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Quarterly Economic Review

2021

January

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Economic Review

This year was a tragic one. Yet global stocks were up 16.3% for the year. U.S. stocks did a bit better, with large caps up 18.2% and small caps up 20.0%. Developed international stocks gained almost 10% and emerging-market stocks gained over 15%.

The comforting full-year returns mask the incredible volatility and stress investors faced earlier in the year. Stock markets around the world were down 30%–40% for the year by March 23, the year's low point. From there, stocks skyrocketed into year-end. Amazingly, the major large-cap indexes are all up over 65% from their lows; smaller-cap U.S. stocks have nearly doubled since then. During the worst days of March, with pandemic fears rampant and the global economy falling off a cliff, very few predicted this year's outsized performance for stocks.

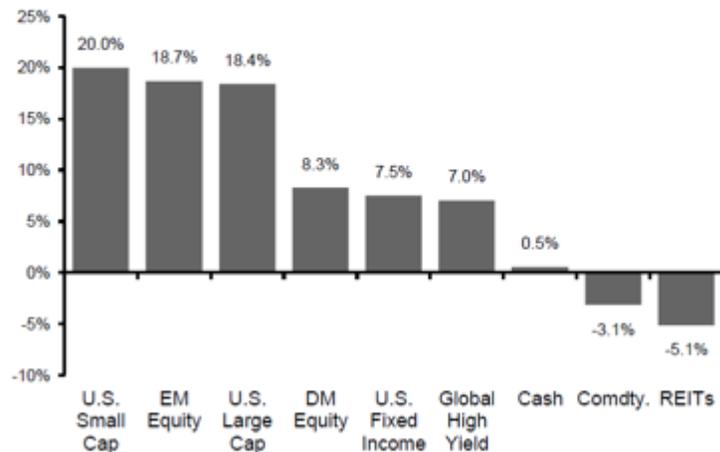
Moving on to fixed-income, core investment-grade bonds gained a strong 7.6% for the year, providing positive returns both during and after the market crisis period. In typical fashion, early on in the year Treasuries and high-quality corporate bonds benefited from falling rates amidst a deflationary shock. Interest rates have risen modestly since the positive vaccine news in November, but they are still generally much lower than they were at the start of 2020.

In the lower-quality sectors of the bond market, high-yield bonds and floating-rate loans posted 6.2% and 3.1% gains, respectively, for the year. Both asset classes materially outperformed core bonds during the last three quarters of the year. But they still have some ground to make up from the tremendous selloff they suffered in March before the Federal Reserve stepped in to support the financial markets with bond-buying and other liquidity-supporting programs.

2020 ended positively for stock markets around the world. Growth stocks, particularly the tech sector, were the strongholds of 2020.

CHART OF THE WEEK

Markets end the year up following positive economic policy and vaccine developments
YTD, total return, U.S. dollar

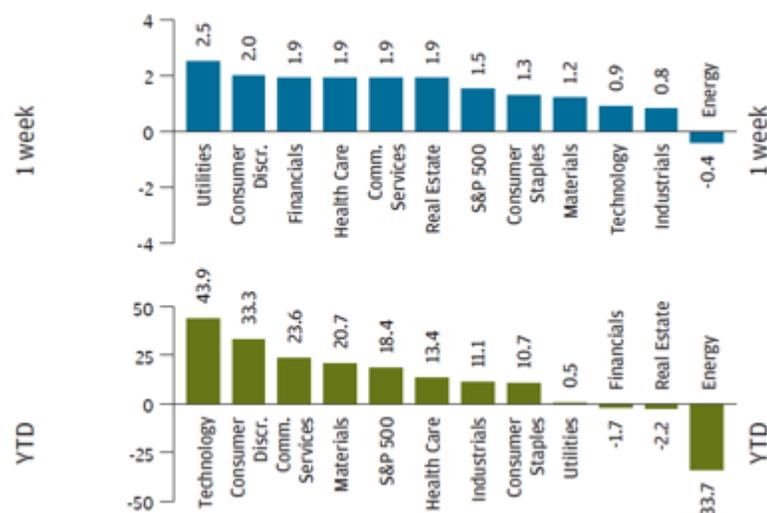


STYLE RETURNS

| | V | B | G |
|---|------|------|------|
| L | 1.3 | 1.5 | 0.9 |
| M | 0.9 | 0.0 | -1.5 |
| S | -0.2 | -1.4 | -2.5 |

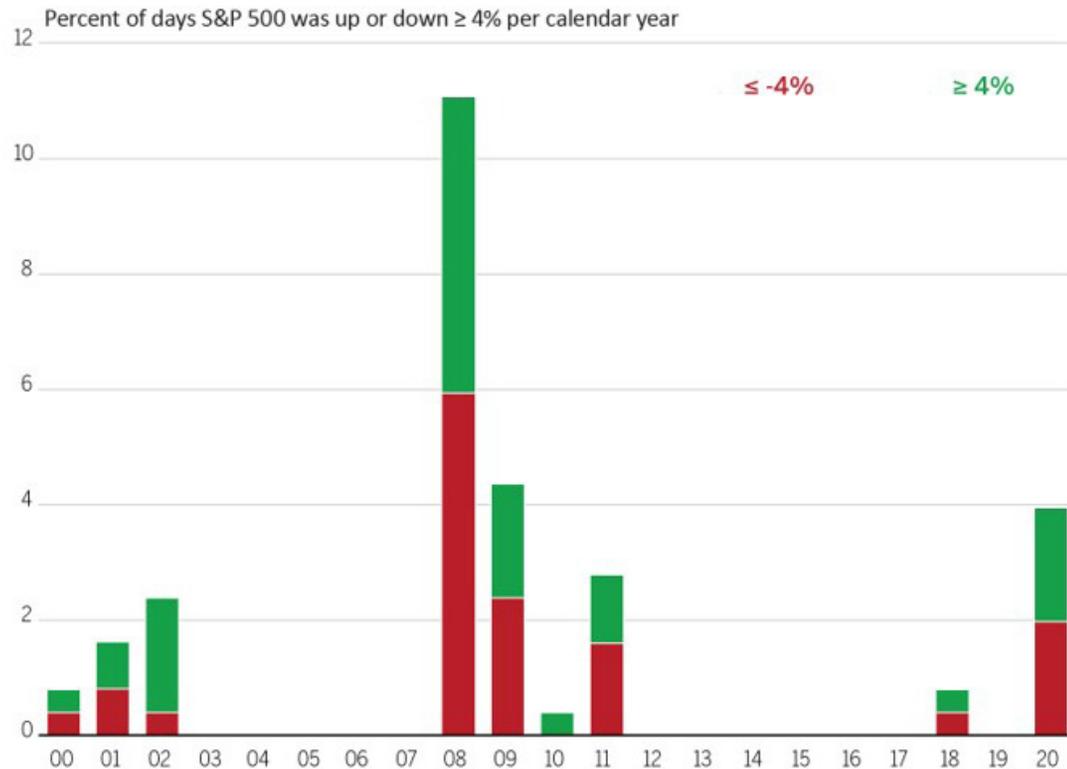
| | V | B | G |
|---|-----|------|------|
| L | 2.8 | 18.4 | 38.5 |
| M | 5.0 | 17.1 | 35.6 |
| S | 4.6 | 20.0 | 34.6 |

S&P 500 SECTOR RETURNS



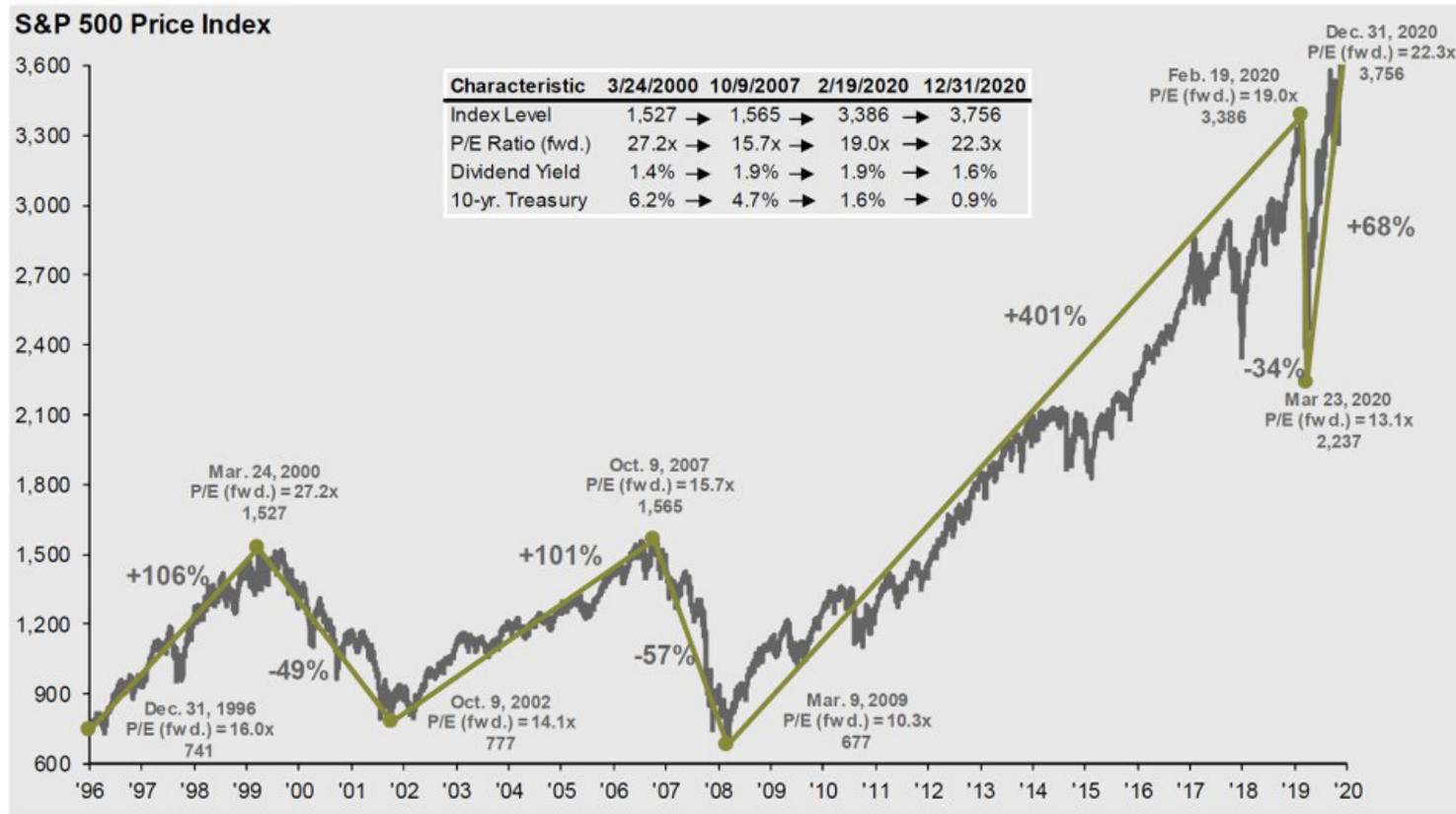
The strong full year returns mask how volatile the market movement was in 2020...

A year of high volatility in down and up markets



Past performance does not guarantee future results. The performance shown is index performance and not representative of a fund's performance. Indices are unmanaged and not available for direct investment. | Sources: Bloomberg, Wellington Management | Chart data: 2000 – 2020

... with the dizzying March market drop and incredible recovery.



Source: Compustat, FactSet, Federal Reserve, Standard & Poor's, J.P. Morgan Asset Management.
 Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by Compustat.
 Forward price-to-earnings ratio is a bottom-up calculation based on the most recent S&P 500 Index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns.
 Guide to the Markets – U.S. Data are as of December 31, 2020.

Much of the S&P 500 return is being driven by the top 10 stocks...

P/E ratio of the top 10 and remaining stocks in the S&P 500

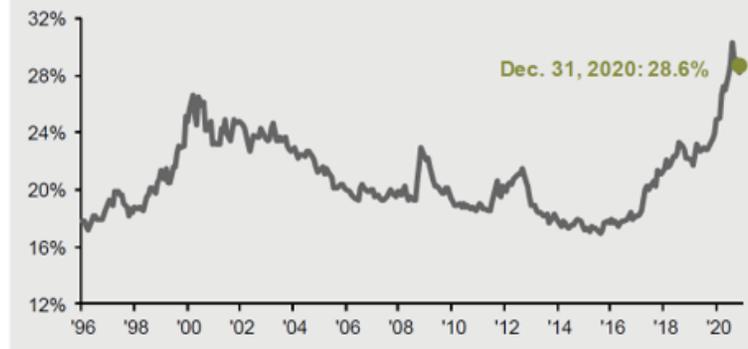
Next 12 months

| | Current | Average | % of avg. |
|------------------|---------|---------|-----------|
| Top 10 | 33.3x | 19.4x | 172% |
| Remaining stocks | 19.7x | 15.5x | 127% |
| S&P 500 | 22.3x | 16.2x | 138% |



Weight of the top 10 stocks in the S&P 500

% of market capitalization of the S&P 500



Earnings contribution of the top 10 in the S&P 500

Based on last 12 months' earnings



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
 The top 10 S&P 500 companies are based on the 10 largest index constituents at the beginning of each month. The weight of each of these companies is revised monthly. As of December 31, 2020, the top ten companies in the index were: AAPL (6.8%), MSFT (5.3%), AMZN (4.5%), FB (2.1%), TSLA (1.7%), GOOGL (1.7%), GOOG (1.6%), BRK.B (1.4%), JNJ (1.3%), JPM (1.2%) and V(1.2%).
 Guide to the Markets – U.S. Data are as of December 31, 2020.

