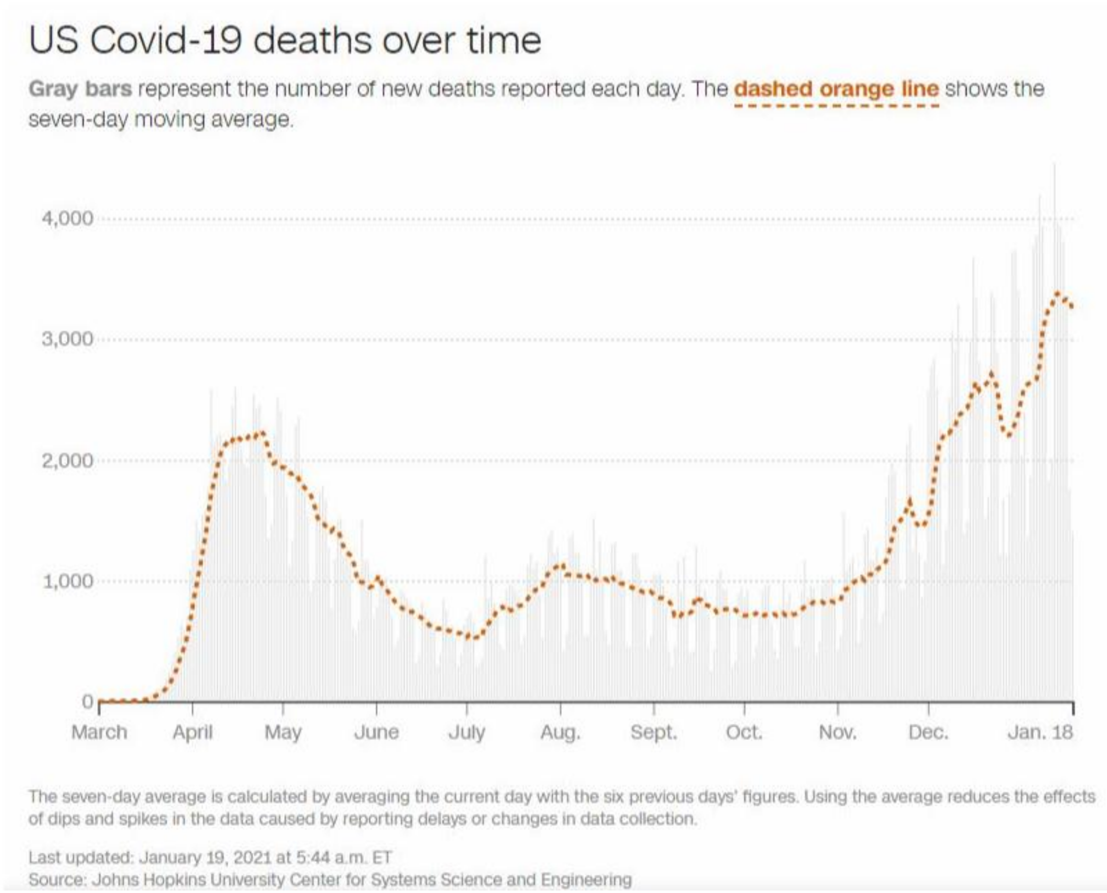
It is difficult to put into words the experience of 2020. A virus emanating from the other side of the world has infected more than 95-million people in the space of ten months, resulting in 2-million deaths. The United States, with just 4% of the world's population, has accounted for 25% of the world's COVID cases. One of every thirteen Americans has been infected since the outbreak was first reported in February, and the death toll will have exceeded 400,000 by the time you read this report. Approximately 100,000 virus-related deaths were recorded in the last month, alone, and the total is expected to surpass 500,000 less than a month from now. Experts agree that things will get worse before they get better.



