NELSON CAPITAL

Quarterly Commentary

2020 | Q4

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No matter who you ask, 2020 was a tumultuous year. It was a year that forced many of us to cancel plans, change habits, gain perspective, and learn never to take for granted long hugs with loved ones. 2020 was also a record-breaking year, for worse and for better. The cost in human life was devastating. 2020 was the deadliest year in U.S. history, with 400,000 more deaths than in 2019, due primarily to the onset of COVID-19. On the other hand, we also witnessed the extraordinary speed of vaccine development, with two SARS-CoV-2 vaccine candidates brought to the U.S. market in a matter of months. The monetary and fiscal stimulus put into place by the Federal Reserve and by the U.S. government not only set new records, but also surpassed the post-Great Recession stimulus in both size and speed.

The S&P 500 index witnessed its fastest bear market on record followed by the quickest recovery in history. The “melt up” in stocks continued into December, despite near-daily new records set for numbers of cases, hospitalizations, and deaths from COVID. The index finished the year up over 18%, recovering all losses from earlier in the year. This rally has been powered by a combination of vaccine optimism, fiscal and monetary stimulus, the “fear of missing out” (FOMO) and “there is no alternative” (TINA) factors that have funneled investors into the equity market, better-than-feared corporate profits, and significant concentration of the index in companies that have benefited from stay-at-home, work/learn-from home trends.

We see signs of froth everywhere. The S&P 500 is now trading at price-to-earnings (P/E) and price-to-sales (P/S) valuations that were last seen at the height of the dot-com bubble. The IPO market set records this year with $167.2 billion raised on U.S. exchanges--far exceeding

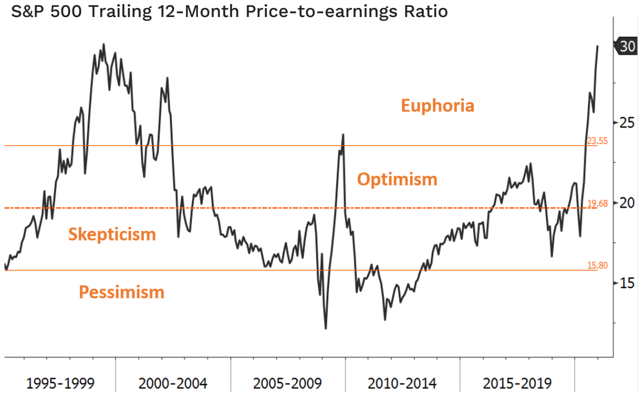
Index Performance	Q4 '20	YTD
Dow Jones Industrial	10.73%	9.72%
Standard & Poor’s 500	12.14%	18.39%
EAFE (international stocks)	16.09%	8.39%
Russell 2000 (small stocks)	31.36%	19.93%
Barclays Interm. Gov/Credit	0.48%	6.43%
Barclays Municipal	1.82%	5.21%

ECONOMIC OVERVIEW (CONT'D)

Dot-Com Bubble 2.0?

the previous high of $107.9 billion set at the height of the dot-com boom in 1999. The average one-day price increase for newly minted public stocks was 40%. Bitcoin is now above $30,000, rising nearly 400% in 2020. Electric-car maker Tesla (tkr: TSLA) was added to the S&P 500 index in December, following a 700%+ stock price increase since January.

S&P 500 Trailing 12-Month Price-to-earnings Ratio



Source: Bloomberg

Meanwhile, economic data has underwhelmed. The labor market is still down about 10 million jobs since the start of the pandemic, and we are witnessing roughly 800,000 jobless claims being filed each week. The November jobs report was particularly disappointing, with just 245,000 jobs added—well below the 460,000 estimated number and much lower than the 610,000 added in October. Furthermore, retail sales have begun to wane as the spike in case numbers across the country has dampened economic growth trends. The stock market appears to have completely delinked from the fundamental economic data that it traditionally cares about.

With euphoria seemingly all around us, it is difficult to avoid comparisons to the valuation bubble of the dot-com era. The question is: How close are we to the end? Are we in 1997 or 1999? Then-chairman of the Federal Reserve, Alan Greenspan, famously warned that equity markets were exhibiting “irrational exuberance” prior to the dot-com bubble bursting. However, Greenspan’s quote was from a speech made on December 5, 1996, more than three years prior to the tipping point at which the bubble burst.

If we are currently in another valuation bubble, what could be the tipping point that causes it to burst this time? In 2000, the Federal Reserve began increasing interest rates to combat rising inflation. In May of 2000, the Fed’s benchmark interest rate stood at 6.5%. By contrast, the current Federal Reserve has promised to keep rates at zero out to at least 2023, while also maintaining its stimulative asset purchase program. The Fed will likely be able to stick to this commitment given the lack of inflationary pressures in today’s environment. Current Fed chairman Jerome Powell commented recently that he does not consider equities to be overvalued on a risk/reward basis. Furthermore, the U.S. recently passed yet another coronavirus relief bill that will add about $900 billion worth of fiscal stimulus on top of the $2.44 trillion that has already been passed. With this stimulus and if we see a flawlessly executed vaccine rollout, it is possible we could see a dramatic earnings recovery that could help support current equity prices. A vaccine manufacturing delay or snafu, on the other hand, could easily lead to a stock market correction.