... but performance leadership shifted in the 4th quarter to small cap, value and international stocks.

EXHIBIT 6: Performance leadership has shifted amid a reflation dynamic, with small caps and emerging-market stocks outperforming since September.

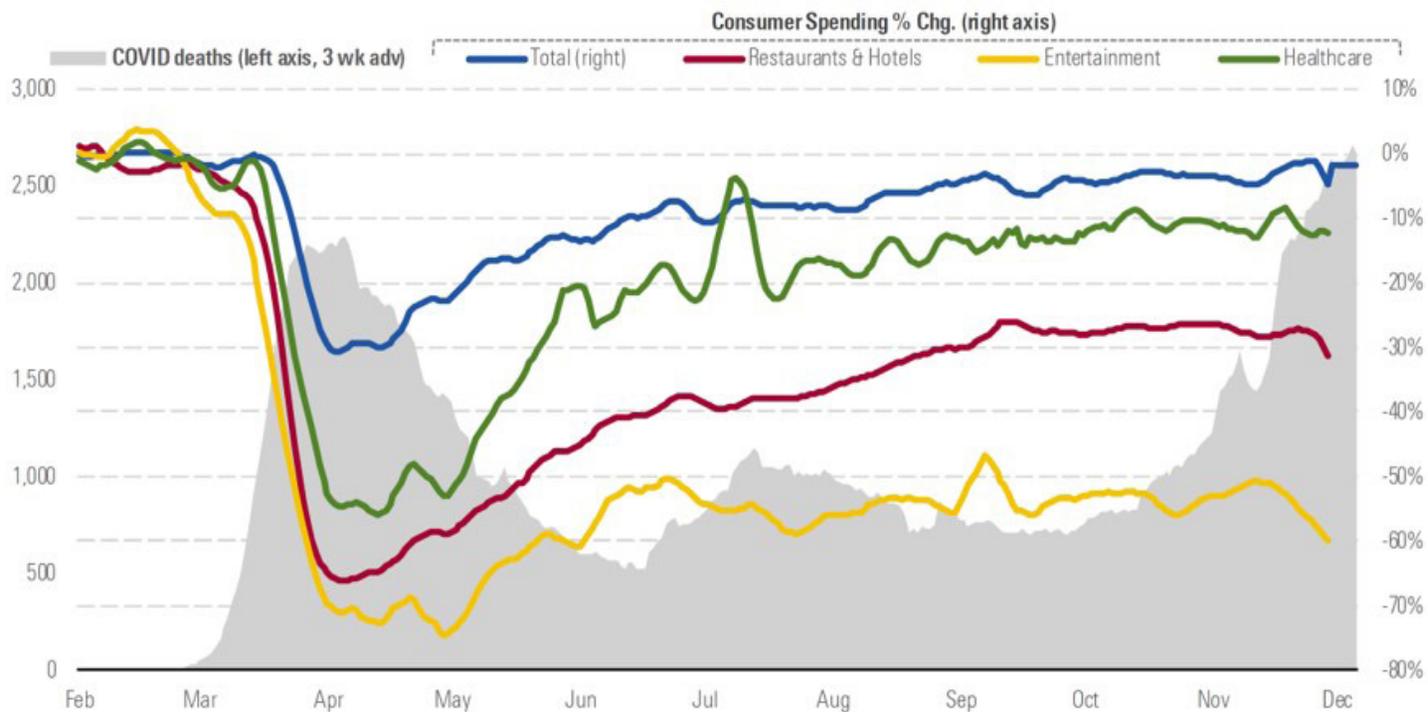
Asset Performance During 2020

| | Jan 1– Aug 31, 2020 | Sep 1– Dec 11, 2020 |
|----------------|------------------------|------------------------|
| U.S. Small Cap | -5% | 22% |
| EM Equities | 2% | 13% |
| DM Equities | -4% | 10% |
| U.S. Value | -10% | 10% |
| High Yield | 2% | 4% |
| U.S. Large Cap | 11% | 4% |
| U.S. Growth | 36% | 1% |
| IG Bonds | 7% | 0% |

EM: emerging market. DM: developed market. IG: investment grade.
Source: Bloomberg Finance L.P., Fidelity Investments (AART),
as of Dec. 11, 2020.

Looking ahead to 2021, the third COVID wave has not impacted consumer spending as dramatically as in the first quarter.

The Coronavirus Third Wave Hasn't Sunk the Recovery

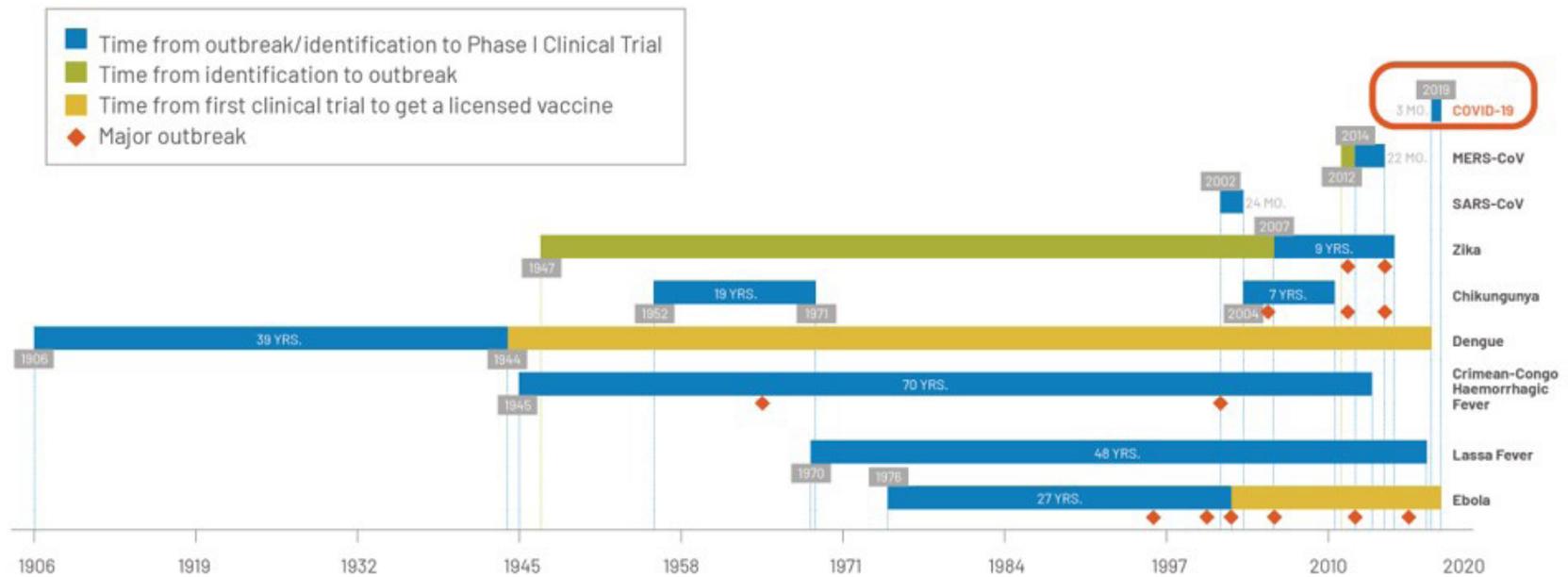


Sources: Tracktherecovery.org, Affinity, Morningstar (As of 1/03/2021)

Optimism about the COVID vaccine is driving the market...

Ingenuity Over Infection

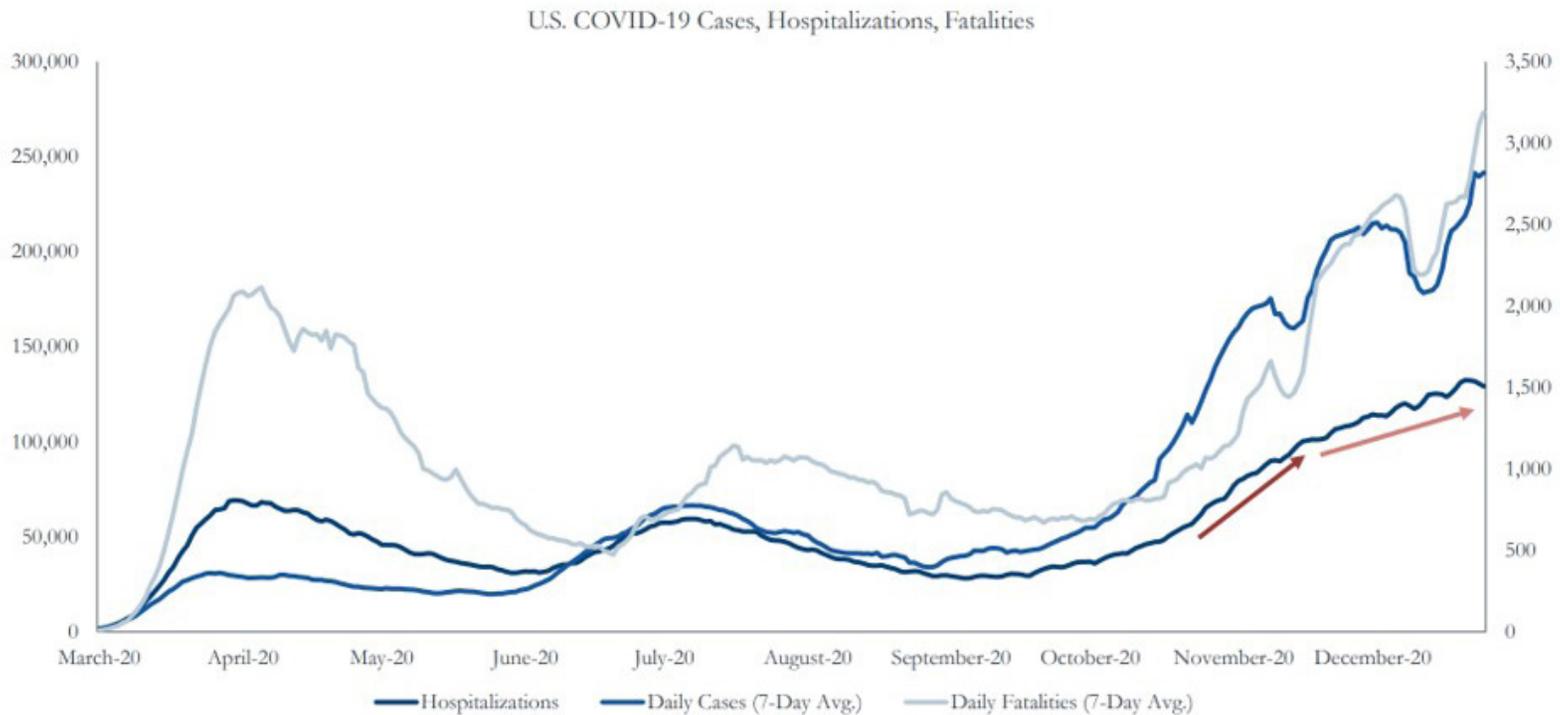
RESEARCHERS DECODED GENETIC MAP OF COVID-19 & BEGAN CLINICAL TRIALS IN A RECORD 69 DAYS



Source: National Research Journal; Kim, Y.C., Dema, B. & Reyes-Sandoval, A. COVID-19 vaccines: breaking record times to first-in-human trials. *npj Vaccines* 5, 34 (2020). <https://doi.org/10.1038/s41541-020-0188-3>.

... and hospitalizations continue to flatten...