The pandemic caused the U.S. to experience the sharpest quarterly decline in economic activity in its history, immediately followed by the biggest rebound. GDP fell 31.4% in the second quarter of 2020, as Americans sheltered in place and virtually all non-essential businesses shut down. The economy then rose a record 33.4% in the third quarter, fueled by more than $3-trillion in pandemic relief and reassurance from the Federal Reserve that it would provide the liquidity necessary to steer the economy through the crisis. Still, it appears that the economy had lost momentum again as the year mercifully drew to a close, as case counts rose and fiscal stimulus was delayed. By the end of the year, GDP remained 3.5% below 2019 levels, and optimistic projections for a rapid return to normal activity were proving to be premature.

As the pandemic unfolded and the economy shut down, the financial markets collapsed in historic fashion, only to rise with even greater speed as the Fed drove interest rates to zero and essentially back-stopped the U.S. credit markets. In one 7-day period in March, the Dow Jones Industrial Average fell more than 2,000 points three separate times! On the worst of those days, March 16, the Dow fell 2,997 points, a 13% decline that was worse than the Black Monday crash of October 28, 1929. The Standard & Poor's 500 Index fell 34% from February 19 to March 23, and the Russell 2000 Index, a benchmark for small cap stocks, fell 41% over the same time. Foreign stocks fared little better, with indices representing developed markets and emerging markets declining 34% and 32%, respectively, as the crisis unfolded. Yet, after all the angst and the tumult, the U.S. market stands today - as it did a year ago - at or near all-time highs.

COVID-19

The economy will not return to anything resembling normal until COVID ceases to be a public health threat. Experts suggest that achieving herd immunity might require 60% to 80% of the world's population to have been infected or vaccinated. With a global population of 7.7-billion, this implies a minimum of 4.6-billion vaccinations and infections, without considering the potential for the virus to mutate over time. Developed economies and some emerging economies such as Brazil, Argentina, Indonesia and India, have already contracted for 4.3-billion doses directly from manufacturers; but lower income countries must rely on the Global Alliance for Vaccines & Immunizations (GAVI) and organizations like the Bill and Melinda Gates Foundation to partner with vaccine manufacturers to provide doses on a non-profit basis. Current estimates are that it will take until 2024 to produce enough doses for the whole world.

So far, we have only described the time it will take to *produce* the vaccine. But once a country gains access to doses, logistics and delivery bottlenecks are likely to create delays that will continue to inflict economic damage for longer than most expected. The Pfizer vaccine requires an extremely low temperature for transport and storage (-68.4 degrees), which requires a proprietary container that can carry only 5,000 doses. The Moderna and Astra-Zeneca vaccines, however, require temperatures that can be achieved by a typical household freezer, which will be helpful in providing distribution to many rural parts of the world.

