First Look 2021: Changes Are Coming; Consumers Increasingly Optimistic

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While domestic equity markets are once again near all-time highs, along with a hot housing market reminiscent of 2005, America stands at the edge of a great precipice.

The global pandemic has rocked global commerce, sentiment and social stability. At minimum, it has triggered cultural, economic and technological reverberations sure to last for years to come — with psychological impacts likely bigger than the Great

Recession.

As winter sets in the Northern Hemisphere, a resurgence of cases have once again sparked fears for health, safety and fiscal stability as COVID-19 adds to the seasonal strain of a typical cold and flu season in a very atypical way. As this is being written, several states and nations have reverted to strict curfews to control the spread as record amounts of Americans are being diagnosed with COVID-19.

But isolation, social distancing and mask wearing are getting much needed relief as two coronavirus vaccines, with greater than 90% efficacy, have now been approved for use in the states. Both Pfizer-BioNTech and Moderna have gained the FDA's emergency blessing and began distribution of millions of doses to frontline personnel and the most critically in need (with more groups soon to follow). Despite the rapid deployment, and promise of hundreds of millions of inoculations by spring, many experts still do not see a return to normalcy until fall 2021, at minimum. Around the world, dozens of other vaccines are currently being developed and even distributed, adding to what seems to be a sense of growing optimism that we are finally nearing the end of what's been a debilitating scourge. But with a still limited number of doses available, there are many more humans in need than supply. We believe that these supply issues will be alleviated over the next few months as other global vaccine producers gain approval and begin distribution.

Domestically, a new administration will take control on Jan. 20, with fresh policies, ideas and messaging. The full effects of the transition aren't likely to be realized for several quarters but have regained fresh momentum after the recent surprise upsets in both of Georgia's runoff elections, which have tilted control of the Senate to the democrats. Biden has telegraphed a willingness to compromise and unify, but with its narrow control of the senate, the administration will find it easier to advance much of its agenda. In the near term, this is likely to mean more aggressive stimulative action, subsidies for certain sectors like clean energy, and other high-priority items that include repealing some of the 2017 Trump tax cuts. The longer-term effects are more of an unknown, and Biden will still face a very tight congressional body unlikely to rubber stamp new legislation outside of any executive orders. Given those factors, bond markets are now pricing in higher inflation as the 10-year rose above 1.08%, its highest level since March.

The new administration, along with the Fed, Treasury and public at large, will have to get even more creative in their quest to overcome virus-related economic sluggishness in the coming year, as an unprecedented amount of money and bipartisan legislation has already been dedicated to the pandemic; there are fewer arrows left in the quiver. The White House is also likely to face greater challenges in providing stimulus, given the magnitude of what's already been provided, but the need remains great for many Americans and the latest messaging seems to suggest another direct payment to consumers may be on the way. Unemployment remains elevated and GDP continues to be under pressure, but we believe that the quick deployment of vaccines, coupled with good old-fashioned American resilience, will help continue to support equity valuations and a snapback in economic growth, particularly during the latter part of the first half of 2021. We expect full-year 2021 GDP growth could likely surprise to the upside relative to the current consensus estimate for 3.8% annualized growth.

