FIRST NEBRASKA Trust COMPANY

Fourth Quarter 2020
Quarterly Letter to Clients
By Scott A. Wendt, CFA
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Happy New Year from all of us at First Nebraska Trust. We hope that this letter finds you and your family in good health and ready for the hope and prosperity that the New Year may bring.

Undoubtedly the past quarter, as well as the whole year of 2020, will not soon be forgotten. America was thrust into war against an unseen foe, a virus, which quickly took on pandemic status. Governments worldwide initially took similar measures to stem the advance of the disease, most of which included lockdowns and restricted movements which essentially immobilized almost the entire globe. The courage and the resolution of old and young were tested by the additional calamity brought upon by social unrest and the politicization of the Covid-19 crisis. In its wake, the pandemic has left no one unscathed. We have experienced extremes and changes at such a rapid rate, that most people are still trying to make sense of the tumultuous and toxic times we live in. We are left trying to find the right words to describe what we have, and are still, experiencing. Most seem inadequate. However, as my colleague Chad Reeson so aptly stated in our annual letter this year, the one word that seemed to capture it was *unprecedented*. As he wrote:

Unprecedented. This was the one word that described the economic environment of the past year. As 2020 began, the U.S. was in the midst of the longest expansion in the history of the U.S. The unemployment rate was just 3.6% and wages were rising. The Federal Reserve had signaled that it was on hold with regard to interest rates, inflation was quiescent, corporate balance sheets were solid, and bond yields were low. Reflecting this, the S&P 500 Index reached a new all-time high in February. A little over four weeks later, the S&P 500 Index had fallen by 34% before hitting the bottom. The cause, of course, was the novel corona virus, which quickly spread across the world, putting an end to the longest economic expansion on record, while hurtling the U.S. into the worst recession since the 1930's. Unemployment peaked at 14.7% in April, and the U.S. economy suffered its worst period ever in the second quarter, with GDP falling by 32.9%!

The 4th Quarter of 2020 shows evidence of additional progress in the recovery from the depths of the economic shut down. Most global economies ended the year in the early recovery portion of the business cycle. U.S. economic data shows a similar pattern. Fourth quarter GDP is estimated by the Atlanta Fed to grow at an 8.5% rate, on the heels of the staggering 33.4% rebound seen in the Third Quarter. The consumer, supported by government stimulus payments, contributed significantly to the rebound by driving personal consumption expenditures to record levels, while pushing retail sales near pre-pandemic levels. However, like most recoveries, not all consumers and businesses are participating at the same pace.

Employment is key to a sustained economic recovery. While unemployment stands at a much improved 6.7% rate, lower-skilled labor, and those employed in the transportation, leisure, and hospitality areas, continue to feel the impacts of a nation still held hostage to the virus. Colder winter weather has reduced the ability of restaurants and bars to have outdoor seating, thus forcing closures and another round of temporary layoffs. There is a real concern that another wave of the virus could turn temporary shutdowns into permanent closures, with the additional consequence of turning temporary layoffs into permanent ones. In addition, the ability of smaller businesses to cover the fixed costs of rent, equipment, and higher minimum wages provides another headwind to a sustainable recovery. Government instituted moratoriums on mortgage and rent payments, in the wake of forced lockdowns in many areas of the country, may just delay the inevitable defaults unless economic activity is allowed to resume.

Of course, the lynchpin for the labor market returning to some sort of normalcy is the success of vaccine development, distribution, and the population actually getting vaccinated. Ramping up production and distribution in normal times would be a herculean task, meaning it most likely will take longer than most pundits think for the necessary and sufficient number of people to be vaccinated. For perspective, imagine the logistics of getting 2 doses of a vaccine to 50% of the 330 million people that make up the U.S. population. ***Roughly 900,000 doses would need to be given every day for a year to vaccinate just half of the population.*** While this is admittedly an oversimplification of the breadth and depth of what has to happen to achieve the goal of herd immunity, it provides a realistic view of the expectation that the war on the pandemic can be won, albeit in another year or two.