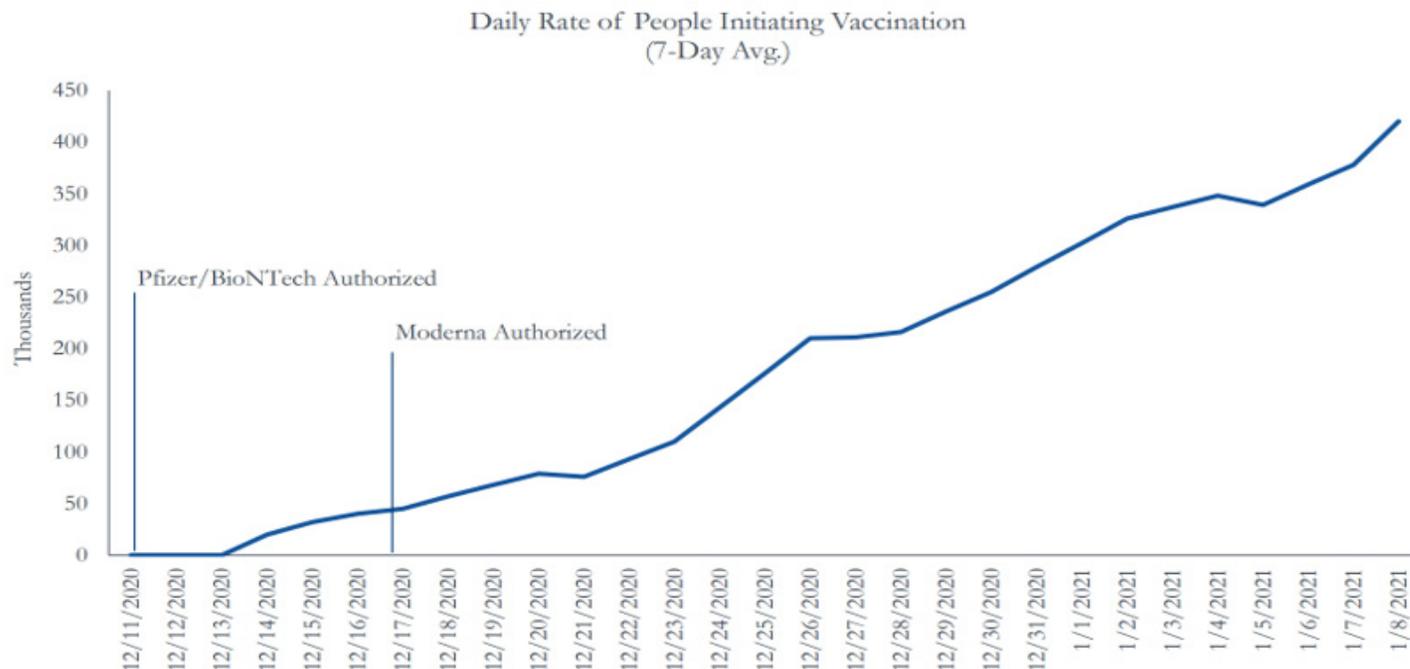
- Hospitalizations increasing at a slower rate, expected to decline in coming weeks
- Impact of new virus strains difficult to assess at this point



Hospitalization and fatality data source from the COVID Tracking Project and supplemented by estimated hospitalization data from IHME where no hospitalization data was officially reported.

... and the vaccine process is improving.

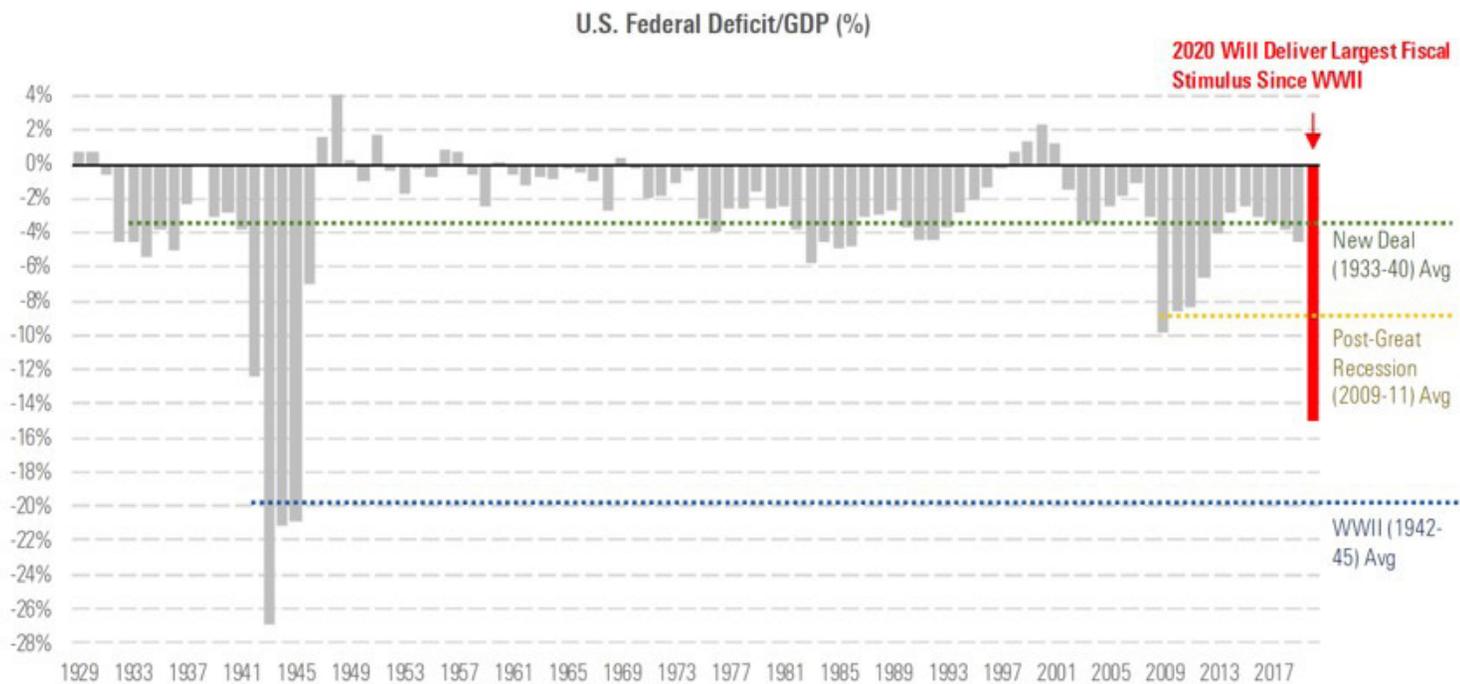
- Approximately 8 million Americans have received their first dose of a COVID-19 vaccine
- Rate of vaccination has risen significantly as inefficiencies are being fixed



Source: Gu, Y. COVID-19 projections using machine learning. <https://covid19-projections.com>. Accessed 1/11/2021. Data reflects actual 7-day average of vaccinations as reported by the CDC.

Massive fiscal support has helped individuals, small businesses and industries affected by COVID.

2020 Delivered Largest U.S. Fiscal Stimulus Since WWII

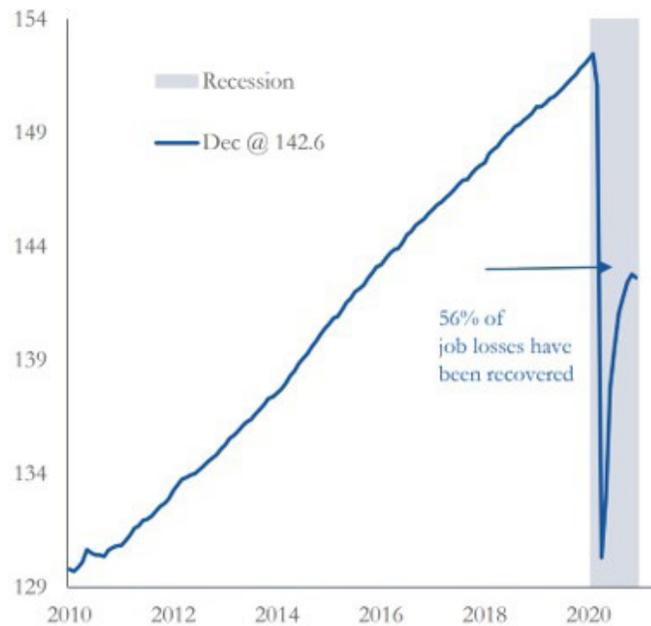


Sources: U.S. Bureau of Economic Analysis, Morningstar (As of 1/03/2021)

Unemployment continues to fall...

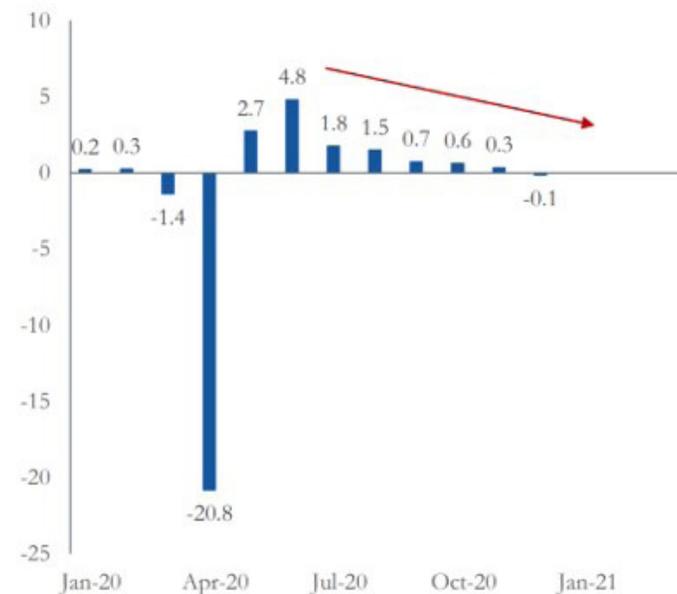
The Recovery in Labor Continues, but at a Slower Pace

Nonfarm Payrolls
millions, seasonally adjusted



Source: Bureau of Labor Statistics as of December 2020.

Nonfarm Payrolls ('000)
millions, monthly change



Source: Bureau of Labor Statistics as of December 2020.

... and core inflation remains low.

US INFLATION — CORE PCE % Y/Y

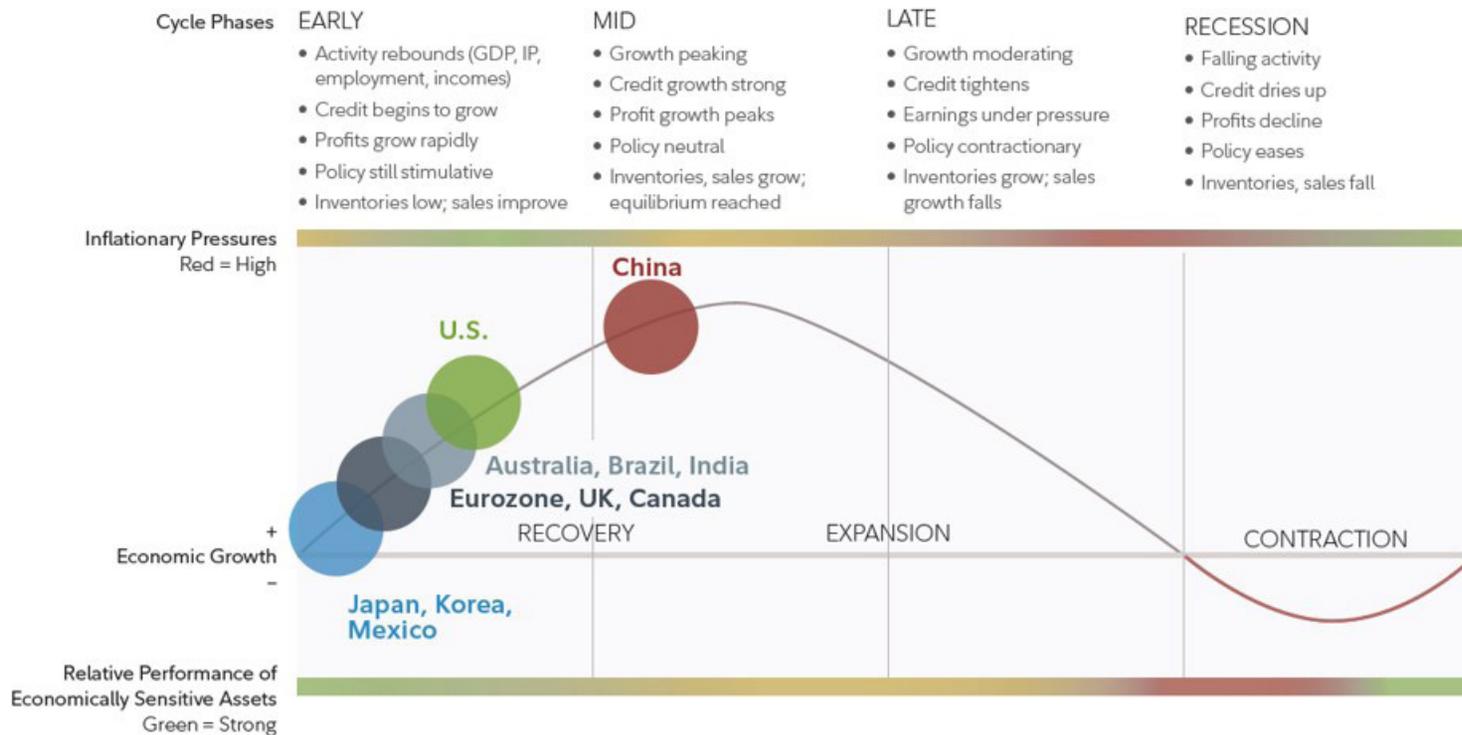


PCE: personal consumption expenditure. Data as of November 2020.
 Source: Bloomberg.

The economies of countries around the world have started to recover...

EXHIBIT 1: Most global economies remain in the early-cycle recovery phase, though a rise in COVID-19 cases has moderated the pace of growth. China has advanced to the mid-cycle phase of expansion.

