December 28, 2020

2021 – THE YEAR AHEAD

The year just ending was unique in the life of nearly every American. One of the worst pandemics to hit the world since the influenza of 1918 was not even on the radar screen a year ago at this time, then swept over the landscape with stunning speed. Debates about how long the economic and stock market cycles might last were replaced by discussions about contagion and fatality, lockdowns, and hopes for vaccines against the coronavirus.

The longest U.S. economic expansion in history came to an abrupt halt in March as frantic efforts to protect the population brought activity nearly to a standstill, an induced economic coma the likes of which our society had not seen before. Gross Domestic Product (GDP) plunged at a greater than 30% annual rate, only to be resuscitated by unprecedented monetary and fiscal stimulus. Stock market indexes followed suit, dropping sharply in March before bouncing back and then reaching new all-time highs near year-end. Already low interest rates dropped even further to near zero as Federal Reserve actions dominated the usual supply and demand.

Will economic growth continue and reach some kind of new "normal"? Has the stock market's recovery already discounted this growth? Will inflation finally become an issue after several decades? In *2021 – THE YEAR AHEAD* we look at the prospects for the new economic cycle that has risen from the ashes of the old one and conclude that positive financial market returns are likely in the coming year.

The Economy

In 2020, the economy started out growing moderately, until the shutdowns put it into a tailspin late in the first quarter and into the second quarter. In the third quarter, GDP rebounded strongly and continued to grow more gradually toward year-end. For the full year, it looks to have declined about 3% from 2019's level. Both consumer and investment spending, after declining precipitously, recovered in the second half of the year. Government spending was strongest in the second quarter in the form of massive support packages passed by Congress, and has since slowed down in the absence of further stimulus. The Federal Reserve has remained unwavering in providing epic monetary support since it began flooding the financial system with cash in March.

2021 will probably see its slowest economic growth in the first quarter, as partial shutdowns to combat recent increases in COVID-19 will affect most areas of the country. The latest federal government stimulus package, totaling about $900 billion, should provide somewhat of an offset. With two vaccines approved and already being distributed, and more on the way, we think that significant portions of the U.S. population will have received a vaccine by mid-year.

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This should help to revive the services sector of the economy as travel, dining, and other social activities gradually resume. Housing has been a strong area of growth so far in the recovery and should continue to grow as mortgage rates remain low and pent-up demand is filled by additional building. Consumers will also likely spend down some of the savings accumulated during the pandemic as employment and confidence increase.

Business spending, having already picked up during the second half of this past year, should continue growing in 2021. As employment and economic activity increase, confidence in the success of capital projects is likely to follow. Inventories, cut to match lower demand in the recession, will be rebuilt back to more normal levels. The commercial aerospace sector, a major drag on capital spending in 2020, should see a resumption of aircraft orders as airline traffic begins to recover. We had thought that government infrastructure spending might have picked up, but a new package was not agreed upon. With bipartisan support in Congress, this may be a priority for the new administration and could add further capital spending. The latest stimulus package passed by Congress also contains additional support for small businesses.

Federal government stimulus going forward will likely be less after the current package is implemented, although one more round is possible if the economy has not already grown sufficiently in the first quarter. One potential area of concern is the possibility of higher taxes on businesses and consumers to help pay for the increased government spending. With a relatively balanced government, however, any changes in taxation are likely to be moderate and gradual. State and local government spending will be held back somewhat by the need to repair balance sheets, so overall government spending will add little to GDP as the year progresses.

International trade recovered in the second half of the past year, but imports have outpaced exports due to U.S. growth initially outpacing that of some other countries. Heavy government stimulus in Europe and Japan should support the growth of their economies and demand for U.S. exports, but the chronic ongoing trade deficit that preceded the pandemic won't go away. Trade is likely to be helped with a new administration, seen as friendlier to trade agreements, although U.S. skepticism toward trade with China is likely to continue.

