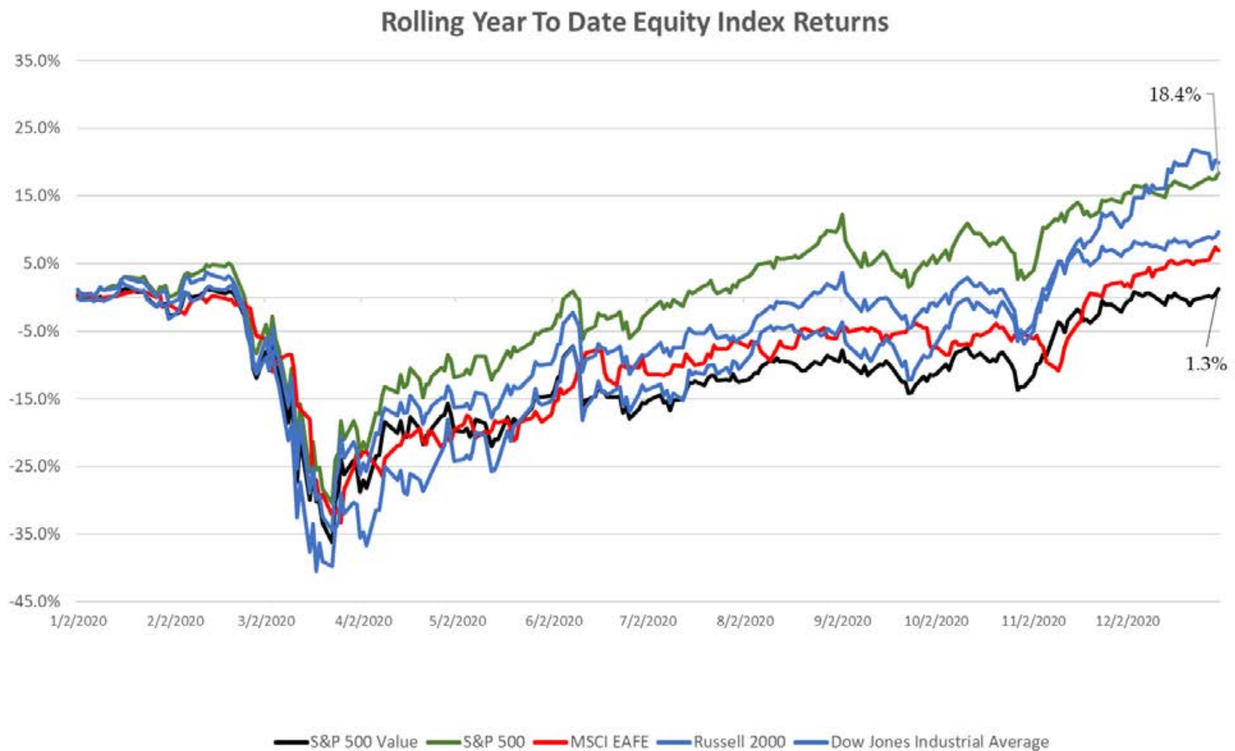
Dear Turtle Creek Client,

Global equity markets surged through year-end, building on the already remarkable recovery from the steep market sell-off in the first quarter of the year. Market fundamentals shifted noticeably during the final months of the year, with down-trodden cyclical sectors suddenly leading market returns and interest rates bouncing from historic lows. We had concluded in the third quarter that securities markets were expressing a defensive and half-hearted embrace of the ongoing economic recovery. Fourth quarter market returns by contrast signaled a full vote of confidence in the future growth of the global economy and corporate profits.



