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2021 Economic & Market Outlook

Six things to watch in the new year

January 2021

Advice-driven financial service.

2020–What a Ride

As investors, we know financial markets can move sharply in one direction or the other. But no one could have anticipated what 2020 had in store for us. After hitting bear territory in March when the country went into lockdown, stocks started a steady climb upward again, reaching new record highs by the third quarter. Optimism about the vaccines was arguably the primary driver behind the sharp rise in global equities in the fourth quarter, with most markets up at least 10%.

The economy took us on a similar roller coaster ride. After a sharp third-quarter rebound from the deep, pandemic-induced decline, the recovery momentum remained strong through the first half of the fourth quarter of 2020. However, the second wave of the virus, renewed business closures and mobility restrictions caused the recovery to weaken towards the end of the year. Even so, U.S. fourth-quarter growth should be comfortably positive thanks to a healthy housing sector, a more resilient consumer and continued capital investment by businesses.

On the bond front, rates rose slightly during the fourth quarter. Additionally, stronger economic growth and inflation concerns led to a steepening of the yield curve. The increase had little impact on U.S. high yield and emerging market debt, which reacted positively to lower-than-expected default rates and the global economic rebound. Returns on investment-grade corporate and municipal bonds remained positive for the quarter.

2021–Looking Forward

Despite the current weakness, we remain optimistic about the year ahead. This outlook explores the six things we'll be watching throughout 2021 to help guide our investment strategy:

- The sustainability of the economic recovery
- Inflationary pressures
- Supportive fiscal and monetary policies
- Progress of global economies
- The implications of low interest rates
- Momentum in the equity markets

Slowing Recovery Picks Up Steam

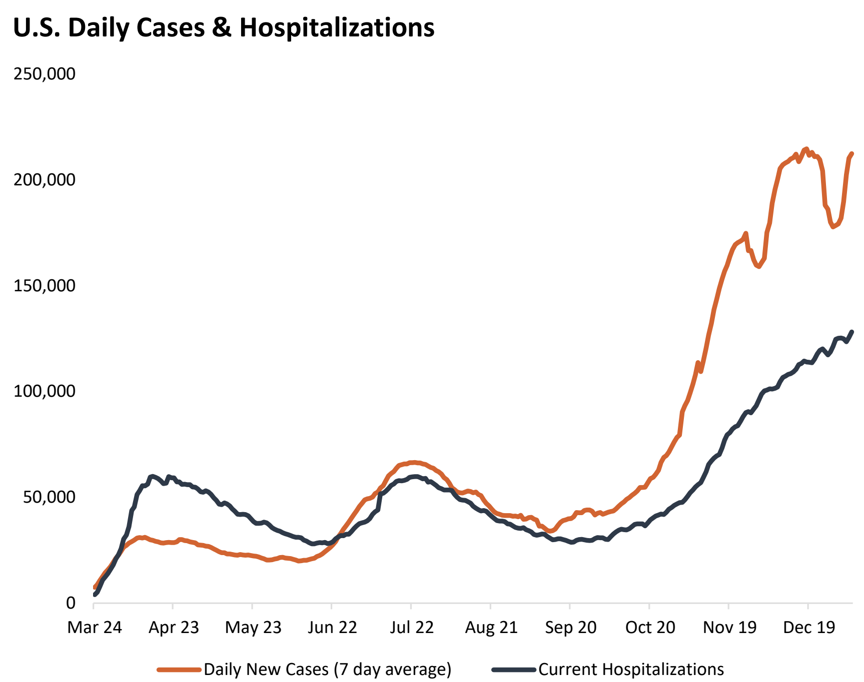
Mass distribution of vaccines should allow the U.S. to regain all its lost output by the middle of 2021.

Hospital Capacity Utilization Rates

While the media tends to focus on the daily infection and hospitalization rates, government officials look to hospital capacity rates to guide their decisions about business closures and mobility restrictions. Overall, capacity shortages are not an immediate concern in most of the U.S. The second wave of the virus has spread more broadly and had a more significant impact on younger individuals who generally don't require hospitalization.

