INVESTMENT STRATEGY OUTLOOK

THE ECONOMY

January 2021

2021 Just Has To Be Better. Doesn't It?

A year that will be neither missed nor forgotten. That's about the best, not to mention the most charitable, way we can describe the year that was 2020. While the calendar may say 2020 is over, it isn't really, at least in terms of the economic and financial impact of the COVID-19 virus and the efforts to stem its spread. Still, if the calendar says that it's a new year, that means it's time for us to look ahead at how we see the U.S. economy faring in the year ahead. After the experience of 2020, however, the natural question might be "why even bother?"

While we've always thought it important to hold ourselves accountable for the calls that we make and have always been open about doing so, when it comes to 2020 the reality is that there is nowhere to hide from forecasts made at the start of last year. Okay, sure, if your 2020 outlook included a global pandemic, the largest quarterly contraction in real GDP on record followed by the largest quarterly expansion on record, nonfarm employment plummeting by over 22 million jobs and the unemployment rate spiking to almost 15 percent, an epic decline in stock prices followed by new record highs, and the FOMC pushing the Fed funds rate back to zero, then you had yourself a very good year. The rest of us, not so much.

In what follows, we'll highlight what we see as some of the main economic themes of 2021 but will dispense with making detailed predictions. This isn't so much a reaction to having our (forecasting) hat handed to us by 2020. Instead, our not laying down specific markers reflects what remains a high degree of uncertainty around the course of the pandemic, progress on a vaccine, and the path of policy. As such, any forecasts we do make come with a lower degree of confidence than is typically the case.

Though Q4 2020 GDP data are not yet available, we're looking for annualized growth of better than 4.0 percent, which would mean for full-year 2020 real GDP contracted by 3.5 percent. Our January baseline forecast, shrouded in uncertainty, anticipates real GDP growth of 3.8 percent in 2021 and 4.3 percent in 2022. While the pandemic continues to act as a significant drag on the U.S. economy as 2021 begins, it is reasonable to expect the economy will be performing much more strongly by year-end.

When specifically growth will begin to accelerate will depend on when a vaccine will be widely available, the willingness of people to take the vaccine, when policy makers will be confident enough to lift remaining restrictions on activity, and whether there have been permanent changes in attitudes and behaviors. No one knows the answers to these questions so, while financial conditions will be in place for there to be a significant acceleration in the pace of economic growth, we cannot say with any certainty when such a transition will take place. We do think a late-Q2/early-Q3 window the most likely timing.

Inflation seems to have faded into the background in 2020, but don't be surprised by a "spike" in inflation in early 2021. Easy over-the-year comparisons for March and April – thanks to prices having tumbled in those months last year – will make inflation look faster than will actually be the case. More fundamentally, should spending on services pick up over 2H 2021 as we expect, that will likely lead to spikes in prices of services such as travel, lodging, recreation, entertainment, and perhaps also dining out. This would fuel a spike, perhaps a significant spike, in measured inflation, but what would matter is whether any such price hikes were one-off adjustments to more normalized demand or whether there were sustained price hikes over time, with the former much more likely than the latter.

Prices for consumer goods were bolstered in 2020 by a strong rebound in consumer spending on goods and a weaker U.S. dollar. Each could be supportive of further increases in goods prices over the course of 2021, though we think stronger growth in consumer spending will be the more persistent support. Additionally, if fiscal policy becomes even more expansionary, as we expect will be the case, that could be a source of additional inflation pressures, but any such effects are likely to be more pronounced later in the year. In short, even though it seems highly unlikely that inflation will rise high enough or stay there long enough for the FOMC to respond in 2021, it seems reasonable to expect inflation to pick up this year.

As for the U.S. dollar, by the end of 2020, the "short the dollar" trade was a very crowded place to be. Sentiment towards the dollar shifted markedly during the year, to the point that while the Federal Reserve's Broad Dollar Index ended 2020 5.5 percent below its year-end 2019 level, it ended 2020 12.3 percent below its intra-year peak. In the early phases of the pandemic, the "haven trade" pushed the exchange value of the U.S. dollar sharply higher. By year-end 2020, however, the prospect of a recovery in the global economy in 2021, an even more accommodative FOMC, and the prospect of substantial U.S. federal government budget deficits on a sustained basis had turned sentiment against the dollar, with expectations of further declines in the exchange value of the U.S. dollar in 2021. That said, we think sentiment on the dollar has become too negative and expect that at some point the dollar will at least begin to stabilize and more likely will begin to reverse some of its recent declines. Whether or not this happens will have implications for inflation, commodity prices, corporate earnings, and interest rates.