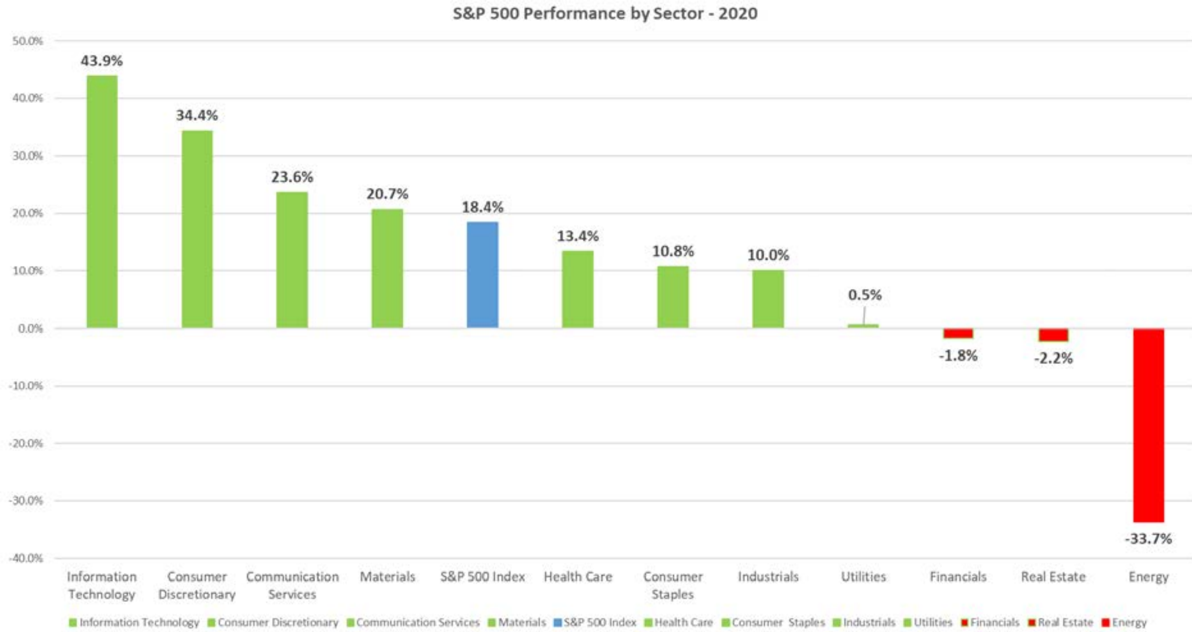

*Source: Bloomberg*

This robust finish brings to close a truly unprecedented year. The shockwave of the COVID-19 pandemic ushered in massive changes to daily life and accelerated societal shifts in retail shopping, entertainment, remote work, fitness, and countless other industries. Certain companies found powerful new tailwinds for long-term growth while others were faced with sudden challenges to long-term sustainability. The crisis drove global monetary authorities to throw out historic playbooks and engage in previously unthinkable levels of government stimulus. Finally, 2020 provided a stark reminder of the true nature of portfolio risk with a once-in-a-century event arriving out of nowhere and quickly altering the potential risk and returns on your assets.

Looking forward, market trends and leading economic indicators seem to be signaling an imminent vaccine-based reopening of global economies. This "return-to-normal" economic pattern hints at potentially new leadership in securities markets over the near-term. It also introduces new risks, primarily related to the sustainability of stock market valuations and the impact of rising rates on the fixed income portion of your portfolio.