Vaccines, Lockdowns and Fiscal Relief

The approval of several COVID-19 vaccines and their eventual mass distribution by the end of the first quarter should allow the economic recovery to continue. In a somewhat ironic twist, the impending delivery may embolden government officials to err on the side of caution in imposing lockdowns and business closures. They may be more confident that these policies will be temporary and have a more limited impact on the economy. The recently passed $900 billion fiscal relief package should help ease any economic pain inflicted in the first quarter.



Source: The COVID Tracking Project

The Resilient Consumer

The speed of the rebound in the production sectors of the economy has helped fuel the U.S. recovery. Particularly impressive was the rebound in the services survey of U.S. purchasing and supply managers, including the travel, leisure and hospitality industries. This positive showing may be a sign of the resilient U.S. consumer. Looking at more offbeat, "high frequency" data helps gauge consumer behavior and determine the real-time impact. Here's what we saw at the end of 2020 that could affect economic growth in the near term:

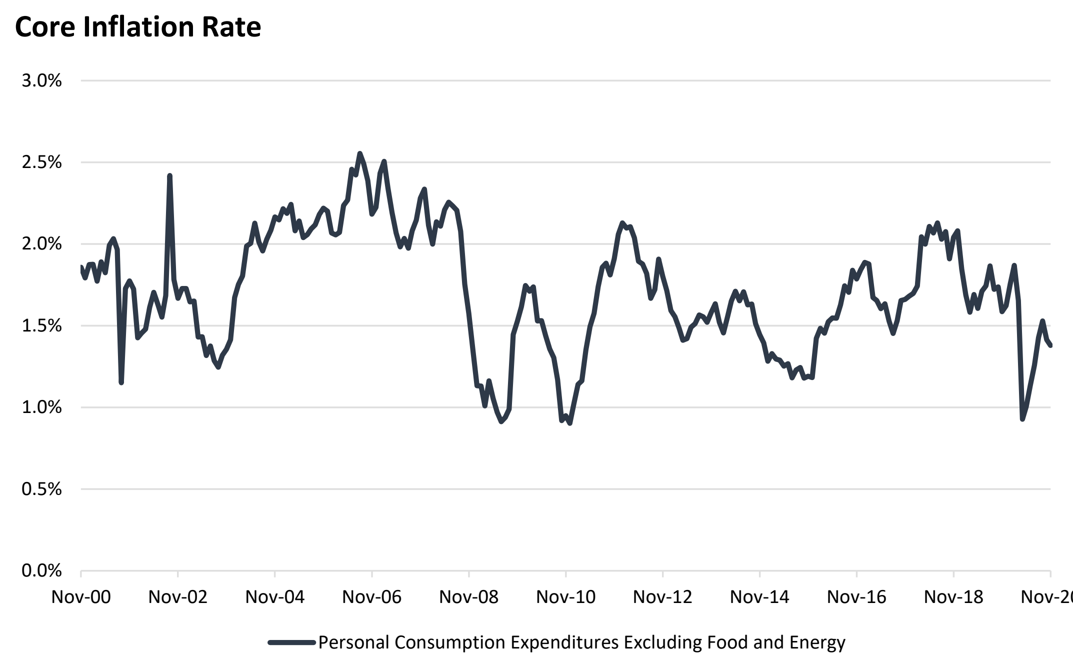
- Rising weekly jobless claims
- Significantly fewer reservations on the Open Table app
- Surprising increase in the number of air travelers

Will Inflation Raise Its Ugly Head?

Concern is growing that the economic rebound and aggressive fiscal and monetary policies will cause inflation to spike in 2021.

Cyclical vs. Secular Inflation

While investors should expect cyclical price pressures in certain sectors, intense global competition should mitigate severe price pressures in the broader economy. Increased spending on productivity-enhancing capital equipment, especially technology, is key for maintaining the current low-inflation environment. And it appears many businesses are willing to make this investment. Even though overall capital spending declined 4.7% in the third quarter of 2020, technology investment rose 8.9%.



