Sit Investment Associates

January 2021

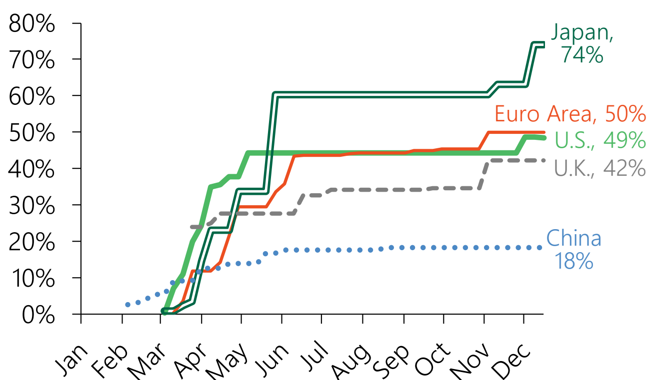
GLOBAL INVESTMENT OUTLOOK AND STRATEGY

- **Favorable Global Outlook but Immunizations a Huge ± Swing Factor**
- **Growth Underpinned by Massive Global Monetary & Fiscal Stimulus**
- **U.S. Economy Poised to Hit on All Cylinders in Second Half of 2021**
- **Vaccine-Led Reopening Will Fuel ST Inflation & Steepen Yield Curve**
- **Stock Picking Matters: Upward EPS Revisions Key to Outperformance**

Liquidity & Vaccine Progress Fueled 2020 Stock Boom; ✚ Fundamentals Must Now Follow

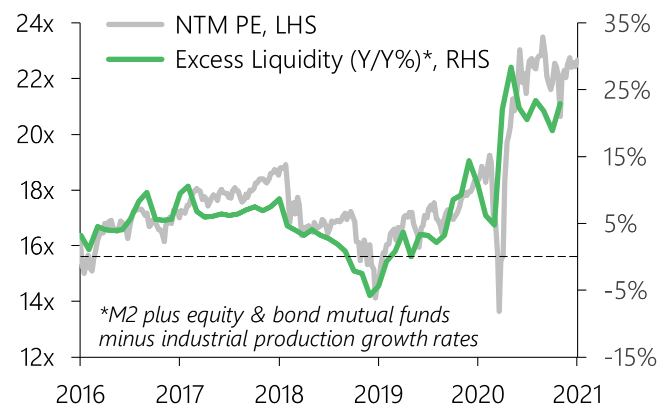
Stimulus Providing Huge Liquidity Boost

Global Covid-19 Policy Response
Monetary and Fiscal Stimulus, Percent of GDP



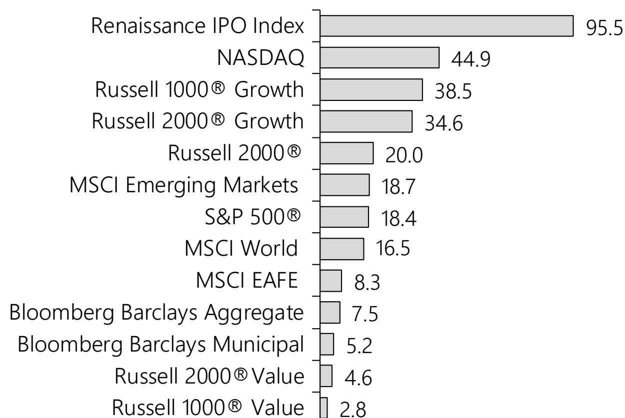
Valuation Rebound After Early 2020 Plunge

S&P 500 Price-to-Earnings Ratio vs Excess Liquidity



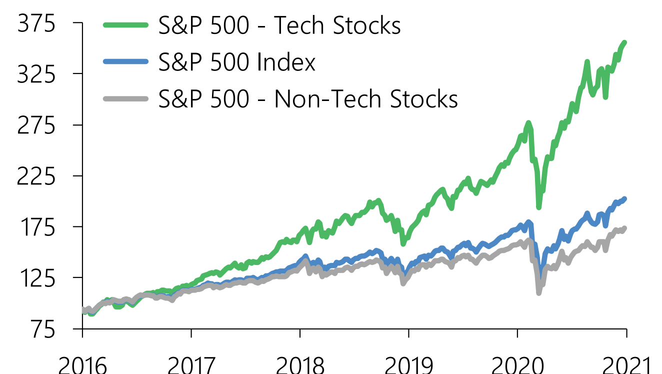
"Risk-On" Sentiment Evident in Index Gains

2020 Returns by Index (%)



Uniquely Good Backdrop for Tech Stocks

Performance of S&P 500 Index, Tech vs Non-Tech
Indexed, December 31, 2015 = 100



Source: Cornerstone Macro, FactSet, 1/8/21

Global Macro Developments

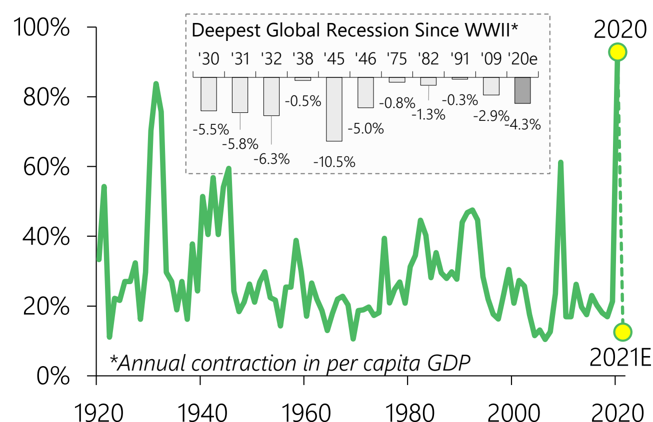
Promising Global Growth Outlook; Immunization Timeline a Huge ± Swing Factor

We expect a post-pandemic synchronized global recovery to gather steam in 2021 following the deepest economic contraction since World War II in 2020 (Exhibit 1). Unparalleled global stimulus, totaling almost $30 trillion thus far (or over 30 percent of GDP), helped stave off an economic meltdown and is now underwriting a nascent worldwide recovery. Global real GDP is poised to expand +5.0 percent or more in 2021 versus a drop of about -4.3 percent in 2020. However, the pace of new Covid-19 infections and vaccine availability represent sizable swing factors. As the virus is brought under control, a wave of pent-up demand, inventory restocking, and business investment should take hold. Rock bottom interest rates, a weakening U.S. dollar, rising commodity prices, and improving global trade are tailwinds for emerging markets. Even so, developed countries (and India) have absorbed the bulk of vaccine pre-orders from Pfizer, Moderna, and AstraZeneca, leaving many emerging nations to secure alternatives from among 300+ yet-proven vaccine candidates. A potentially sluggish rollout of vaccines across emerging markets could push out economic normalization. Also, governments worldwide have amassed considerable debt used to cushion the pandemic's economic blow, with lower long-term global GDP growth rates the likely outcome. However, as the pandemic winds down, we anticipate at least a couple of years of above average growth given current catalysts and easy comparisons.

