ENTASIS ASSET MANAGEMENT

QUARTERLY NEWSLETTER

4Q2020

CEO Comments

During the time I sat down to organize thoughts for this newsletter I came across the sad news of baseball legend Henry (Hank) Aaron passing away. He was by far my father's favorite baseball player when he was growing up, so I heard a lot about him when I was young. My dad used to joke that if our house ever burned down, he would grab my mom and his Hank Aaron rookie card.

For a long time, Hank Aaron held the home run record in baseball, but he was way more than that. He was also a prolific hitter in general, amassing more than 3,000 hits even if you were to exclude his 755 home runs. Perhaps more importantly, however, he was an incredible human being that committed his life to philanthropy and the civil rights movement in our country. I am sorry that he is gone.

When I was growing up, I spent a ton of time playing, watching and reading about baseball. I also loved collecting baseball cards and looking through the unbelievable number of statistics and analytics that have always surrounded the game. I am sure it had a big influence on the career path I have ultimately chosen given the amount of data present in the investment industry.

In today's market environment, data and statistics are what I will always fall back on. It is the only thing that is tangible. I have come to appreciate behavioral finance and the impact it has on investing decisions, but it will always be a supplement to data and statistics because making decisions based on sentiment and momentum is too risky of a strategy – at least from my perspective. I can't begrudge anyone that is swinging for the fences right now. The wind is blowing out. There is a lot of support for home runs. That just isn't the type of baseball player I was as a kid, or the type of investor I am now. Baseball players like Hank Aaron that did both are anomalies. Most home run hitters strike out a lot. Most players that hit for average do not hit a lot of home runs. Both can have successful careers, but home run hitters tend to be much more volatile at the plate. The same is true in investing. As a fiduciary and someone being charged with acting as a good steward with hard earned client capital, I believe hitting for average is the only course of action that is appropriate.

Bob Batchelor, CFA®, CFP®
Chief Executive Officer

Summary

In today's market environment, data and statistics are what I will always fall back on.

Most home run hitters strike out a lot. Most players that hit for average do not hit a lot of home runs. Both can have successful careers, but home run hitters tend to be much more volatile at the plate. The same is true in investing.

As a fiduciary and someone being charged with acting as a good steward with hard earned client capital, I believe hitting for average is the only course of action that is appropriate.

When we start working with any client, we believe in setting realistic, achievable goals and hitting for high average over the full relationship by trusting our long-term analysis.

CEO Comments

One of the best hitters in baseball when I was growing up was a player named Tony Gwynn. Sadly, he is also gone. He played baseball for 20 years and had more than 10,000 at bats. Amazingly, he only struck out 434 times. There were only 34 times that he struck out more than once in a game and 45 times he recorded four hits in a game. That means over his 20-year career he was more likely to get four hits than strike out twice on any given day. In 2019, there were 393 players that struck out at least 41 times. Gwynn never struck out that much in any year of his 20-year baseball career. That is the type of consistency we strive to deliver for our clients. I would never be so bold as to suggest we are Tony Gwynn, Hall of Fame caliber, but hopefully the analogy is useful.

At Entasis, when we start working with any client, we believe in setting realistic, achievable goals and hitting for high average over the full relationship by trusting our long-term analysis. We want to consistently compound wealth over time for our clients by making investment decisions that have a margin of safety. Taking zero risk is impossible, but we prefer to invest in situations where the upside potential is skewed in our favor relative to the downside. We like favorable risk/reward scenarios. The likelihood of that strategy yielding home runs in the short-term is low, but it should produce more consistency and less volatility for clients over their time horizons.

We realize the definition of value varies by investment type, sector and market cycle, but our experience has taught us that the concept of value endures. Hope, optimism and euphoria are not investing strategies. They are fun for a time, but are always fleeting, so you can’t build an investment process around those ideas. This means that thrilling rides like Gamestop (GME) will not end up in client portfolios. It represents the type of news story that we view as a distraction.

Instead, as we look at the investing landscape, we like that Covid hospitalizations and positive test results are on the decline, we like that businesses are opening, and we like that the vaccine is rolling out. Those things should translate to long-term business activity and consumer spending, which should ultimately drive earnings and support balance sheet health. Then the question becomes, what is the price we are paying? C.J. and Mike will elaborate further. Just click on the boxes below to jump to each section summary page.

Bob

Market Performance

Equity Portfolio Comments

Fixed Income Portfolio Comments

Click on any button to skip to a new section.

Market Performance

Annualized % Returns (As of 12/31/2020)

Source: Morningstar Direct

Index Name	Index Category	1 year	3 year	5 year	10 year
S&P 500 Index	Large Cap Stocks	18.40	14.18	15.22	13.88
Russell 1000 Index	Mid/Large Cap Stocks	20.96	14.82	15.60	14.01
Russell 1000 Growth Index	Growth Stocks	38.49	22.99	21.00	17.21
Russell 1000 Value Index	Value Stocks	2.80	6.07	9.74	10.50
Russell 2000 Index	Small Cap Stocks	19.96	10.25	13.26	11.20
MSCI EAFE Index	Non-U.S. Developed Market Stocks	7.82	4.28	7.45	5.51
MSCI Emerging Markets Index	Emerging Markets Stocks	18.31	6.17	12.81	3.63
MSCI ACWI Ex USA Small Cap Index	Non-U.S. Small Cap Stocks	14.24	4.59	9.37	5.95
BofAML Preferred Stock Fixed Rate Index	Preferred Stocks	6.95	6.39	6.38	6.78
Barclays Municipal Bond Index	U.S. Municipal Bonds	5.21	4.64	3.91	4.63
Barclays Aggregate Bond Index	U.S. Bonds	7.51	5.34	4.44	3.84
Barclays Intermediate U.S. Gov/Credit Index	Government/Corporate Bonds	6.43	4.67	3.64	3.11
BofAML U.S. Treasury Master Index	Treasury Bonds	8.22	5.29	3.87	3.43
BofAML U.S. Mortgage Backed Securities Index	Mortgage Backed Bonds	4.09	3.84	3.12	3.03
BofAML U.S. Corporate Master Index	Corporate Bonds	9.81	7.03	6.71	5.62
BofAML U.S. High Yield Master II Index	High Yield Bonds	6.07	5.85	8.42	6.61
BofAML Convertible Bonds Index	Convertible Bonds	55.68	24.48	20.16	14.19
BofAML Euro Broad Market Index	European Bonds	13.35	4.10	5.35	3.31
BofAML Local Debt Market Plus Index	Emerging Markets Bonds	4.50	4.99	7.17	2.45