Source: Fred

Boosting Productivity

The pandemic has compelled many companies to re-examine the limitations of their offshore supply chains and implement more onshoring initiatives. Since labor costs tend to be much higher in the U.S., these businesses are investing in transportation logistics and robotics to enhance labor productivity and keep unit labor costs down. While it's hard to measure productivity in the service sectors, there is evidence that technology spending in these industries is also boosting output per employee. In addition to helping control inflation and maintain profit margins, productivity increases are the primary means for growing wealth and reducing income inequality.

Supportive Congress and Federal Reserve

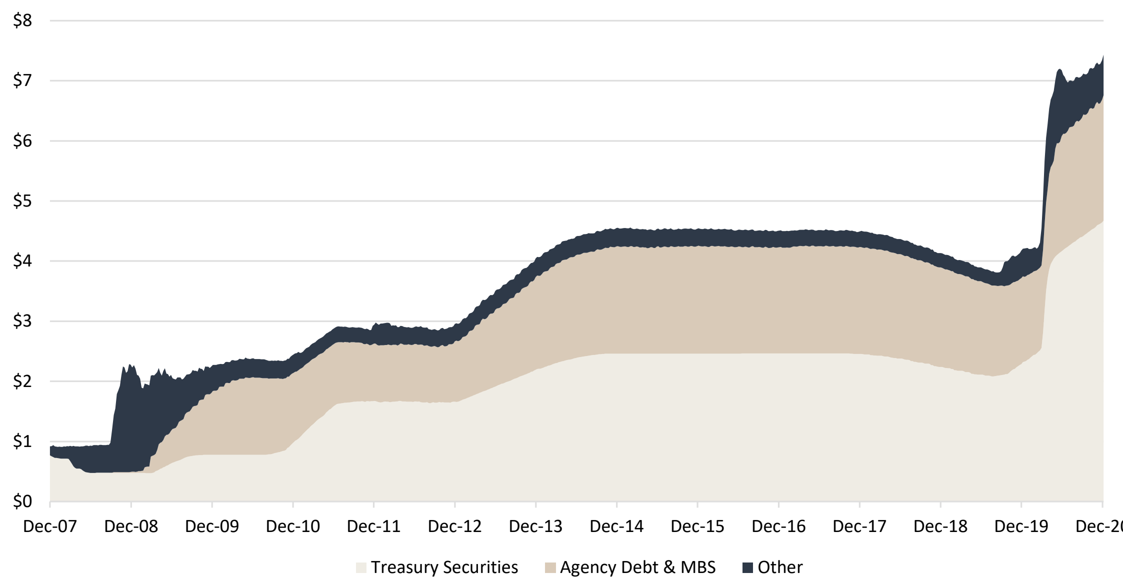
A combination of fiscal relief and easing monetary policy is needed to sustain individuals and businesses during the recovery.

Aid from Washington

Congress has learned that in a deep recessionary environment, it is better to provide fiscal support quickly and at a relatively high magnitude to stave off more permanent economic damage. In addition to the fiscal relief packages implemented earlier in the year, another $900 billion aid bill was enacted into law at the end of December, consisting largely of income replacement for consumers and assistance for businesses.

Whether more aid will be forthcoming depends on many factors, including the speed of the recovery, the vaccines' effectiveness, and the ability of Congress and the new administration to work together. The initial cabinet appointments of President-elect Biden seems to suggest a more centrist approach to governing.

Federal Reserve Balance Sheet



Source: Factset

Committed Fed

The Federal Reserve's response has been equally dramatic. Its willingness to purchase other securities besides government and government agency bonds helped the country avoid a liquidity crisis in early 2020. At its last meeting, the Fed announced its intention to maintain its aggressive monetary policy until inflation moves past 2% for an extended time and the economy reaches full employment (roughly 3.5% unemployment). The current unemployment rate is around 6.5%. Given these targets, rates are not expected to increase until 2023 at the earliest. Of course, any sharp increase in inflation would warrant a re-examination of the Fed's policies.

