans. Collaboration is a fundamental aspect of Jimmy's role and he works closely with our teammates in each office. He takes great pride in helping our clients succeed financially and feels privileged to work with them. Please feel free to reach out to him any time.

Jimmy lives in Greenville with his wife, Patton, and their one-year-old daughter, Caroline. He was born and raised in Alexandria, VA, and maintains his unwavering support for all D.C. sports teams and the Gamecocks. Jimmy loves to go hiking with his family on the weekends and enjoys playing basketball, tennis, and golf.

Market Commentary

We traditionally begin this newsletter evaluating our prior year forecast, but we did not predict a pandemic, so rehashing our forecast seems futile. The pandemic caused the shortest bear market in history, lasting only 128 days. The economic damage was unevenly distributed, and fiscal stimulus prevented a worst-case scenario. The health impacts have been enormous globally and have touched nearly everyone in some fashion. The markets looked past the virus to better times in 2021. For this missive, we will take a cue from the markets and review where we stand and the future.

We'll begin with the anatomy of recessions. Most recessions are triggered by a financial shock, where the negative effects on output take time to develop and more time to resolve. This is caused when malinvestment reaches a tipping point causing the economy to contract. The damage must be worked through with write-downs, business failures, and a resetting of the financial deck. This recession, driven by a pandemic, is atypical and its impacts uneven. In the spring, most of the economy shut down. As restrictions were removed, many sectors realized demand remained strong or increased due to the virus. For example, home sales and technology spending quickly returned to pre-pandemic levels. Travel and leisure spending remain depressed, but large parts of the economy have returned to normal. Fiscal and monetary stimulus softened the blow to individuals most affected, while wealth increased for many who were less affected. We believe this atypical recession will lead to an atypical recovery.

The markets offered positive returns during the quarter and 2020. The S&P 500 jumped 12.1% for the quarter and 18.4% for the year. The annual performance was led by technology; however, in the 4th quarter energy, financials, industrials, and materials outperformed. The rally broadened in the quarter and cyclical companies that benefit from an economic recovery began to outperform the “stay at home” stocks that drove returns through September. International equity markets finished the year in the green, due to strong 4th quarter returns. The MSCI EAFE Index of developed countries returned 16.1% for the quarter and 8.4% for the year, while the MSCI Emerging Markets Index returned 19.6% for the quarter and 18.5% for the year. The Bloomberg Barclays Agg Bond Index returned 0.7% for the quarter and 7.5% for the year. The strong equity market performance seems incongruent with a 6.7% unemployment rate and a pandemic, but equity markets are forward looking and see stronger growth ahead.

The economy saw a V-shaped recovery during the 3rd quarter. GDP growth was 33.4% and 4th quarter estimates are for 4.6% growth. This year GDP is projected to grow 3.9% and surpass prior highs in late 2021. The character of the rebound differs from the pre-COVID economy. According to BEA, the strongest of 3rd quarter growth was in personal spending on durable goods (up 82.7%), business investment on equipment (68.2%), and residential real estate (63.0%). These areas have surpassed pre-pandemic levels. Consumer services spending grew 38.0% in the quarter but remains depressed. Business investments in structures declined 17.4% for the quarter, marking the 3rd quarterly reduction. Income was stable for many consumers, but their ability to spend on services was limited. This spending was redirected into new cars, RVs, and housing. Remote work forced businesses to spend on equipment while deferring investment in office space. The service sector was ground zero in this recession and should be the last area to recover. We expect divergence in this recovery, with pent-up demand driving service spending post-vaccines, while business spending on structures may remain below trend.

Any forecast must consider the path of the virus. The 4th quarter’s surge in cases was worse than the prior two waves, with the seven-day average of new cases increasing 500% during the quarter. This increase was nationwide with the COVID Tracking Project reporting 34 states with rising cases. Hospitalizations have climbed to more than 125,000 and deaths reached nearly 4,000 per day on December 30th. The uptick in cases shortly after Thanksgiving may repeat after Christmas and experts predict a grim January. While the current situation is dire, the future looks brighter. Drug companies have developed vaccines in less than a year versus the typical five to ten years. There are two vaccines approved by the FDA for Emergency Use Authorization and being distributed. The rollout is slower than planned, but each day more people are vaccinated. There are 65 vaccine trials ongoing, with 11 in Phase III. AstraZeneca and JNJ will report their Phase III results to the FDA in January and the US has secured 300 million doses and 100 million doses, respectively. When combined with doses from Moderna and Pfizer/BioNTech doses, there are sufficient doses to vaccinate the entire US. Dr. Fauci expects the country to reach herd immunity by late spring or summer. It will be a difficult winter, but a new dawn is coming.

