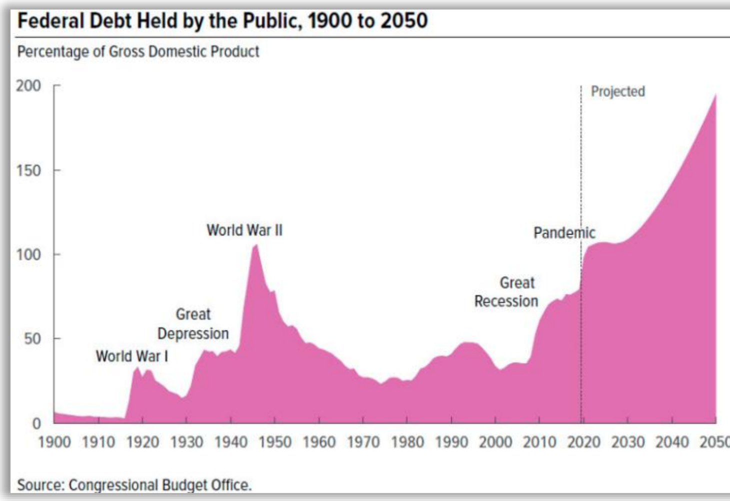
Market Brushes of Virus Uncertainty

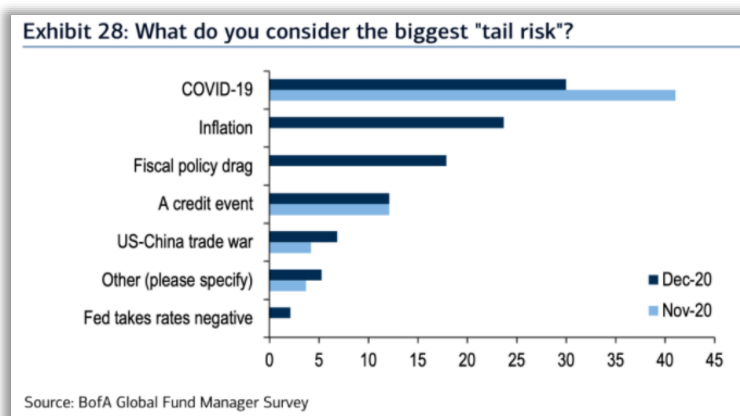
- S&P 500 returned 16.3% in the 4th Quarter of 2020.
- Market performance was fueled by the rollout of the COVID-19 vaccine and the prospect of additional federal stimulus on the heels of the presidential election.
- The Fed's commitment to lower for longer and broader increases in money supply pushed US Equities to all-time highs.
- The Information Technology sector continues to drive broad market return as Tech comprises over 27% of the S&P 500.
- Cyclical sectors rallied, leading to the Russell 1000 Value Index to outperform the Russell 1000 Growth Index by 4.86%. Reversing a 16-quarter trend where Growth has outperformed Value.

Fiscal Stimulus and Structural Unemployment Driving the Market

The Great Lockdown resulted in a 31.4% decrease in annualized US real GDP in the second quarter. This, however, marked the bottom of the recessionary trough with real GDP rebounding 33.4% in the third quarter. The recovery was largely driven by an accommodative Federal Reserve that is committed to lower rates for longer and a Federal Government prone to spending their way out of record unemployment, currently at 6.7%. Both are expected to maintain or increase their current dovish posture.



With expectations of very loose monetary and fiscal policies from the Federal Government, we expect a weakening Dollar over the course of 2021. This should be accretive to export demand. Every 10% drop in the U.S. dollar relative to a basket of global currencies translates to a roughly 3% boost in S&P earnings. A weakening dollar and the Federal Reserve's more tolerant stance on inflation could contribute to an increase in prevailing rates. Growth stocks (e.g. tech names with high valuations) typically place a great deal of emphasis on terminal value, or long term future cash flows. A change in interest rates have a more meaningful impact on those valuations relative to value companies whose prices are derived more from current cash flows. That is why next to COVID, inflation fears are considered to be the largest tail risk. If monetary and fiscal policy are the drivers behind 2021 market performance, we can expect laggards to be the communications sector, software industry, and IT services industry.

