QUARTERLY MARKET OUTLOOK

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2021 SECOND QUARTER OUTLOOK

Consumers Are Ready for Reopening

People around the globe are being vaccinated and there is a light at the end of the tunnel, driving stock investors' enthusiasm. With Congress passing a $1.9 trillion coronavirus relief bill, consumers will have more spending power.

At-a-Glance

Both economists and investors are optimistic as the world population is being vaccinated.

Savings rates in the United States hit all-time highs and remain elevated, so when the restrictions are lifted, consumers may be ready to spend.

The stock market is forward-looking and much of this optimism may already be factored in.

Risks remain elevated as bond investors are driving up bond yields, which increase borrowing costs for corporations and hurt stocks, especially technology stocks.

We continue to recommend diversifying across and within asset classes, along with a focus on long-term objectives and not getting caught up in day-to-day fluctuations and noise.

Overview

We all saw what government stimulus did to equity markets in 2009 and now 2020, so there is reason to be hopeful. Unfortunately, the government and central bank's help can't get workers back to work during a pandemic. Of the over 20 million jobs lost since the pandemic, only roughly half have been recovered. The good news is this could change soon as many parts of the country ease social distancing restrictions.

Further adding to optimism, households in the upper tax brackets have been saving money and those in the lower brackets are also about to have more to spend. But stock markets are forward-looking, and already trading at all-time highs, so how much of this optimism is already included in the price of these stocks?

In past outlooks, we have written a lot about high valuations which remain today. Stocks are trading at high prices relative to their earnings, suggesting much of this relief package and reopening is reflected in stock prices. This recovery is virus-dependent, creating unique risks like the risk of virus variants wreaking more havoc on mankind and economies. Additionally, bond investors are very aware that consumers are about to spend a lot more money as restrictions ease. These investors have been demanding higher bond yields, sending bond prices lower and jitters through stock markets as higher borrowing costs are not good for corporations. They fear the risk of higher inflation.

We have already seen manufacturing input costs rise and it makes sense to see inflation pick up soon. However, we think the rise in inflation will be somewhat short-lived and will pass. It is a big risk and we will be watching for signs of persistent inflation carefully. This fear of inflation may continue to be a headwind for longer-maturity Treasury bonds. Corporate bonds of both investment grade and below investment grade varieties are offering relatively low amounts of yields or compensation over their safer government counterparts, as investors are expecting few rating agency downgrades and corporate defaults. This makes them more sensitive to stock fluctuations.

With this economic and market backdrop, we continue to recommend being diversified across asset classes, sectors and countries and adhering to long-term risk and return objectives. We too are cautiously optimistic, but we are also aware of the risks and therefore more balanced in our outlook. Your financial professional can help you stay on track and keep your sights on your long-term plans.