A key source of uncertainty around our 2021 outlook is how the policy landscape will change. In short, there are likely to be significant changes in fiscal, trade, and regulatory policy, but without yet having specific details and a specific timeline, there is no way to account for them in our January baseline forecast. That said, we expect fiscal policy to be more expansionary, regulatory policy to be less business-friendly, and trade policy to be more collaborative, with the specifics emerging in the months ahead.

Clearly, there is no shortage of uncertainty around the outlook for the economy in 2021. As such, while we think we have reasonable expectations as to how the year will evolve, it's hard to have a high degree of confidence in any calls we make at this point. After all, the main lesson from 2020 was be prepared for anything, even things we've never seen before. Somehow, we can't help but think that 2021 is going to present us with a test of whether we learned the main lesson from 2020. ▲

Source: BEA; BLS; Federal Reserve

STOCKS

Looking Back, Then Forward

All things considered, 2020 proved to be nothing short of a remarkable year for equity investors. Large-cap U.S. stocks (S&P 500) finished the year higher by 17.6% on a total return basis, and were outpaced by small-cap stocks, as the Russell 2000 rode a parabolic fourth quarter rally to a 20.2% total return for the full year. Abroad, emerging markets were a relative winner, the MSCI EM index rising 18.5% on the year, pulled higher by 20%-plus gains out of South Korea, Taiwan, and China, which combine to make up over 66% of the emerging markets index. Developed international markets also posted a positive return but lagged domestic and emerging market stocks, broadly speaking. The MSCI EAFE ended 2020 up by 7.8% as gains out of Japan and Germany, which account for almost 35% of the EAFE, offset a double-digit decline out of the United Kingdom and lackluster returns out of France, Spain, and Italy, among others. Notably, Japan's Nikkei 225 index traded at an all-time high to close out 2020, which could lead to interest from momentum investors over the course of the coming year.

The rally in stocks from the March low through year-end was driven by unprecedented fiscal and monetary support provided by governments and central banks globally. In the U.S., cash sent to consumers intended to bridge the gap between the economic shutdown and an improved employment picture found its way into the stock market. Purchases of epicenter stocks, those most negatively impacted by the economic shutdown, and upside call options skyrocketed as day traders picked up the baton while institutional investors moved to the sidelines awaiting clarity on the economic path forward. But even as "reopening" turned

into "reclosing" stocks barely noticed, powering to a new all-time high in early September. After trading in a wide range throughout October, in the wake of the election, the removal of political uncertainty allowed the S&P 500 to rally 11.8% from election day (November 4) through year-end, while the small-cap Russell 2000, fared even better, spiking 22.6%.

We expect the new year to be another profitable one for equity investors, driven by a combination of ultra-easy monetary policy out of global central banks, increased fiscal support, and global economic momentum spurring investors to take 'risk.' Stateside, smaller capitalization stocks could outpace large-cap stocks as small and mid-cap indices skew toward economically sensitive sectors poised to benefit as economic tailwinds build. Small caps led the Q4 2020 rally and were overbought at year-end. Excesses have been building and may need to be worked off either via the passage of time or pullback in price before the upward trend resumes. Expected return alone shouldn't drive decisions surrounding large vs. SMid allocations, as drawdowns can be unsettlingly swift farther down the market cap spectrum. Great expectations are worth noting entering 2021 as S&P 500 earnings are projected to grow from an estimated $135 in 2020 to $165 in 2021, a 22% increase, while Russell 2000 earnings are expected to jump 141%. While we are constructive on domestic stocks, lofty expectations, bullish sentiment, and aggressive positioning/asset flows could spark a pullback in the 1st quarter. We favor small/mid-caps relative to large caps in the coming year but await a pullback before allocating additional capital there as small caps appear overbought and may need to work off some froth.