Business Cycle Framework



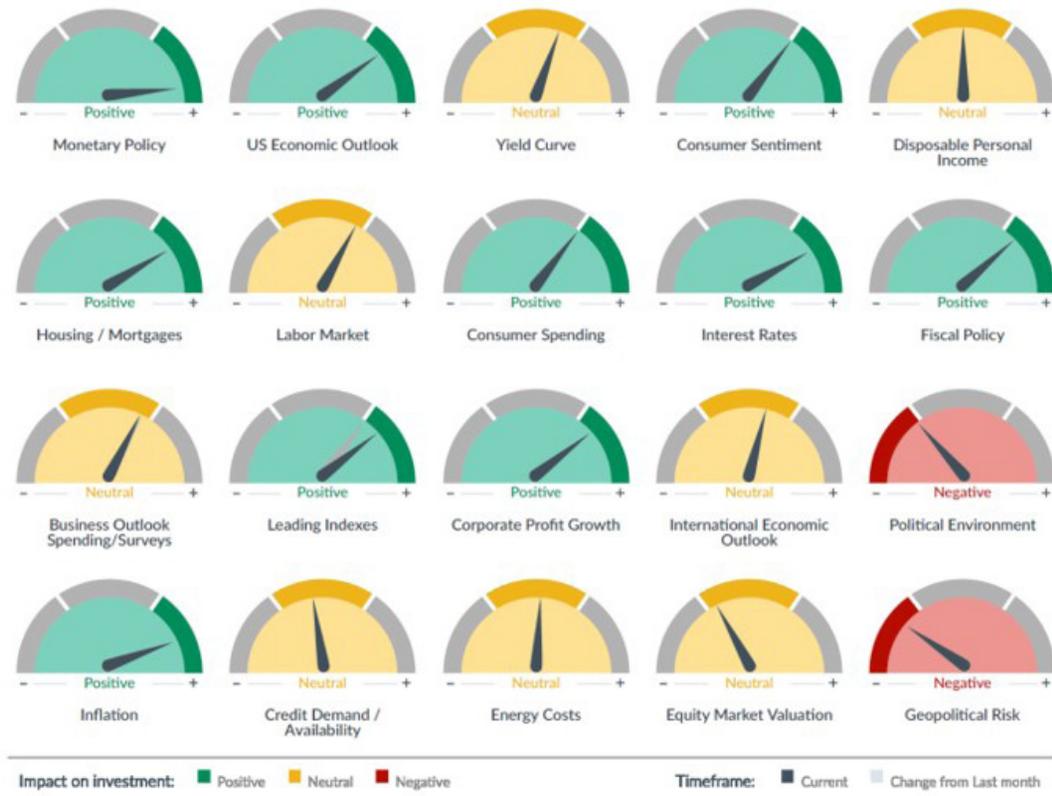
The diagram above is a hypothetical illustration of the business cycle. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one. Source: Fidelity Investments (Asset Allocation Research Team), as of Nov. 30, 2020.

...and forward looking indicators are beginning to turn positive...

Economic and Financial Indicators

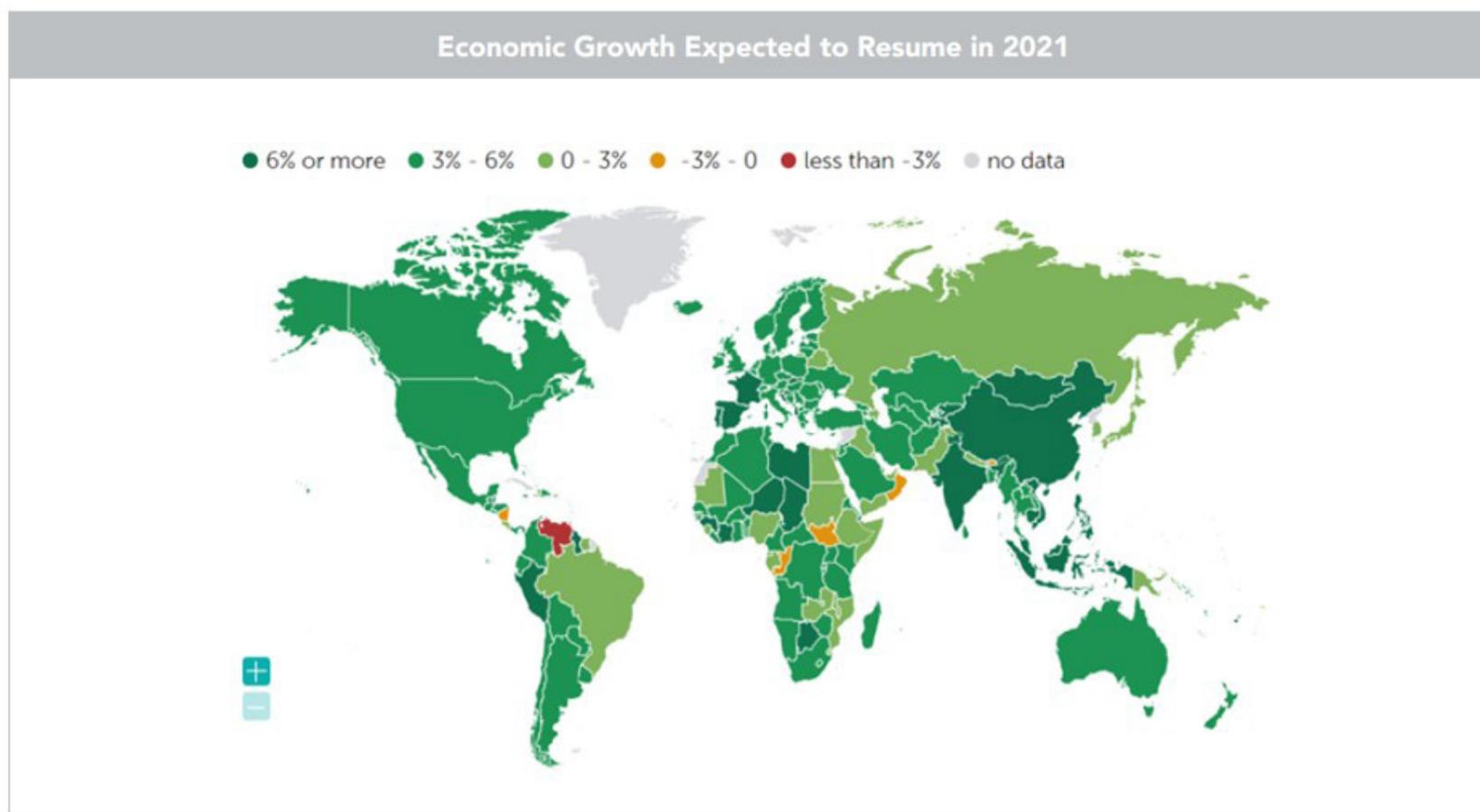
Indicators Are Forward-Looking Six to Nine Months

Indicators are signaling a more entrenched and durable recovery from the COVID-19 crisis developing in the second half of 2021 as vaccine availability becomes widespread.



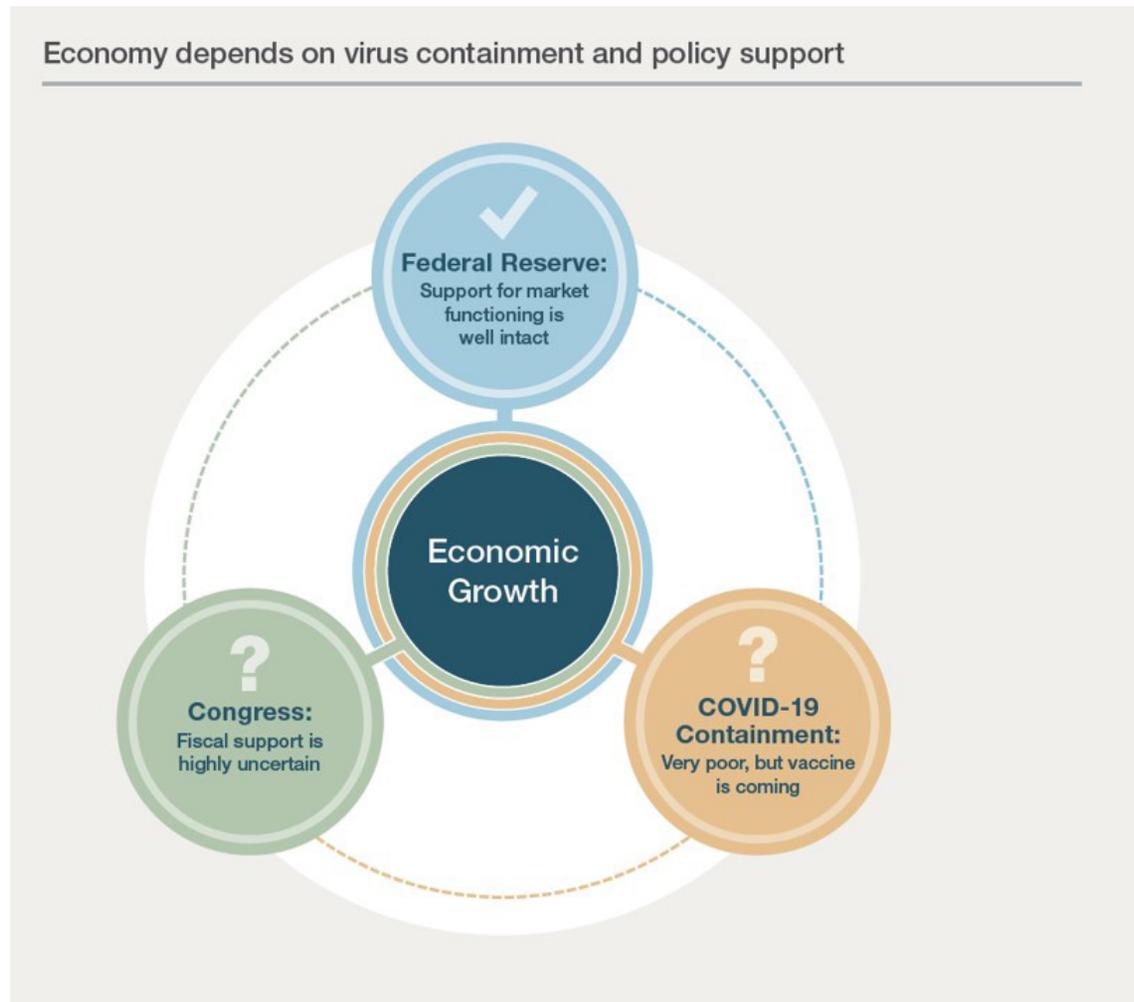
Source: City National Rochdale. As of January 2021.

... and most world economies are projected to grow in 2021.



Source: International Monetary Fund (IMF), as of October 2020.

Continued US economic growth is dependent on COVID containment and continued fiscal and monetary support.



The US Stock market has traded ahead of earnings on optimism of COVID containment...

Market and Economic Chartbook | January 4, 2021



The Stock Market and Earnings

S&P 500 Index price and trailing earnings-per-share since 1990

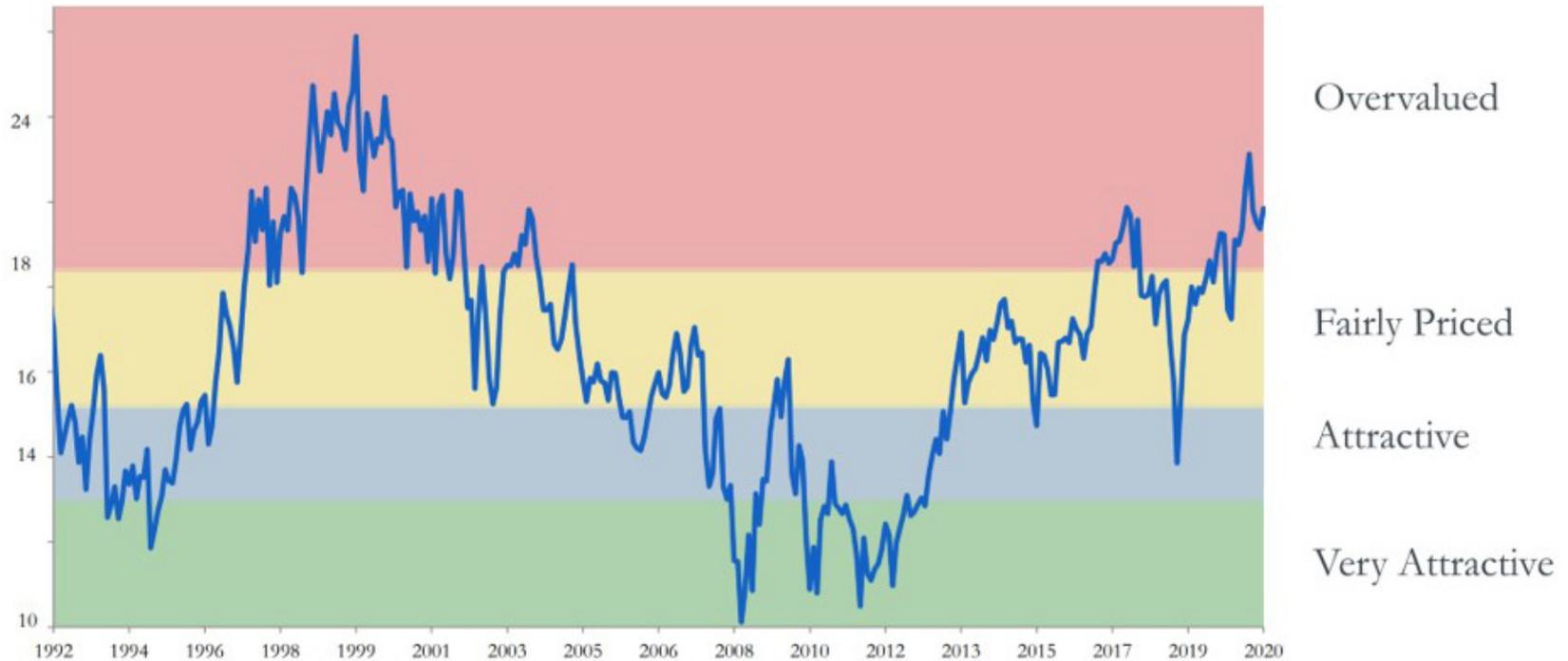


Latest data point is Dec 31, 2020

Source: Refinitiv, Standard & Poor's. © 2021 Clearnomics, Inc.