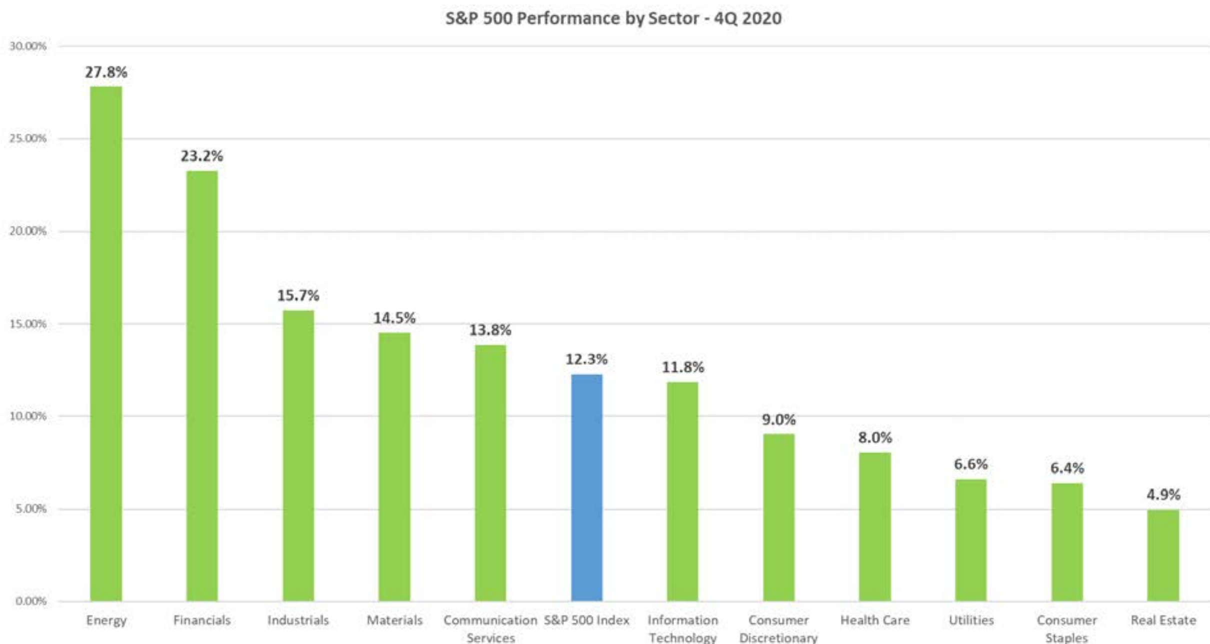
## Fourth Quarter and Full Year Market Performance

The S&P 500 Index advanced an impressive 12% in the final quarter of the year, pushing it full-year return to over 18%. The final tally of S&P returns through 2020 reflected the significant outperformance of growth-oriented technology and communications companies over their economically sensitive peers in commodity and the financial sectors.