Calendar Year % Returns (QTD as of 12/31/2020)

	QTD	2020	2019	2018	2017	2016
S&P 500 Index	12.15	18.40	31.49	-4.38	21.83	11.96
Russell 1000 Index	13.69	20.96	31.43	-4.78	21.69	12.05
Russell 1000 Growth Index	11.39	38.49	36.39	-1.51	30.21	7.08
Russell 1000 Value Index	16.25	2.80	26.54	-8.27	13.66	17.34
Russell 2000 Index	31.37	19.96	25.52	-11.01	14.65	21.31
MSCI EAFE Index	16.05	7.82	22.01	-13.79	25.03	1.00
MSCI Emerging Markets Index	19.70	18.31	18.42	-14.57	37.28	11.19
MSCI ACWI Ex USA Small Cap Index	18.56	14.24	22.42	-18.20	31.65	3.91
BofAML Preferred Stock Fixed Rate Index	4.55	6.95	17.71	-4.34	10.58	2.32
Barclays Municipal Bond Index	1.82	5.21	7.54	1.28	5.45	0.25
Barclays Aggregate Bond Index	0.67	7.51	8.72	0.01	3.54	2.65
Barclays Intermediate U.S. Gov/Credit Index	0.48	6.43	6.80	0.88	2.14	2.08
BofAML U.S. Treasury Master Index	-0.91	8.22	6.99	0.80	2.43	1.14
BofAML U.S. Mortgage Backed Securities Index	0.33	4.09	6.51	1.00	2.45	1.67
BofAML U.S. Corporate Master Index	2.99	9.81	14.23	-2.25	6.48	5.96
BofAML U.S. High Yield Master II Index	6.47	6.07	14.41	-2.27	7.48	17.49
BofAML Convertible Bonds Index	21.68	55.68	23.06	0.68	16.03	11.94
BofAML Euro Broad Market Index	5.64	13.35	4.11	-4.39	14.61	0.37
BofAML Local Debt Market Plus Index	9.15	4.50	16.44	-4.90	14.71	6.53

How should you use the information provided in the table?

- The returns are not projections. They are historical. Future returns will vary.
- Annualized returns can generally be used to understand historical return trends.
- Calendar returns provide a general understanding of year-by-year return volatility.

Corporate Earnings

At the end of 2020, the S&P 500® Index was expected to post an aggregate decline in year-over-year fourth quarter earnings of -9.2%. However, relatively strong results from companies that have reported so far in January lowered the expected aggregate decline in year-over-year fourth quarter earnings to approximately -4.7% (as of 1/22/21). Despite the negative estimated earnings results for the S&P 500®, revenue growth is expected to be positive for the fourth quarter (+0.7% year-over-year). Positive revenue growth in combination with net profit margins in excess of 10% (see chart below) have helped to fuel the relative improvement in earnings.

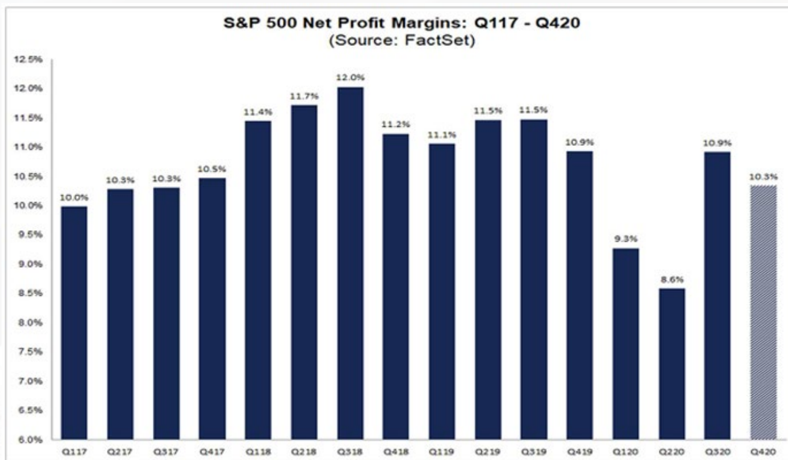


Chart courtesy of FactSet Earnings Insight (January 22, 2021)

One interesting development so far this quarter has been the market response to companies that have beaten earnings estimates. Historically, the market has viewed positive earnings surprises favorably, with a corresponding increase in the underlying company's stock price. However, the opposite has been true so far this year (on average) as companies that have reported positive earnings surprises have seen their stock prices decline, while companies that have reported negative earnings surprises have seen their stock prices increase. There may be a variety of reasons for this, but the overriding theme may be to "buy the rumor" and "sell the news." This may also be a sign that for companies that weathered the storm in 2020 (earnings were either minimally impacted or improved because of the lockdown) and saw corresponding large stock returns, that investors will need significantly better than expected results to push already elevated prices even higher. Said differently, since these companies may not have experienced as large of a downturn, there is not as much room for year-over-year improvement in 2021.

Charles (CJ) Batchelor, CFA
Chief Investment Officer – Equity

Summary

Positive revenue growth in combination with net profit margins in excess of 10% have helped to fuel the relative improvement in earnings for the S&P 500®.

Despite a checkered track record over short timeframes, valuation measures do a significantly better job at predicting longer-term returns in equity markets.

Even if we do not experience the "popping" of a bubble, investors very well could be looking at years of relatively meager returns in excessively valued areas of the market as earnings for these companies attempt to grow into their lofty valuations.

Emerging markets equities are among the most attractively priced market segments from a valuation standpoint and have the highest estimated 3-5-year earnings per share growth rate.

Looking ahead, analysts are expecting a sharp uptick in S&P 500® earnings (year-over-year) for every quarter in 2021. This would result in a strong year-over-year calendar year increase for 2021, with a new record high in aggregate earnings (relative to 2019 earnings). See the chart below.

What is also apparent is that analysts expect another banner year for earnings growth in 2022. This may be a factor in explaining recent market gains, but we believe the largest overriding factors for market appreciation continue to be expectations for an unending supply of fiscal and monetary support, low interest rates and a speculative fervor based on the presumption that stocks only go up (or will not be "allowed" to go down).