Overall, we expect U.S. GDP growth to rebound at around a 5% annual rate in 2021, which would be the fastest in over 35 years. Sluggishness in the early part of the year should give way to both strong consumer and business spending as the year progresses. About half of the jobs lost in the recession have been brought back so far, but official unemployment is still elevated at nearly 7%. We think economic expansion will bring this rate closer to 5% by year-end as the economy reopens. There have been many business failures because of the pandemic, primarily among smaller owners, but entrepreneurs are resilient and new businesses will emerge.

Inflation, Interest Rates, and the Bond Market

Inflation as measured by the Consumer Price Index has been subdued in the early months of the new economic cycle, and it should remain so in 2021. Currently running at a 1.2% annual rate, we expect it to be around 1.5% in the early part of the year, gradually picking up toward 2% by year-end (an anomalous spike will occur in the upcoming second quarter as it compares to the depressed figure of 2020). Plenty of slack in employment and industrial capacity utilization leaves room for more economic growth before any major inflation pressures start to build. There may be some commodity inflation as demand picks up. In addition, as airfares and hotel room rates recover from depressed levels, there should be an increase in overall service sector prices. These and other signs of inflation bear watching, but should level off once capacity in services ramps up again.

While massive money printing on the part of the Federal Reserve and other monetary authorities around the world may have been necessary to support the economy during the pandemic, we are concerned about the long-term inflationary effects. Such concerns turned out to be unnecessary during the previous economic cycle when the money supply was expanded, but this time monetary stimulus has been joined by fiscal policy stimulus, leading to higher growth and making inflation more likely, in our view. And politically, the easiest way to get out from under the large debt loads that governments have incurred to finance this stimulus is to inflate our way out of the burden.

Short-term interest rates dropped to near zero in March of 2020 as the Federal Reserve deployed "shock-and-awe" monetary policy to support the economy, and we expect that they will stay at this low level throughout 2021. The Federal Reserve has indicated that it wants to see inflation above 2% for some time before raising rates, in order to ensure that employment is maximized, particularly for the segments of the population hit hard by the pandemic.

Rates on intermediate and longer-term bonds also dropped in 2020 from already-low levels at the end of the previous year. The benchmark ten-year U.S. Treasury note yield declined from 2.0% to as low as 0.5% briefly over the summer. A flight out of assets perceived as riskier drove initial heavy buying. The Federal Reserve's renewed policy of quantitative easing, including the purchase of $120 billion of Treasury and mortgage-backed bonds every month since the pandemic started also helped to push down yields. As the economy has recovered, the ten-year Treasury yield has moved back up close to 1%, but still reflects very low inflation expectations. Yields on most other bonds were pulled downward by those in the Treasury market, and also remain low.

We think yields on U.S. Treasury bonds, and others, will move a bit higher over the course of the coming year, as economic activity picks up and concerns about inflation receive more discussion. The yield curve will probably also steepen as rates on longer-maturity bonds rise more than those with shorter maturities, which are more closely anchored to near-zero short rates. Nevertheless, with the Fed continuing to support bond prices across the entire maturity spectrum, the ten-year benchmark yield is not likely to exceed 1.5% in 2021.

For bond investors, the opportunities are indeed slim right now. Total returns on Treasury securities will be minimal and could even be negative as a moderate rise in yields would cause price declines greater than the paltry income received. Treasury Inflation-Protected bonds (TIPs) offer a better relative return if inflation starts to rise but, with current yields that are actually negative, their total returns will also be meager until inflation becomes a meaningfully bigger issue.

Corporate bonds provide higher yields than Treasuries and, while the spreads (extra yield) have come down from the levels reached last spring, they could become even lower as the economy grows and corporate balance sheets strengthen, so prices of corporate bonds should perform better than Treasuries. We find some relatively good value at the lower-rated end of investment grade bonds. Corporate bonds that can be called provide a little higher yield on top of that, and occasionally we are also finding corporates with coupons that adjust with inflation.