If vaccinations play out as expected, we will see slow growth in the 1st quarter as consumers curtail spending. The $900bn stimuli will mute the economic impacts, with many receiving stimulus checks, higher unemployment benefits, and PPP for small businesses. Growth will increase in the 2nd quarter through year-end led by consumer spending. Household net worth is at all-time highs at $123.5 trillion, with the 5.8% fall in the 1st quarter offset by a 10.9% increase over the last two quarters. Increasing equity and home prices have consumers feeling flush and the pandemic has caused savings rates to double versus their 30-year average, providing the dry powder for more spending. We expect spending on travel, dining, and entertainment as consumers can only buy so many RVs and Pelotons. We believe consumers will continue to spend on housing and renovation, driven by low interest rates. Growth will also be fueled by business investment. Corporate balance sheets have $1.7 trillion in cash. We expect companies to increase spending on equipment, intellectual property, dividends, and mergers. Many large companies benefited from dovish Fed policy by raising capital and reducing expenses, positioning them to continue to take market share from smaller competitors in 2021.

As mentioned, the virus has caused changes in our economy and some will be permanent. It is worth discussing some of these changes for their investment implications. The pandemic accelerated the digitization of the US economy. E-commerce is a perfect example. In 2008, e-commerce accounted for 6% of retail sales and by 2019 penetration increased to 16%. In 2020, e-commerce accounted for 26% of retail sales. Many consumers learned to shop online and will continue to utilize these platforms, which is good for Amazon and omni-channel retailers and bad for smaller retailers without a digital footprint. The virus has also changed the way we work. Remote work accelerated the move to the cloud allowing employees to access data from home. We expect many employees to return to the office, but some companies allow employees to work remotely indefinitely. Many remote workers have far-reaching implications. This would be negative for office real estate, restaurants in metro areas, and local dry cleaners. It has positive implications for cloud computing companies and cybersecurity firms, where spending will increase to ensure those employees have access to the workloads in a secure manner.

Though some changes seem clear, we believe it will take time to determine the full impact of the pandemic. We are optimistic about drug research as the race for vaccines fostered enormous investment, specifically messenger RNA. This technology injects synthetic mRNA into the body which provides instructions for cells to make proteins to treat or prevent disease. Scientists have worked on this technology which has much promise for three decades. Two of these scientists founded Moderna and BioNTech, which are biotech start-ups focused on mRNA. Moderna and BioNTech, partnering with Pfizer, have developed the first viable vaccines with mRNA technology. This platform has applications beyond COVID. According to Science Magazine, vaccines for Zika, influenza, and other virus are advancing through clinical trials using mRNA. There are also trials underway to determine mRNA efficacy to fight cancer. This research is in its infancy, but COVID has accelerated the development of these platforms.

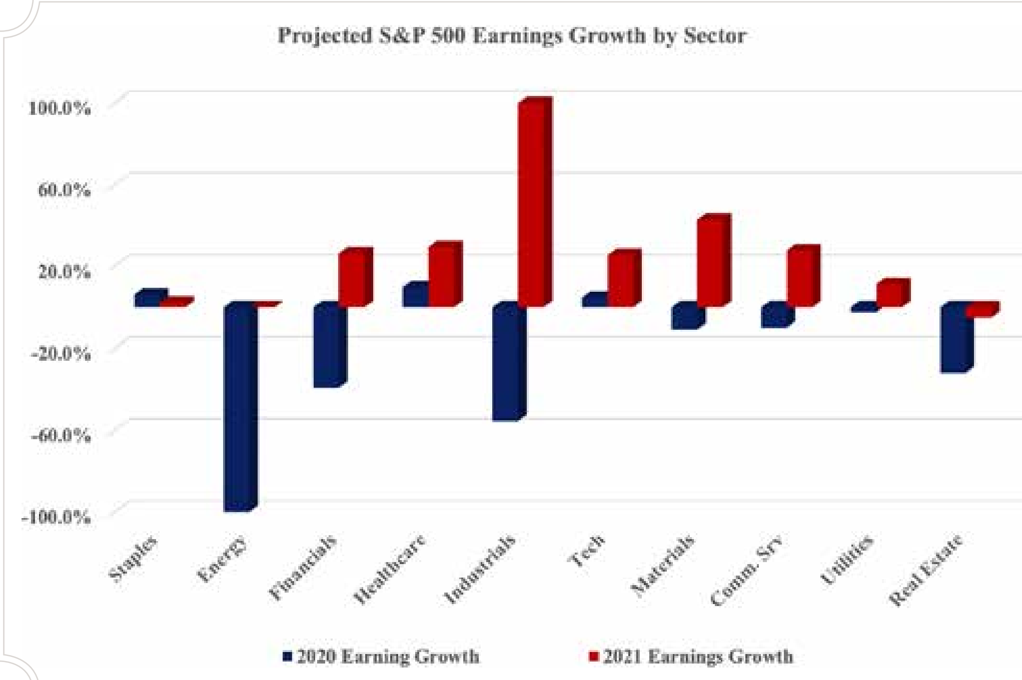
Any forecasts must also factor in the policy environment. There is little ambiguity on monetary policy for the next several years. The Fed intends to purchase $80 billion in treasuries and $40 billion in mortgages every month and keep rates at 0.0% until we approach full employment. Since March, the Fed purchased $3.1 trillion in assets and expanded its balance sheet by 74% to $7.4 trillion. Monetary policy will remain supportive with low rates and ample liquidity in 2021. The fiscal policy environment is less certain given the election results. The Democrats will have their smallest majority in the House since the WWII era. It appears the Senate will be tied, with the VP as the tiebreaker. Legislation and regulation will move to the left, although the degree of the shift is hard to gauge. Biden’s agenda was very progressive, but slim majorities in Congress make it unlikely the most progressive items will become law. Joe Manchin has become the most important Senator and pledged not to vote to end the filibuster or pack the courts and has spoken out against socialism and the Green New Deal. Tax increases are on the table through reconciliation, where the Senate can pass budget bills with 51 votes. Congress’s initial focus will be the pandemic and more stimulus, likely on infrastructure which would include roads and bridges as well as green initiatives. The Senate will approve Biden’s nominations for key appointments, which will lead to higher regulation in many industries, including energy, finance, labor, and technology. It is difficult to handicap the likelihood Biden’s tax plan will be enacted. Congress may believe large tax increases are ill-timed during a recovery and could not survive any Democratic defections in the Senate and few in the House. We will likely see large deficits and high federal debt without large tax increases in 2021. We hope slim Congressional majorities force the parties to compromise rather than pursue extreme policies that are unpopular with most of the country.