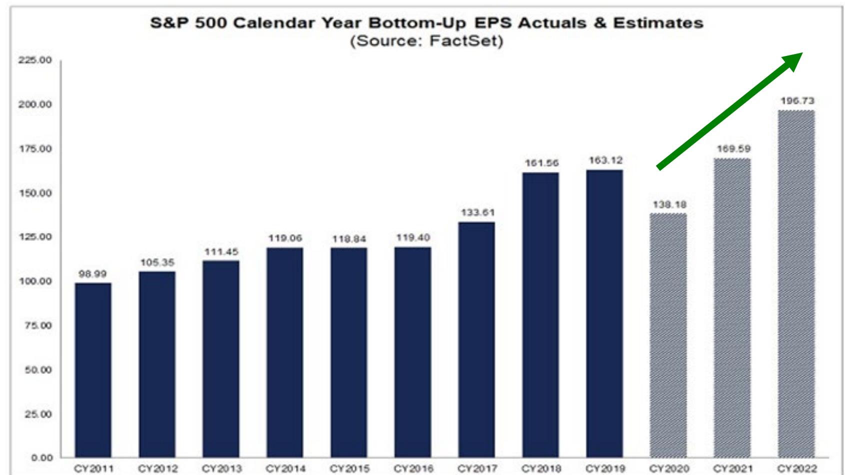


Chart courtesy of FactSet Earnings Insight (January 22, 2021)

We had a lengthy discussion on the disconnect between company fundamentals and stock prices in last quarter's newsletter (along with the differences between speculating and investing), so we will not repeat the same diatribe here. However, the chart below does a great job at showing the large gap that remains between stock prices and earnings. This continues to be true even though earnings expectations have improved.

We believe that we will see a convergence of these lines in future periods because market results tend to track the path of earnings over the long term, even though the relationship may not hold over the short term. Whether this convergence will occur through a combination of increased earnings and stagnant equity results, or a readjustment of stock prices relative to earnings, is another matter. More on this later.

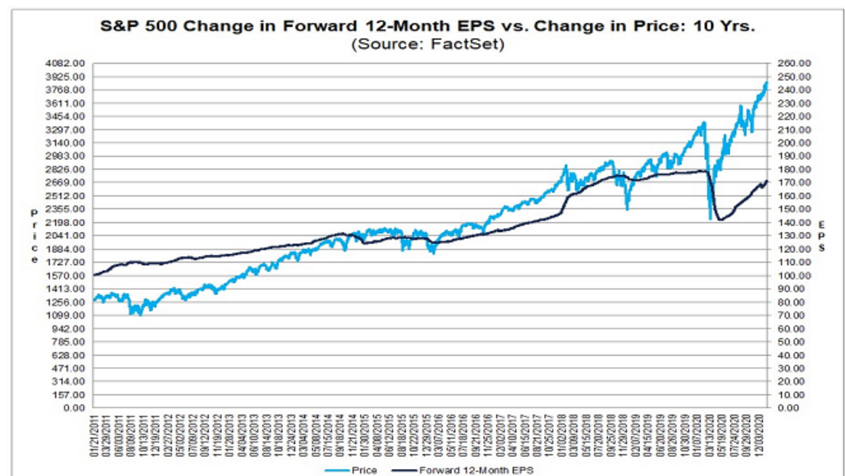


Chart courtesy of FactSet Earnings Insight (January 22, 2021)

Market Valuation

As valuations continued to ratchet to historically high levels, debate around the question, "Do valuations matter?" has intensified. Depending on who you ask, you may get two very different

responses. In fact, the topic has seemingly become the "politics" of the financial world, with strong opinions on both sides. Based on our experience, we have found the debate gets the loudest as valuations approach nosebleed levels. Momentum-chasing "bulls" argue that old valuation methods are no longer applicable, while value purists argue that fundamentals will never lose their place in determining underlying value. As is usually the case, we believe the answer is not simply black or white, but rather resides somewhere in between. In this case, we strongly believe that traditional valuation metrics do indeed matter; however, as we have stated over the years, how much they matter depends on the timeframe in question.

We liken the discussion to a ball being thrown into the air. The ball may be able to continue its climb higher despite forces working against it (such as gravity), but in the end, gravity always prevails. This is similar to equity valuations. Equities can continue to climb to new heights despite an absence of underlying support from fundamentals if an attractive enough narrative is in place to overshadow fundamentals. This is the case now as many investors have largely ditched traditional components of equity valuation (earnings, revenues, profit margins, etc.) to instead focus on factors outside of corporate control such as never-ending fiscal and monetary support, or to simply follow the belief that whatever has worked recently will continue to work ad infinitum. As a result, traditional valuation metrics, such as the ones shown in the table below, have not mattered much in hindering the upward progression of markets despite that nearly every valuation metric "screams" overvalued.

Equity valuation percentiles (100% = most expensive)

S&P 500 valuation metric	Dec 2019 percentile	Current percentile
US market cap / GDP	99%	100%
Enterprise value / Sales	99%	100%
Enterprise value / EBITDA	93%	100%
Forward P/E	88%	97%
Price / Book	90%	93%
Cash flow yield	85%	93%
Cyclically adjusted P/E	89%	92%
Free cash flow yield	53%	60%
S&P earnings yield - 10Y UST	28%	33%
Median metric	89%	93%

Chart courtesy of Goldman Sachs Investment Research

How long can equity prices, and in turn valuations, suspend "gravity?" We believe the answer to this question is more pertinent than inserting ourselves too deeply into the polarizing debate of whether valuations matter. Unfortunately, we do not have a good answer to this question since similar instances of overvaluation in the past have lasted for varying durations. For instance, Fed Chairman Alan Greenspan delivered his famous "irrational exuberance" speech cautioning that the stock market may be overvalued in late 1996, a full three years and three months prior to the dotcom bubble "popping." Does this mean that the market could sustain its current trajectory for years into the future? Not necessarily. But what it does mean is that valuations can remain at elevated levels, or continue to push higher, for as long as the overriding narrative remains in place.