Abroad, the consensus view is decidedly bullish on the emerging world as developing markets provide greater leverage and potential upside should a global economic recovery take root. A weaker U.S. dollar is a tailwind, on balance, for developing economies, many of which import commodities priced in U.S. dollars. While we tend to side with the bull case for emerging markets in the coming year, we are mindful that rising regulatory risks in China could potentially derail the bullish thesis as investors may think twice about how much exposure to China is too much. On Christmas Eve, China's government announced a probe into anti-competitive practices by Alibaba, the 2nd largest holding within the MSCI EM index. The investigation is viewed as a retaliatory measure for comments Alibaba founder Jack Ma made months prior related to outdated regulatory oversight provided by the Chinese government. The announcement of the probe and subsequent sell-off in Alibaba's stock is a reminder of who is in charge in China, and if one of the country's 'national champions' can be in the crosshairs, no company is safe.

Economic growth expectations for the Eurozone and Japan are far from lofty and valuations aren't demanding, setting up a potentially attractive risk/reward scenario for international developed markets in the coming year(s). Monetary policy support from the European Central Bank (ECB), relatively attractive valuations, and investors remaining underexposed to developed international markets after a 'lost decade' could generate increased demand for European and/or Japanese equities. The MSCI EAFE index that tracks international developed market stocks has generated a total return of just shy of 71% since the end of 2010, which pales in comparison to the S&P 500's total return of nearly 267%. The significant underperformance out of the EAFE versus U.S. large caps over the past decade combined with expectations of a synchronized global economic recovery taking hold leads us to conclude that a drastic underweight to international developed markets isn't as easily justified. ▲

Source: Bloomberg, Factset

BONDS

Another (Relatively) Good Year For Credit Ahead

Investing is a relative exercise, with opportunity costs and trade-offs inherent in every decision made. Thankfully, although not encouragingly, rarely do we see an opportunity set holding so little appeal from a risk/reward perspective than what is available across the fixed income spectrum at present. Both 10- and 30-year U.S. Treasury yields spent the month of December mired in a tight trading range, remaining relatively resolute despite economic data, broadly speaking, consistently falling short of expectations during the month. In our view, long-dated Treasury yields appear poised to break out to the upside early in 2021 as vaccines are disseminated, spurring a return to 'normalcy' as higher government spending leads to wider budget deficits while buoying economic growth expectations. Long duration Treasury bonds have historically played a key role in limiting drawdown for equity-heavy portfolios in adverse market environments with yields falling/prices rising as stocks sell off. But, given our expectations of a global economic recovery taking root in the new year larger government budget deficits, the Federal Open Market Committee (FOMC) remaining firmly on the sidelines,, and what could be rising inflation expectations, sizable allocations to Treasuries could prove problematic for portfolios in 2021.

Investors in long-dated Treasuries receive very little compensation (yield) for taking on interest rate risk, and even after a 9.7% total return in 2020 for the Bloomberg Barclays U.S. Corporate index, investors will likely continue to flock to investment-grade corporates as a higher yielding substitute with implied backing provided by credit and lending facilities put in place by the Fed and Treasury. The U.S. Corporate index is made up of relatively higher yielding securities with lower durations, broadly speaking, and if they are good enough for the Fed to purchase for its own balance sheet, investors should remain willing to move farther out on the risk curve to clip a higher coupon and achieve a higher expected total return.

Fixed income investors find themselves in an unenviable position as 2021 begins with high hopes for a global economic recovery potentially pushing the long end of the yield curve higher as economic growth and inflation expectations are ratcheted upward. Yields on Treasuries and investment-grade corporates are low across the board while interest rate sensitivity is high, leading us to expect a more volatile year ahead for portfolios heavily allocated toward the highest quality fixed income instruments. The temptation to reach for yield is likely to build over coming quarters, but with even the Bloomberg Barclays High Yield index carrying a yield-to-worst (YTW) of just 4.1% at year-end, investors must temper return expectations as 2021 is likely to look very different than 2020 and the past half-decade. We maintain a preference for investment-grade corporates relative to Treasuries but expected total return out of investment-grade corporate bonds likely won't be anything to write home about over the next year either. Our high yield allocation remains neutral or in-line with our long-term strategic target to the sub-asset class. U.S. dollar denominated emerging market debt continues to hold appeal as a potential beneficiary of continued U.S. dollar weakness and due to a higher expected total return profile over the next 7-10 years, but drawdowns can be sharp, and exposure should be monitored and well understood. ▲

Source: Bloomberg, Factset

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