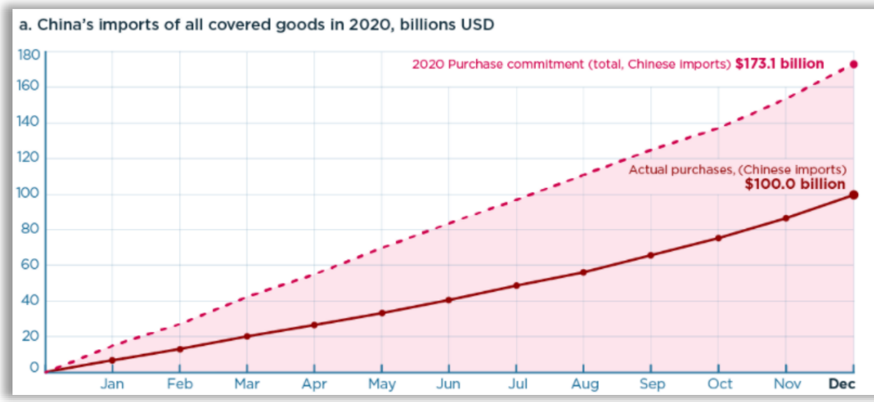


Inflation is the second-most popular "tail risk" for markets as we head into 2021, according to Bank of America's latest Global Fund Manager Survey.

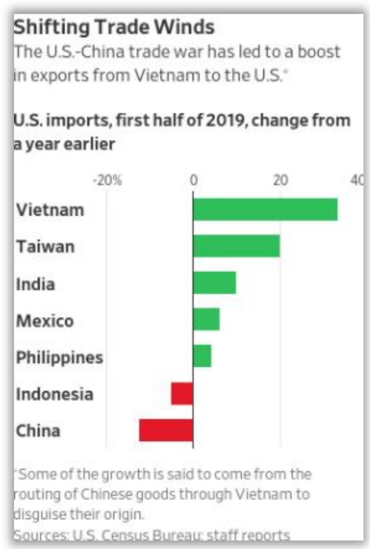
Implications of a Biden Administration

With a Democratic presidency and control of congress, we expect expansionary fiscal policy as the federal debt heads towards all-time highs. This will likely be accomplished through the passing of further COVID stimulus coupled with a major infrastructure bill. This infrastructure bill would have the largest positive effects on the industrials sector, particularly machinery and building products. The increased industrial activity could benefit utilities and oil and gas as power consumption normalizes. Additionally, the potential for modest inflation could aid the banking sector which has been plagued with historically low interest rates coupled with a hazy consumer default landscape.

At Janet Yellen's confirmation hearing she indicated that a repeal of the 2017 tax cuts is unlikely but certain elements will be reversed. A new tax policy was a large part of the Democratic Party Platform and President Biden has supported increasing the tax rates on corporations, individuals making over $400k per year and long-term capital gains. It is estimated that the administration's full tax proposal would reduce S&P 500 earnings by approximately 7% and most of that would come from the increase in corporate tax rates. With the country fighting a health and economic crisis, the tax increases are likely to be held off until 2022 unless they are attached to a future stimulus bill or an appropriations bill which will have to be passed before September 30, 2021 (End of the US Budget Fiscal Year).



We expect the Biden administration to maintain the "tough on China" stance that was initiated by the Trump administration. With China's increasingly aggressive totalitarian regime, we believe that ideological differences alone will be reason enough for the Biden administration to maintain pressure. As of the end of December, China had achieved 58% of the year-to-date targets agreed upon in the Phase 1 Trade Deal. President Biden is expected to work closely with global allies in reigning in China's increased totalitarian actions which could further strain relations. This will likely result in continued strain on the supply chain of many technology companies. As the graph illustrates, US imports have shifted to other South East Asian Countries, primarily Vietnam.