For example, if we were to reexamine the previous table, it could be seen that many of the metrics in the table were also at historically elevated levels at the end of 2019. Considering the S&P 500® posted a double-digit positive gain in 2020, this highlights the fact that just because a security, or an entire market index, is undervalued or overvalued based on a historical valuation metric today does not mean that it will go up or down tomorrow, next week, next month, or even next year. There needs to be a catalyst, either to impose value or unlock value.

Oftentimes the catalyst is not known in advance, such as was the case last year when a virus changed the world as we know it. However, when the catalyst does present itself, underlying business fundamentals and valuations tend to matter in a hurry. The more stretched valuations are when the catalyst presents itself, the more dramatic the market movements.

Equity Portfolio Comments

Despite a checkered track record over short timeframes, valuation measures do a significantly better job at predicting longer-term returns in equity markets. See the scatterplot below. It examines forward P/E ratios for the S&P 500® and subsequent 5-year annualized equity returns.

Notice that as the forward P/E ratio increases on the x-axis, the subsequent 5-year annualized equity return decreases on the y-axis. Because we are long-term investors and allocators of capital for our clients, this relationship makes valuation metrics a key input to consider when constructing portfolios.

Bringing everything together, our view is that the U.S. market is priced to near perfection. When that happens, it does not take much to disappoint. We also believe that there are increasing signs of "bubbles" forming in certain segments of the market due to speculation. This is reflected not only in the valuation metrics that we have reviewed, but also in other market data such as margin debt, IPO (and SPAC) issuance and investor sentiment indicators (to name a few). Unfortunately, large increases in these types of data series typically do not presage a happy ending for investors that partake in the speculation.

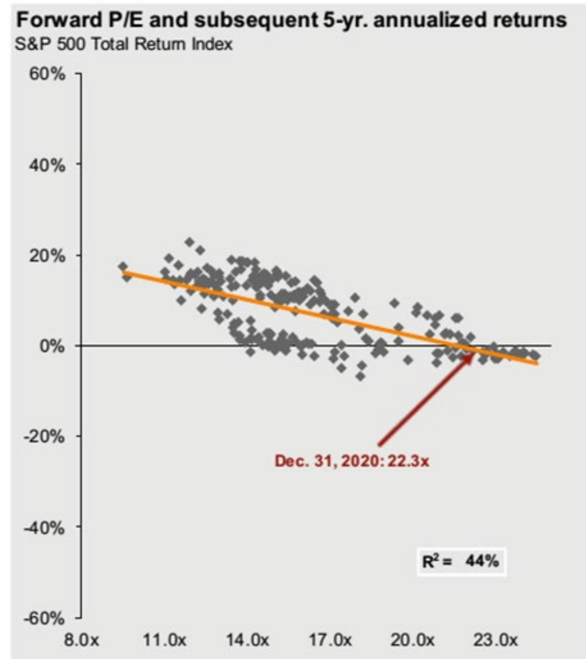


Chart courtesy of J.P. Morgan – Guide to the Markets 1Q21

These viewpoints may make it seem quite bleak for investors. However, it is important to remember that our discussion to this point has only focused on earnings and valuation metrics for large-cap, U.S. based stocks (S&P 500® Index) in aggregate. Despite many individual stocks and segments of the U.S. market being overvalued, that does not mean that there are not opportunities for investment. To the contrary, this is where relative value comes into consideration because investment decisions and portfolio construction occur across asset classes, sectors, market-capitalizations, countries, regions, and currencies.

The table below displays valuation metrics and other characteristics for the S&P 500® Index (large-cap U.S.), Russell 1000® Growth (large-/mid-cap U.S. growth), Russell 1000® Value (large-/mid-cap U.S. value), MSCI EAFE® (foreign developed markets) and MSCI EM (foreign emerging markets).

	S&P 500	R1000 Growth	R1000 Value	MSCI EAFE	MSCI EM
Dividend Yield (%)	1.53	0.73	2.24	2.40	1.72
Forward P/E	22.44	31.28	17.97	17.51	15.35
Price to Book	4.09	12.37	2.36	1.85	2.17
Price to Cash Flow	15.12	26.21	10.84	9.20	10.34
Price to Sales	2.81	5.03	1.91	1.42	1.82
Est 3-5 Yr EPS Growth (%)	12.19	17.56	7.83	9.88	20.05
5 Yr Dividend Growth Rate (%)	7.01	5.75	5.99	5.13	8.63

Data Courtesy of Eaton Vance – Monthly Market Monitor January 2021

Several things are worth reflecting on in the table. The first is that U.S. growth stocks have an attractive 3-5-year earnings per share growth rate. However, these stocks are extremely expensive across all valuation metrics relative to the other indices shown. The second is that U.S. value stocks are much more attractively priced relative to the other U.S. indices shown (forward P/E, price to book, price to cash flow and price to sales). The third is that U.S. stocks (S&P 500®) are more expensive across all valuation metrics when compared to foreign markets. Lastly, emerging markets equities are among the most attractively priced from a valuation standpoint, have a higher dividend yield and dividend growth rate than the broad U.S. market (S&P 500®) and have the highest estimated 3-5-year earnings per share growth rate.

Many more factors need to be examined beyond what is shown in the table above prior to making an investment decision. However, what relative value data (and characteristics) do help with is to provide a better understanding for how various markets are priced relative to future expectations. In turn, it is one additional piece of the puzzle that helps to inform decision-making for portfolio construction.

Outlook

Markets continued to ramp higher during the fourth quarter due to the announcement of multiple effective vaccines, a reaffirmation of support from the Fed, a partial reopening of the economy and an improvement in corporate earnings and the global economy. While the gains were undoubtedly a welcome sight for investors following a tumultuous start to the year, market and investor euphoria also spiked higher, which led to historically high valuation levels and signs that certain segments of the market are approaching, or have entered, “bubble” territory (a “bubble” is characterized by the rapid increase in the market value of assets).

In our last newsletter, we highlighted areas of the equity market that had experienced historically large divergences in performance. One such divergence was between U.S. growth and value stocks. We emphasized two factors that we thought may influence a reexamination of value-oriented equities: 1) signs that the economic recovery may accelerate (one such factor being the approval of an effective vaccine); and 2) rising inflation expectations, which may cause a reassessment of valuation multiples. The approval of multiple vaccines, along with signs of rising inflation expectations both occurred during the quarter, which led us to purchase an actively managed, U.S. value investment manager. We made the adjustment because we believe these factors (among others) will spur a rotation towards more attractively priced (less “expensive”) cyclical value companies as investors begin to rotate out of traditionally higher growth, more “expensive” areas of the market.