U.S. Economy Poised to Hit on All Cylinders in the Second Half of 2021

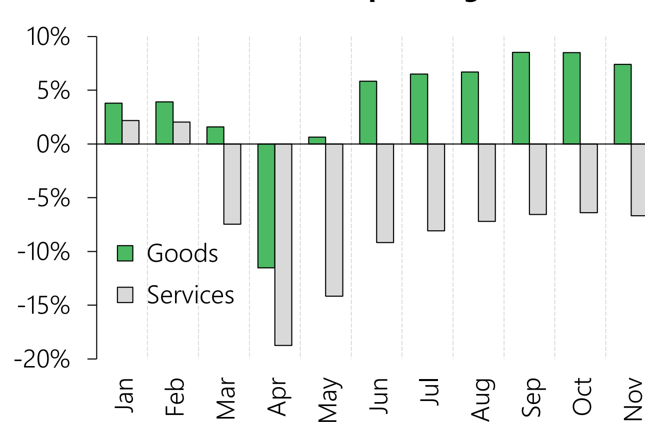
U.S. health officials predict ready availability of Covid-19 vaccines by midyear, setting the stage for a full reopening of the economy. Bolstered by ongoing federal stimulus, pent-up demand unleashed by a return to normalcy could kickstart a virtuous cycle of GDP growth. However, potential supply chain bottlenecks, logistical snags, and public resistance represent risks to the inoculation timetable. So far, the U.S. economy has proved relatively resilient post last spring's draconian lockdowns, as robust demand for home-related and leisure goods has partly offset a hobbled services sector (Exhibit 2). Still, a continued surge in new infections is tamping down economic activity and consumer confidence. The prospect of increased restrictions to reign in the outbreak also weighs on the near-term outlook. We anticipate a challenging first calendar quarter of 2021 for Covid-19 caseloads and year-over-year GDP growth (though now buoyed by a fresh $900 billion stimulus deal) to give way to improved trends and easy comparisons in the second. In the back half of 2021, the U.S. economy may very well be hitting on all cylinders, assuming no huge delays in vaccine delivery. While the immunization process is off to a slow start, President-elect Biden has vowed to direct 100 million injections (of a two-dose regimen) in the first 100 days of his administration. We currently forecast real GDP growth will rebound +4.4 percent in 2021 from a -3.4 percent contraction in 2020. The services sector (>75 percent of GDP) represents the largest source of potential upside as social distancing restrictions end.

Exhibit 1: Pct. of Global Economies in Recession



Source: World Bank, 1/5/21

Exhibit 2: U.S. Consumer Spending (Y/Y%)



Source: Bureau of Economic Analysis, 12/31/20

Biden Readies Federal Spending Bazooka Following Democratic Sweep

With wins in the two Georgia Senate run-off elections, Democrats now control both chambers of Congress, paving the way for higher federal spending and other policy priorities (Exhibit 3). Excluding Covid-related aid, President-elect Biden's agenda calls for added spending exceeding $7 trillion over ten years, offset by $4 trillion in higher taxes/other revenue. Without repealing the filibuster, Senate Democrats will likely rely on a budgetary process known as reconciliation, for which only a simple majority is required. Yet, razor-thin Senate control suggests moderate Democrats may temper Biden's more ambitious policies. Cornerstone Macro pegs the upper bounds for spending at $2.8 trillion and offsets at $2.3 trillion given the slim Senate majority. Oxford Economics projects that, if enacted promptly, a so-called "Biden-lite" agenda could still add over 120 basis points to its baseline 2021 GDP growth forecast. Increased infrastructure spending, which has bipartisan support, may prove the line item with the most upside – Biden seeks $2 trillion in additional spending, while consensus expects less than $1 trillion. On the negative side, re-regulation, a partial rollback in corporate tax cuts, and higher individual taxes for the wealthy may dent business sentiment and spur a wave of multinational firm relocations.

The U.K.-European Union Trade Deal Fits Within the Definition of a "Hard Brexit"

An (extra) cloud of uncertainty has hung over Europe since the U.K.'s 2016 referendum in which 52 percent of votes cast favored exiting the European Union. The U.K. officially left the E.U. on January 31, 2020. However, many aspects of the prior arrangement were kept in place until yearend to provide more time to secure a trade deal, as failure to do so would be disruptive to the region's economies. The Office of Budget Responsibility estimated a no-deal exit would reduce U.K. real GDP by -2.00 percent in 2021 and long-term GDP by -1.75 percent. British lawmakers' eleventh-hour ratification of a so-called "thin" trade deal on December 30 lessens the fallout from a no-deal exit but may do little to dissipate uncertainty. Dubbed the Trade and Cooperation Agreement, the deal preserves tariff- and quota-free trade in goods between the U.K. and the E.U. and the free movement of capital. However, the agreement largely excludes services, and other vital issues remain pending. Also, a rise in non-tariff barriers (i.e., red tape) will be a sizable drag on the U.K. economy, less so on the E.U.'s, and comes as much of the area is reeling from another wave of Covid-19 infections. As a result, we expect the Bank of England and the U.K. government to offer added accommodation to mitigate the near-term trade shock.