Going into 2021, it doesn't appear the Fed wants to delve into a negative fed funds rate. Negative rates have had questionable success in other countries and heighten the margin pressure on the banking industry. If longer-term yields spike higher, the Fed could potentially increase its purchases of 10 to 30-year debt to help control the yield curve.

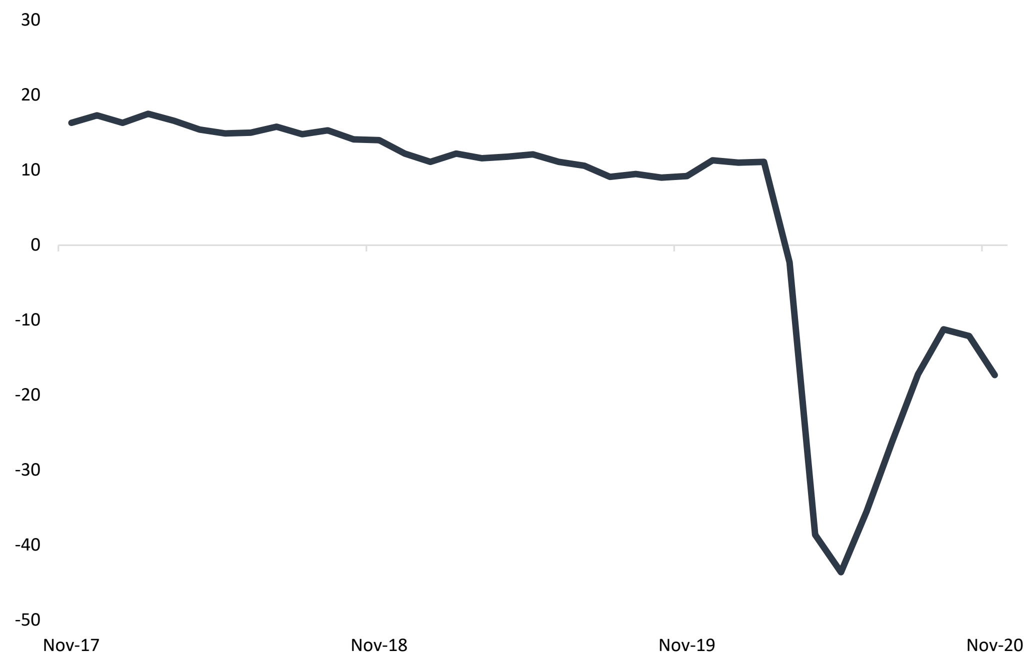
Global Economies Progressing at Different Speeds

The impact of the virus has varied by country, so too has the recovery.

Europe Struggles

The second wave of the virus and re-imposition of harsh lockdowns and mobility restrictions have placed more pressure on European economies compared to the U.S. The region's greater reliance on the travel and leisure sectors will likely lead to a stunted economic recovery and perhaps a "double-dip" recession. As is often the case, Germany is better positioned relative to its neighbors because of its strong production and export industries.

Eurozone - Services Confidence Indicator



Source: Factset

China Rebounds but Not Out of the Woods

Having been the first country affected by the virus and the first to reopen, China has virtually recaptured all its lost production going into 2021. However, the Chinese consumer has yet to return to previous spending levels. Lingering virus concerns have kept people from fully re-engaging. Continued hesitancy may lead to an excess inventory problem in the short term. Longer-term, it may delay the desired change in the country's economic structure away from export and production towards a consumer-driven model. While trade wars with the U.S. may de-escalate under a Biden administration, they will not completely evaporate, increasing China's dependency on the consumer for continued economic growth.