Like sub-asset classes, mutual fund managers tend to go through periods of underperformance and outperformance over time as their style and areas of focus in their portfolios oscillate relative to underlying economic and earnings cycles. This had been the case with the strategy we purchased on behalf of clients. The manager had struggled from a performance perspective in recent years as investors favored high-growth companies during a period of expanding valuation multiples, versus its price sensitive style. In addition, the manager’s portfolio of securities was relatively inexpensive when compared to other areas of the market but was also invested in companies that had the ability to grow and prosper during a more favorable economic environment. See forward P/E ratio data below.

S&P 500® Index = 22.0x　　Russell 1000® Growth Index = 30.6x
Russell 1000® Value Index = 18.1x　　**Value Mutual Fund** = 10.7x

We highlight this purchase because it demonstrates two important concepts for how we invest. The first is to be patient when making shifts in the overall construction of portfolios. We will not chase performance, or simply buy what has been doing well with the expectation that it will continue to do well in the future. Through our experience, we have found this to be a detrimental strategy to follow, especially when investing with a long investment horizon. Conversely, we will not simply buy a manager or investment because it has performed poorly, or because a style has been out-of-favor. For this manager, we patiently waited (in this case, for multiple years) for what we believed to be an opportune time to invest, given the manager's particular strategy for investing, along with the current and prospective operating environment. The second concept is to conduct in-depth research on investment managers, so that when an opportunity arises, we are confident that the manager will execute on their strategy. This is oftentimes a crucial component to our investment strategy since it is much easier to chase recent good results as opposed to making an investment in a manager whose style has been out-of-favor and has registered relatively weak results. Overall, we believe the manager's portfolio is positioned well for the future given our opinion that we have begun to see a shift in investor sentiment towards attractively valued, well-run businesses that can grow their companies at attractive rates over the intermediate- to long-term (although, given recent speculative excesses, this is certainly not the case for all investors!).

The other notable adjustment we made during the quarter was to invest in a mutual fund that focuses on foreign small- and micro-cap companies that the manager believes have scalable business models, offer premium products, the ability to grow market share and have relatively safe balance sheets that can support future growth. The investment in a growth-oriented, smaller-cap mutual fund in foreign markets is consistent with how we have been positioning client portfolios for some time, which is to invest more aggressively in foreign markets, while being more defensive and sensitive to valuation among U.S. investments.

Outside of those two notable purchases, we continue to have a significant emphasis in emerging markets equities. Because we believe these markets are relatively inefficient, we have allocated capital to active managers our research has shown have the ability to outperform their benchmarks on a risk-adjusted basis over the intermediate- to long-term. Our positive view on emerging markets at the asset class level is based on many different variables that we believe provide support for relatively attractive rates of return well into the future. These include the reversal of U.S. dollar strength (we believe emerging markets currencies are undervalued), a rapid increase in the percentage of middle-class citizens in key emerging markets countries such as China and India, attractive valuation levels in tandem with attractive long-term growth rates (see the index comparison table in the valuation section), and in many cases, supportive (and fiscally healthier) underlying economies. While there will inevitably be periods of heightened volatility in these markets over shorter timeframes, we believe the risk/reward ratio is attractive, especially when viewed over a longer investment horizon and relative to developed markets such as the U.S.

While we do not claim to have anywhere near perfect foresight, we feel confident in saying that the next 10 years will look very different when compared to the last 10 years. Our current positioning in portfolios is reflective of that belief. "Bubbles" will "pop" where there is excess, money will rotate to new investments and what appear to be obvious winning investments now (such as innovative tech companies with an endless supply of optimism but no sales and massive debt), will be relegated to market history books as cautionary tales for future investors. This is not to say that winners will not

emerge from the speculative froth, but there will be many more multiples of forgotten losers. It's challenging to see potential potholes amid a raging, speculative-driven market, but as Matthew Broderick said in *Ferris Bueller's Day Off*, "Life moves pretty fast. If you don't stop and look around once in a while, you could miss it." While he certainly was not referring to the equity market, the theme is the same. If an investor does not stop and look around occasionally to examine what is occurring in markets, they could be pulled into the speculative fray. And when the music stops playing in these types of markets, investors do not want to be one of the participants that gets caught without a chair.

In conclusion, even though certain segments of the global equity market appear to be extremely overvalued, that does not mean there are not attractive investments to be made. Will a so-called "bubble" pop? It is certainly a possibility. However, it is important to remember that a bubble bursting does not necessarily mean large losses for the entire market. Certain companies, and specific industries and sectors may indeed "pop," but relative gains may rotate into other forgotten areas of the market such as what occurred when the dotcom bubble popped in 2000. Even if we do not experience the "popping" of a bubble, investors very well could be looking at years of relatively meager returns in excessively valued areas of the market as earnings for these companies attempt to grow into their lofty valuations (see the forward P/E relative to subsequent five-year annualized returns chart in the valuation section). The key at this point is not to debate whether valuations matter, if the market or certain securities, industries and sectors are in a "bubble" or not, or even if the exact timing of new investments is perfect. The key is to maintain an intermediate- to long-term outlook for investments, avoid behavioral biases that could result in a significant departure from a long-term financial plan and continue to focus on investing as opposed to speculating. As always, we will continue to monitor market developments and share our rationale and research with clients as changes occur.

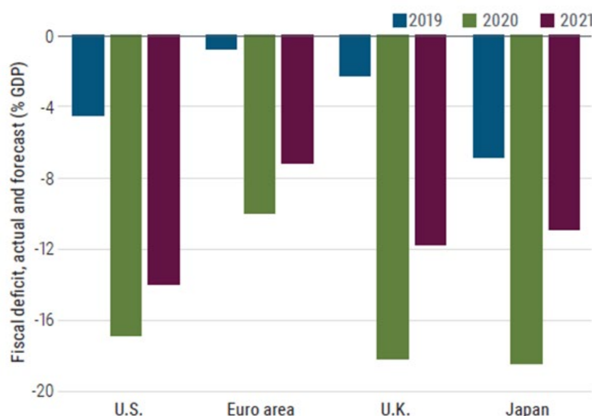
Fixed Income Portfolio Comments

Economic and Policy Review

Over the past year, the globe was turned upside down by a painful pandemic, which generated significant economic stress on households and businesses. To counter the impacts of the virus, policymakers around the globe implemented an unprecedented monetary and fiscal response. The size and speed of the policy response helped avoid an even larger economic contraction in the second quarter and paved the way for a healthy rebound in activity in the third quarter. Naturally, the pace of the rebound slowed in the fourth quarter but was still robust in many aspects. Overall, U.S. GDP is expected to shrink by nearly 3% in 2020, which would be the first annual decline since 2009.