Continued Central Bank Liquidity Injections Buoy Europe's GDP Growth Prospects

Another round of lockdowns and increased restrictions across Europe, though less severe than those enforced last spring, has helped slow an autumn surge in Covid-19 infections. A notable exception is the U.K., where a more contagious variant has taken hold (Exhibit 4). The region's central banks continue to inject considerable liquidity into the financial system to backstop the economies and kickstart growth. In the last ten months alone, the European Central Bank has

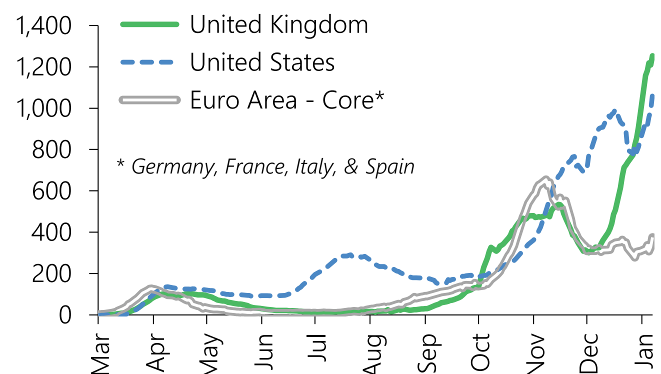
Exhibit 3: Democratic Sweep Policy Options

Taxes	Most of Biden agenda on ind. taxes (no payroll & less on cap gains), 25% corp. rate & double GILTI.
Health Care	Expand ACA, surprise medical billing, & onshoring drugs/PE. No real chance of public option, but major drug price controls possible.
Infrastructure	Roughly $1 trillion infrastructure package done in reconciliation (like HR 2).
Energy	Targeted energy tax hikes (~$20bn) & regulatory actions to limit drilling, methane emissions, rejoin Paris, strict fuel efficiency standards.
Green Energy	Generous subsidies for green energy production transp., & homes. Carbon pricing considered.
Safety Net	Federalize UI & boost stabilizers, paid leave, big refundable credit expansions; forgive student loans

Source: Cornerstone Macro, 11/9/20

Exhibit 4: New Confirmed Covid-19 Infections

Per Million of Population, Five-Day Moving Average



Source: Johns Hopkins Coronavirus Resource Center, 1/8/21

expanded its balance sheet +50 percent to €2.3 trillion versus €2.8 trillion for the prior ten-year period (Exhibit 5). Manufacturing also continues to recover thanks in part to solid export demand, with the December manufacturing PMI climbing to a 36-month high in the U.K. and a 32-month high in the Euro Area. Still, with services accounting for more than two-thirds of GDP, continued social distancing restrictions are gutting economic growth – the U.K. and the Euro Area are on pace for year-over-year real GDP declines of -11.0 percent and -7.5 percent, respectively, in 2020. Fortunately, western Europe appears well-positioned in terms of vaccine readiness and distribution capabilities. As is the case elsewhere in the world, pent-up demand and easy comparisons underlie better growth prospects as the outbreak is controlled. We now project 2021 real GDP growth of +5.5 percent for the U.K. and +4.5 percent for the Euro Area.

Uneven Recovery for Japan in 2021; Exports Favorable, Consumer Less So

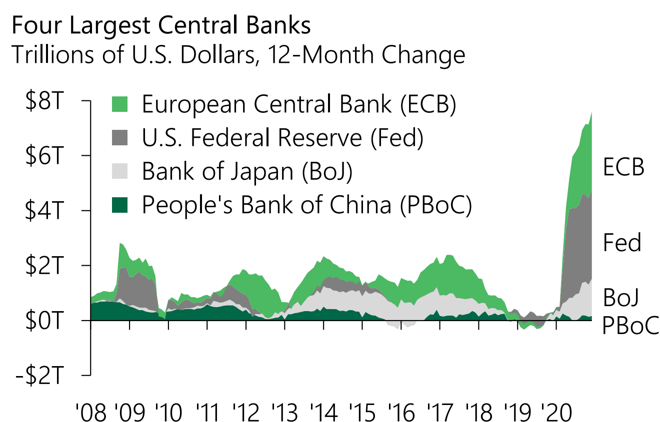
We expect Japan's economy to grow +2.5 percent in 2021 following a -5.3 percent contraction in 2020, as the uneven recovery from the virus-induced shock continues. Economic indicators have turned decidedly mixed lately as a resurgence in new Covid-19 infections has dampened activity. Nonetheless, we expect the recovery to resume in the months ahead as containment measures and broader vaccine distribution take effect. The export sector, historically a growth engine, should again lead Japan's recovery as improving growth overseas bolsters demand. Recovery prospects for the industrial sector are supported by a stable yen, low inventory levels, and a bottoming in capital equipment orders. Conversely, the outlook for the consumer is more mixed as stimulus measures will wane, prospects for wage growth are limited, and confidence remains subdued. The policy backdrop is broadly accommodative, though limited options for additional monetary stimulus continue to put the onus for further support on fiscal policy.

China Will Gradually Normalize (Tighten) Policy with Economy on Firmer Footing

China's November economic data implies real GDP growth is tracking above +6.0 percent year over year for the fourth quarter of 2020, on par with pre-Covid growth rates. Looking forward, we estimate real GDP growth could exceed +8.0 percent year over year in 2021, driven in part by increased private consumption and manufacturing capital spending, both of which lagged in 2020. The GDP growth rate will likely peak in the high teens in the first quarter of 2021 and slow to the mid-single-digit range in the second half. Given the steady economic recovery and vaccine development progress, Beijing stated it would normalize policy (Exhibit 6). However, as 2021 is the beginning of the 14th Five Year Plan and the 100th anniversary of the Chinese Communist Party, growth stability will remain a top priority. Thus, the pace of normalization will likely be gradual and flexible. Policymakers guided to broad credit growth roughly in line with potential nominal GDP growth to stabilize the leverage ratio. We expect a smaller fiscal budget and a smaller quota for local government special bonds as well. Finally, the government will likely accelerate reforms in 2021 while emphasizing financial risk prevention.