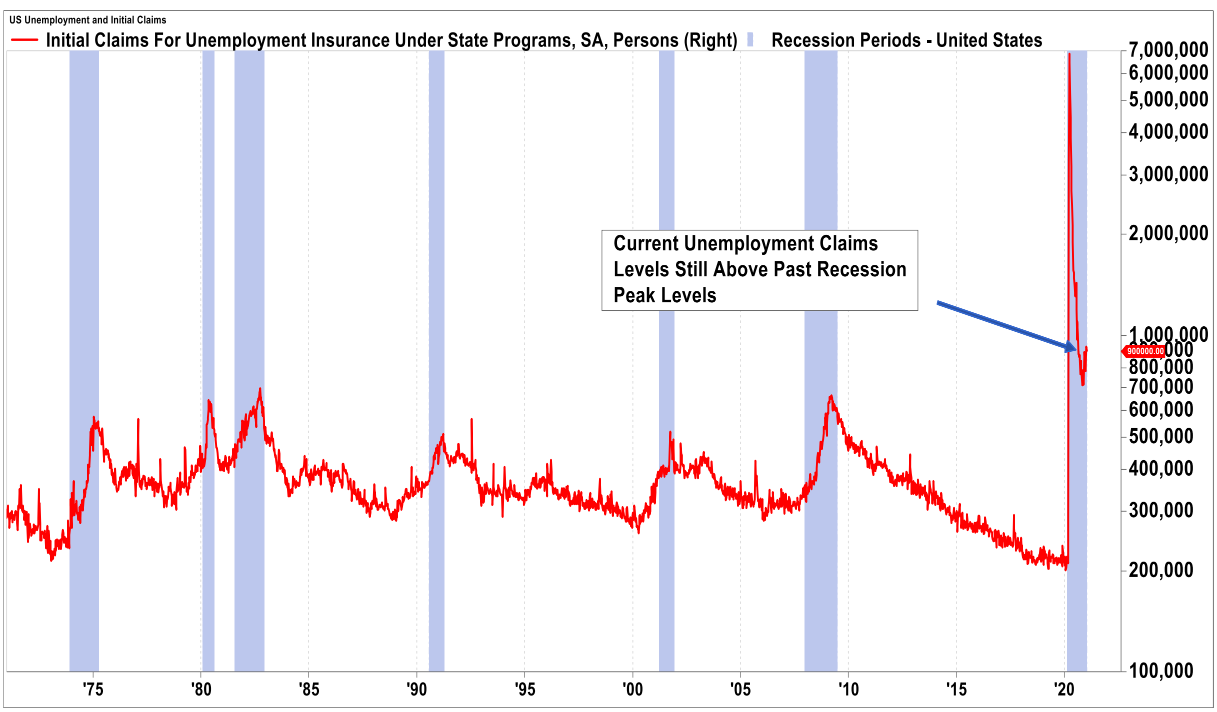
Beyond the challenges of producing, transporting and storing the vaccines, administering the vaccines will require political decisions in every country, beginning with who gets the doses first. There are algorithms which can guide decision makers in establishing a sequence that will produce the greatest benefit, both socially and economically. But if countries simply succumb to the tendency to prioritize wealthier regions or neighborhoods, the potential for further economic loss and social unrest will grow. Beyond this, there is the challenge each country will face in coordinating its efforts from the national level down to the local level and the individual clinics. The protocol for all of the drugs requires multiple doses, from the same manufacturer, to be administered at precise intervals. So timely access to the second dose adds another layer of complexity to the process.

In the U.S., Operation Warp Speed was established with the goal of inoculating 80% of the country's 330-million citizens by June 30. To meet that goal, approximately 1.9-million initial doses would have to be administered each day. As of January 15, 3.2% of Americans have received at least the first shot of one of the vaccines, a rate of about 440,000 per day since the first shots were administered on December 14. In other words, the U.S., with one of the most advanced health care systems in the world, is able to administer shots at less than 25% of the rate needed to achieve its goal of achieving herd immunity by June. At the current rate in the U.S., the required number of vaccinations would not be administered until the end of 2022, although it's reasonable to expect the pace to accelerate as the process unfolds. It is also reasonable to expect that deaths attributable to the virus will begin to decline at a faster pace than new cases, as the most vulnerable have received the highest priority in receiving the vaccines.

The point of this is to emphasize the challenges we face in getting this global crisis behind us, the difficulty of predicting the course of the COVID-19 recession, and to question the extent to which a pandemic recovery can lead to an economic recovery. The longer workers remain unemployed, the harder it will be for them to find new positions or learn new skills. There are 7 million fewer people employed today than were employed a year ago, and it is estimated that 4 million of those job losses will be permanent. Investors were understandably elated by the news that effective vaccines had been developed in a matter of months, not years, thus offering hope that the country and the economy could return to normal sooner rather than later. But we should be prepared for the possibility that "sooner" may not be as soon as we had hoped, and "normal" may be less than what we had expected.

Jobs and the Economy

The labor market took a step in the wrong direction in the most recent reports, as COVID case counts have risen and localities have responded with additional closures. Claims for first time unemployment benefits rose to 965,000 in the latest weekly report, up substantially from the 784,000 reported the previous week, and far worse than had been expected. Weekly initial unemployment claims, which had been as high as 6 million in the early stages of the pandemic, had fallen below 1 million by August. But there has been little improvement since then, and the trend has been rising again.