...so stocks appear at least fully valued...

S&P 500 Forward Price/Earnings Ratio



Source: FactSet, CNR Research as of January 2021.

...and possibly slightly overvalued.

U.S. Equity Market 8% Overvalued

Morningstar U.S Price to Intrinsic Value (P/FV Metric) Heatmap

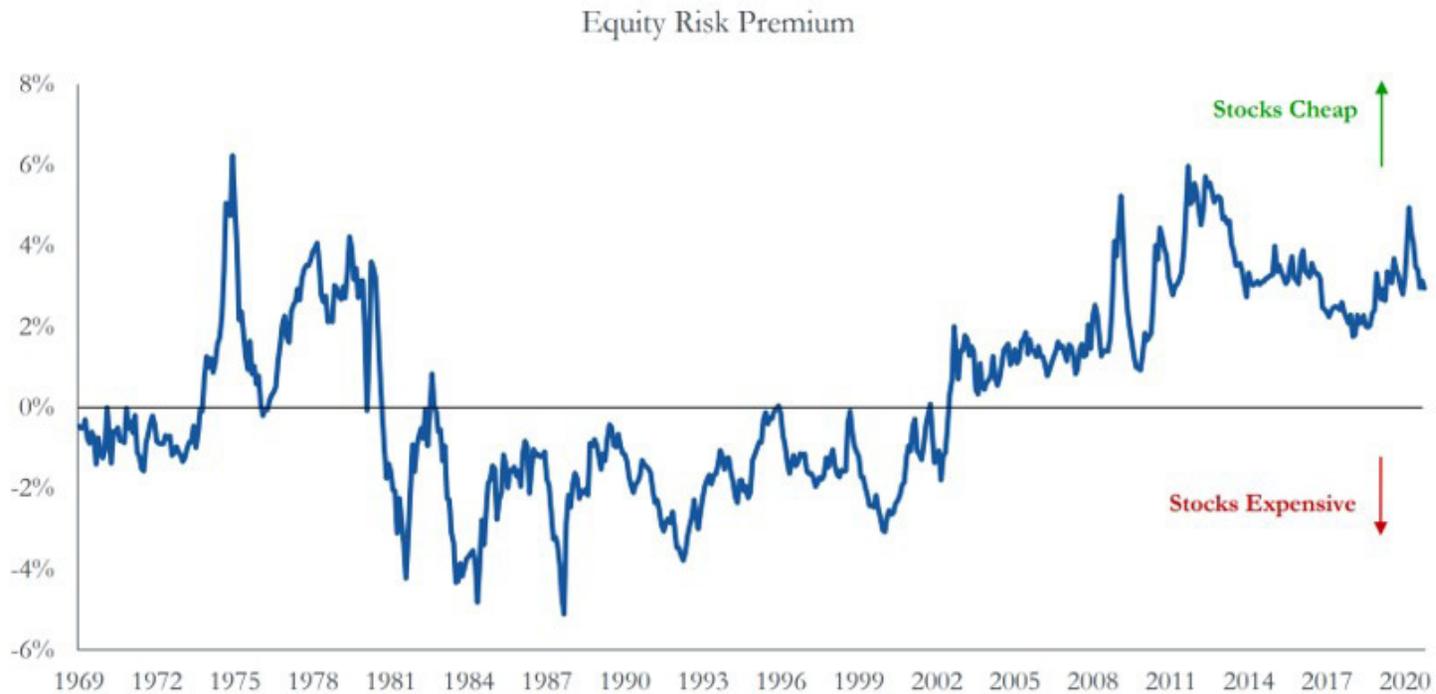
| | All Coverage | Value | Core | Growth |
|-------|--------------|-------|------|--------|
| All | 1.08 | 0.91 | 1.15 | 1.13 |
| Large | 1.09 | 0.92 | 1.15 | 1.12 |
| Mid | 1.06 | 0.90 | 1.12 | 1.28 |
| Small | 0.96 | 0.86 | 1.09 | 1.19 |

Source: Morningstar. Data shown is the price fair value metric as of December 18, 2020.

Past performance is not a reliable indicator of future results and data is presented for illustrative purposes.

However, when compared to bonds, equities look attractive...

Equities Still Look Attractive vs. Bonds



Source: Bloomberg. FactSet.

...particularly with dividend yields higher than average bond yields.

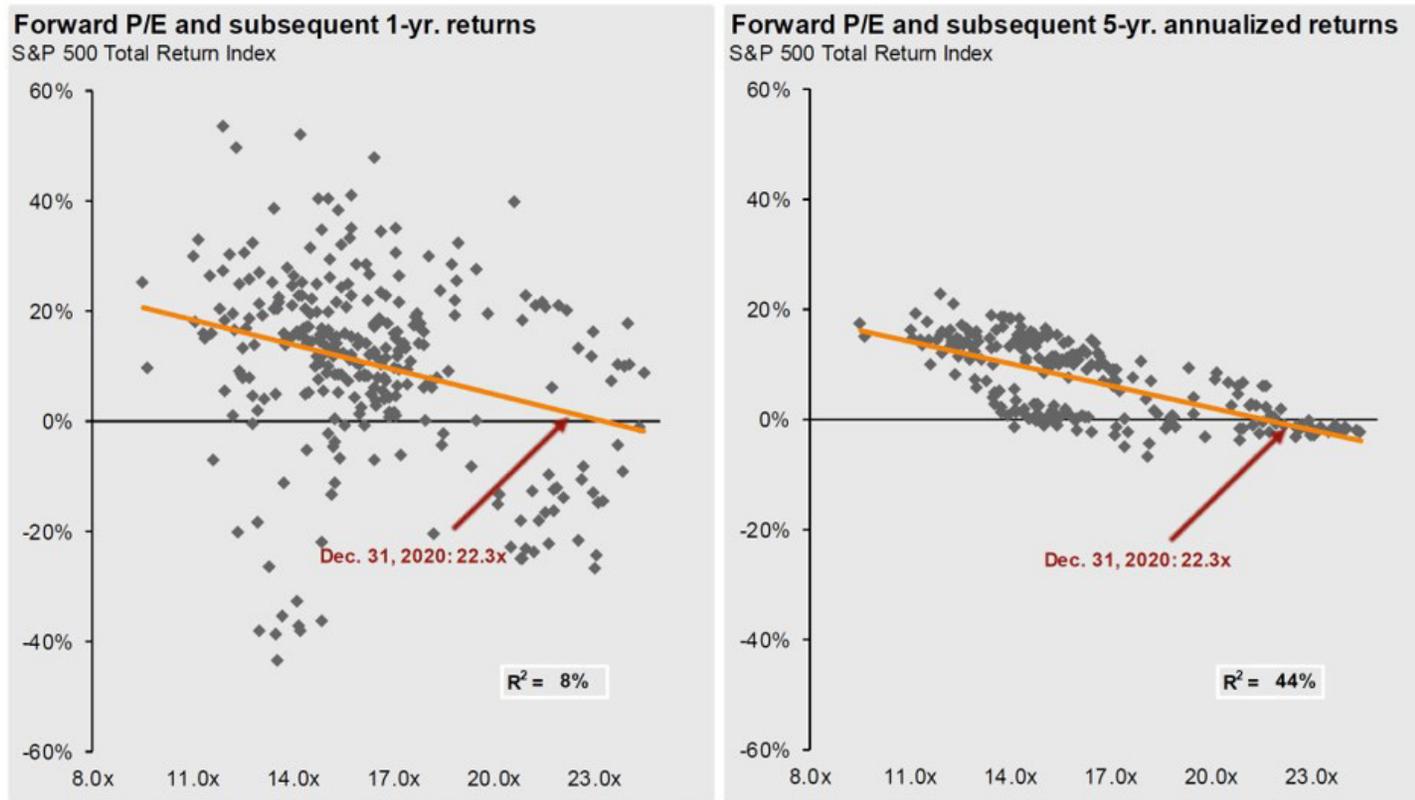
EARNINGS AND DIVIDEND YIELDS VS BOND YIELD

'Earnings yield' is the inverse of the price-to-earnings ratio



Source: Refinitiv Datastream, RiverFront; data weekly, as of 12.3.2020. Chart shown for illustrative purposes only. 'Risk-Free' rate is the theoretical rate of return of an investment with zero risk, which we define by using the 10-yr US Treasury Yield. Past Performance is no guarantee of future results.

Historically, when starting at current valuations, market returns are more muted in the near term.

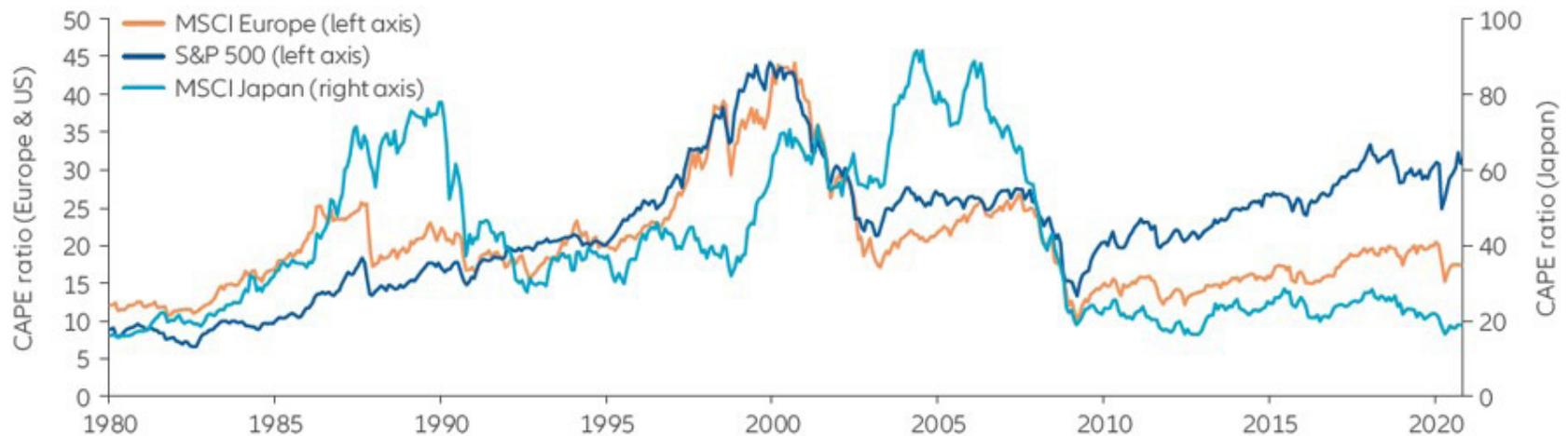


Source: FactSet, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management. Returns are 12-month and 60-month annualized total returns, measured monthly, beginning November 30, 1995. R² represents the percent of total variation in total returns that can be explained by forward P/E ratios. Guide to the Markets – U.S. Data are as of December 31, 2020.

Interestingly, compared to US markets, international equities appear better valued...