We remain disciplined in our strategy, seeking out investments that carry attractive valuations on a relative basis. But given the low-rate environment, low inflation and unprecedented stimulus, we think the markets may head further into euphoria.

ASSET TRANSACTIONS

Swap in Consumer Staples

We had a quiet fourth quarter, making just one swap within our consumer staples sector. We sold our position in Hormel (tkr: HRL). Hormel has seen tailwinds from the pandemic, as the maker of Spam and Skippy peanut butter has experienced higher demand from nervous consumers seeking out products with longer shelf lives. The stock had risen 18% year-to-date and its price-to-earnings (P/E) ratio had expanded from 25x to over 31x. Hormel pays a 2% dividend which is lower than many of its peers in the consumer staples sector. Furthermore, Hormel's Jennie-O Turkey brand has experienced disruption in recent years as raw material over- or undersupply has caused large swings in revenue that lead to unpredictability. We decided to seek out better opportunities within the sector, particularly looking for a more attractively valued company that pays a higher dividend and sells everyday products that people will buy even in times of economic distress.

To replace Hormel, we purchased a position in General Mills (tkr: GIS). General Mills is a manufacturer and marketer of branded consumer foods and pet food products sold mainly through retail stores. It has greatly benefited from the "people eating at home" theme during the pandemic. Although this growth driver is likely to persist through 2021, that is not the main reason to own General Mills. The management team has done an excellent job diversifying product lines, and has successfully identified new trends and brought products forth accordingly. Some notable brands and products include Annie's, Cheerios, Betty Crocker, Blue Buffalo, EPIC, Pillsbury and Yoplait. General Mills has maintained a healthy balance sheet, consistent with industry practice. It is relatively inexpensive with a P/E ratio of 15x (about half that of Hormel) and pays a 3.4% dividend, making it a great core holding within the consumer staples sector.

General Mills, Inc. Stock Price

Source: FactSet

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FIRM UPDATES

We are proud to announce our new firm name, Nelson Capital Management. We are returning to our roots, as this is an homage to Phil Nelson, who originally founded the business in 1975. Looking ahead, we are excited to continue providing clients with the same excellent service and values that Phil instilled in the firm nearly half a century ago.

The team at Nelson Capital would like to wish everyone a safe and healthy New Year.

WEALTH MANAGEMENT

Tax Updates

The Biden campaign platform proposed major tax changes aimed at increasing taxes on high-income earners and corporations to pay for $3.4 trillion in policy proposals. We suspect many of these proposals were included to help Biden gain the nomination by appealing to the more progressive wing of the Democratic party. Here are a few of the more significant proposed tax changes:

Individual Taxpayers

- Impose Social Security payroll tax of 12.4% on wages earned above $400,000. Under current law, payroll taxes are applied on the first $137,700 of wages. No tax would be applied for incomes between those two levels. (Expected to generate $820 billion in revenue)
- Tax capital gains and dividends at 39.6% (effectively double the current rate) on income over $1 million and repeal the tax-free step-up in basis at death. Individuals inheriting assets would retain the decedent's basis instead of the cost basis resetting upon the owner's death (Expected to generate $470 billion in revenue)
- Reduce estate and gift tax exemption threshold from $11.5 million to $3.5 million. Note that the current estate tax exemption is set to expire in 2025, so the reduction is effectively an acceleration of that expiration. (Expected to generate $280 billion in revenue)
- Increase highest individual ordinary tax rate from 37% to 39.6%. (Expected to generate $150 billion in revenue)

Business Tax Provisions

- Increase the top corporate tax rate to 28% from 21%. Note that before it was reduced in 2017, the corporate tax rate was 35%. (Expected to generate $1.05 trillion in revenue)

Source: Tax Foundation

How likely are these changes?

Biden will not have decisive Democratic majorities in the House and Senate to work with, making a drastic overhaul of the tax code difficult to accomplish. The likelihood of any change could hinge on the run-off elections for two Senate seats in Georgia in January. Currently, Republicans are favored to win, according to polling data. Republicans only need to win one seat to maintain control of the Senate. If Republicans manage to keep control, a split Congress would indicate that we will most likely not see significant tax changes. If Democrats win both, neither party would have a Senate majority and the vice president would cast the deciding vote when issues divide along party lines, effectively meaning Democrats control both houses of Congress and the presidency. However, even if we see both Democrats win in Georgia, it is not clear that these proposals will pass. Thus far, Biden's cabinet picks have indicated he is aiming for a more middle-of-the-road administration rather than pulling far left. We will be carefully following this and will proactively reach out if we identify any opportunity or impacts to our clients' individual circumstances.