Bond and Stock Markets

The capital markets continue to focus on the high likelihood of additional government stimulus programs to provide consumers and businesses with the funds to bridge the chasm created by forced shutdowns. The hope is that government borrowing today will accelerate the recovery enough that, when combined with increasing vaccinations, there will be a release of pent-up consumer and business demand that moves economic growth into a broad expansion. The fear is that Federal, State, and Municipal governments' reliance on debt will be too much of a burden for future tax payers to bear. In the interim, the Federal Reserve is expected to continue to maintain its highly accommodative monetary policy, which has the dual impact of keeping the costs of debt funding low and supporting financial asset price increases. This focus by bond and stock market participants is a partial explanation for the disconnect between the economy experienced by Main Street, and the fastest stock market recovery in history.

While the world appears to be awash in liquidity, Central Banks, including our own Federal Reserve, are facing a growing dilemma. After conditioning market participants for well over a decade to the siren song of low interest rates and easy money, the Fed finds itself wielding a quiver that is mostly empty. What remains are a few blunt, and increasingly ineffective, tools that seem to have less direct impact on economic activity, while simultaneously inflating the financial markets. In addition, the more that Fed action props up the stock and bond markets, the greater the divide and disparity in financial outcomes for the nation's populace. Increasingly, Fed Chair Powell has called on Congress to act through fiscal means to stimulate an economy that is progressively unresponsive to massive liquidity injections. With few tools left, we have an economy that is still far from reaching a healthy, self-sustaining level of growth. In addition, debt from record deficits is climbing to levels that were not expected by experts to occur for decades into the future. Thus, the Fed's dilemma remains: How long can this massive stimulus continue without any consequences? The practical answer is that there will be consequences, and many of them will be severe. However, policy makers in the unspecified distant future will have to deal with them. (That clanking sound you hear in the distance is the can being kicked down the road).

All these factors are contributing to the changing expectations that have been impacting bond prices and yields over the past 90 days. For the quarter, U.S. Government yields fell on the shorter end of the curve, while longer-dated maturities saw a 15 to 25 basis point increase. The yield on the U.S. Treasury 10-year increased 24 basis points from its September 30, 2020 level of 0.69% to end the third quarter at 0.93%.

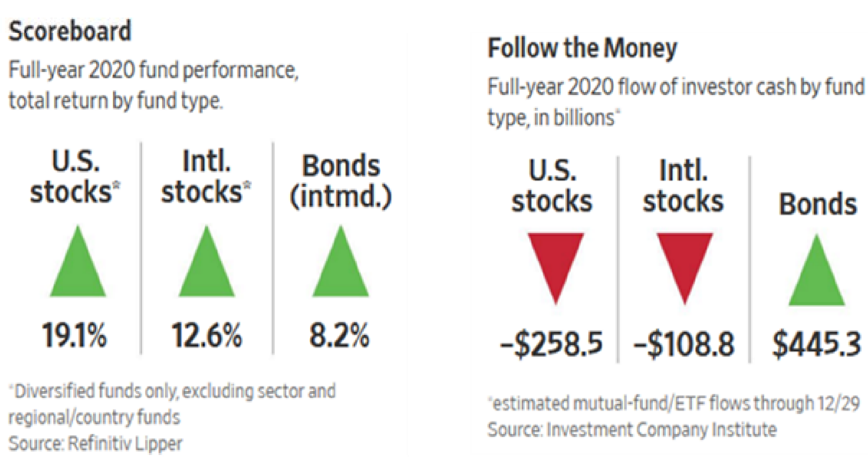
Fixed income investors continued to see tight credit spreads, implying market participants are not able to earn the extra yield necessary to compensate for the many risks of holding these bonds. Nevertheless, buyers have lined up to purchase poorer quality bonds and bond funds in an attempt to "reach for yield" and earn something on their fixed income allocations. As the performance table below shows, lower-quality and shorter-duration credits outperformed their higher-quality brethren, with stocks significantly outperforming bonds during the quarter.