Tax-exempt municipal bonds also have better yields than Treasuries on an after-tax basis, so we continue to search for appropriate bonds in this area for clients in high-tax brackets. Taxable municipal bonds have become more common in recent years, and they offer somewhat higher yields than Treasuries.

Bonds continue to provide diversification against stock market downturns, so it is still worth holding some in balanced portfolios for that reason. However, it will be a while before investors see the kind of income available in past years. Therefore, we continue to hold bonds with relatively short maturities, expecting that there will be opportunities within a few years to lock in higher rates. With many of our higher-coupon bonds being called in 2020 and with a dearth of attractive replacements, our balanced accounts are currently underweighted in bonds relative to long-term target allocations.

The Stock Market

During 2020, stock markets around the world endured the mother of all roller-coaster rides, but have been more calmly trending higher into the end of the year. We expected positive returns for the year, but certainly not by taking such a path or for the same reasons. As we have written previously, there were really two stock markets during the year: a small group of very large technology and internet companies on the one hand, and everything else on the other. Companies perceived to benefit from the pandemic saw their stock prices lifted, much more than the earnings benefit in many cases, while stocks of companies more exposed to the ups and downs of the business cycle were hit harder in the early days of the pandemic. Financial, industrial, and energy stocks were particularly affected, although these sectors have seen increasing strength as the year comes to a close.

With the economy continuing to gradually re-open and with huge monetary policy support as tailwinds, we expect the U.S. stock market to continue its upward trajectory in 2021. The strong recovery from March's downturn already anticipates this growth, so some of the market move we might otherwise expect for 2021 has already taken place. However, as long as both earnings growth and monetary policy remain pointed in the right direction, returns should be positive for the full year.

Earnings per share for the S&P 500 appear to have dropped around 15% during 2020, as a recovery in the second half of the year was not enough to fully offset the earlier decline. For 2021 as a whole, they will likely rebound as much as 25-30%, thanks to continued improvement in the economy as the year progresses. Lean inventories and other cost-cutting measures during the pandemic have set up many companies for a resulting expansion in profit margins on top of revenue growth.

With the strength of the stock market following the pandemic bottom, the Price-to-Earnings (P/E) ratio at year-end has risen to about 21 times our expectation for next year's earnings, a well-above-average level, but one supported at least somewhat by both expected cyclical earnings growth and very low interest rates. By the time the end of 2021 rolls around, earnings should still be growing, although at a less spectacular rate, and interest rates will likely have risen a bit. Therefore, we would expect some contraction in the market P/E to about 20 by the end of the year. Combining a slightly lower P/E ratio with 2022's estimated earnings would put the S&P 500 approximately 5-7% higher than the current level. With the average dividend yield now at 1.5%, we think it is reasonable to anticipate a high-single-digit overall stock market total return in 2021.

Although we forecast a positive year for stocks, the market rally in the second half of 2020 and resulting high valuations make us cautious. Stocks could be vulnerable to bumps along the way, especially in the first part of the year. With the pace of economic growth slowing at least in the fourth quarter of this year and possibly in the first quarter of next, earnings growth for those periods could disappoint a bit relative to elevated expectations. Any setbacks in vaccine distribution or higher spikes in infections could also increase investor nervousness, and cause a pullback in bullish sentiment, which is high at the moment. However, any corrections would provide buying opportunities given our view that we are still in the early stages of the next economic cycle.

As we have noted, the relative performance of stocks in 2020 has been very bifurcated in favor of large tech and internet stocks. We expect that imbalance to reverse somewhat in 2021 as market leadership broadens and continues to rotate toward more cyclical companies. Technology stocks may or may not see actual price declines for the year; rather, their relative performance may just lag. While those companies will still generate good earnings growth, it won't be anything special, given that many cyclical companies will see big jumps in earnings relative to the depressed levels of the past year. Some beneficiaries of the pandemic could even see a temporary slowing in growth. Many stay-at-home activities, including remote working and online shopping, could be at least partly replaced by returning to the office at least some of the time and increased focus on social activities and travel. In the meantime, the valuations of many tech stocks leave little room for error should interest rates rise.