TOP 15 HOLDINGS

- VANGUARD DEVELOPED MARKET ETF
- AMAZON.COM INC.
- ISHARES S&P SMALL-CAP ETF
- MICROSOFT CORP.
- APPLE INC.
- COSTCO WHOLESALE CORP.
- ALPHABET INC.
- WALT DISNEY CO.
- QUALCOMM INC.
- FIRST REPUBLIC BANK
- ILLUMINA INC.
- VANGUARD EMERGING MARKET ETF
- MEDTRONIC
- LINDE PLC
- TRANE TECHNOLOGIES

FEATURED EQUITY

Chewy, Inc. (tkr: CHWY)

One of our investment themes over the last several years has been the "humanization of pets," which refers to the increasing amount of time and money that people are devoting to their animals. This theme has become even more evident during the pandemic, as many families and individuals have adopted pets while spending more time at home. Today, more than 85 million US households have pets. In 2015, roughly 7% of pet products in the U.S. were bought online. By 2019, that number had increased to 22%. Moreover, the pandemic has caused pet parents, new and experienced alike, to sign up for delivery of pet supplies in order to avoid trips to physical stores. 72% of pet owners made at least one online purchase for their pets in the past 12 months and 39% of those were subscription-based purchases.

Chewy, Inc. Stock Price

Source: FactSet

Chewy (tkr: CHWY) is the largest pure-play pet "e-tailer" in the world, offering "the personalized service of a neighborhood pet store combined with the convenience and speed of e-commerce." The company was founded in 2011 and was bought by PetSmart in 2017, for $3 billion. In June, 2019, Chewy went public. All of its sales are currently U.S.-based. The company has co-headquarters with one facility in Dania Beach, Florida and one in Boston, Massachusetts, and employs about 12,000 people. Chewy offers a selection of high-quality pet food, treats, supplies, and pet healthcare products.

In addition to one-time sales, Chewy is creating a recurring revenue model through its "autoship" program. This is essentially a subscription service for products that are sent at intervals specified by customers and includes such items as food and medicine. Customers are more profitable the longer they stay with the company, as their "lifetime value" grows. The company is organized around providing an exceptional customer experience. Chewy has 10 fulfillment centers scattered across the US, which enable cost-efficient overnight shipments to about 80% of the U.S. population and cost-efficient two-day shipments to nearly 100%. This allows Chewy to provide excellent service to the company's more than 12.7 million active users.

Chewy's ability operate profitably in the future hinges on two key variables: growing its customer base and more efficiently managing its fulfillment costs through automation of its fulfillment centers, thereby decreasing labor costs. Chewy has a smart, experienced management team and the company is expected to become profitable at the end of this fiscal year.

(The preceding information regarding the featured equity should not be construed as a recommendation to purchase the security. It should not be assumed that future returns will be profitable or will equal the historical performance. Please contact us for a complete list of holdings.)

OUR TEAM

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Tiffany Young

SPECIAL TOPIC

Vaccine Rollout Reality Check

The current U.S. Secretary of Health and Human Services, Alex Azar, has been quoted as saying that there will be enough doses of one or more vaccines against SARS CoV-2 and the disease that it causes, COVID-19, for all Americans by the spring of 2021 (March to early April). However, many medical and logistics experts believe that this is an exceptionally rosy forecast and that there are a significant number of potential issues that might slow the vaccine rollout and administration.

First, the drug makers must manufacture enough doses. This is not a trivial exercise, as making billions of doses of vaccines requires a huge amount of raw materials and equipment. Any glitches in the supply chain could slow down vaccine production. Vaccine logistics experts say that "wastage" of 1% to 10% of doses during production and distribution is common.

Next, doses have to be transported to where medical personnel will be administering them. Both the Pfizer/BioNTech and Moderna vaccines must be kept cold during transport and storage prior to administration. The Pfizer/BioNTech vaccine in particular must be kept at a temperature of -70 degrees Celsius. This has set off a race to acquire special freezers for storage once the vaccine arrives at its destination.

Finally, there is the process of getting vaccines from the freezer into arms. Determining who to vaccinate first, second, third, etc. is already becoming controversial. There is also some confusion at the frontlines about when and which vaccines will arrive, how many doses will be available (and when), and how to cover staffing needs while workers get vaccinated. Vaccine administrators will also want to ensure that doses are not wasted once a package is opened. Some vaccines, including both Pfizer/BioNTech's and Moderna's, require two doses. Therefore, people receiving the initial dose need to be scheduled and reminded to return for the second at the appropriate time.

Based on current contracts with Pfizer/BioNTech and Moderna, there should be enough doses produced by the end of the first quarter of 2021 to vaccinate 100 million people in the U.S. Moderna has recently contracted with the U.S. government for an additional 100 million doses to be delivered in the second quarter of 2021, which would be enough doses to vaccinate 50 million additional people. The hope is that Johnson & Johnson's and AstraZeneca's vaccines will be able to significantly supplement these numbers starting in the spring, but neither of these are yet approved in the U.S. and likely will not be until February at the earliest.

The development of not one, but multiple vaccines less than one year after SARS CoV-2 was genetically sequenced is an extraordinary scientific achievement. Mass vaccination will allow the world to return to normal over a period of months. However, we should not be surprised if it takes a bit longer to offer vaccination to everyone than is currently being projected. The complex logistics make mass vaccination a major undertaking and there will inevitably be some delays. That said, most experts believe that anyone in the U.S. who wants to receive a vaccine should be able to do so by late summer 2021.

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