Exhibit 5: Global Central Bank Asset Purchases

Four Largest Central Banks
Trillions of U.S. Dollars, 12-Month Change



Source: ECB, Federal Reserve, BoJ, PBoC, 1/4/21

Exhibit 6: China's 2021 Policy Stance

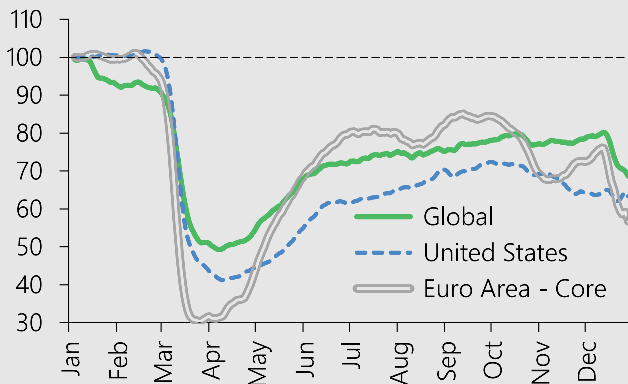
	Official Narrative	Our Take
Overall Tone	A gradual exit from stimulus	We expect a gradual and flexible pace of counter-cyclical tightening in 2021
Growth Target	Keep growth in "*a reasonable range*"	Policymakers will likely downplay the 2021 growth target
Fiscal Policy	Fiscal policy to "*maintain some strength, but be more sustainable*"	The augmented fiscal deficit to narrow to 12% of GDP in '21 (vs 15.4% in '20)
Monetary Policy	Prudent monetary policy to be targeted and flexible	Broad credit growth to retreat to 11.5% Y/Y by end of 2021 (vs 13.7% in 4Q20)

Source: Morgan Stanley, 12/18/20

Notable Global Macro Data Points

Economic Activity at the Mercy of the Virus

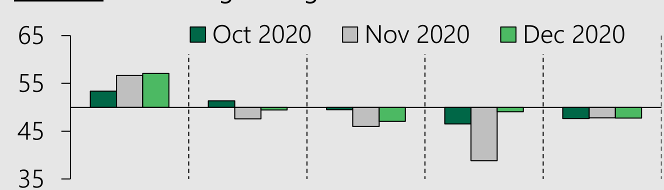
Daily Economic Activity Indices
January 8, 2020 = 100, 5-Day Moving Average



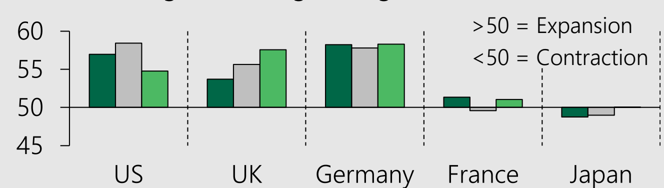
Source: Bloomberg, 1/7/21

Services Lagging Under Weight of Restrictions

Services Purchasing Managers' Index



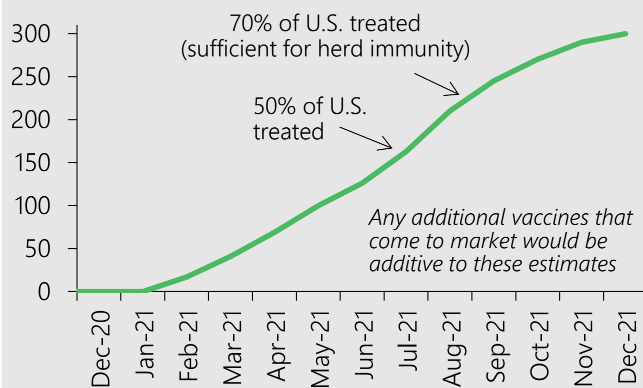
Manufacturing Purchasing Managers' Index



Source: Markit, 1/6/21

Hope, in Form of Vaccines, on the Way

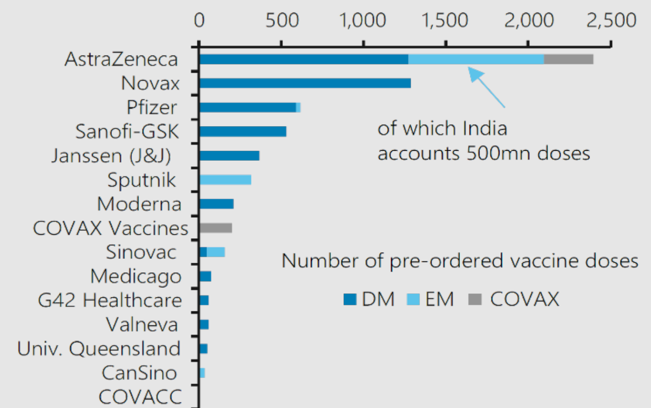
U.S. Covid-19 Vaccine Treatments Available
Millions



Source: JP Morgan, 1/8/21

D.M. Absorbed Much of the Vaccine Pre-Orders

COVID-19 Vaccine Pre-Orders: EM vs DM



Source: Barclays, 11/25/20

Enormous Global Stimulus Still Accumulating

Global Monetary & Fiscal Stimulus

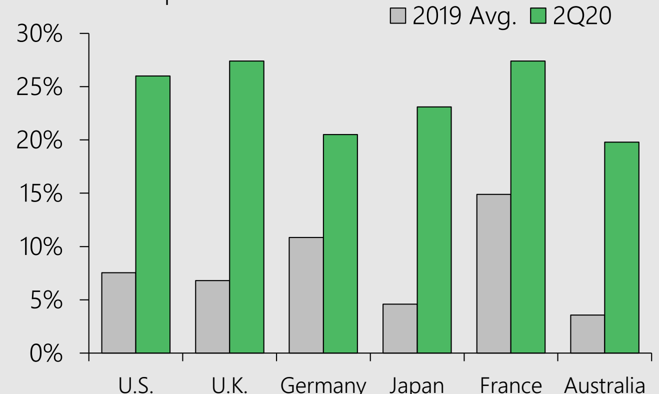
	Potential Ctrl. Bank Liquidity Injection		Potential Govt. Fiscal Stimulus	
	$ Tln	% GDP	$ Tln	% GDP
U.S.	6.21	29.0%	4.19	19.6%
Euro Area	2.38	17.9%	4.27	32.0%
Japan	1.03	20.0%	2.79	54.1%
U.K.	0.57	20.7%	0.59	21.6%
China	1.43	10.0%	1.22	8.4%
Others*	0.94		2.85	
Total	**12.56**	**14.5%**	**15.91**	**18.4%**