We have outlined optimism for a vaccine led economic recovery in the second half of 2021 with accommodative monetary policy. The legislative environment is mixed and, we don’t see the majority necessary for sweeping legislation. This brings us to capital market expectations for 2021. To capture our thoughts in a nutshell, equities outperformed the economy in 2020 and we expect the economy to return the favor. Equity market volatility may be elevated in the first half of the year as investor focus moves between rising case counts and vaccines. As immunizations increase and cases fall, the focus will shift to fundamentals. Fundamentals should improve and markets to move higher; however, we believe part of 2020 strong returns discounted the improvements coming in 2021. Therefore, we expect market returns to moderate from the strong levels seen in 2020.

Part of the rationale for moderate returns is current market valuation. When including expectations for 4th quarter earnings, S&P earnings fell 31.5% in 2020, while the index rose 16.3%. This caused the price to earnings ratio (P/E) to increase from 18.4x to 29.7x during the year. This valuation level is high compared to the 30-year average at 19.7x. Over the last 30 years the P/E ratio has been north of

25 on five occasions, with four of those when the economy was coming out of recession and the other was 2000. We don't believe the market is valued like 2000 for several reasons. First, the interest rate environment differs from the Fed Funds rate and 10yr treasury at 6.5% and 6.8% then compared to 0.0% and 1.04% now. Inflation was over 3% and rising and is now under 2.0% and stable. The Fed was then tightening policy and is currently accommodative. Second, the epicenter of 2000 was technology where share prices were detached from reality, whereas now they are expensive but tech companies' profitable and growing. Rather than a 2000 comparison, we believe P/E ratios are elevated due to depressed earnings and investors project better earnings going forward. The fall in earnings in the first two quarters of 2020, when earnings fell 48.7% and 33.3%, have depressed full-year earnings. The fall was most pronounced for areas most affected by lockdowns. In 2021, S&P earnings are projected to grow 36.7%, led by sectors most impacted in the first half of 2020. Profitability will improve as companies have reduced costs and invested in productivity during 2020. We believe elevated P/E multiples are partially a function of depressed current earnings and high expectations for 2021.

We expect P/E ratios to fall in 2021 as earnings growth outpaces share price gains. While valuations should moderate, we don't believe they will return to long-term averages. Valuations are influenced by interest rates and the average 10yr treasury yield over the last 30 years was 3.9%, compared to 1.04% today. Lower yields result in higher valuations, which is the other rationale for higher prices. A comparison to historical valuations must consider the expected path of interest rates. The Fed is forecasting short-term rates will remain zero until 2023. We don't expect long rates to move materially higher with the Fed purchasing $960 billion in treasuries annually and negative global yields keeping treasury yields low. Inflation could increase due to stronger growth and large deficits, pushing yields higher. The forces of demographics, high sovereign debt levels, and technology have reduced inflation around the world for some time. We expect those forces to remain disinflationary in 2021.



Low rates also make safe investments unattractive. Fixed income investments offer record low yields and we don't expect this to change significantly in 2021. Low bond yields create upward pressure on equity share prices as investors move out the risk curve in search of return. Fixed income will continue to offset equity volatility but offer little income in 2021.

As we begin a new year, we want to thank our clients for the confidence in a difficult year. We tried to provide context to the economic and financial impacts of the virus, but the human tragedy cannot be forgotten. Many of us have been impacted and seen loved ones suffer. Our optimism on the economic front spills over to optimism on the health front. We hope the vaccines reach the arms of our clients and friends quickly and we can put 2020 behind us. We wish you a happy and prosperous New Year.