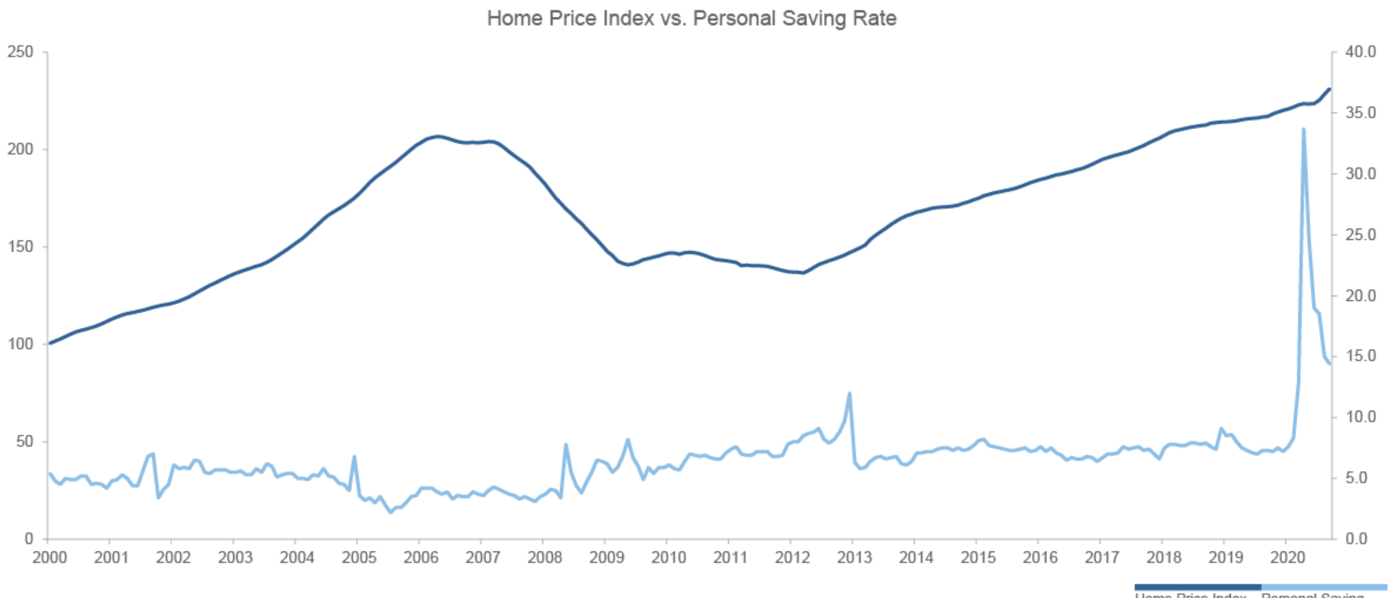
Some Perspective on Last Year's Events

By the end of 2019, stocks were making record highs and investors had just begun to express concerns over COVID-19 risks. Most could not yet fathom the severity of the pandemic, nor the social and economic ramifications that followed. Equities and the economy continued on their record run until the first quarter of 2020, but hit a proverbial brick wall as the coronavirus revealed its potential for havoc. The virus had spread quickly from China into nearly every developed nation on Earth, triggering unprecedented government responses including massive lockdowns, grandiose fiscal stimulus packages, moratoriums on evictions, and other novel solutions to keep many fragile economies from collapse while researchers scrambled to develop a standard treatment or cure. During the first two quarters of 2020, vast commercial and industrial shutdowns, coupled with unprecedented government interventions, made it near impossible for analysts to model what future earnings might be given the uncertainty.

By mid-year, the S&P 500 had already suffered the worst quarter since 1928, falling 19.6%. The government-ordered shutdowns and shelter-in-place orders overwhelmed many businesses, with several having to shut their doors permanently or completely rethink their core strategy. U.S. equity markets (S&P 500) dipped to three-year lows early in the crisis as traders and investors reassessed the potential longer-term effects of the coronavirus. Scenes of empty metropolises, highways, and the sweeping transition to digital learning and online work triggered windfalls for tech companies like Zoom, Microsoft, Facebook and Google, while large real estate operators, transportation companies, dine-in restaurants and others (to name a few) experienced pain not seen since the Great Recession.

But as we discussed in our Mid-Year Update, the sharp decline in equity values, GDP drawdowns and even unemployment, appeared to be mostly transitory as all mentioned have experienced notable, though uneven, recoveries as the pandemic lingers. During the course of 2020, many Americans entered a hyper-safety mode of living, driving the personal savings rate to a record of near 35%, when 7% to 8% had been the average since 2013.

Consumers forced to work from home made big investments in housing and home remodeling, driving the prices of building materials higher late in the year and real estate values to their highest levels ever, even as unemployment remains elevated. We expect continued strength in the housing market as supply remains limited and remote work, even partially, is likely to be a continuing trend for many American workers.



Source: Federal Reserve Bank of St. Louis. As of Sept. 1, 2020.

We enter 2021 with a sense of optimism and a desire to get back to the little things that make us happy. Investors should realize that there will be a shift in market dominance to those businesses who were best prepared to deal with the blow of the pandemic and those ready to capitalize on a post-pandemic recovery and a new administration with drastically different policies than the previous.