Impact of Low Rates Extends Beyond Government Bonds

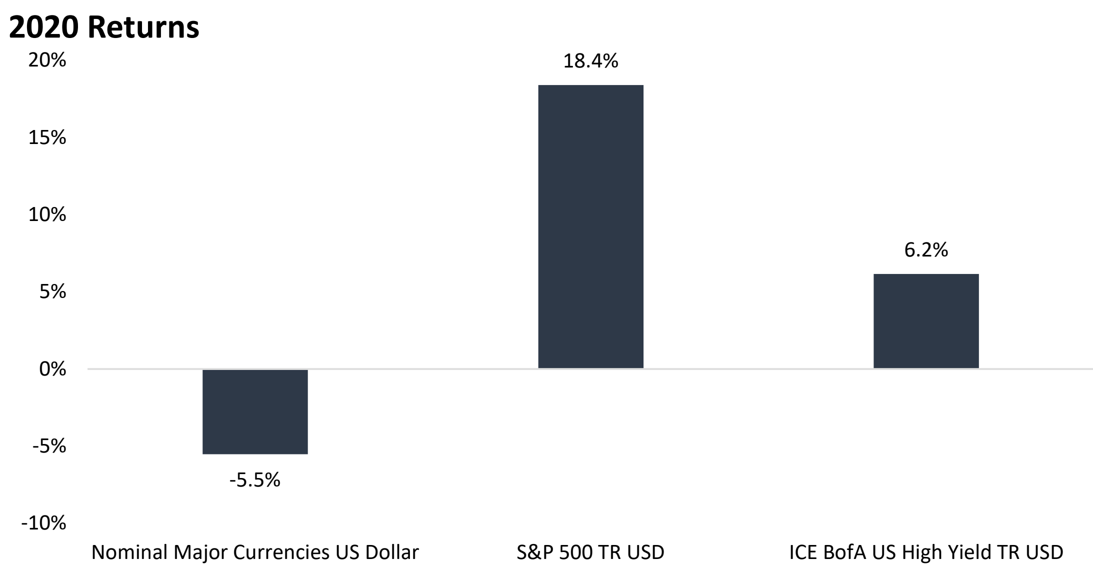
The current low-rate environment has affected other asset classes.

U.S. Equities

Lower rates tend to increase valuation unless corporate earnings are declining, which is not the case right now. The U.S. economy and corporate earnings are firmly in recovery mode. As such, further equity multiple expansion is certainly possible in 2021.

High-Yield Debt

Like most other asset classes in the past year, high-yield (below investment grade) debt rebounded sharply from the March 2020 lows, with interest rate spreads to government bonds falling to pre-pandemic levels. The search for yield in this low-rate environment has driven the yields of this asset class lower. The resulting higher prices may not fully reflect the heightened default risk in certain sectors of this market such as telecommunications, energy and retail.



Source: Morningstar Direct

U.S. Dollar

The global economic recovery and the extensive U.S. fiscal and monetary stimulus drove the trade-weighted value of the U.S. dollar down more than 6% in 2020. This decline helped domestic exporters, the earnings of U.S. multinational companies and commodity prices across the industrial, agricultural and precious metals sectors. The only exception was gold, which held its ground in the fourth quarter after advancing more than 25% during the first nine months of 2020. Perhaps more attention was placed on bitcoin and other cryptocurrencies as a better hedge against the potential devaluation of currencies.