Global Economy

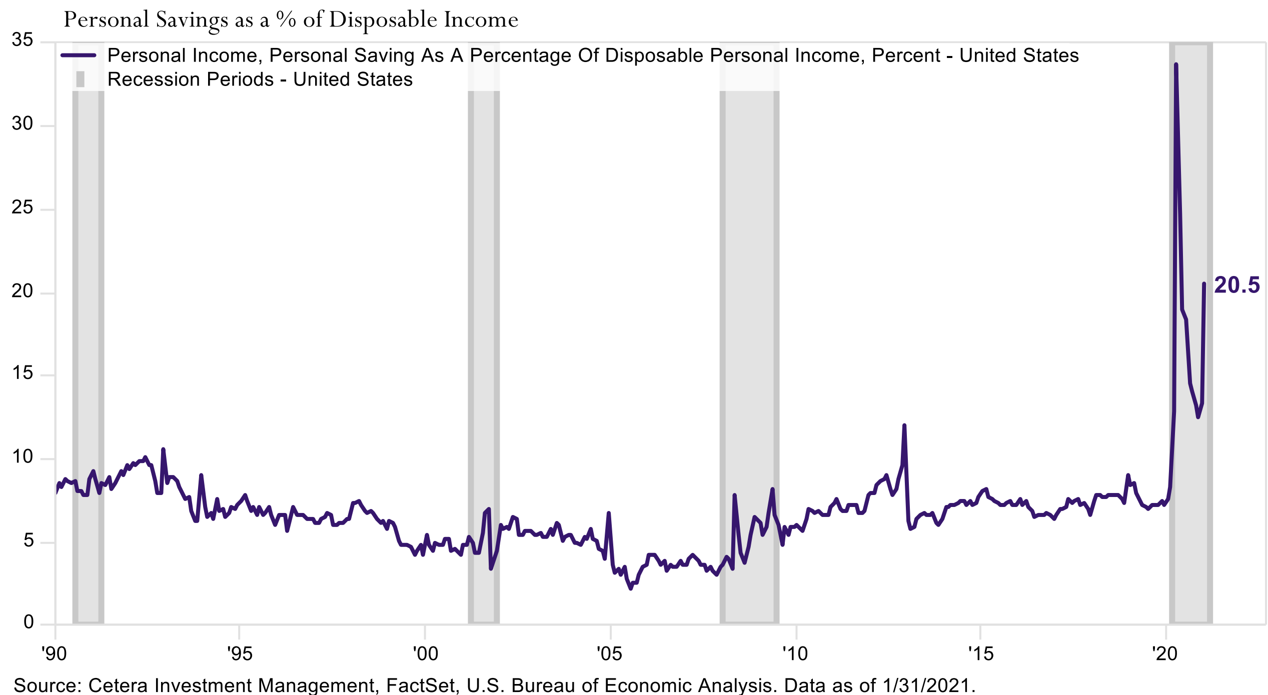
A couple of months into the new year, our 2021 thesis is playing out perhaps even faster than we anticipated. Congress just passed a larger relief package than what we anticipated in December. This is significant because the recovery in 2020 was largely driven by stimulus from the Federal Reserve (Fed) and lawmakers in Congress. Although there is a possibility of more fiscal spending later in the year, this could be the final boost and the economy will have to rely more on fundamentals rather than Congress and the Fed as we progress into 2022.

It is important to take a step back and grasp the amount of stimulus to assess its near-term impacts. There will certainly be longer-term impacts as the U.S. debt-to-GDP is now over 100% and around World War II levels, but we want to stay focused on the near-term impacts for this outlook. In 2019, prior to the pandemic, the United States Gross Domestic Product (GDP) (GDP is the total amount of money spent on goods and services and is a measure of the size of the economy) was about $21.5 trillion. In 2020, GDP is estimated to have only dropped to $20.8 trillion. The non-partisan Committee for a Responsible Federal Budget (CRFB) estimates the COVID Response from administrative actions ($0.7 trillion), legislative actions ($4.1 trillion) and Fed actions ($5.8 trillion) was a total of nearly $10.6 trillion. Of this total, however, only $6.4 trillion has been disbursed or committed. Put in perspective, the amount authorized last year was about half of the United States GDP in 2019, although currently only about 60% of that has been distributed. This provided a huge tailwind for the economic rebound in 2020 and should continue to provide support in 2021.

Another $1.9 trillion was authorized by Congress in the newest relief package in 2021. According to the non-Partisan Tax Policy Center, the new coronavirus relief bill will boost annual cash income by 3.8% across all tax brackets. The increase is less for higher earners, who tend to save larger portions of their income, but could be as high as 20% for lower tax brackets. This is important because lower income brackets, as a whole, tend not to save money but spend it. A Bureau of Labor Statistics Consumer Expenditure Survey showed that the lowest income bracket spent over 400% more than its annual income change in 2019. This tax bracket spent more than the additional income earned in 2019. This is well-documented in economics and referred to as the multiplier effect, as lower incomes have a higher marginal propensity to consume. This will act as an immediate tailwind as we expect consumers will spend the money on groceries and restaurants, while retail items such as clothes and automobiles could also stand to benefit.

We note that the fiscal aid so far has been less targeted – in order to get help out as quickly as possible, it was distributed to most households in the U.S. With many sectors of the economy essentially closed, people were also limited in where they could spend the additional cash. This was evident in personal savings rates in the United States, which spiked to all-time highs when the first payments were sent to households, **Figure 1**. Typically, savings rates have hovered around 7% and this figure skyrocketed to 33.7% in April 2020 and was 20.5% in January 2021.

Figure 1: Personal Savings Rates



Source: Cetera Investment Management, FactSet, U.S. Bureau of Economic Analysis. Data as of 1/31/2021.