** includes Row, ADB, IMF, WB*

Source: Cornerstone Macro, 1/4/21

Excess Savings Can Sustain Pent-Up Demand

Household Savings Rates
Percent of Disposable Income



Source: FactSet, National Sources, 12/31/20

The Return of Inflation

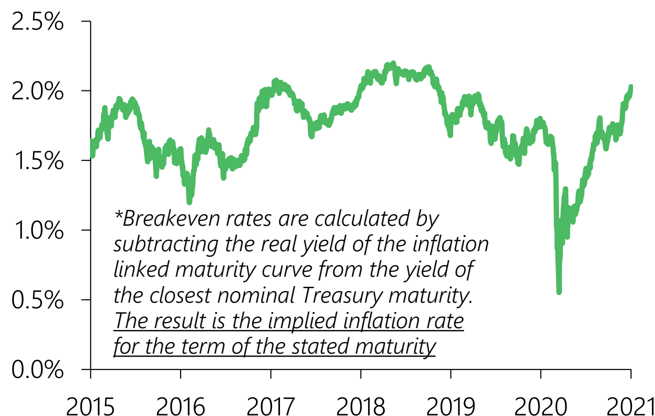
The dynamic shift in 2021 to a focus on the spread of the vaccine rather than the spread of the virus is a welcome change. The extraordinary amount of fiscal and monetary stimulus created to counteract the economic destruction wrought by Covid-19 set the stage for a robust rebound, accompanied by a surge, albeit temporary, in inflation. Massive increases in the money supply have driven down interest rates and the U.S. dollar. Inflation from rallying commodity prices is exacerbated by the higher cost of imports resulting from a weaker dollar. Domestically, low interest rates have supported housing activity and bond issuance, as stimulus payments have increased the savings rate. We anticipate a surge in economic activity driven by massive pent-up demand just as bankruptcies have blasted a hole in the economy's capacity to supply goods and services. This is especially pronounced in the leisure and entertainment sectors hit the worst; the very sectors that will realize the sharpest spike in demand.

There will be upward pressure on prices as more people become vaccinated and the economy reopens. We expect inflation to rise easily above the Federal Reserve's previously stated target of +2.0 percent by mid-year considering the "easy" comparison to the depressed prices of the previous summer (Exhibit 7). Nonetheless, we expect the increase in inflation to be a relatively short-term phenomenon, lasting 12-18 months. As the economy normalizes and pent-up demand subsides, we believe inflation pressures will naturally follow. Given the Fed's recent shift to an average inflation target and its commitment to keep short interest rates low, we do not anticipate much of a reaction at the short end of the yield curve. In the meantime, we expect longer-term rates to rise with higher inflation expectations, which will lead to a steeper yield curve in 2021 as the Fed continues to hold short rates near zero for much longer than they probably should (Exhibit 8).

Taxable Fixed Income Strategy

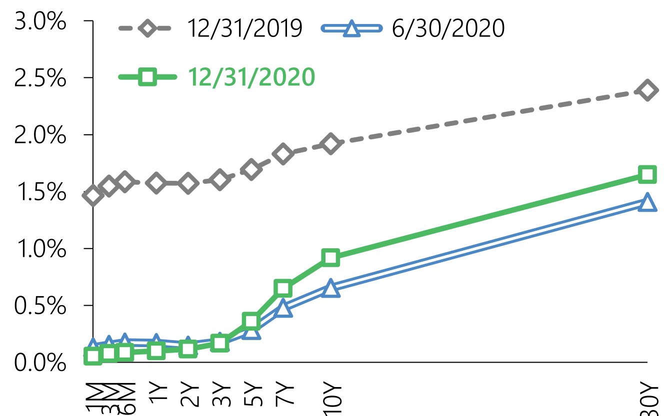
The stimulative monetary and fiscal policy environment will continue to be supportive of capital markets. We expect the Federal Reserve to leave rates low past the end of the pandemic despite pent-up demand from homebound consumers driving a massive spending spike in the second half of 2021. While the resulting economic strength will be modestly tempered by a less supportive federal government, it will still be enough to create an economic boom and increases in near-term inflation. As such, we have positioned portfolios for a steepening yield curve, while emphasizing investments in specific cyclical sectors we believe will be the largest beneficiaries of the recovery. We intend to capitalize on tactical trading opportunities provided by a changing political landscape and shifts in confidence levels as the economic recovery takes hold.

Exhibit 7: 10-Year U.S. Treasury Breakeven Rate



Source: Bloomberg, 1/5/21

Exhibit 8: U.S. Treasury Yield Curve



Source: FactSet, 12/31/20

Tax-Exempt Yield Curve Flattens with Fall in Long-Term Rates

The tax-exempt yield curve flattened during the fourth quarter of 2020 but steepened for the year (Exhibit 9). Short-term tax-exempt rates were relatively unchanged during the fourth quarter, remaining at low absolute levels with shorter-term U.S. Treasuries. Conversely, yields on intermediate- and long-term tax-exempts decreased and approached the all-time lows experienced over the summer months of this year. The 30-year MMD yield declined 23 basis points in the fourth quarter to 1.39 percent, and the 10-year MMD yield decreased 16 basis points to 0.71 percent. As a result, rates across the tax-exempt yield curve ended the quarter and the year close to lows for 2020.

Tax-Exempt Credit Quality and Duration Continue to Drive Performance

Similar to last quarter, credit quality and duration were the primary drivers of fourth-quarter performance. Longer bonds outperformed shorter bonds for both the quarter and the year. Lower credit quality bonds outperformed higher credit quality bonds during the quarter. However, for the year, lower-quality bonds generally underperformed higher-quality bonds. This difference highlights that while tax-exempt spreads continue to recover from the depths experienced at the onset of the pandemic, in general, they have not fully recovered.

Record Total Municipal Issuance

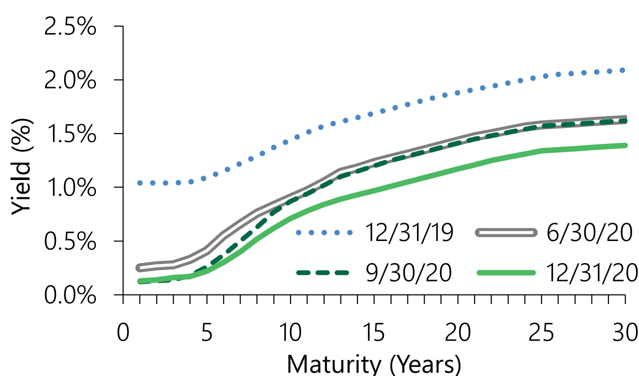
Total municipal issuance was approximately $474 billion during 2020, the highest on record (Exhibit 10). Taxable bonds were nearly 31 percent of total municipal supply, the highest since reaching slightly over 35 percent in 2010 when Build America Bonds were issued. It is interesting to note that, although total municipal bond issuance reached record levels, neither the taxable nor tax-exempt sub-components surpassed prior category records independently. In fact, tax-exempt issuance declined on a year-over-year basis. Many strategists expect supply to remain strong during 2021 and believe investor appetite for taxable municipal debt, some of which comes from overseas, will continue.