Time-Weighted Rate of Return Summary *As of 12/31/2020*

Bond Indexes	Quarter	1-Year	3-Year	5-Year
US Treasury Bills	0.0	0.6	1.7	1.3
Barclays US Gov 1-3 Year	0.1	3.4	3.0	2.1
Barclays Intermed Gov/Corp	0.5	6.4	4.7	3.6
Barclays Muni Bond 5 Year	0.8	4.3	3.8	2.8

Stock Market Indexes	Quarter	1-Year	3-Year	5-Year
DJ Industrial Average	10.7	9.9	9.8	14.5
Dow Jones TTL Stock Mkt US	14.3	18.7	12.3	13.2
NASDAQ Composite	14.7	43.0	23.2	20.9
S&P 500	12.2	18.4	14.2	15.2
MSCI EAFE (NET DIV)	16.1	7.8	4.3	7.5

For most of the past year, Wall Street ignored the waves of fear and gloom experienced by Main Street. Investors and speculators alike appeared to look past the pain of layoffs and lockdowns towards the brighter future of a vaccinated, post-pandemic world. Share prices repeatedly rallied higher, pushing the major indices from the depths of the March selloff to record highs by yearend. As the Scoreboard graphic below shows, the average diversified U.S. stock fund was up +19.1% for the year. [1] International stock funds continued to lag the broader U.S. Market, climbing +12.6% over the same period.



While the major benchmarks posted above average returns, those returns were again dominated by the largest, technology-oriented companies for most of the year. For example, at mid-year 2020, Amazon (AMZN), Apple (AAPL), Facebook (FB),

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1 https://www.wsj.com/articles/u-s-stock-funds-rose-19-1-in-a-grueling-2020-11610157674?mod=markets_lead_pos6

Alphabet (GOOGL), Microsoft (MSFT), and Tesla (TSLA) accounted for **49%** of the NASDAQ 100 index weighting. The impact on the S&P 500 was similar, with the largest five stocks in the index posting a 35% year-to-date return, while the other 495 stocks declined by 5 percent. This narrow participation trend appeared to change during the 4th Quarter of 2020, as smaller stock prices began to rally and post better relative gains than their mega cap brethren, helping to mark a quarterly return that most folks would have been happy to have as annual gain. During the past quarter, the S&P 500 climbed +12.2%, while the Dow Jones Industrial Average (DJIA) increased +10.7%, and the tech-heavy NASDAQ rose +14.7%.

Even as the markets continue to forge a path towards new record highs, the underlying fundamentals that drive corporate and small business economics continue to be challenging. To maintain adequate levels of cash during the lockdowns, companies large and small cut staff (either temporarily or permanently), suspended planned capital expenditures, cut or suspended dividends, and borrowed large sums to bolster their liquidity during the crisis. While the economic conditions are improving, balance sheets will take years to show significant improvements. The combination of higher debt, and the accounting write down of assets deemed impaired during the pandemic, is putting further pressure on many company balance sheets.

The follow-on effect of this increased leverage is two-fold. First, assets declining relative to debt translates into higher borrowing costs. Secondly, companies with higher financial leverage are more prone to financial stress in times when revenues fall precipitously. Without the government intervention back in March of last year, many of these companies would have succumbed to the aftershock of the pandemic. Earnings and cash flows continue to be challenged, as rolling lock downs in parts of the country continue to provide a hurdle to many businesses' ability to recover. The probability for seeing increased bankruptcies, supply chain interruptions, and dwindling capabilities to service customer needs are already appearing in many parts of the country.

For many, the currently unanswered question is whether or not the pandemic's lingering impacts will be temporary or permanent. This in turn may provide insight into how investors may handle a stock market that is already approaching record valuation levels. Generally, higher valuations imply higher risks and the potential for lower future expected returns. With the risk-reward balance tipping to the risk side of the ledger, our focus will remain on controlling risks in your account through the combination of an appropriate asset allocation range to meet your financial goals, while using our security selection process to construct a well-diversified portfolio.

From a capital markets' perspective, politics always seems to have a delay in impacting company and consumers alike. Both are forced to adapt to survive. However, falling to the temptation of making investment decisions based on raw emotions usually doesn't turn out well. As David Bahnsen, former Managing Director at Morgan Stanley recently stated: "Confusing what one WANTS to happen in POLITICS, with what WILL happen in MARKETS, is perhaps the most dangerous and avoidable mistake around. History can't be any clearer."[2] Thus, investors will need a good dose of patience and flexibility to adapt to the ever-changing world we are living in.

[2] *"Year of the Gripping Hand"* Thoughts from the Front Line, by John Mauldin January 9, 2021.