While the economic recovery has been somewhat stimulus-dependent to this point, the economy will have to make it on fundamentals later in the year, and that will be largely dependent on containing the virus. With fairly new technologies, vaccines were developed in record time and around 25% of the U.S. population has already received at least one dose of a COVID vaccine as of this writing. Small business optimism is improving, and the leisure and hospitality sector was responsible for 94% of jobs growth in February as employment in bars and restaurants benefited from easing restrictions. People are driving more, increasing the demand for gasoline, a byproduct of oil, so oil prices are rising. Oil is back above $65 a barrel for the first time since 2019 and before the pandemic. In a recent survey of U.S. manufacturers, input costs are also rising and have hit levels not seen since 2008. This has many investors, and especially bond investors, fearing inflation which we will discuss in the equity and fixed income sections.

With this backdrop of economic growth aided by money in the relief package, while at the same time local governments are easing social distancing restrictions, it is hard not to be bullish on the economy in 2021. How much of this is already accounted for and anticipated in stock markets will be explored in the equity section below. It is important to note, as we wrote our 2021 Outlook late last year, the recovery has not been even. The service sectors, and especially hotel and leisure sectors, have been hit particularly hard, resulting in job losses that are still to recover.

Looking at the overall unemployment rate, one may wonder if we even need more fiscal monetary support. Currently, the unemployment rate is 6.2%, which is elevated but in familiar territory as we saw higher levels in the first half of the 2010s. Digging deeper though, Fed Chair Jerome Powell explains this overall rate is misleading. Correcting for misclassified workers being counted as employed and workers that have left the labor force and are not currently looking for jobs, the unemployment rate is closer to 10%. In total, more than 18 million are receiving government unemployment benefits, compared to roughly 2 million before the pandemic. The number of unemployed workers looking for work for at least six months is rising. Long-term

unemployment now makes up roughly 40% of total unemployed workers. The number is getting close to levels after the great recession when this percentage hit a record of 45.5% in 2010.

The labor market has seen a V-shaped bottom as we have recovered 10 of the 20 million jobs lost relatively quickly. The recovery for the next 10 million jobs will take longer. It is encouraging that social distancing measures are being eased as COVID-19 cases fall, and this is evident in our social distancing recovery dashboard. Vaccinations are up, so people are driving, walking, traveling via airplanes, using public transportation and going back to work. This will increase overall economic activity and hopefully be good news for those looking for work. As labor demand normalizes, and people return to the workforce, companies may need to compete more for qualified labor, which will drive up wages.

Looking globally, the Eurozone's economy is expected to contract in the first quarter as individual country social distancing restrictions have been extended and even made stricter in certain parts. Easing of these restrictions later in the year will increase GDP in the middle of the year, but policymakers and the central bank should continue pumping support into the economy. Much of the growth story in Asia is a Chinese story. Growth in China surpassed many expectations because the country limited travel for their annual Lunar New Year celebrations, many factory workers were stuck in cities and not able to travel home. This allowed factories to stay open longer, providing a boost to the economy. China's central bank, the People's Bank of China (PBOC), and policymakers are focusing on financial risks in the market. The PBOC may not raise rates this quarter but policymakers are trying to reduce leverage in the Chinese economy as it begins to heat up and stock prices and property prices rise. This may prove to be a slight headwind to the Chinese economy.

Equity Markets

We painted a pretty rosy economic backdrop for 2021, and we are cautiously optimistic regarding stock market returns this year. However, we want to temper some of this enthusiasm and explain why we may not be as bullish on equities as the economic section may imply. So, let's balance our outlook with the risks in the market.

First of all, we mentioned this economic recovery is dependent on controlling the virus. With the fast development of vaccines and deployment underway, solid progress has been made. However, there are fears around new variants and the effectiveness of some treatments and vaccines on them. This is a risk that is hard to quantify but should be considered. Positively, to date, these fears have not come to fruition. Cases and hospitalizations have trended lower since the vaccine rollout intensified.