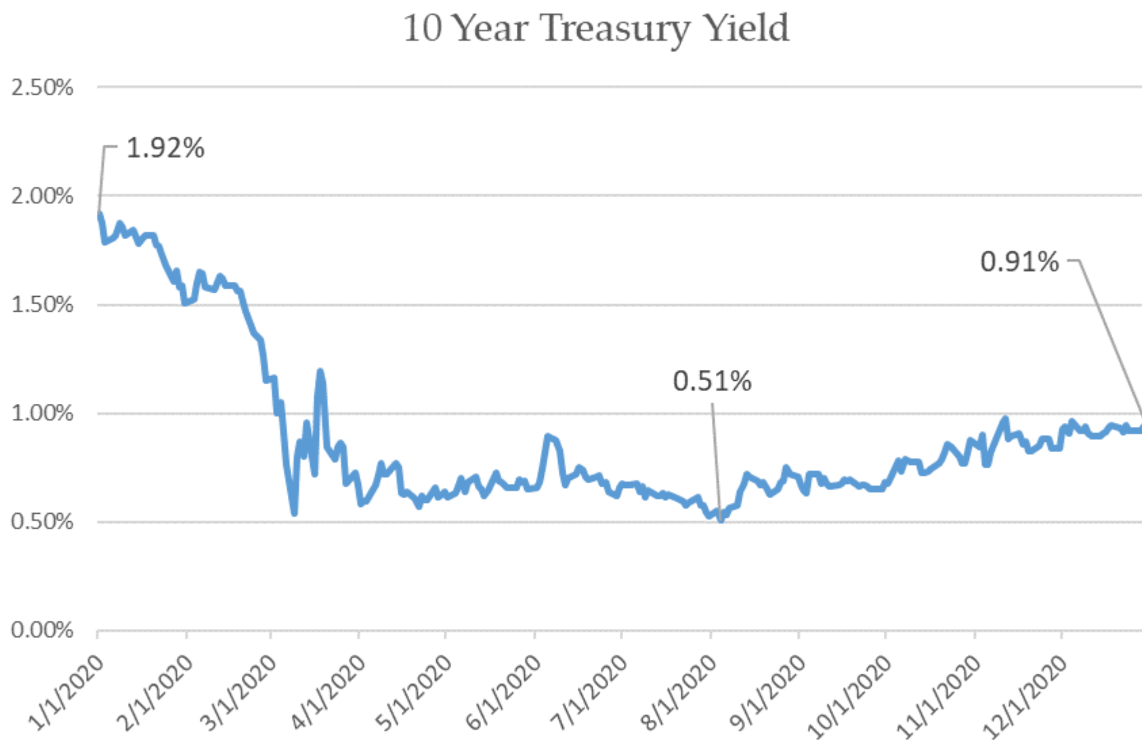

*Source: Bloomberg*

This significant performance gap narrowed in the final weeks of the year. The fourth quarter saw market leadership flip almost entirely with Energy, Financial, and Industrial companies outpacing the broader market and their Growth-Oriented and Defensive peers.




*Source: Bloomberg*

Bond rates also rallied through the end of the year while remaining well below pre-COVID levels. The yield on benchmark 10 Year Treasury bond finally reached a bottom in early August and steadily rose back towards one percent through year-end.




*Source: Bloomberg*

**<u>Rates, Valuations, and Investing During an Economic Recovery.</u>**

Rising rates, improving corporate earnings, cyclical stock leadership, and ongoing government stimulus are classic signs of an early-stage recovery from recession. This advent of a new economic cycle should be a welcome development but has raised several concerns among Turtle Creek clients.

The primary worry is the fate of currently richly valued stock market. The S&P 500 traded at a near 30x multiple of its aggregate earnings per share at the end of the year, a level only seen once in 1999 during the peak of dot.com era exuberance. Clients have expressed concern that these elevated valuations are purely a product of historically low interest rates and stimulus measures. If rates continue to rise and stimulus measures are relaxed, market valuations will shrink and stock values will suffer in turn.

While stretched market valuations are always a legitimate point of concern, a study of similar historical episodes should ease investor worries somewhat. There have been ten episodes of consistently rising interest rates over the least fifty years. In half of those, the S&P 500 P/E multiple did compress. Despite those headwinds, the stock market posted a negative return just once during the early 1970s.

In most every case, rapidly accelerating corporate earnings more than offset shrinking market multiples. This phenomenon is called the Molodovsky Effect, named after the economist who researched the topic in the 1950s. Price/earnings multiples on individual stocks or even the market in aggregate become temporarily elevated, sometimes to extreme degrees, as investors look through temporarily depressed corporate performance and price securities on longer run expected profits.

**10 Year Treasury Yield - Positive Shifts Since 1970**

| Start | End | Beginning Yield | Ending Yield | Increase in Rates | Duration (Months) | S&P 500 P/E -Start | S&P 500 P/E - End | % Change | S&P 500 Return Annualized |
|---|---|---|---|---|---|---|---|---|---|
| 3/31/1971 | 9/30/1975 | 5.53% | 8.48% | 2.95% | 55 | 18.7 | 10.7 | -43% | **-0.4%** |
| 12/31/1976 | 9/30/1981 | 6.81% | 15.84% | 9.03% | 58 | 11.0 | 7.9 | -28% | **7.1%** |
| 3/31/1983 | 6/29/1984 | 10.62% | 13.84% | 3.22% | 15 | 12.0 | 10.1 | -16% | **4.7%** |
| 12/31/1986 | 9/30/1987 | 7.22% | 9.59% | 2.36% | 9 | 16.3 | 22.4 | 37% | **35.9%** |
| 9/30/1993 | 12/30/1994 | 5.38% | 7.82% | 2.44% | 15 | 23.1 | 17.4 | -25% | **2.9%** |
| 9/30/1998 | 12/31/1999 | 4.42% | 6.44% | 2.02% | 15 | 23.1 | 29.3 | 27% | **35.9%** |
| 6/30/2003 | 6/29/2007 | 3.52% | 5.03% | 1.51% | 49 | 20.4 | 17.2 | -16% | **13.5%** |
| 12/31/2008 | 12/31/2009 | 2.21% | 3.84% | 1.63% | 12 | 16.8 | 19.4 | 15% | **26.4%** |
| 6/29/2012 | 12/31/2013 | 1.65% | 3.03% | 1.38% | 18 | 14.2 | 17.4 | 22% | **25.2%** |
| 6/30/2016 | 9/28/2018 | 1.47% | 3.06% | 1.59% | 27 | 19.9 | 20.7 | 4% | **18.1%** |