Weakness in the labor market was confirmed by the December employment report, that showed a drop of 140,000 in non-farm payroll employment, the first decline since April when the economy was in a freefall. The losses were seen primarily in the leisure and hospitality sectors as well as in private education, and were largely offset by gains in retail trade and construction. But the reported numbers matter less than the trend, and the reports on jobless claims point to further weakness in the weeks ahead.

There is, however, good news to report with respect to jobs and income, and it is that while the number of people working is still significantly below the number working a year ago, income is actually up $1.1-trillion due largely to the massive stimulus measures enacted by Congress. More important, the gap between the current level of overall compensation and what it would have been without COVID has narrowed to just 3.4%. That gap had been 10.5% as recently as May. During the 2007-09 recession, by comparison, compensation levels declined 10% and never caught up. Trend growth recovered, but "catch-up growth" did not and the economy and the labor market thus recovered slowly.

Federal Reserve Actions

The actions of the Federal Reserve in response to the economic risks from Covid-19 have been unprecedented, and dwarf its response to the 2008-2009 Financial Credit Crisis. The Fed reduced its overnight lending rate to nearly 0%; initiated a $3.2 trillion round of quantitative easing, which for the first time included direct purchases of Exchange Traded Bond Funds; made nearly $200 billion of direct loans and expanded its foreign exchange lines – a means of preventing financial stress from becoming a global issue.

The Federal Reserve has reiterated that it is committed to maintaining the necessary liquidity and availability to credit that is needed in the financial system to bridge the economy to the post Covid-19 era.

The Stock Market

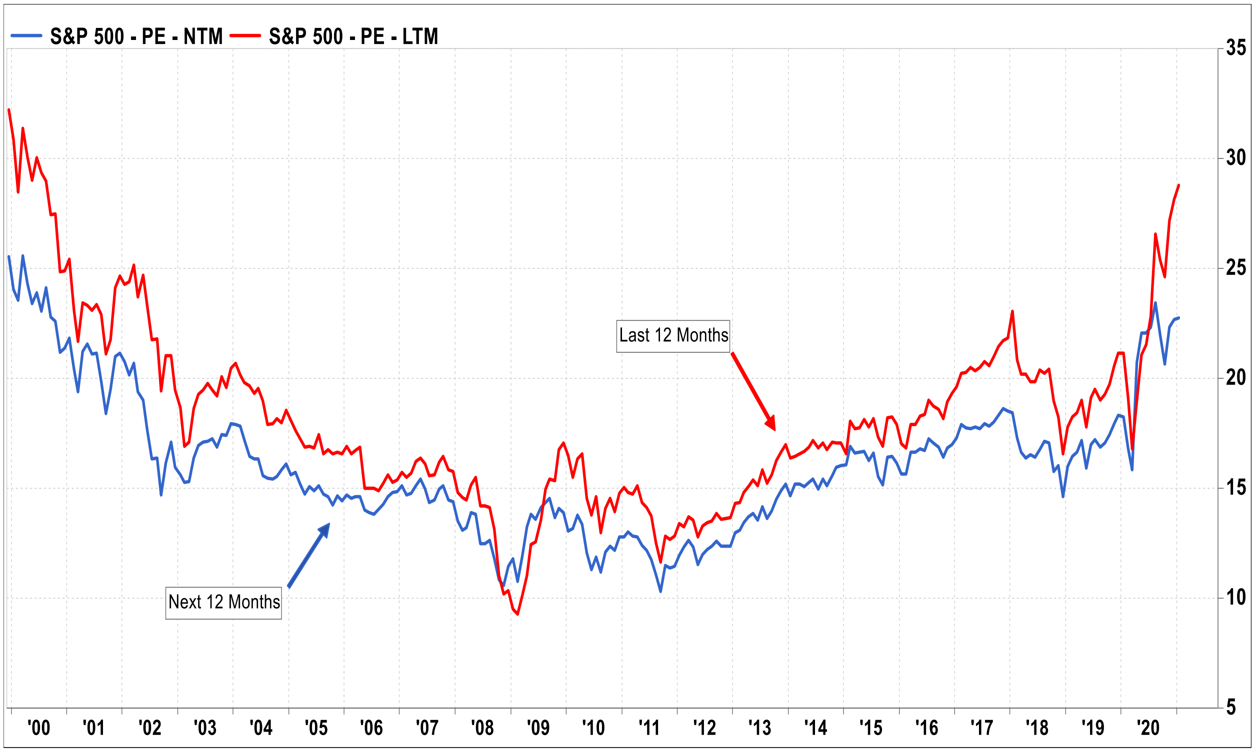
Anyone who had madly predicted that a pandemic would spread across the world and cause the worst economic collapse in history, would have had their rantings relegated to the space next to the horoscopes in their local newspaper. Anyone predicting that the equity market would soar 70% or more while the pandemic raged on and reach new highs in the same year, would have been dismissed from the fortune teller's guild for malpractice. But that is the story we lived in 2020.