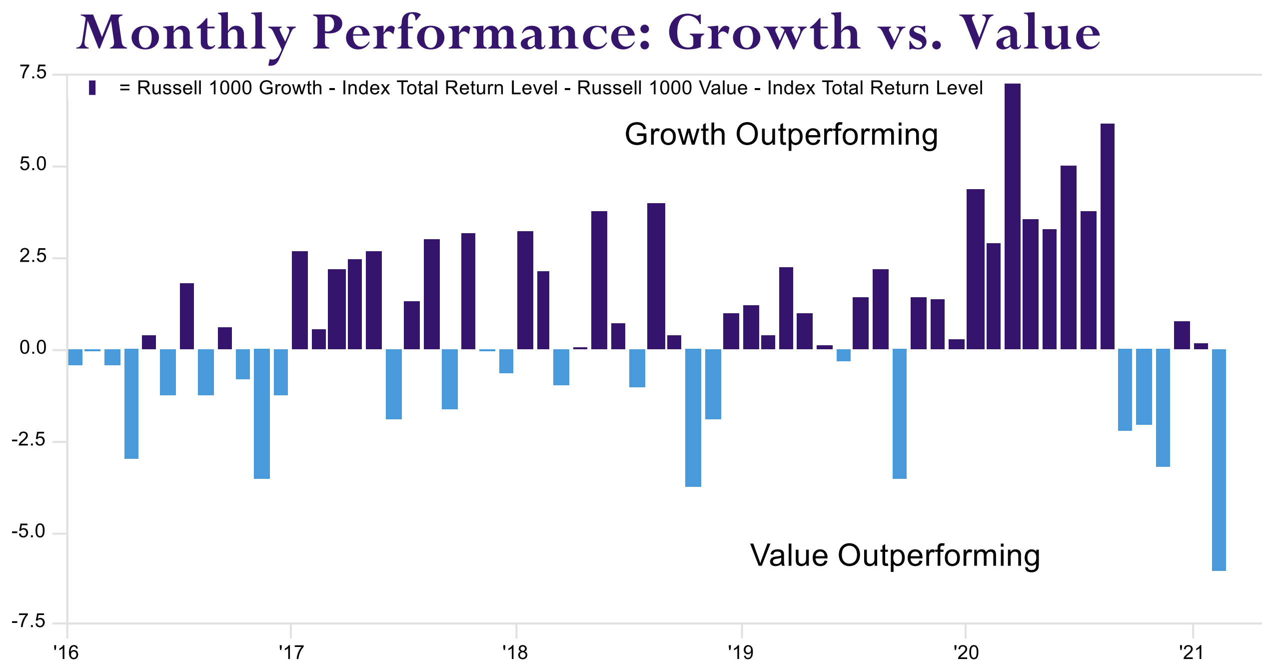
Secondly, much of this economic recovery seems to be already accounted for in stock prices. We wrote a lot last year about elevated stock valuations. Companies' stock prices are expensive relative to their earnings, compared to historical norms. Stock markets are forward-looking, so a lot of the 2021 economic recovery should be priced into markets. In addition, some of the run-up in stock markets last year was driven less by rational investors assessing the future fundamentals of the recovery, but by the increase in savings rates we discussed in the economic section.

Many in upper tax brackets have extra savings, with limited places to spend it. At first, these consumers shifted from spending money on services and started buying goods, but there are only so many goods people need or want. For instance, they probably aren't going to buy more than one exercise bike. There is some indication that some of the extra savings have been directed to the equity market, with some people even bidding up speculative stocks of bankrupt companies they heard about on internet message boards. And stocks were not the only thing people were investing in with the excess savings. People even bought "non-fungible tokens" like tweets, with the first tweet ever expected to sell for over $2.5 million. If you collect sports cards and/or memorabilia, you may have seen this firsthand. A Mickey Mantle baseball card broke the record for the highest-selling sports card of all time, going for $5.2 million in January. While this is an extreme example, sports cards have seen a broad resurgence in prices recently.

Thirdly, bond investors are starting to get nervous about the future strong growth trajectory of the economy and the possible resulting inflation. Long-term bond yields have been rising on this anticipation (see our recent commentary titled, Technology Selloff Continues as Investors Fret Rising Yields). This is important for equity investors because higher bond yields mean higher borrowing costs for consumers, potential homeowners and corporations. Technology stocks, in particular, are sensitive to this rise because so much of their value is determined by future earnings expectations, which have to be discounted more with higher rates. This is one of the reasons we saw volatility in technology stocks in February.