Tax-Exempt Fixed Income Strategy

Absolute yield levels are low at the end of 2020, and our base case calls for modestly increasing U.S. Treasury yields during 2021. We think high-grade tax-exempt rates are also likely to rise during 2021, although they could increase to a lesser extent than taxable bonds due to continued investor demand for tax-exempt income. Also, should taxable muni issuance remain a meaningful portion of total municipal bonds issued, as we think it will, the available supply of tax-exempt debt will be less than it would be otherwise. Further, although spreads have tightened markedly from their widest points this spring, we expect they will tighten further from current levels. We plan to maintain duration near current levels and, as always, view diversification as a critical component of managing portfolio risk.

Exhibit 9: Tax-Exempt Yield Curve

Municipal Market Data (MMD) AAA GO Yield Curve



Source: Thompson Reuters, 12/31/20

Exhibit 10: Composition of Muni Bond Issuance

**Tax-exempt totals include bonds subject to AMT*

Source: The Bond Buyer, 12/31/20

Central Banks Laying the Groundwork for a Recovery and a Bubble or Two or . . .

Central banks continue to inject massive amounts of liquidity into the global financial system, with total support announced thus far equating to almost $13 trillion, or roughly 15 percent of world GDP. Along with global fiscal stimulus of over $15 trillion (and mounting), the scale of accommodation is without precedent. The actions have helped stabilize economies worldwide in the face of the global pandemic and set the foundation for GDP growth. Rising stock markets are an offshoot of improving prospects for corporate earnings and abundant liquidity. Plus, as central banks employ a low-interest rate policy, the T.I.N.A.-effect (i.e., there-is-no-alternative) is pushing some investors out on the risk curve and into equities. The fear of missing out and the day trader's return have also contributed to positive equity momentum. With the so-called "Fed put" firmly in place and Covid-19 vaccines approved, Citi's Panic-Euphoria model rose to an all-time high in December, surpassing investor euphoria at the height of the 2000 dot-com bubble. While other investor confidence gauges are not as extended, many are near historically peak levels. The maxim "don't fight the Fed" is as true for equities as it is for bonds. However, excess liquidity (and low rates) is fostering speculation in some segments of financial markets.

Signs of Froth in U.S. IPOs; M&A Activity Lagged in 2020 but Poised to Accelerate

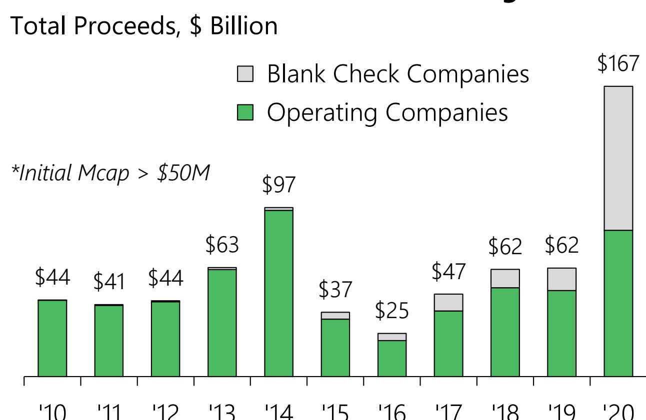
Excess liquidity and a rebound in stocks contributed to a banner year for initial public offerings in 2020 (Exhibit 11). Total gross proceeds for U.S. offerings with initial market capitalizations of at least $50 million spiked +70 percent year over year to $78 billion, excluding direct listings, closed-end funds, and special purpose acquisition companies (SPACs). The average first-day return was roughly +42 percent, leaving ≈$30 billion "on the table" – the highest since 2000. Consequently, the Renaissance IPO Index, which contains operating companies offered within the last two years, far outperformed the S&P 500 Index in 2020 (Exhibit 12). Equally of note, the number of so-called "blank check" offerings, mainly in the form of SPACs, surged +335 percent year over year to 244, generating gross proceeds of $83 billion (+538 percent). SPACs use the IPO proceeds for acquisitions, having two years to do so (or must return the funds). Amplified interest in SPACs is undoubtedly a function of massive liquidity and ultra-low rates, as some investors chase returns. Conversely, merger and acquisition (M&A) activity continued to slow in 2020, both in terms of the number of deals and total deal value. Still, an improving economic landscape, record cash held by U.S. corporations, and meaningful dry powder held by SPACs (and traditional private equity) suggest higher M&A activity may be forthcoming.

Big Tech Dominated 2020 U.S. Equity Returns but Market Breadth Now Improving

The S&P 500 Index steadily rebounded from a pandemic-induced correction in February and March to generate a total return of +18.4 percent in 2020 versus its prior ten-year annualized

Exhibit 11: U.S. Initial Public Offering Proceeds

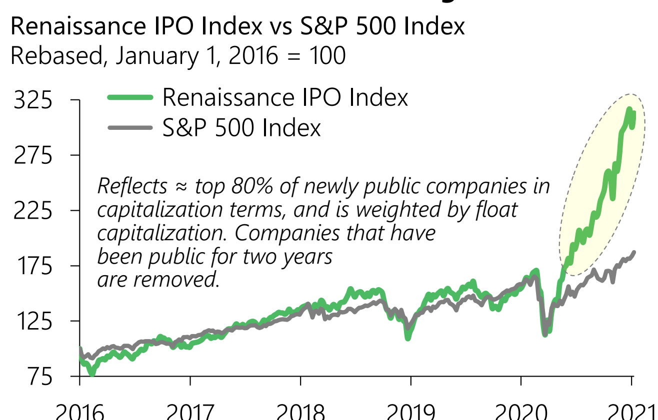
Total Proceeds, $ Billion



Source: FactSet, 12/31/20

Exhibit 12: Initial Public Offering Performance

Renaissance IPO Index vs S&P 500 Index
Rebased, January 1, 2016 = 100



Source: FactSet, 1/8/2021

average return of +13.6 percent. Growth equity indices outperformed value peers considerably for the year, continuing a trend that has persisted for much of the past decade. Driven by stellar gains in large-capitalization technology stocks and stay-at-home beneficiaries, the tech-heavy Russell 1000 Growth Index produced a whopping +38.5 percent return in 2020. The so-called FAANG + M technology stocks (i.e., Facebook, Amazon, Apple, Netflix, Google, and Microsoft) contributed 66 percent and 52 percent to the annual return of the S&P 500 and Russell 1000 Growth indices, respectively. However, stock market breadth has improved considerably over the last two months on encouraging Covid-19 vaccine developments, with gains realized across market capitalization ranges, growth-value indices, and all eleven GICS sectors. Globally, the MSCI China Index returned +29.7 percent on a U.S. dollar basis in 2020, besting the MSCI World Index's +16.5 percent and the MSCI EM Index's +18.7 percent. While U.S. and Chinese stocks were the standout performers for the first nine months of the year, participation in global equity market gains also widened significantly in the fourth quarter on positive vaccine news.