Dollars, Rates and Debt

Given the immense amount of fiscal, monetary and policy stimulus flowing from multiple angles, the U.S. dollar has been on a mostly bearish trajectory against most major currencies throughout much of the year, but given the similar actions by many of our trade partners, the U.S. Index is still firmly above its Great Recession lows. The pressure on the U.S. dollar can also be attributed to improving global outlooks and more stable trade policies. We expect the global economic landscape to continue to improve, adding to modest dollar weakness relative to our trading partners. If the dollar continues to weaken, it will be a sign that the global recovery is occurring, not that the world has all of a sudden turned on the greenback as the global reserve currency. In the grand scheme of things, the trade-weighted U.S. Dollar Index is closer to a 40-year peak than trough.

Source: Federal Reserve Bank of St. Louis. As of Dec. 18, 2020.

Adding to near-term dollar pressure and supporting increasing debt is the fact that the Federal Reserve has made it abundantly clear that it will do everything within its power to keep rates low until the economy has seen substantial and sustained recovery — at least until 2022. The Fed has held off (for the time being) on its longer-term bond purchases, which tend to drive mortgage rates lower, as those rates are already at all-time lows. The 10-year note yield currently stands at 0.94%, dropping below the key 1% mark in early March. Those tactics are not completely off the table if an anticipated recovery doesn't pan out or if new challenges arise.

Based on her track record, incoming Treasury Secretary Janet Yellen is likely to support hyper-accommodative policies in her new role as the administration's economic consigliere. Again, the closely split Congress, which has become more common in recent times, may prohibit dramatic action unless another crisis emerges that requires swift bipartisan action.

Source: Federal Reserve Bank of St. Louis. As of Dec. 24, 2020.

Employment Struggles, but Consumers Still in the Game

In its December report (detailing November data), the Bureau of Labor Statistics reported the seventh straight decline in the unemployment rate, down to 6.7% (unemployment had been steady below 4% prior to the shutdowns), an 8% decline from the peak unemployment rate that approached near 15% in April. It is important to note that the rate at which employers added jobs had been slowing over the last five months as business owners remain cautious. We should also note that the return to employment has favored certain industries such as construction, health care, manufacturing and professional business services, while others may face a longer dearth of open positions.

Spending Remains Strong

Consumers who've been stuck at home and/or limited in travel were not afraid to spend on the things that bring them joy. Cyber Monday sales were $10.8 billion, a 15% jump from last year and an all-time record. Black Friday, which has typically been more a boon for brick and mortar, also saw a 21.6% jump over 2019, with the lion's share ($9 billion) of those dollars going toward online purchases. Those retailers with an online presence, coupled with the ability to deliver goods curbside were rewarded greatly, while traditional and local retailers fared less favorably. We see digital shopping trends continuing (even after the pandemic) as companies like Amazon, Walmart, Target and others soak up online market share.

Hope for Normalcy

Consumers enter 2021 with hope and excitement that things return to "normal." It's likely that once critical herd immunity is reached, the travel, entertainment and tourism industries all will see an extraordinary influx of business, which should gradually even out, in spite of an economy that may or may not seem ideal. In an interview with the Harvard Gazette, Dr. Anthony Fauci, director of the National Institute of Allergy and Infectious Diseases, projected potential herd immunity as early as third quarter 2021. Of course, the caveat is that 75% to 80% of Americans will need to be vaccinated. We believe that a return to more normal social habits may drag out until late 2021 given the initial pushback by the public seen toward the vaccine.

Americans' hope and optimism is not only being fueled by the coming vaccines and recently approved stimulus, but also by the continued flow of cheap money and for many, the massive appreciation in home values. Since January 2016, the 10-city Case-Shiller Home Price Index has leapt more than 22%, while the 20-city index is up nearly 26%. And with the 30-year mortgage rate now down below 2.5%, homeowners can continue to leverage and/or parlay those gains into other investments. U.S. household debt is certainly elevated, but remains far below Great Recession peaks.

The Winners of 2020 and Beyond

Equity valuations are certainly elevated, and some might think it is counterintuitive that values be so rich at such an uncertain time. But when the largest investors continue to see equity outperformance against fixed income and cash, it may become a self-fulfilling prophecy, especially when the world's central banks are expected to remain in low-rate, hyper-accommodating mindsets. These efforts will continue to suppress volatility in the markets while providing extraordinary support for market valuations, even at these higher levels.

Tech Will Remain Hot

There is an ever-increasing tech war between the U.S. and China that is likely to escalate if Biden applies more of his typical, traditional approach to foreign relations. Depending on how policy shakes out, we will continue to see massive shifts in supply chains, mergers and perhaps more gravitation to domestic trading partners and/or facilities by companies in both nations. Optimistically, we hope the current administration will stay firm on China's trade and intellectual property policies and moderate its military operations in the South China Sea.