So, while the economic outlook may be good, we are balancing our market outlook with potential risks. Coming into the year, we wrote a lot about an uneven recovery in early 2021 and how, later in 2021, we could see a broadening of this recovery. Last year, much of the returns were driven by large growth companies and particularly technology companies that benefited from social distancing measures and increased work from home. We are already seeing the recovery even out this year, with more value-oriented and smaller companies outperforming. **Figure 2** illustrates the large outperformance by value stocks recently in 2021. The recovery seems to be broadening already and we expect this to continue as more social distancing measures are eased. Consumers will once again be able to spend money on more service-oriented sectors like travel and leisure. This should also help those employed in these industries.

Figure 2: Growth vs Value



Source: Cetera Investment Management, FactSet, Russell Investments. Data as of 2/28/2021.

While this rotation continues and bond markets assess the risk of inflation, we expect more volatility in equity markets, so diversification, not having too much concentration in any one sector or industry, will remain extremely important. With the decade-long outperformance of U.S. stocks relative to international stocks, now may be a good time to check your diversification across different countries, including emerging markets.

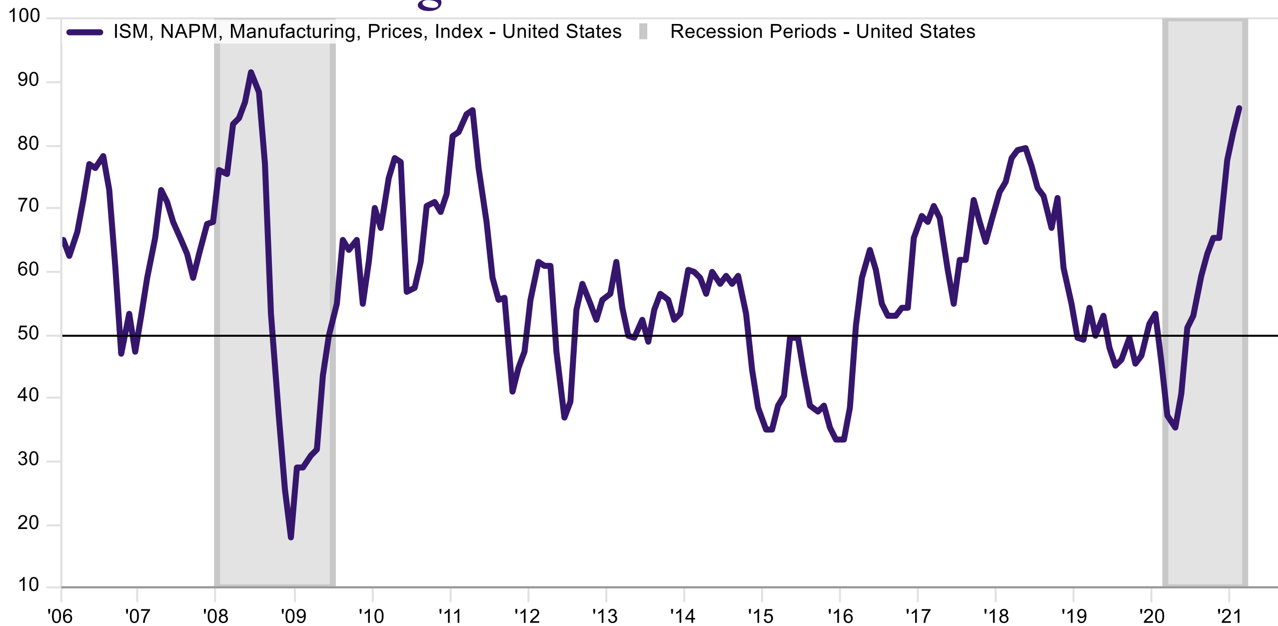
Fixed Income

As mentioned earlier, long-term bond yields are rising because bond investors are anticipating future growth and the possibility of above-average inflation. Inflation eats away at bond returns because their returns are fixed. For instance, if you buy a bond paying a yield of 1% annually and inflation is 2%, your "real return", or return after inflation, is -1%. Your purchasing power has been eroded by inflation because your money depreciated more than the return on your bond.