With the pains of the past year now in the rearview mirror and the start of a worldwide vaccination program underway, many have an optimistic outlook for the new year. It is likely the economy will continue its transition from hurting to healing in 2021, especially in the second half of this year.

Until a significant portion of the population gets vaccinated, the virus will likely continue to rage in the early months of 2021. This increases the potential for a new wave of lockdowns and an uneven recovery. In this period, fiscal and monetary stimulus are going to be needed to pick up the slack. The U.S. recently passed a new $900 billion fiscal stimulus package providing fresh rounds of direct payments, PPP loans and enhanced unemployment benefits. With the Democrats poised to narrowly control the Senate, another round of stimulus is likely in the next few months. President Biden recently proposed a $1.9 billion stimulus package, most of which is aimed in a similar direction. The U.S. Federal Reserve (Fed) has all but committed to monetizing the deficits created by the stimulus. See chart below for major economies around the world. In the U.S., the 2021 budget deficit is projected to be approximately 13% of GDP.



Source: Haver Analytics, PIMCO calculations as of December 2020

Mike Peters, CFA
Chief Investment Officer – Fixed Income

Summary

Until a significant portion of the population gets vaccinated, the virus will likely continue to rage in the early months of 2021. In this period, fiscal and monetary stimulus are going to be needed to pick up the slack.

2020 was a wild year in fixed income markets, but with significant central bank support, they weathered the storm with remarkable resilience.

With the economy still below its 2019 peak, the Fed is on hold for the foreseeable future. In its latest meeting the FOMC saw rates on hold until at least 2023.

We are partnering with active managers in many fixed income sectors that can respond in a nimble fashion to the potentially uneven economic recovery.

If the fiscal stimulus is effective in supporting the economy during the first half of the year and the vaccine rollout is successful, pent-up demand will likely take over in the second half of 2021. Economists are projecting that U.S. and global growth will be 4% and 5.4%, respectively, in 2021.

What does the optimistic outlook mean for markets? It is likely risk markets can continue to perform well in the near-term as these factors take hold. However, markets are forward looking and much of this may already be priced in. Investors need to be aware of this and position portfolios to take advantage of the value that still exists while also keeping one eye on the intermediate-term.

The pandemic has caused significant economic scarring, which will transform it forever. There are several unresolved questions that will take time to answer. Will the demand for stay-at-home sectors be maintained? Will the small businesses that shut down be lost permanently? Will the travel sectors make a full recovery? Will office workers return, or will they work from home permanently? All these questions, and many more, will have significant long-term impacts on the economy and labor force.

In December, the FOMC stated that they would maintain monthly bond purchases of at least $120 billion until it sees “substantial further progress” in reducing unemployment and increasing inflation. However, we cannot live off stimulus and debt monetization indefinitely. At some point the economy must stand on its own two feet. This transition has the potential to be bumpy and lead to market volatility, particularly if the handoff between the end of the stimulus and the fundamental economic healing we need is not perfect. This transition is likely a 2022 phenomenon, or beyond, but depending on the speed of the recovery, markets may start to price it in during the back half of 2021.

Performance Review

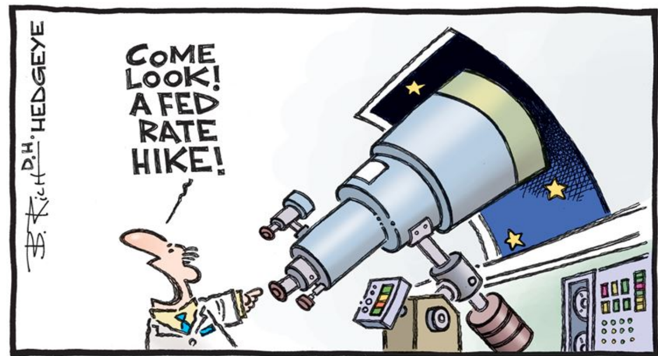
2020 was a wild year in fixed income markets, but with significant central bank support, they weathered the storm with remarkable resilience. Surprisingly, credit spreads (yield compared to an equivalent maturity U.S. Treasury bond) in most sectors ended the year relatively close to where they began, covering up the massive intra-year volatility. See table to the right. This in combination with lower Treasury yields produced attractive returns in many fixed income sectors. Thanks to an effective bailout from the Fed, U.S. investment grade corporates posted the strongest returns in 2020 (+9.81%). U.S. Treasury bonds placed a close second, generating +8.22%. With an impressive 4Q2020 rally, below investment grade corporate bonds (high yield) posted a +6.07% return. Mortgage-backed securities were the weakest performing sector (+4.09%), largely due to record low mortgage rates and historically fast refinancing activity, which led to large prepayments in premium bonds.