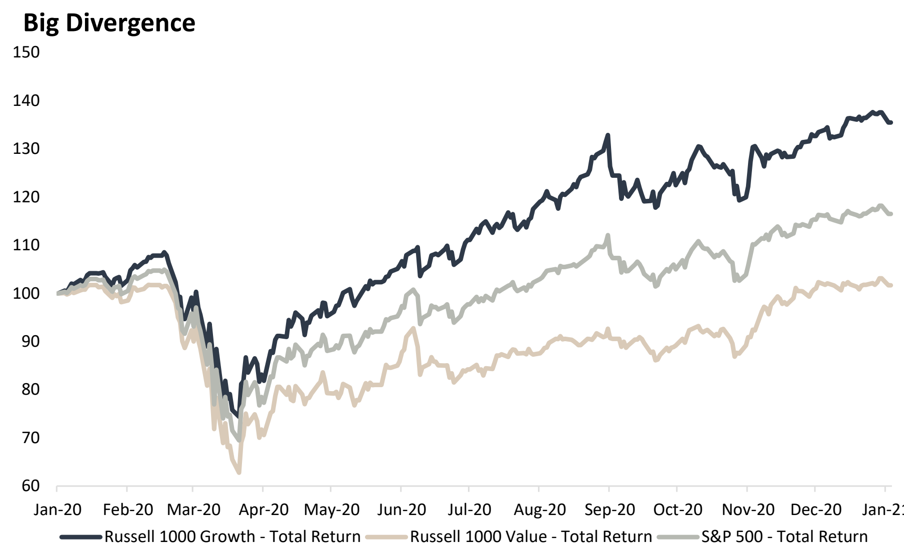
That said, the dollar is likely nearing its limits. Relatively high interest rates and economic growth favor the U.S. against most other countries. The one possible exception to the dollar's expected stabilization is the Chinese renminbi, which could further appreciate due to stronger economic growth and relatively tighter monetary policy.

Equities Poised for Another Run

2021 will likely mark the first full year of a new economic expansion and bull market.

Stay the Course

The outsized gains in 2020, particularly in the final months of the year, may set the stage for an early 2021 correction. This is not cause for alarm. Corrections are routine occurrences. Taking portfolio action in anticipation of them is unwise. Looking at the coming year, S&P 500 companies are widely expected to have record profits. This projection comes from the high level of recently reported profits and expectations that COVID-19 vaccines will rejuvenate pandemic-hit sectors such as travel, leisure, energy, and office real estate. The return to profitability in these sectors will help propel overall corporate earnings. Moreover, the projected low-interest-rate environment for the next few years supports higher-price-to-earnings multiples. When combined with the expected profit growth, excessive valuations should not be cited as a cause to sell stocks. With the bright picture ahead of us, it's unwise to try to time a correction and risk being on the sidelines if a rally develops.



Source: Factset

Broader Participation in the U.S.

Last year, a handful of sectors led the market rebound. Will the same thing happen in 2021? Probably not. A broadening of the rally has been underway for months and includes previously ignored sectors such as financials and industrials. Small-cap, international and emerging markets stocks have also recently outperformed the S&P 500. These sectors have languished for years as U.S. growth stocks hogged most of the positive returns. We expect cyclical sectors to do comparatively better in 2021. That said, we don't believe large-cap growth stocks are on the edge of a cliff. While there are pockets within the growth sector where bubbles have formed (Tesla, Zoom and software stocks), these stocks make up a small portion of the overall sector. Should they decline, as some have started to do, they are unlikely to drag the sector and market down with them.

Potential Resurgence of Emerging Markets Equities

In 2020, China dominated the emerging markets while Latin American markets generally struggled. This trend could reverse to a certain degree in 2021. The Chinese economy and markets have already recovered, and therefore, may not see a big boost from the vaccines' distribution. On the other hand, Latin America should benefit significantly from a vaccine-induced reopening of their economies. A sustained global economic rebound could also have a positive impact on the commodities industries.

What This Means for Investors

Amid current weakness, there are many reasons to be optimistic about the year ahead.

Key Takeaways

- The impending broad distribution of vaccines should allow global economies to sustain the economic recovery into 2021.
- Fiscal and monetary policy will remain expansive, supporting both the economy and asset prices.
- While there will likely be a cyclical boost in inflation rates, intense global competition, lack of wage growth, and strong productivity trends should prevent the onset of secular global inflation.
- Low interest rates and rebounding earnings should sustain the current historically high equity valuation multiples.
- The economic recovery and expansion should allow for broader participation by cyclical stocks. They should also lead to better performance in foreign equity markets, which tend to be more concentrated in economically-sensitive sectors.

For more insights, contact a Cerity Partners advisor or visit the thought leadership section of ceritypartners.com.

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