This is a concern for bond investors, so they are demanding more yield on their new bond purchases. When bond yields rise, the market price for bonds that have already been issued falls to adjust to the prevailing market yield. Long-term bond prices have fallen over 10% year-to-date, as long-term bonds are more sensitive to fluctuations in yields. The risk of bond prices falling in response to rates is known as duration risk.

Inflation is hard to predict. It often comes fast and unexpectedly. We have seen manufacturing input costs rise recently **Figure 3** and the price of copper, a key metal used in manufacturing, has doubled over the past year. Additionally, when local economies reopen fully, many consumers have been saving and could be ready to spend all at once. Employers could be competing for labor as workers return to the workforce, driving up wages. Wage inflation is a key driver of inflation because companies would have to pass this expense on to consumers.

Figure 3: Manufacturing Prices



Source: Cetera Investment Management, FactSet, Institute for Supply Management (ISM). Data as of 2/28/2021.

At this time, we think there will be a rise in inflation, but we expect it likely will be transitory and will pass. In our view, there could be a short-term blip of inflationary growth that won't be sustained. We are monitoring this closely for any changes to our thesis. Futures markets are currently pricing in inflation around 2.25% if we look at the break-even inflation for 10-Year Treasury bonds. This is the rate at which Treasury Inflation Protection Securities (TIPS) become more profitable than their Treasury Bond counterpart. This number is rising, but still

at a modest level. Keep in mind, TIPS also have a long duration so while the inflation protection could help, if yields rise, these bonds will fall in price as well.

Inflation and rising bond yields are risks to both bond and equity investors, and it is important to watch these risks. With the quick jump in long-term bond yields this quarter, we think bond yields could moderate and even fall in the near term. Longer-term, there will be upward pressure though. We still think it is important to hold high-quality bonds in a portfolio because they are one of the best buffers against equity volatility, which we expect will increase. Diversification is a balancing act, with all the components of the portfolio pushing and pulling on each other.

Moving away from high-quality government bonds to high-quality investment-grade corporate bonds, spreads are relatively tight. What that means is that their yield spread over government equivalent bonds is relatively low from a historical basis. In other words, investors are not anticipating a lot of credit downgrades. If credit conditions and the economy get worse, this spread will rise and the price of these bonds will fall. With the good economic backdrop, we believe that lower spreads may be justified. The extra yield on these bonds still makes them more attractive than government bonds.

Lower-grade corporate bonds, known as high-yield bonds, have higher spreads to compensate investors for the additional risk of default. The spreads on these bonds are also tightening, although less so than investment-grade bond spreads. These bonds will typically rise and fall with stock prices, so they offer less diversification from stocks. Smaller allocations to this space can offer a diversification benefit with more yield than higher-grade bonds.

Summary

We seem to be at a turning point in the economic recovery. While there is a possibility we could get more fiscal support later in the year, we may have received the final coronavirus relief package. U.S. savings rates have skyrocketed as social distancing restrictions limit consumers in their spending habits. Consumers have been pumping money into the stock market as a result, driving valuations higher. As vaccinations continue, we expect the economic recovery to broaden more into other sectors of the economy, mainly the service sector. This should be advantageous to unemployed workers. We do expect a jump in short-term inflation as consumers start to spend some of their savings and relief money, but at this point, we think higher inflation will be short-lived. This, however, has bond investors nervous as well as technology stock investors. As the economy transitions away from fiscal support and becomes more fundamentally driven, we expect higher volatility in asset markets.

We continue to recommend being diversified across asset classes, sectors, and countries and sticking to long-term risk and return objectives. There is a lot to be optimistic about, but also a lot of risks to consider. Your financial professional can help you stay on track and keep your sights on your long-term plans.

This report is created by Cetera Investment Management LLC. For more insights and information from the team, follow @CeteraIM on Twitter.

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

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The Russell 1000 index is a stock market index that tracks the top 1,000 stocks by market capitalization in the Russell 3000 Index, which represent about 90% of the total market capitalization of that index. The index, which was launched on January 1, 1984, is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

The Russell 1000 Growth index is a subset of the Russell 1000 as measured by three factors: sales growth, the ratio of earnings change to price, and momentum.

The Russell 1000 Value index is a subset of the Russell 1000 as measured by three factors: the ratios of book value, earnings, and sales to price.