Regulatory & Valuation Headwinds for Big Tech

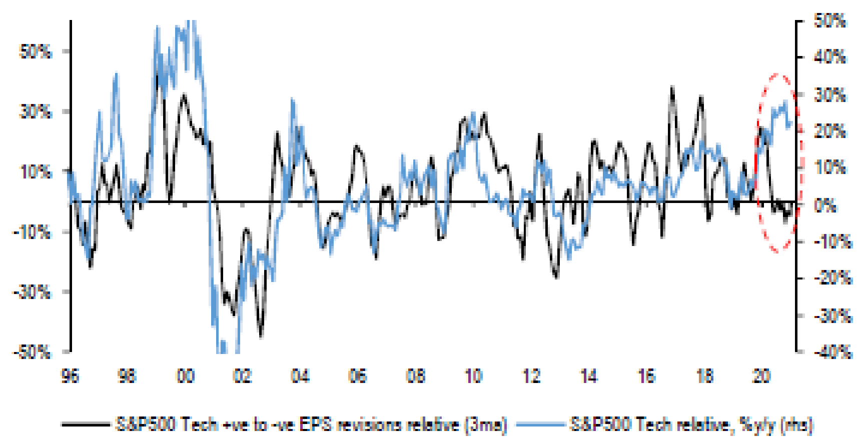
Big Tech has faced backlash from consumers and global regulators, 81% of Americans have some level of concern over the amount of data that these large platforms access. Google, Amazon, Apple, and Facebook are all either involved in ongoing investigations for anti-competitive behavior or have already been named in suits filed against them by the Department of Justice. The ongoing emphasis on big tech regulation is just beginning, with the DoJ increasing the direct appropriation amount for the Anti-Trust Division by 104% from 2020 to 2021.

Company	Lawsuit Filing Year	Impact Between Lawsuit & Resolution	Resolution Year	Resolution	Impact Post-Resolution
AT&T	1974	Valuations Fell	1982	Breakup Ordered	Growth slows, valuations rise
Microsoft	1998	Valuations Fell	2000/2001	Settlement, ordered to change practices	Growth slows, valuations continue to fall in settlement era through 2011
IBM	1969	Valuations Fell	1982	Dropped Lawsuit	Growth slows, valuations initially rise but then continue to fall

Date as of 2020
Source Investment Strategy Group, Goldman Sachs Global Investment Research

Previous technology anti-trust lawsuits have led to lower valuations for the companies between lawsuit and resolution, we are on the cusp of such lawsuits that could drag on for years. The headline risk for these companies, especially the social media companies that are currently protected by Section 230 of the Communications Decency Act, could create significant volatility within the market which would negatively impact investors, especially those passive index funds that instill a false sense of diversification (27% technology in the S&P 500).