In the first month of the outbreak of COVID-19, the Standard & Poor's 500 Index fell 34% as the economy shut down and job losses mounted at an historic rate. Less than ten months later, the S&P stands 72% above its March low. In the same time, international developed and emerging market indices are up 65% and 86%, respectively, and U.S. small cap benchmark is up a stunning 118%!

As we have noted in past monthly *Outlooks*, broad market benchmarks like the S&P 500 don't always give an accurate picture of the overall market. That has never been more true than last year.

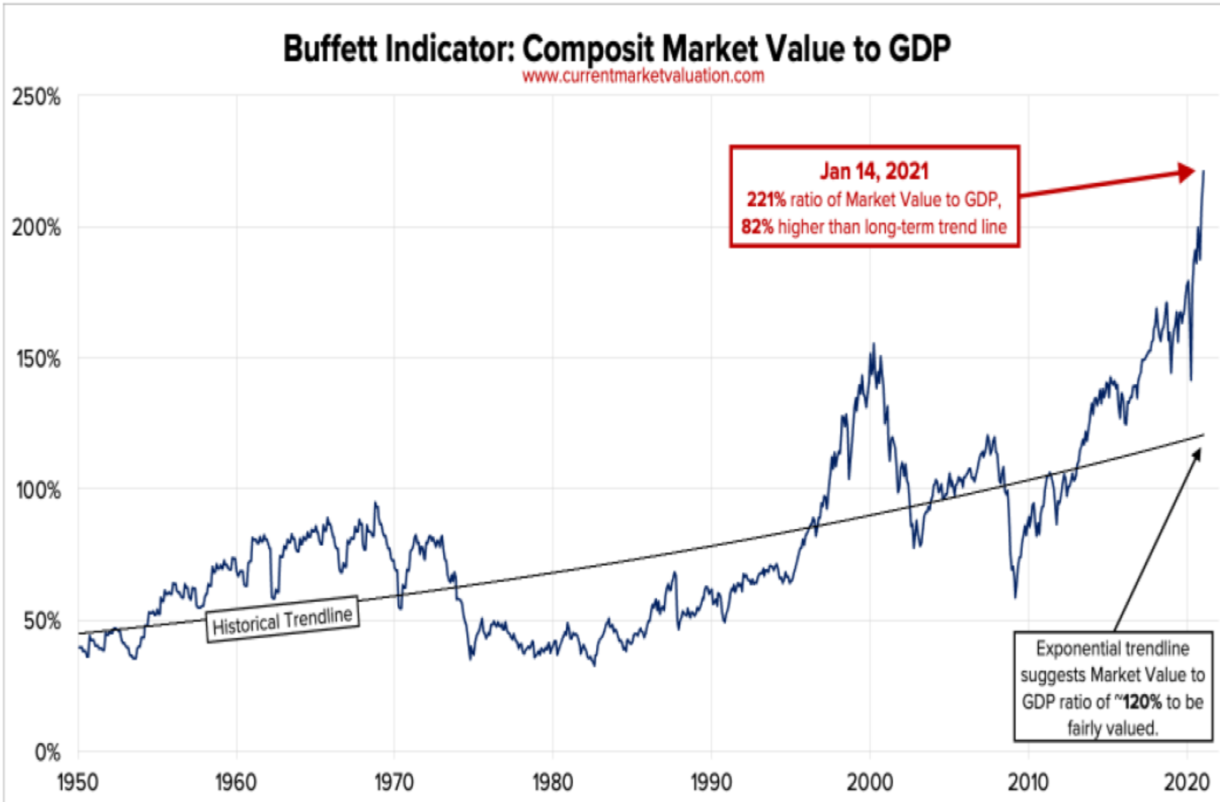
For much of the year, nearly all of the S&P's advance was the result of the out-performance of just a handful of the largest stocks in the index. By September, six companies – Facebook, Amazon, Apple, Netflix, Google and Microsoft – had grown to account for 25% of the total market capitalization of the S&P 500. These companies were largely beneficiaries of the measures taken to halt the spread of the virus, and their stock prices rose between 46% and 77% during the first nine months of the year, while the remaining 494 stocks fell an average of 5%. By the 4th quarter, the valuations of these few companies, and "growth" stocks in general, had become stretched and investors began to rotate into those areas of the market that had been out of favor during the early stages of the market's recovery. The rotation was aided by the rapid approval of two effective vaccines, providing affirmation that the economy could recover more quickly than once thought, thus improving the near term outlook for financial and cyclical stocks, and other traditional "value" sectors.