Option-Adjusted Spreads (in bps)

	12/31/19	March Wides	9/30/20	12/31/20	Q4 Chg	YTD Chg
U.S. Aggregate Index	39	127 (3/20)	60	42	-18	3
U.S. Agency (non-mortgage)	10	53 (3/25)	16	10	-6	0
Mortgage and ABS Sectors						
U.S. Agency Pass-throughs	39	132 (3/19)	61	39	-22	0
U.S. Agency CMBS	53	144 (3/23)	62	44	-18	-9
U.S. Non-Agency CMBS	85	348 (3/25)	139	109	-30	24
Asset-Backed Securities	44	325 (3/26)	41	33	-8	-11
Corporate Sectors						
U.S. Investment Grade	93	373 (3/23)	136	96	-40	3
Industrial	99	383 (3/23)	140	101	-39	2
Utility	97	298 (3/24)	141	106	-35	9
Financial Institutions	80	378 (3/23)	126	83	-43	3
Other Govt. Related	72	180 (3/23)	84	66	-18	-6
U.S. High Yield Corporates	336	1100 (3/23)	517	360	-157	24
Emerging Market Debt	573	1370 (3/23)	638	503	-135	-70

Source: Bloomberg Barclays Indices

Fixed Income Outlook



Source: Hedgeye

Interest Rates

With the economy still below its 2019 peak, the Fed is on hold for the foreseeable future. In its latest meeting, the FOMC saw rates on hold until at least 2023. It also stated that monthly bond purchases of at least $120 billion would be maintained. This combined with the recent change to the inflation response mechanism, almost eliminates a pre-emptive move to stave off inflation. As a reminder, the Fed is now targeting an average of 2% inflation rather than a ceiling. This means we are likely to see several quarters of inflation above 2% before the Fed would act. Taking these two factors into consideration, it is highly likely the yield curve will continue to steepen. We believe the 10-year Treasury is fairly valued at 1.30%, with the potential to increase toward 2.00% if inflation comes in hotter than expected.

From a portfolio construction standpoint, we positioned client portfolios to have less interest rate risk than their investment policy statement (IPS) benchmarks. We continue to prefer a bulleted portfolio focus for strategies with intermediate durations (3-7 years). Our approach is designed to capture yield while also playing defense against an increase yields on the long end of the yield curve (10-30 years).

Corporate Bonds

During 2020, the Fed's Corporate Credit Facilities allowed companies to raise liquidity at lower rates than before the COVID crisis, when balance sheets were in a significantly better position. This effectively facilitated an ability to "kick the can down the road". The hope is there is a long enough liquidity runway for earnings to come back before debt overwhelms companies. Currently, the combination of higher debt and weaker earnings has exacerbated the deterioration in credit metrics.

A good example of this is seen when we evaluate interest coverage ratios (the measure of a company's ability to pay interest on outstanding debt). Despite record low corporate yields, interest coverage ratios have declined to the lowest level since 2003. From a positive standpoint, many companies plan to focus on balance sheet improvement as earnings increase. It is also likely the Fed will step in again if we were to experience another liquidity crunch due to the systemic risk posed from a corporate debt bubble bursting. Nevertheless, liquidity does not equal solvency and there are surely some companies that will not be saved.

Taking everything into consideration, we are neutral on corporate debt on a look-through basis. We are getting our exposure through mutual funds that can invest up and down the quality spectrum. We are relying on our managers to help us navigate the landscape, as idiosyncratic factors will determine which companies successfully repair balance sheets and which ones do not.

Securitized Bonds

Continued support from the Fed's sizable asset purchase program provides a strong tailwind for agency mortgage-backed securities. Given that repayment has effectively become guaranteed by the government, the bonds are trading with a very low default risk premium. The spreads of these bonds

are a function of cash flow timing uncertainty, which widened in 2020 due to significant prepayments as rates decreased. Now that rates are moderating and most of the refinancing wave is behind us, we believe the sector currently offers attractive relative value. As a result, we are overweight agency mortgage-backed securities in client portfolios. Fundamentally, there has been some improvement in overall delinquency rates across non-agency (non-guaranteed) mortgage-backed securities. In addition, legacy non-agency mortgages are currently being priced with conservative assumptions for losses and prepays, which make them attractive as well.

In the asset-backed securities sector there is less fiscal support, and a weak recovery may challenge underlying collateral. As a result, it is likely collateral performance will start to deteriorate next year. These factors highlight the importance of security selection. We continue to partner with active managers in the space.

Non-U.S. Bonds

Considering the recent negative trend in the U.S. dollar is likely to continue, we are constructive on non-U.S bonds – particularly emerging markets debt. With a supportive backdrop, attractive valuations, and the global search for yield, we think the sector has strong potential. We have direct and indirect exposure to the asset class in most client portfolios.

Municipal Bonds

2020 was a year of significant volatility in the municipal bond markets. When the year started, municipal bond funds were benefiting from record weekly inflows, state and local tax revenues were rising on the back of a healthy economy and municipalities were stockpiling reserves. Then everything reversed dramatically when the Covid-19 lockdowns took effect in early March. Liquidity in the municipal market almost completely froze when a flood of selling pressure overwhelmed the system. It was brought on by a huge demand for cash from municipal bond fund holders. Outflows reached record levels as funds lost $12.2 billion and $13.7 billion, respectively, in the last two weeks of March. The selling and lack of dealer support drove municipal yields to record highs relative to comparable maturity Treasuries. At that point, sellers had no way of knowing how rapid and coordinated the response from policymakers (the Fed, Congress, and the Trump administration) would be. Their actions produced the $2.2 trillion CARES Act which, along with other measures, offered substantial aid to nearly every sector of the municipal market. The goal was to cover Covid-19-related costs and help offset lost revenue. In addition, the Municipal Liquidity Facility (MLF) was established, which for the first time ever, allowed the Fed to lend directly to states and other select municipalities. These actions calmed the markets by providing the liquidity needed to stabilize it and create a path toward fundamental improvement. Investors who were able to stay the course by riding out the volatility were rewarded. For the full year, tax-exempt rates fell sharply, which led to solid returns. The full investment grade maturity spectrum (1-30-year bonds) generated a 5.21% return. Despite most of the returns coming in the fourth quarter, high yield municipal bonds almost kept pace, generating a 5.13% return. Going forward, the prospects for additional fiscal stimulus are high, which should aid further fundamental improvement. While low from an absolute standpoint, high quality municipal yields compare favorably to their taxable counterparts. This combination makes us optimistic about the outlook for investment grade and high yield municipal bonds. As a result, we continue to emphasize these types of securities in tax aware client portfolios.

Our Team

Bob Batchelor, CFA®, CFP®
CEO
Co-Founder

Bob J. Batchelor, CFA®, CFP® is Co-Founder and Chief Executive Officer of Entasis Asset Management. Bob has 20 years of experience in the investment industry. Prior to founding Entasis, Bob worked at Artisan Partners where he held a variety of roles including Head of Corporate Communications, Managing Director, Head of Marketing and Technology and Head of Marketing and Communications. He also served as a member of Artisan Partners Executive Committee. Before Artisan Partners, Bob worked at Strong Capital Management as Client Account Manager and Director of Investment Research and Communication.