*Source: Bloomberg*

The pattern of stock leadership we witnessed in the fourth quarter is also very typical of early cycle recoveries. If history is any guide, this leadership trend should persist for at least the near-term. Companies ranging from banks to oil and gas firms to manufacturers saw the sharpest drawdown in earnings and the most compressed valuations throughout the year. Both conditions should ease as the economy mends over the next several years, allowing for a sustained run-sway of both above-trend earnings growth and valuation expansion.

The impact of rising rates on the bond market is more straightforward. Rising rates are a net negative for the value of your bonds. The degree of impact is positively correlated with the duration of your bonds, meaning that longer maturity bonds will suffer to a greater degree in a rising rate environment.

## Lessons from the 2020 Market Year

The 2020 market provided another reminder of the importance of accounting for tail-risk in a portfolio strategy.  Tail risk is defined as a low probability events that can have a significant impact (positively or negatively) on portfolio outcomes. They have more recently been referred to as Black Swans, based on the popular book by author Nassim Taleb. Despite the supposedly low-probability nature of these happenings, investors were hit with two in a single year. In February, investors pondered the almost apocalyptic worst-case scenario of the COVID pandemic interrupting global commerce for years. They were subsequently rewarded as the medical community harnessed new technology to bring forth highly effective vaccines in a time period unthinkable even a decade ago.

Throughout both dramatic shifts, investors had to be sure that their investment strategy could provide for their needs no matter how deep the economic trauma of current events. These are usually the best times to re-analyze your longer-term strategic allocation to ensure it meets your needs and goals.

We also received a valuable lesson regarding the intrinsic value of your investments. The true worth of an investment is the product of decades of future growth, profits, and cash flow. While the immediate economic trauma from the COVID Crisis was daunting, it still represented a relatively minor deviation from the longer-term economic value generated by a high-quality companies throughout their lives. When that is considered, the 40% decline in stock market value at the lows of the February market collapse seem totally unjustifiable.

## Investment Strategy

Looking forward, the economic backdrop continues to favor risk assets such as stocks while the expectation for rising interest rates elevates the risks in the fixed income portion of your portfolio.

The potential normalization of stock market valuations during a period or rising interest rates should serve as a headwind to stock market gains, but we do not expect it to derail market expansion during a period of cyclical earnings recovery. Indicators such as the equity risk premium and earnings and dividend yields continue to favor quality equities over bonds and cash, with the caveat that the significant stock market run of the fourth quarter diminished that advantage to some degree. All these factors point to near-term stock market performance that should still be positive but will likely lag the impressive performance of the last decade.

Even with this diminished outlook, potential stock market gains still outshine the thin yields still on display in most fixed income securities. Considering that and the risk of capital loss in your bonds in a period of rising rates, we continue to favor a short-duration and high credit quality position in your fixed income investments.

Many clients have asked if a stock market correction is likely after such a stellar run. The answer as always is maybe and that we have no ability to time such market gyrations. If one does occur, we would view it opportunistically given all the factors we have cited above.

As always, we appreciate the trust and faith you have placed in our firm during this most unusual year. We look forward to discussing these thoughts and any other question or concerns you might have.

Sincerely,

TURTLE CREEK MANAGEMENT, LLC
TURTLE CREEK TRUST COMPANY, LTA