Exhibit 1: equities in the US are expensive compared with Europe and Japan

Cyclically adjusted price/earnings ratios (1980-2020)

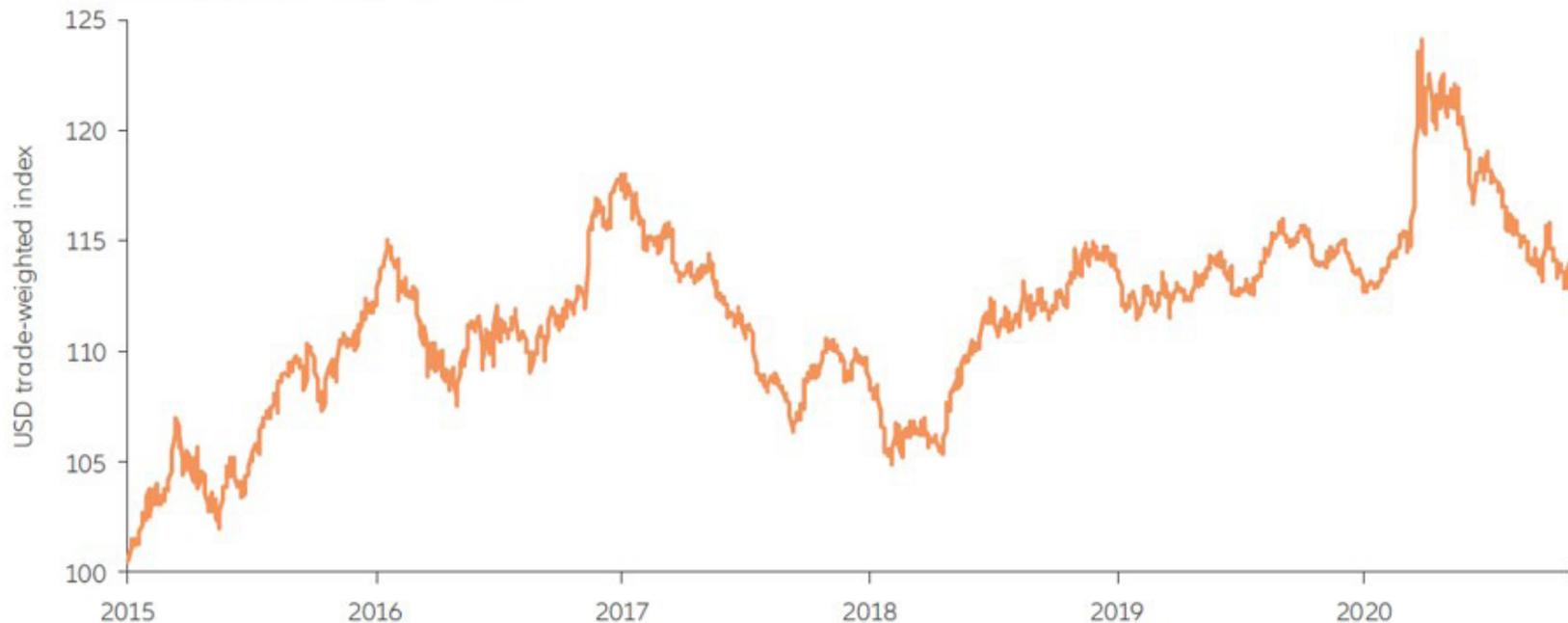


Source: Refinitiv Datastream, Bloomberg, Allianz Global Investors. Data as at November 2020.

... and have currency tailwinds with dollar declining versus other world currencies.

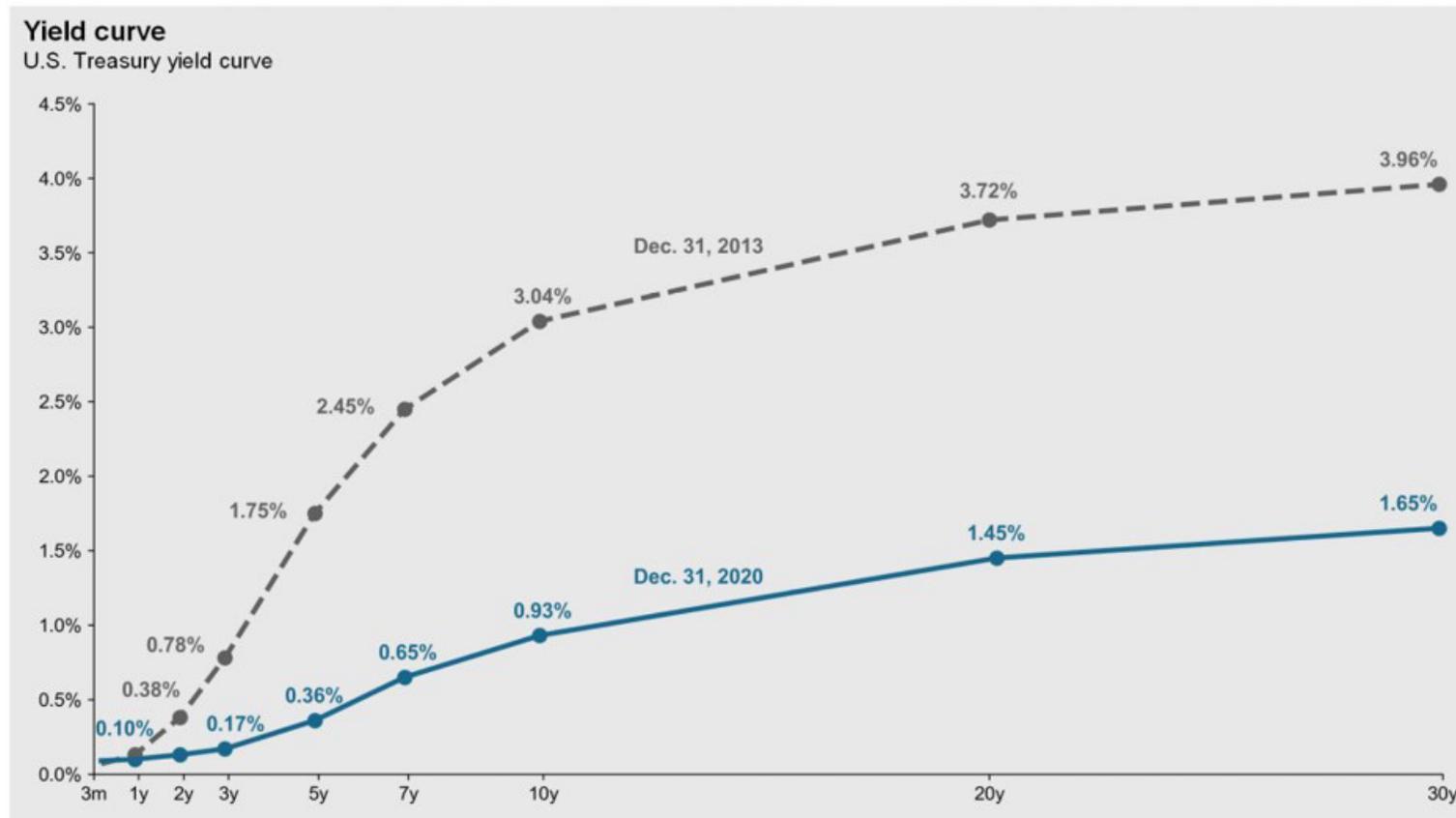
Exhibit 4: the US dollar dropped in 2020 as the global economy recovered

US dollar trade-weighted index (2015-2020)



Source: Bloomberg, Allianz Global Investors. Data as at October 2020.

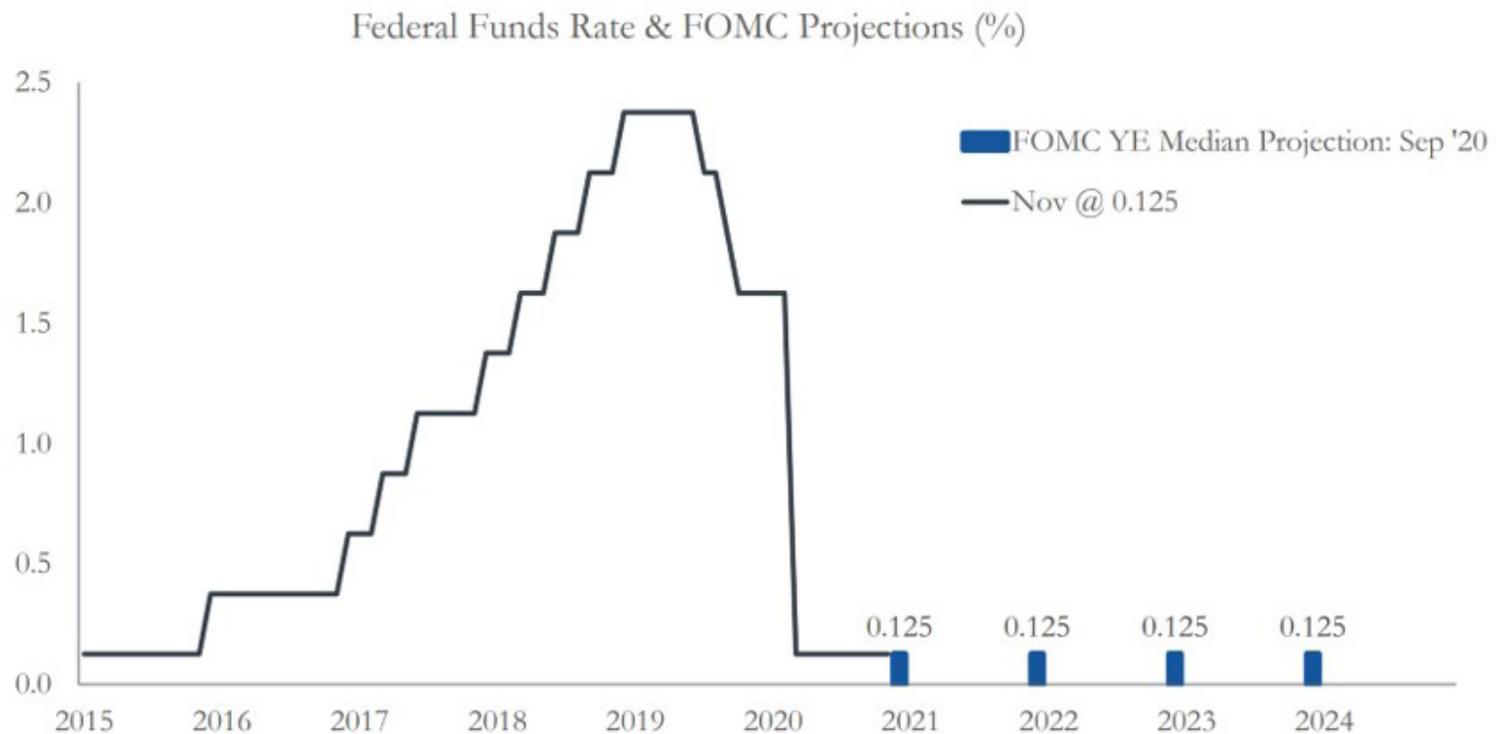
Bond yields continue to shift lower...



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of December 31, 2020.

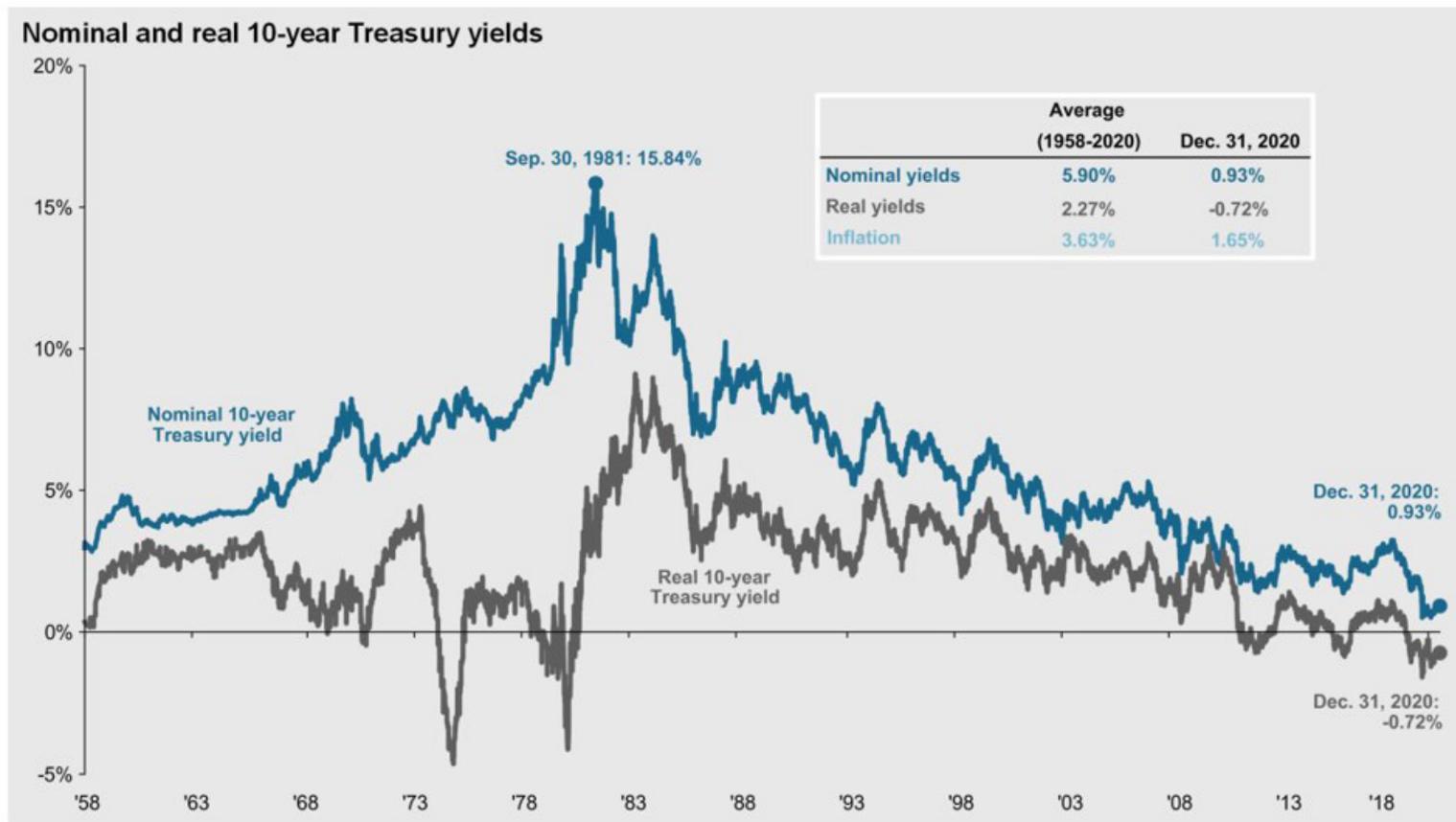
... and the Federal Reserve has proposed to keep rates lower for longer.