Equities Attractive Relative to Bonds but EPS Growth Needed for Further Gains

The S&P 500 is now trading at 22.7 times consensus next twelve-month earnings projections, above its long-term average 15.1 times. While certainly not cheap relative to its own history, we believe the stock market rally has brought the S&P 500 closer to fair value – especially when record low interest rates, benign inflation, and elevated equity risk premiums are considered. Moreover, sell-side estimates often prove overly cautious coming out of recession, implying upside to current earnings projections. Equities do, however, remain attractive relative to fixed income – the S&P 500's earnings yield of +3.8 percent compares very favorably to the 10-year U.S. Treasury yield of +0.92 percent. Although the Federal Reserve expressed its desire to keep interest rates low for an extended period, inflationary pressures may force its hand in late 2021 or early 2022 – higher inflation/interest rates would weigh on equity valuations. However, we expect double-digit year-over-year earnings growth for the S&P 500 in both 2021 and 2022 to more than offset contraction in the overall market multiple and drive positive equity returns in 2021, and perhaps beyond as the economic upturn endures. Given full market multiples and evolving risks, picking quality companies with improving fundamentals, attractive valuations, and a high potential to exceed expectations will be crucial for portfolio outperformance.

Global Equity Strategy

We remain constructive on U.S. equities over the intermediate-term and think participation in market gains will continue to broaden beyond large-capitalization FAANG +M tech stocks as the pandemic comes under control and global economies normalize. Near term tailwinds for stocks include positive seasonality, elevated cash levels, global stimulus, vaccine deployment, easing financial conditions, and valuations that are attractive to bonds. However, with investor enthusiasm at historical highs and overall market price-to-earnings multiples now discounting a lot of good news, stocks remain vulnerable to pullbacks on disappointments. With vaccines now being deployed, investors are looking past the current surge in new Covid-19 infections to an acceleration in economic growth by the second half of 2021. Yet, investor assuredness may be tested in the interim by several potential issues to include: an increase in pandemic-related restrictions, setbacks in vaccine delivery/uptake, the emergence of a virus variant that renders current vaccines less effective, a reversal in positive macro surprises, or a re-escalation of U.S.-China tensions.

While lingering uncertainties continue to support diversification, we have shifted portfolios toward a more pro-cyclical stance over the past few months. In addition to fundamental factors cited above, President-elect Biden and the Democratic sweep of both chambers of Congress have significant implications for financial markets, including the likelihood of increased fiscal stimulus. The prospect of higher taxes, more debt, and higher interest rates will eventually matter to investors. However, over the near term, this will likely add to the reflation impulse prevailing in markets in recent months.

In terms of sector positioning, this reflationary backdrop has led to a more constructive view on the financial sector, as a combination of higher rates, improving credit, and strong asset prices provide an earnings tailwind. We continue to overweight the technology sector but have shifted the emphasis to hardware from software due to valuation concerns. We believe select semiconductor and hardware companies will continue to benefit from both cyclical (i.e., business capital investment) and secular trends (e.g., A.I., cloud computing, electric vehicles, 5G communications, Internet of Things, robotics, and autonomous vehicles) that will drive growth for many years to come. We also remain positive on the outlook for industrials, although stock prices are, at least partially, discounting an improvement in most major end-markets in 2021. Holdings in industrial stocks focus on companies that will benefit from potential infrastructure legislation, a clear priority of the Biden Administration. Finally, we continue to find attractive opportunities in the health care sector, although sentiment will continue to be influenced by political and regulatory developments. Hospital and healthcare service companies are poised to see accelerating revenue and profit growth as utilization increases while the global pandemic abates. Medical device manufacturers will also benefit from accelerating procedure volume growth globally and currency tailwinds. Although major drug stocks are trading at compelling valuations, the group's defensive orientation may weigh on sentiment as investors seek pro-cyclical/economy reopening beneficiaries as macro conditions improve in 2021.

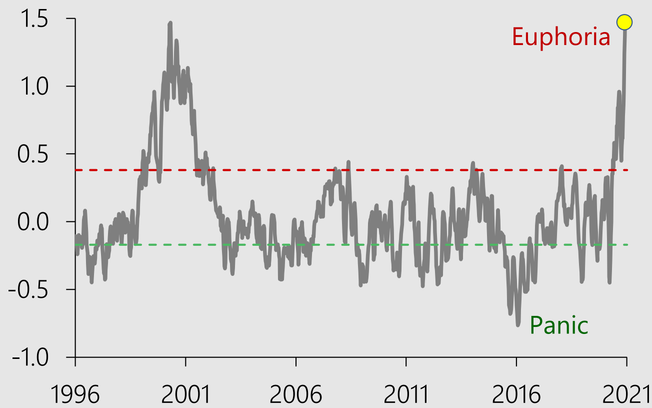
Sentiment has begun to improve for dividend-paying stocks as fears over dividend cuts have subsided in recent months. As of December 31, 2020, we calculate that over two-thirds of S&P 500 stocks currently offer dividend yields above the 10-year Treasury yield. Corporations have been understandably hesitant to increase payouts in 2020. Nonetheless, we expect dividend growth to resume in the near-term, particularly for companies with durable business models, solid balance sheets, and strong cash flow. We believe an improving economy in the year ahead will lead to an acceleration in earnings and dividend growth. This, combined with attractive valuations for dividend-paying stocks, should lead to sustained positive sentiment of dividend-paying equities. Sentiment has also turned noticeably positive for smaller capitalization stocks. This capitalization size has trailed the overall market for the last several years. Yet, with the U.S. economy poised to gain sustainable traction, the stars are aligned for solid small-cap stock performance. U.S. small-cap stocks are more direct beneficiaries of economic improvement, attractively valued, and a segment that investors turn to when comfortable taking more risk.