In contrast to the tech-oriented sectors, many cyclical companies will see improved revenue growth relative to this past year, along with profit margin expansion. We think industrial stocks are a good case in point, benefitting from the cost cutting incurred, the rebuilding of inventories, and increased demand from both domestic and international customers. We also see financial stocks benefitting from the economic upturn as lending activity grows, a steeper yield curve improves net interest margins, and creditworthiness of borrowers recovers so that loan-loss reserves are released. Energy stocks are another sector that typically does well when the economy is growing; however, there is a lot of shut-in supply ready to meet higher demand and investor attention has increasingly become focused on alternative energy companies. Stocks of small and medium sized companies may do well relative to larger ones, as they have a more cyclical tilt on average.

The healthcare sector is one we have favored for some time, and we continue to like its prospects. With an apparent mandate from voters not to take extreme policy steps, we expect any changes in the U.S. healthcare system to be evolutionary, not revolutionary. An aging population and technological advances in meeting its medical needs provide ongoing opportunities for successful investment. While COVID-19 vaccines will not provide large profits, they do focus investor attention on pharmaceutical and biotech stocks, and many companies have robust new product pipelines. Medical device providers should see continued growth and health insurance companies continue to adapt to the evolving healthcare landscape.

One area in which we have become a bit more interested is precious metals. An initial wave of outperformance crested as the metals, and stocks of gold and silver miners, were used as safe havens during the initial stage of the pandemic.

Since then, they have fallen back somewhat as the "re-opening" trade has caused some investors to take profits. Looking forward, the dollar may be weaker as other parts of the world open up and grow again, a positive for precious metals prices. Gold and silver have also historically been good hedges against inflation, which may become more of an issue as time goes on. Silver will see the additional benefit of its usage in semiconductors and solar panels.

A year ago, we began looking seriously at international investments for the first time in a decade. Now, it appears that at least some overseas markets may finally be starting to show more competitive performance. In contrast to the last economic cycle, massive monetary stimulus has occurred in nearly every major economy, so reflation and growth are more likely to be synchronized. The economies of both Europe and Japan are tilted more toward cyclical companies than the U.S. (with its large tech component) and have lower average valuations combined with what may be higher earnings growth for at least the next year or two. We will be considering making moves into investments outside the U.S. as appropriate.

Conclusion

We see 2021 as a better year for the economy than 2020 turned out to be. Support from monetary and fiscal policy, along with multiple vaccines against the coronavirus, will aid in re-opening and eventually getting back to a new "normal." Both consumer and business spending, as well as trade, should see good growth.

Inflation ought to remain low while excess capacity in the economic system is being absorbed, although toward the end of next year or in 2022 it may begin creeping up. Massive monetary and fiscal expansion is likely to lead to higher inflation down the road. Interest rates will not rise much until inflation becomes a bigger problem, but even small rate increases will produce poor bond market returns with current yields so low. Shorter maturities and bonds other than U.S. Treasury securities should produce the best relative returns.

While the initial stock market rebound from the pandemic has already discounted some of the growth in the new economic cycle, we think there are still gains to be made as earnings growth continues and interest rates remain relatively low. Cyclical stocks should outperform those that benefited from the pandemic, while healthcare remains a growing sector. Precious metals are of increasing interest, and international stocks may start to earn returns competitive with those of domestic companies. Given high starting valuations for stocks, the year may also witness one or more market corrections, but we would use those as buying opportunities given the still early stage of the new economic cycle.

We wish all of our friends and clients peace, joy, health, and prosperity in the New Year, and for many years to come.