- More discretion, less preemption
- New bias to keeping rates on hold well after economic and inflation growth sets in
- Supportive of risk assets — equities and high-yield fixed income



Source: Federal Reserve Bank as of November 2020.

Real Treasury yields after inflation are negative...



Source: BLS, FactSet, Federal Reserve, J.P. Morgan Asset Management.
 Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core CPI inflation for that month except for December 2020 where real yields are calculated by subtracting out November 2020 year-over-year core inflation.
 Guide to the Markets – U.S. Data are as of December 31, 2020.

... as is return on cash equivalents like CDs.

Market and Economic Chartbook | January 4, 2021



Interest Income on Cash

\$100k invested in 6-month CDs against inflation. Actual rates may vary

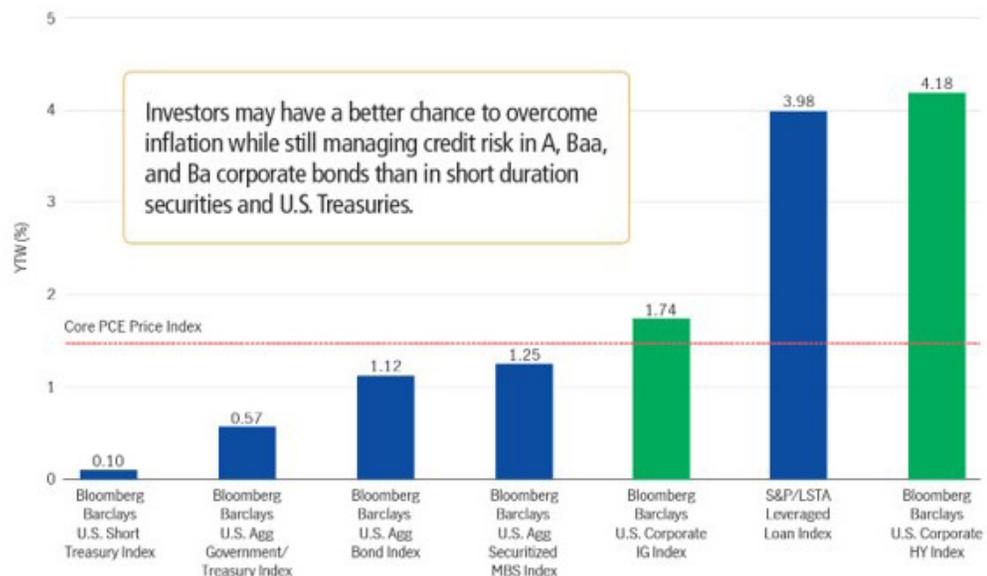


Latest data point is Dec 28, 2020

Source: FDIC. © 2021 Clearnomics, Inc.

Investment grade US Bonds barely outpace inflation rates...

While inflation has been low, many fixed-income yields are substantially lower



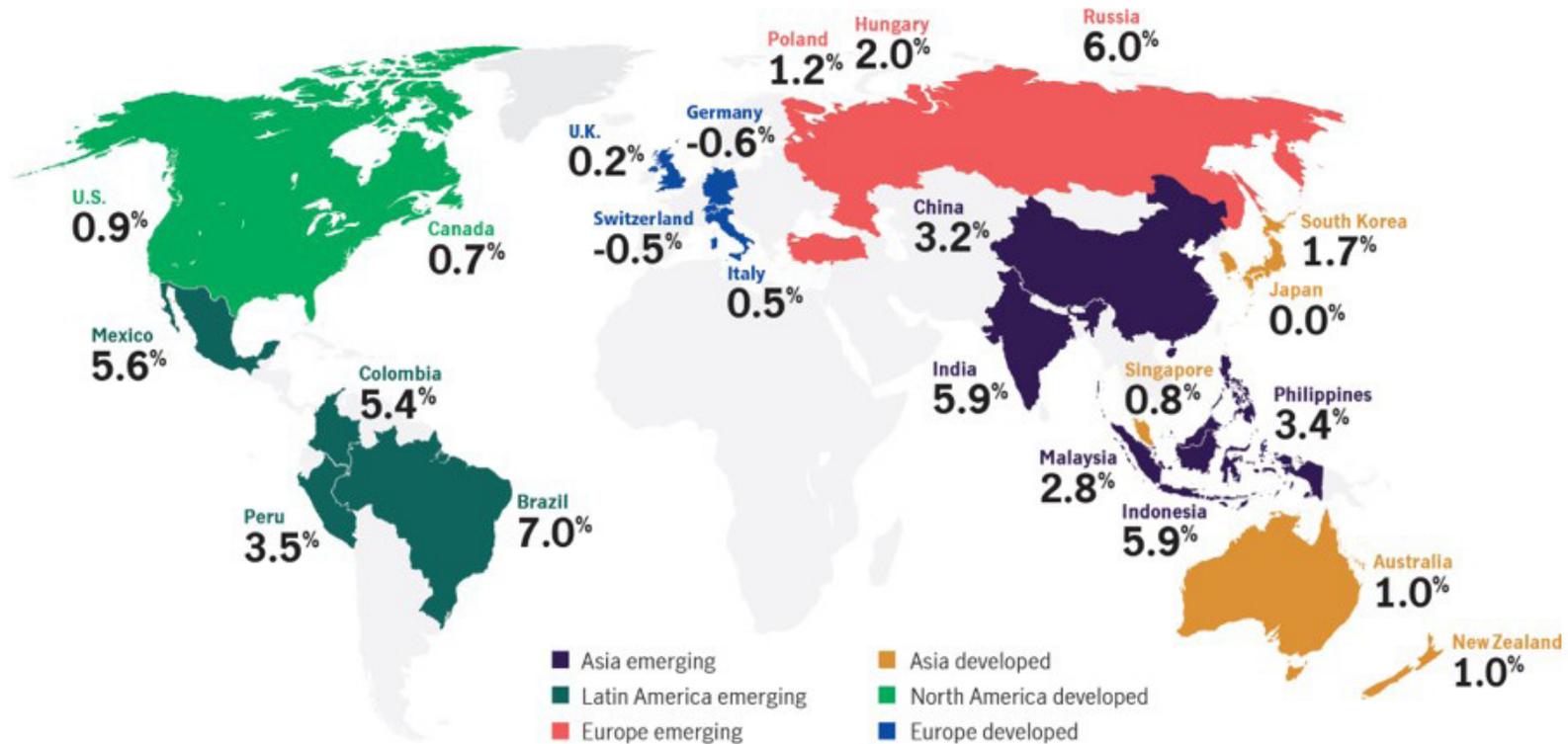
Investors may have a better chance to overcome inflation while still managing credit risk in A, Baa, and Ba corporate bonds than in short duration securities and U.S. Treasuries.

| Moody's rating (Bloomberg Barclays indexes) | YTW (%) |
|---|---------|
| U.S. Agg Corporate (Aaa) | 1.59 |
| U.S. Agg Corporate (Aa) | 1.40 |
| U.S. Agg Corporate (A) | 1.49 |
| U.S. Agg Corporate (Baa) | 2.01 |
| U.S. Agg Credit-Corporate HY (Ba) | 3.21 |
| U.S. Agg Credit-Corporate HY (B) | 4.43 |
| U.S. Agg Credit-Corporate HY (Caa) | 7.12 |

Source: FactSet, Moody's, as of 12/31/20. Moody's ranks the creditworthiness of borrowers using a standardized ratings scale, from Aaa to C, with Aaa being the highest quality and C the lowest quality. Ratings are not meant to be recommendations or a sole basis for investment decisions. The Core Personal Consumption Expenditure (PCE) Price Index measures the prices paid by consumers for goods and services, excluding more volatile food and energy prices. The Bloomberg Barclays U.S. Short Treasury Index tracks the performance of the U.S. Treasury bills, notes, and bonds under one year to maturity. STRIPS are excluded from the index because their inclusion would result in double counting. The Bloomberg Barclays U.S. Aggregate (Agg) Government/Treasury Index tracks public obligations of the U.S. Treasury comprising U.S. Treasury bonds and notes across maturities ranging from one to thirty years. The Bloomberg Barclays U.S. Agg Bond Index tracks the performance of U.S. investment-grade bonds in government, asset-backed, and corporate debt markets. The Bloomberg Barclays U.S. Agg Securitized Mortgage-Backed Securities (MBS) Index tracks the performance of investment-grade U.S. securitized MBS. The Bloomberg Barclays U.S. Corporate Investment Grade (IG) Index tracks the IG, fixed-rate, taxable corporate bond market. The S&P/LSTA Leveraged Loan Index tracks the market-weighted performance of U.S. dollar-denominated institutional leveraged loan portfolios. The Bloomberg Barclays U.S. Corporate High Yield (HY) Index tracks the performance of the U.S. dollar-denominated, HY, fixed-rate corporate bond market. The Bloomberg Barclays U.S. Agg Corporate Index is a broad-based benchmark that tracks the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market. The Bloomberg Barclays U.S. Agg Credit-Corporate HY Index is a broad-based benchmark that tracks the HY, U.S. dollar-denominated, fixed-rate, taxable corporate bond market. It is not possible to invest directly in an index. Yield to worst (YTW) is the lowest potential yield calculated by taking into account an issue's optionality, such as prepayments or calls. Past performance does not guarantee future results.

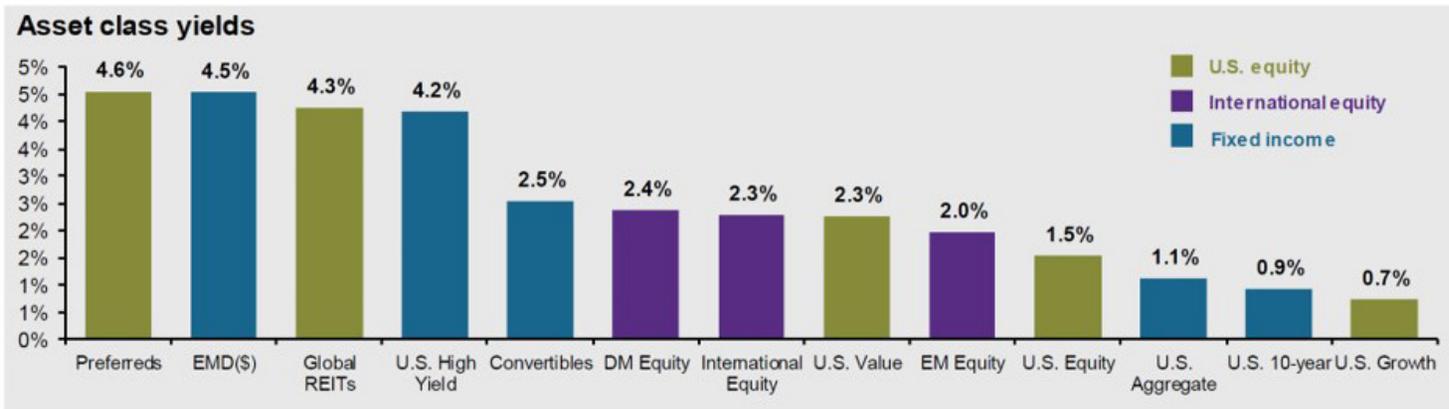
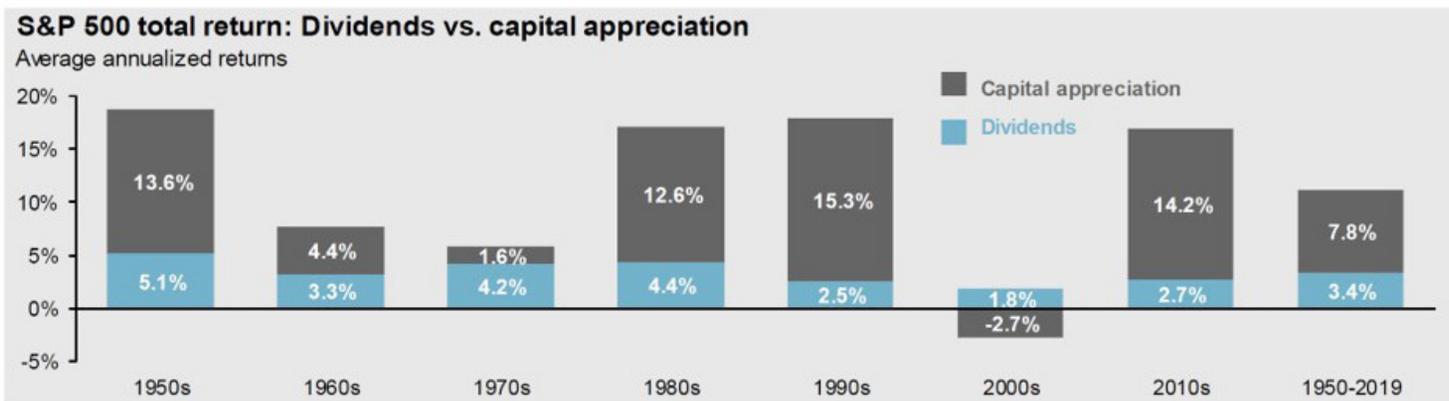
... so widening search for yields to global bonds may make sense.