Source: United States Census Bureau. As of Oct. 2020.

That said, we continue to see disruptive tech companies remain successful, and many may be names you have never heard of. We will be looking for innovation in 5G, wireless, productivity and digital solutions as we believe consumers are just seeing the tip of the iceberg in what we call digital revolution 2.0. Look for an increase in global CapEx spend with technology, digital and automation at the top of the list. Businesses need to create their own growth catalysts and digital solutions and automation go beyond increasing efficiency to potentially create revenue streams for those who execute their digital plans effectively. Emerging markets and/or small cap domestics may offer some of the most transformative opportunities for those who do the homework as new players emerge and old ones reinvest themselves for the future. A rising challenge will remain for employers needing improved infrastructure and ways to keep their "new" remote workforce engaged and effectively managed by providing tools they need to be successful.

Sustainability

Sustainability and ESG will continue to grow in trend, bolstered by the policies of the current administration and the continued grassroots digital efforts sweeping the world today. Initial dialogs have begun on providing more uniform disclosures, helping set standards through inclusive discussions, so that investors can understand the efforts underway by company management teams. More work will need to be done to ensure efforts are being made to truly address these issues versus merely "greenwashing" over them.

Income Investors Will Need to Get Creative

Investors will have to look to more creative tactics in order to fill the void that traditional bonds have left. Mainstream bonds and bond strategies are proving to be a less-reliable source of diversity in this marketplace, where more nuanced and/or complex strategies including multi-asset portfolios are now being considered given their lower correlations and volatility profiles for investors desperately searching for yield.

For income-seeking investors, the stubborn low-yield environment creates a challenge unlikely to subside in the near future, both domestically and internationally. Ironically, investors in the sovereign debt of nations with less-than-stable economies are lucky to get any real yield. Even countries like Ireland require you to pay them if you want to lend them your hard-earned money. In fact, 25% of all investment grade debt currently has a negative yield, and these trends are unlikely to change for years to come. Simply put, investors will need to get creative and hyper-specific for yield-producing opportunities and inevitably take on increased risk. Whether through multi-asset solutions or shifting further out the risk curve to include leveraged strategies, investors will need to overcome these challenges to solve for their return outcomes.

Healthcare Will Remain in the Forefront

Lastly, we see big opportunities in health care innovations, both here and abroad. Obviously, vaccine producers, distributors and clinics stand to benefit short term, but the Biden administration will likely seek out ways to improve patient care while keeping costs low. Telemedicine is currently at least one benefactor here and emerging markets may again be an area to focus on as there are outsourcing opportunities.

Potential 2021 Risks

Yes, Coronavirus Still in Control

Even though the government's latest stimulus package provides some short-term relief for consumers and businesses, it's less than half the value of the initial CARES Act stimulus and may not have a large impact on gross domestic product (GDP). At the end of the day, the health of our economy depends heavily on just how quickly vaccines are delivered, the number of cases and deaths, and when America can get back to business as usual. These stimulus efforts provide a much needed bridge to span the gap in consumption from the unemployed and underemployed Americans today. The negative news flow over recent weeks around infection rates does give us pause when considering turnaround timing for earnings and GDP.

Policy Changes Could Cloud Recovery

Without taking any specific political stance, it's well-known that President-Elect Biden intends on making changes to Trump-era tax cuts, focusing on environmental issues, immigration policy, infrastructure, climate change policies, health care and education. While it's too early to tell what strategies will be utilized and implemented, Biden will likely have to work with a Republican Senate majority, deadening the potential impacts of a democratic sweep.

That said, shifts could create rifts in specific sectors and/or companies most exposed. We believe that these risks should be minimal in the near term and look forward to observing just how aggressive the new administration is with each campaign promise. As we all know, pushing agendas in Washington can take time and are likely to be telegraphed so investors can adjust portfolios accordingly.

Geopolitical Risks

China's operations in the South China Sea are likely to create sporadic headline risks rather than outright war. We expect China's government to push Biden early on to see just how strong a line he's willing to take. These exchanges could create some volatility, but again we expect that to be minimal for the first half of 2021.

In Europe, Italy remains a country we are focused on as a separation risk while the UK completes its Brexit. We will continue to monitor those situations carefully as well as Scotland, which seems to be gravitating toward its own UK-exit.

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