Now, as a result of the surge in stock prices in the face of lower earnings and an uncertain earnings outlook for the next 1-2 years, current market valuations are at historically high levels by virtually any measure. The S&P 500 current trades at almost 29 times trailing earnings and 23 times forward 12-month earnings estimates, the highest multiples experienced since the dot.com bubble of 2001.



Another interesting, but seldom used metric is the so-called Buffet Indicator, which relates the total market capitalization of all U.S. stocks to the level of GDP. Historical comparisons are not useful here, as you can see that this relationship trends upward over time. But this chart, which shows this relationship since 1950 and has been a useful measure of the long term attractiveness of equities, shows that the market has never been so over-valued relative to the overall economy. We would also point out that while the U.S. accounts for less than 16% of the world's GDP, its share of the world's total market capitalization has risen to more than 40%.

The point of this is not to suggest that we are in the midst of a market bubble, or in danger of an imminent market collapse. Rather, we are acknowledging that the market's steep rise from the March low does make it vulnerable to short term declines if the economic recovery is uneven or delayed.



Finally, there are two factors that offset, at least to some degree, our concerns over current valuations.

The first is that, just as the market's rise in 2020 was inflated by the relative out-performance of a handful of large companies that have a disproportionate influence on market performance, so too is the market's valuation disproportionately affected by these same stocks. The S&P's forward P/E is nominally 23 times forward earnings, but the six large companies, mentioned earlier have a weighted P/E ratio of 38 times forward earnings. Then in December, Tesla was added to the S&P and instantly became its 5th largest component. Tesla's forward P/E multiple is 218! An *equal-weighted* market P/E is actually closer to 20 times forward earnings – still high, but not alarming in an economy with low interest rates and in the early stages of an economic recovery.

The second is that the broadening out of the market into the more cyclical, undervalued sectors in the market, which began in the fourth quarter and is ongoing, is more indicative of the early stages of a market advance than the late stages. Over the last three months, it has become less a stock market and more a market of stocks, and that is a good thing.