Bob holds an M.B.A. from Marquette University and a B.B.A. from the University of Wisconsin-Madison. He has earned the right to use the CFA designation. Bob is a member of the CFA Institute and CFA Society of Milwaukee. Bob has also earned the Certified Financial Planner™ certification.

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CIO – Equity
Co-Founder

Charles J. (C.J.) Batchelor, CFA® is Co-Founder and Chief Investment Officer – Equity of Entasis Asset Management. C.J. has 15 years of experience in the investment industry. Prior to founding Entasis, C.J. worked at Cleary Gull, a multi-billion dollar investment advisory firm, as Director of Investment Research. He also served as a member of Cleary Gull's Investment Policy Committee, Investment Committee and Equity Strategy Group.

C.J. holds a B.B.A. in Finance from the University of Wisconsin-Milwaukee. He has earned the right to use the CFA designation. C.J. is a member of the CFA Institute and CFA Society of Milwaukee.

Mike Peters, CFA®
CIO – Fixed Income
Co-Founder

Mike Peters, CFA® is Co-Founder and Chief Investment Officer – Fixed Income of Entasis Asset Management. Mike has 15 years of experience in the investment industry. Prior to founding Entasis, Mike worked at Cleary Gull, a multi-billion dollar investment advisory firm, as Fixed Income Portfolio Manager. In his role he served as voting member of Cleary Gull's Fixed Income Strategy Group and Complement (Alternative) Strategy Group. Before Cleary Gull, Mike worked for several years at Madison Investment Advisors, a multi-billion dollar asset management firm, as a Fixed Income Analyst.

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David LaCroix
Senior Financial
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David D. LaCroix is a Senior Financial Advisor at Entasis Asset Management. David has more than 45 years of experience in the investment industry. Prior to joining Entasis, David worked at Cleary Gull Advisors, a Johnson Financial Group Company, and Cleary Gull Inc., a prior affiliate of Cleary Gull Advisors, where he most recently served as Vice President, Relationship Manager responsible for high net worth clients. Before Cleary Gull, David worked in a variety of portfolio management and client relationship management positions with A.G. Edwards and M&I Capital Markets Group.

David received his M.B.A. and B.B.A. in Finance from the University of Wisconsin-Madison. He has served as a member of the Archdiocese of Milwaukee Investment Committee, as a Trustee for the Village of Shorewood and as Director/Treasurer of Milwaukee Summerfest.

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The **Dow Jones Industrial Average℠** is a price weighted index that measures the performance of thirty component large-cap U.S. stocks. The **S&P 500® Index** is a market capitalization weighted index that measures the performance of 500 leading companies in leading industries of the U.S. economy. The **Russell 1000® Index** measures the performance of roughly 1,000 U.S. large-cap companies. The **Russell 1000® Growth** Index measures the performance of U.S. large-cap companies with higher price/book ratios and forecasted growth values. The **Russell 1000® Value Index** measures the performance of U.S. large-cap companies with lower price/book ratios and forecasted growth values. The **Russell 2000® Index** measures the performance of roughly 2,000 U.S. small-cap companies. The **MSCI EAFE® Index** is a market capitalization weighted index that is designed to measure the performance of developed markets, excluding the U.S. and Canada. The **MSCI Emerging Markets Index** is a market capitalization weighted index that is designed to measure equity market performance of emerging markets. **The MSCI ACWI Ex USA Small Cap Index** is a market capitalization weighted index that represents the performance of smaller capitalization companies in developed and emerging markets excluding the U.S. The **Barclays Aggregate Bond Index** tracks the performance of intermediate-term government bonds, investment grade corporate debt securities and mortgage-backed securities with at least one year to final maturity. The **Barclays Intermediate U.S. Gov/Credit Index** tracks the performance of intermediate U.S. government and corporate bonds. The **Barclays Municipal Bond Index** is considered representative of the broad market for investment grade, tax-exempt bonds with a maturity of at least one year. The **BoAML Fixed Rate Preferred Securities Index** tracks the performance of fixed rate U.S. dollar denominated preferred securities in the U.S. domestic market. The **BoAML Treasury Master Index** tracks the performance of the direct sovereign debt of the U.S. Government. The **BoAML U.S. Mortgage Back Securities Index** tracks the performance of U.S. dollar denominated fixed rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. market. The **BoAML U.S. Corporate Master Index** tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market. The **BoAML High Yield Master II Index** is a broad based index consisting of all U.S. dollar-denominated high-yield bonds with a minimum outstanding of $100 million and maturing over one year. The **BoAML All Convertibles All Qualities Index** measures convertible securities' performance of U.S. dollar denominated convertible securities not currently in bankruptcy with a total market value greater than $50 million at issuance. The **BoAML Euro Broad Market Index** gives exposure to euro-denominated investment grade debt publicly issued in the Eurobond or euro member domestic markets including government, quasi-government, corporate, securitized and collateralized securities. The **BoAML Local Debt Markets Plus Index** is a broad composite designed to track the performance of local currency sovereign debt of emerging markets countries. Past performance is no guarantee of future results. All indices are unmanaged. Investors cannot invest directly in an index. Index returns do not include expenses.

Investment Terms

Valuation levels are typically shown by calculating the price level of an index or a company relative to any number of characteristics of an index or company. For instance, the price-to-earnings valuation metric looks at the price of an index (or stock) divided by the total earnings of an index (or stock). Based on the multiple (in this instance, the multiple is how much investors are willing to pay – the price – for a given amount of earnings), it provides investors with a general sense of how expensive, or cheap, the overall market is at the present time. While there are a significant number of valuation metrics that are used in practice, and many ways to vary/modify the calculation of the price-to-earnings ratio, in this summary we are focused on the price investors are willing to pay (the level of the S&P 500® Index) divided by earnings expectations for the equity market (S&P 500 Index) over the next 12 months. This valuation metric is referred to as the forward P/E. A **yield curve** is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. A **basis point** is a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% (0.0001). **Interest coverage** is a measure of a company's ability to meet its interest payments on its debt. **Federal funds rate** is the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. It is one of the most influential interest rates in the U.S. economy, since it affects monetary and financial conditions, which in turn have a bearing on key aspects of the broad economy including employment, growth and inflation.

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