10-year government bond yields



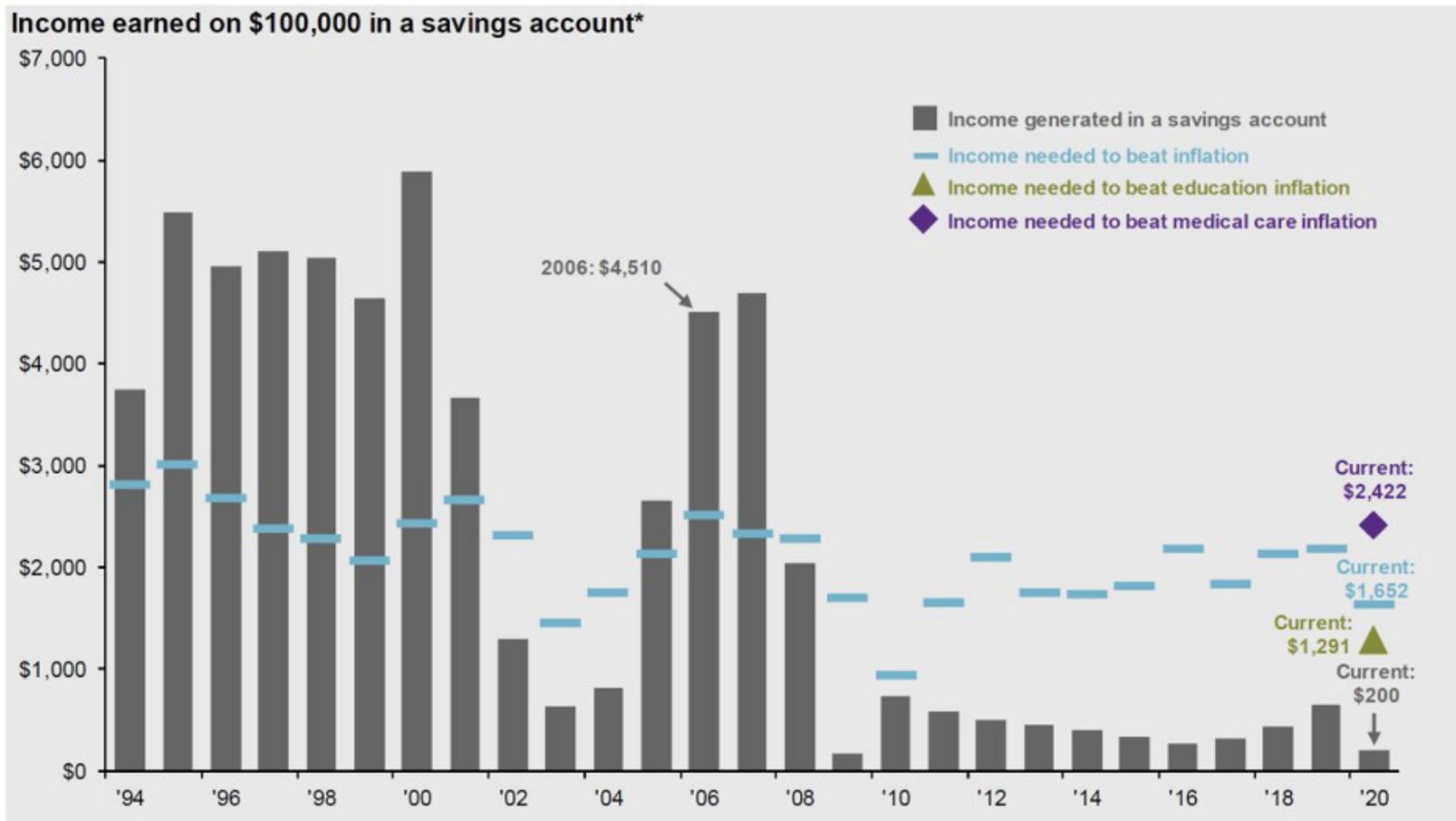
Source: FactSet, as of 12/31/20. Foreign investing, especially in emerging markets, has additional risks, such as currency and market volatility and political and social instability. Past performance does not guarantee future results.

Considering alternative yield sources like dividends and non-core bonds may be necessary...



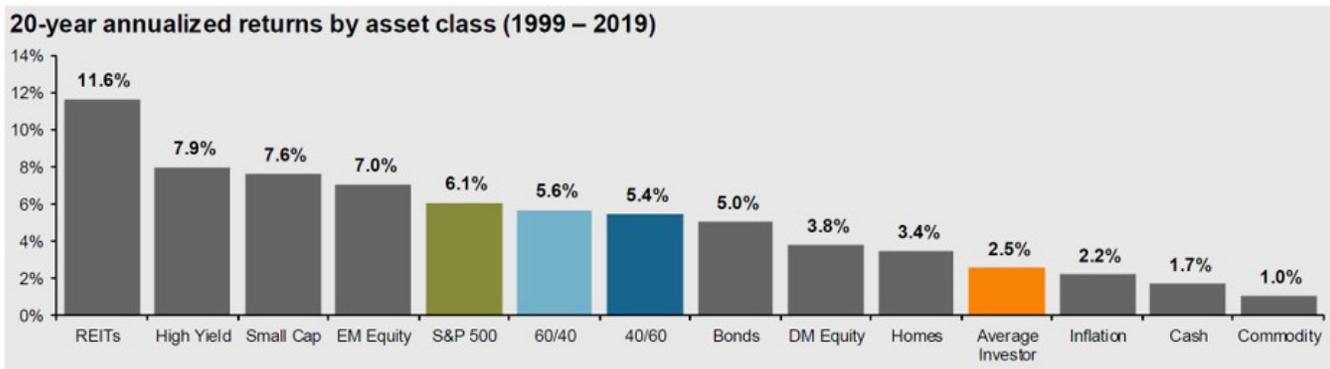
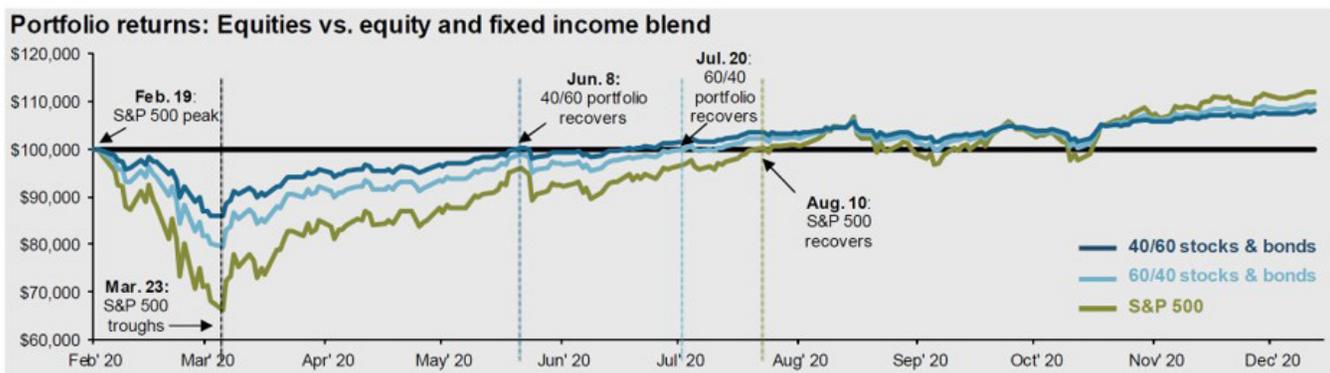
Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management; (Top) Ibbotson; (Bottom) BAML, Barclays, Bloomberg, Federal Reserve, FTSE, J.P. Morgan, MSCI, NCREIF, Russell. Dividend vs. capital appreciation returns are through 12/31/19. Yields are most current. Preferreds: BAML Hybrid Preferred Securities; U.S. High Yield: Bloomberg US Corporate High Yield; Global REITs: FTSE NAREIT Global REITs; U.S. Aggregate: Bloomberg Barclays US Aggregate; EMD(\$): J.P. Morgan EMBIG Diversified; Convertibles: Bloomberg Barclays U.S. Convertibles Composite; International Equity: MSCI AC World ex-U.S.; EM Equity: MSCI Emerging Markets; DM Equity: MSCI EAFE; U.S. Equity: S&P 500; U.S. Growth: Russell 1000 Growth; U.S. Value: Russell 1000 Value; U.S. 10-year: Tullett Prebon. *Guide to the Markets - U.S.* Data are as of December 31, 2020.

...especially if attempting to outpace education or medical care inflation.



Source: Bankrate.com, BLS, FactSet, Federal Reserve System, J.P. Morgan Asset Management.
 *Savings account is based on the national average annual percentage rate (APR) on money market accounts from Bankrate.com from 2010 onward.

Low interest rates may push long term investors further into risky assets than desired, so total asset allocation is important...



Source: Barclays, Bloomberg, FactSet, Standard & Poor's, J.P. Morgan Asset Management; (Bottom) Dalbar Inc, MSCI, NAREIT, Russell. Indices used are as follows: REITs: NAREIT Equity REIT Index, Small cap: Russell 2000, EM Equity: MSCI EM, DM Equity: MSCI EAFE, Commodity: Bloomberg Commodity Index, High Yield: Bloomberg Barclays Global HY Index, Bonds: Bloomberg Barclays U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Cash: Bloomberg Barclays 1-3m Treasury, Inflation: CPI, 60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high-quality U.S. fixed income, represented by the Bloomberg Barclays U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31/19 to match Dalbar's most recent analysis. *Guide to the Markets – U.S.* Data are as of December 31, 2020.

... as is diversification among various asset classes!



Portfolio Implications

The vaccines, easy financial conditions, and stimulative fiscal policy are all reasons for our optimism for society, the economy, and markets looking ahead. The likelihood of widespread vaccine distribution supports the case for a cyclical economic recovery beginning in the second and third quarter of 2021. Central bank monetary policy is almost certain to remain very accommodative for at least the next year or two. And fiscal policy is unlikely to be restrictive and could be stimulative, depending on political outcomes. This macro backdrop should be supportive of equities and other financial risk assets, at least for the next year.

U.S. stocks have high absolute valuations. But U.S. stocks don't look expensive relative to extremely low bond yields. On the other hand, non-U.S. stock markets, emerging-market stocks in particular, are more attractively valued and have much higher five-year expected returns than U.S. stocks. Currency is another potential tailwind for non-U.S. stocks over U.S. stocks. If the dollar continues to decline, U.S. investors in non-U.S. stocks will earn a currency return on top of any equity return.

As always, there are numerous risks to be aware of in the coming year. Unexpected shocks can happen at any time, whether a jump in inflation, domestic political dysfunction, geopolitical conflict, or trade

disputes. Financial market history teaches us to expect the unexpected and expect to be surprised.

We work to position portfolios for the base-case cyclical recovery from the global pandemic, but our positioning always incorporates a wide range of potentialities. We think in terms of multiple plausible scenarios, not in point estimates and dramatic binary bets. Should a less sanguine outcome occur, we have investments in the portfolio that can offer downside protection. And we are prepared to prudently, but opportunistically, respond as events unfold as we did in 2020.

The market has always exhibited dramatic mood swings, whipsawing investor sentiment, and 2020 was no different. We recommend investors ignore the crowd's actions completely and "stay the course." While it's a cliché in the investment business, that advice proved prescient this past year.

We've seen countless studies of unguided investors selling their stock exposure near the market bottom, then reinvesting as markets stabilized or fully recovered—the investor sentiment "whipsaw" effect that we often warn about. Instead, one should be greedy when others are fearful. A disciplined approach allows investors to do just that.

Disclosures

Please remember that past performance may not be indicative of future results. Therefore, no current or prospective client should assume that the future performance of any specific investment, investment strategy (including the investments and/or investment strategies recommended by the adviser), will be profitable or equal to past performance levels.

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