As for international portfolios, we remain positive on equities in China, South Korea, and India as these nations are further along in their economic recoveries due to the early implementation of strict social-distancing measures to control the Covid-19 outbreak. The MSCI China Index underperformed the MSCI Emerging Markets and MSCI World indices in 4Q20 due to policy tightening concerns and renewed U.S.-China tensions. Nonetheless, we remain constructive on Chinese stocks given improving earnings growth, a still-benign domestic policy setting, a recovering global economy aided by expanded vaccinations, a more predictable U.S.-China relationship under a Biden administration, and continued Fed policy support. We are cautious on Chinese internet stocks near term given regulation uncertainties but remain optimistic on the segment's growth prospects mid-to-long term. South Korean holdings include exporters, work-from-home/consumer spending beneficiaries, and electric vehicle companies. Electric vehicle demand is expected to rise as part of the secular worldwide commitment to net-zero carbon emissions by 2060. Our equity holdings in India are positioned in sectors that will profit from an improving domestic economy – i.e., consumer, financials, energy, information services, and industrials.

Notable Global Equities Data Points

Investor Euphoria a Notable Near-Term Risk

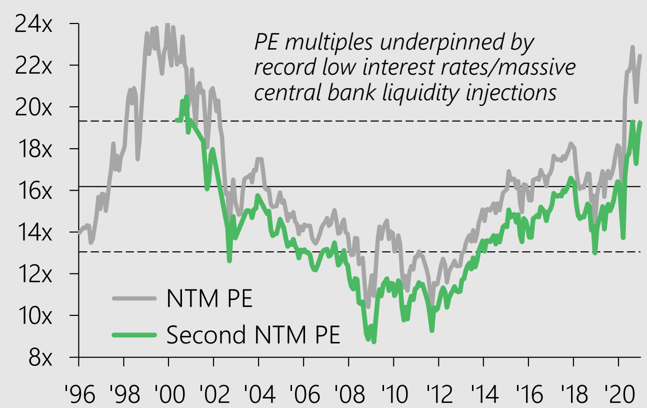
Citi Panic-Euphoria Model



Source: Citi Research, 1/8/21

Market P/E Provides Little Room for Letdowns

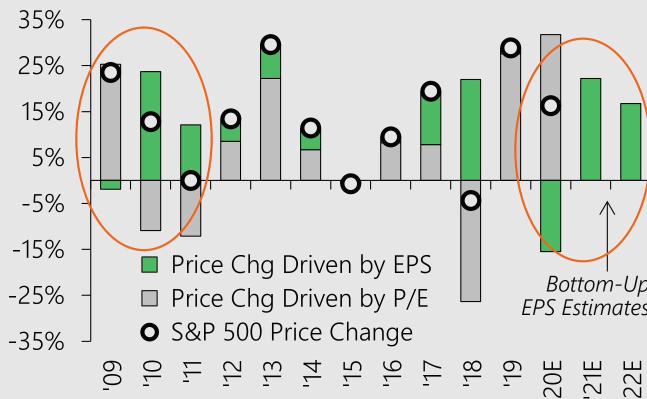
S&P 500 Price-to-Earnings Ratio



Source: FactSet, 12/31/20

EPS Growth Vital for Further Stock Gains

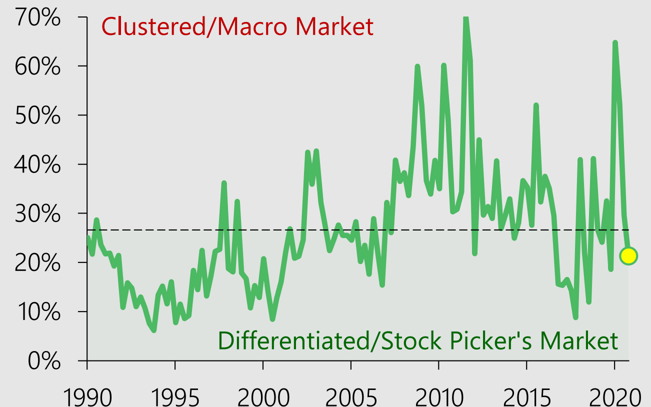
S&P 500 Price Returns, Contribution from EPS and PE



Source: FactSet, 1/7/21

Return to a Stock Picker's Market

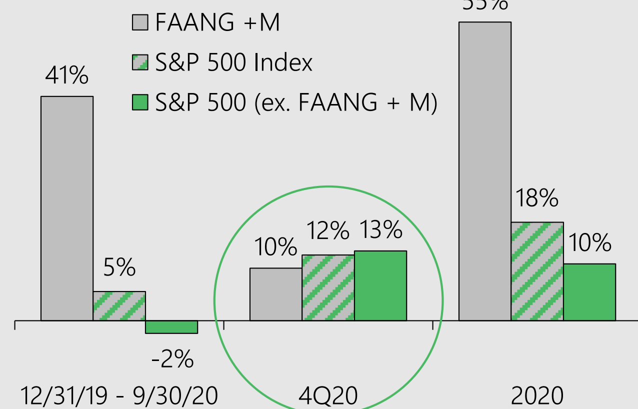
Avg. Pair-Wise Correlations of S&P 500 Stock Combos



Source: BofA/Merrill Lynch, FactSet, 12/31/20

Market Gains Broadening Beyond Big Tech

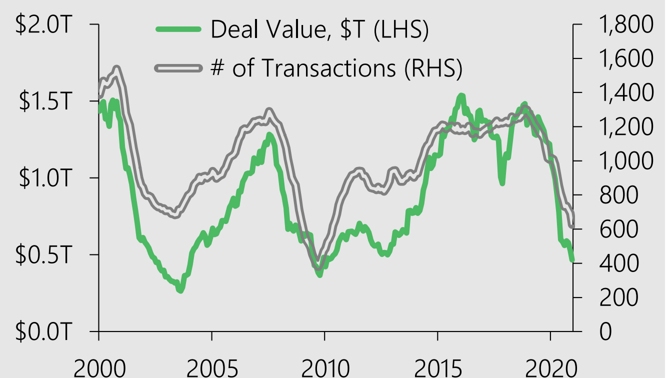
S&P 500 Index, Total Returns



Source: FactSet, 12/31/20

M&A Activity Poised to Accelerate in 2021

U.S. M&A Transactions Announced
LTM Total Deal Value, $ Trillion



Source: MergerMetrics, 12/31/20

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