Inflation Concerns – Not Necessarily

The massive amounts of fiscal stimulus pumped into the economy have begun to raise concerns by many about inflation becoming an issue in the foreseeable future. The stimulus measures enacted in the U.S. so far amount to more than 13% of our GDP, and rank fourth among the world's major economies behind Japan (21%), Canada (16%), and Australia (14%). Wall Street consensus is that price inflation will begin to pick up next year, and Strategas Research reports in a recent survey that the percentage of its institutional clients who are worried about inflation over the next three years has risen to a record 77%. But a recent report by Federated Hermes argues that such concerns ignore the digitization surge of recent years, including a 13% increase in information technology/software spending this year in the midst of an economic collapse. This suggests that productivity growth, which began to break out to the upside in 2020, could continue to counter any pricing pressures. Labor unions have been rendered largely moot in the modern economy, and globalization, while under threat in the current circumstances, remains a powerful disinflationary force. There is also the fact that much of the money supply growth has flowed increasingly into corporations and the equity market than into the accounts of consumers, whose spending ultimately leads to supply constraints and price inflation.

It's probably safe to say that seldom, if ever, has there been such rapid money supply growth without a major inflation shock, but it is also probably true that seldom, if ever, have there been so many impediments in place to mitigate inflation risk.

<u>The Outlook post-COVID</u>

The concerns of investors have naturally been focused on the next couple of years; the impact of additional restrictions that might still be necessary to contain the spread of the virus; the speed at which vaccines can be produced and administered, and the shape of the eventual recovery.

As has been the case in past crises, the economy is likely to return to trend growth from a point well below its pre-crisis level. Idle capital becomes obsolete and persistent unemployment causes workers' skills to atrophy, reducing the capacity of the economy to produce and grow. Consumers, too, are less likely to spend, focusing instead on repairing their balance sheet. The behavior of consumers and businesses will change, with more working from home, more on-line shopping, and less business travel.

In two respects, though, the COVID recovery has the potential to be significantly different than the post-dot.com (2001) and post-financial crisis (2009) recoveries. First, as we have said, the income and savings gap between current level and that level that would have existed without COVID has already been narrowed as a result of unprecedented intervention by policy makers. Second, this crisis was not preceded or caused by a financial bubble, thus lowering the bar for what might be considered a return to normalcy.

Undoubtedly, the COVID pandemic will leave a profound economic legacy, not only in its effect on long term global growth, but also in changes to economic structures and alliances, and the role of government in managing these changes.

Taxes will likely have to be raised and become more progressive, especially after we return to full employment, but austerity measures to bring down public debt levels may be impractical, and public spending will likely continue to grow.

Finally, the fallout from COVID is likely to intensify the pushback against globalization, which had been building for years before the outbreak. We will simply have to watch whether the economic benefits are increasingly eroded by a growing wave of nationalism within countries, or whether countries are able to carve out new alliances in pursuit of their shared interests.

All these are questions to be dealt with in time, but the post-COVID environment will almost certainly require an indefinite period of accommodative monetary policy and low interest rates, in part to manage the massive amounts of debt that accumulated during – and even preceding – the COVID crisis.

In such a scenario, we should expect that equities will outperform bonds, but we should also be prepared for shocks along the way.

Above all, the events of the last year should remind us that some things are simply unknowable until they happen, and they will happen within the time frame envisioned here. When they do, we will respond, as we have always tried to do, by recognizing what does and does not matter in plotting the path forward.

Our best wishes for a safe and fruitful 2021!

Joseph J. Tascone
Senior Vice President &
Senior Investment Officer
JTascone@chemungcanal.com

Michael D. Blatt, CFA
Vice President &
Senior Investment Officer
MBlatt@Chemungcanal.com

Peter M. Capozzola, CFA
Vice President &
Senior Investment Officer
PCapozzola@capitalbank.com

John E. Shea
Vice President &
Investment Officer
JShea@chemungcanal.com

Kevin W. Brimmer
Assistant Vice President &
Portfolio Manager
KBrimmer@chemungcanal.com

Shelby M. Fay, CFP®
Assistant Vice President &
Portfolio Manager
SFay@chemungcanal.com

Chemung Canal Trust Company

CAPITAL BANK