Figure 25: US Tech +ve to -ve EPS revisions and performance

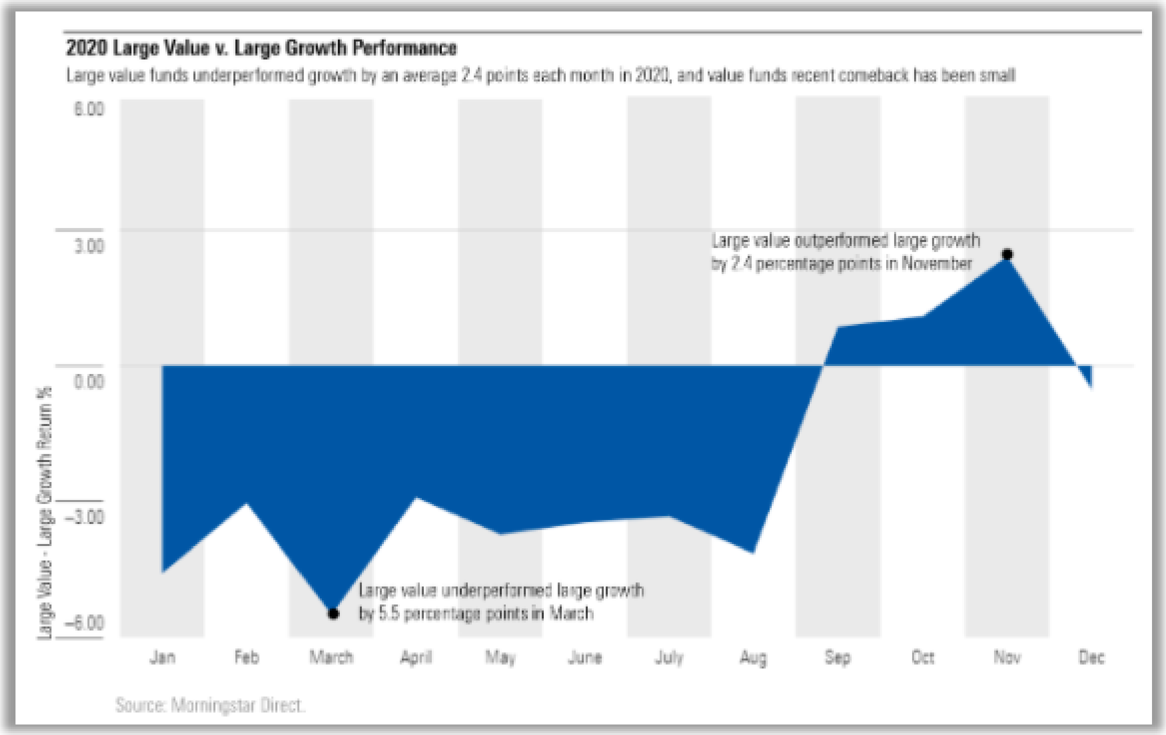


Source: IBES

The excess money supply has also led to irrational exuberance, where investors have deemphasized business fundamentals and have replaced them with speculation driven by hope and greed. The graph on the right shows the US Technology Sector inflated returns despite repeated reductions of earnings estimates for the sector. Street consensus is that the tech sector will not see strong earnings growth in 2021. Tesla and Zoom are great examples of valuations running away from fundamentals. This is evident by their Price-to-Earnings ratios of 130X and 266X versus the Russell 1000 of 26X.

Evidence of the Value Rotation

In 2020, because of pandemic driven economic trends, the equity markets saw the largest spread between the performance of value vs growth since the end of the dot-com bubble. These economic trends lasted until September, when lockdowns were lifted, and the economy normalized. Value funds bested growth by an average 1.5% each month from September to November.



After the dot-com bubble burst in 2001, the value index beat the growth index by 16.1 percentage points. Irrational exuberance appears extremely similar to the dot-com bubble at its peak. We expect a convergence of style performance between growth vs value in 2021 as the economy and cyclical sectors rebound.

Why Brookmont in 2021

The companies that will emerge as leaders in 2021 will be those that have adjusted business models for the new normal and apply the improved efficiencies to cyclical end markets. This overall theme will help these companies create improved cash flows that are not yet priced in. Brookmont carefully evaluates company's cash flows from operations, while considering investing and financing cash flows to understand the ability of a company to meet its capital allocation needs. We do not believe that any of our holdings are short-term investments, and continuously evaluate them to provide assurance that their fundamentals align with our prioritization of long-term growth and stability of free cash flows and dividends. This highlights the importance of Brookmont's process and its success in accomplishing its goal of participating in market upside while having relatively low downside capture. Brookmont's philosophy of investing in companies with strong balance sheets, disciplined management with resilient dividends continues to represent an attractive allocation for strategic investors in the equity market.

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