2021 Market Outlook: The restart

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INTRODUCTION

After a volatile and historic 2020 we are optimistic headed into 2021

2020 was a year of surprises - an unexpected pandemic, a global economic shutdown, the sharpest US recession since the 1930s, and then the fastest ensuing economic recovery in history. Equity markets faced similar volatility with the S&P 500 experiencing the fastest bear market in history, and then the accompanying fastest bull market recovery in history. And yet by late-summer the market was once again in full stride and making new all-time highs, even as the wounds from the global pandemic remained.

Heading into year-end the world (and global economy) faces a difficult winter as the labor market recovery is slowing, COVID cases are spiking, and the sustainability of economic growth is uncertain amid new lock-downs. However, as we turn the corner and enter 2021 our outlook is positive. Much of the uncertainty that plagued markets this year appears resolved (US election, COVID vaccine), and we believe the worst to be behind us. We expect the economic recovery to resume in 2021, with widespread distribution of COVID vaccines the key catalyst.

Our theme for 2021 is “restart”, and with a restart comes optimism and the chance to begin anew. The post-COVID era provides that chance for investors, with both opportunities to capitalize on and challenges to avoid. The combination of COVID vaccines and accommodative monetary policy should help restart latent services sector businesses, while also emphasizing the strength of cyclical ones. At the same time, business models will need to adapt, and so labor market slack may persist into the near-future. Accommodative fiscal policy should provide a safety net for individuals and businesses, and help to soften the drag on the economy as this happens.

For investors, portfolios and investment strategies will need to adapt to the current environment. There will be volatility and bumps along the way as this happens, but for those that are disciplined and able to look past them, we see more opportunities ahead for upside than downside.

Five key investment themes for 2021

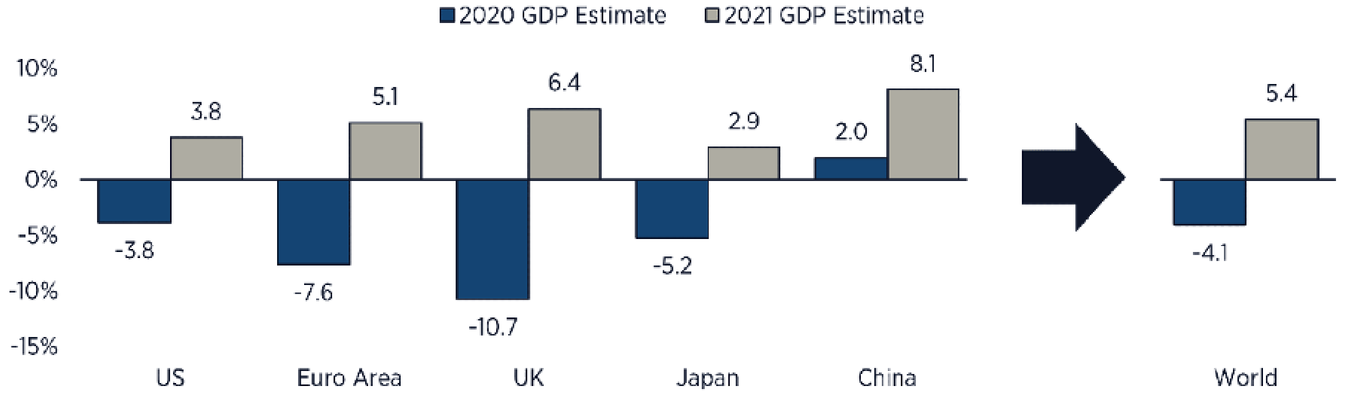
Heading into 2021 we expect a pick-up in global economic activity to provide tailwinds for further market upside, but caution that it will likely be a volatile path given COVID-uncertainty. Our five key investment themes discuss how the ongoing recovery is likely to impact the broader economy and markets. Our outlook is highly contingent on the trajectory COVID cases, including a successful global vaccine distribution, as well as ongoing fiscal and monetary policy.

1. The economic recovery will continue, helped by COVID vaccine roll-out

The market recovery in 2020 was impressive and historic, but economic activity still remains well below pre-COVID levels. Specifically, the recovery has favored technology sectors and consumer goods, while services sector (e.g. entertainment, travel, dining) business activity has stagnated. For the recovery to progress a pick-up in services sector activity is essential, which we see as contingent on, 1) stability in COVID case trajectory, 2) the ending of “lockdowns” across cities and counties, and 3) a successful COVID vaccine roll-out.

As the COVID vaccine(s) is rolled out for global distribution, we expect consumer sentiment towards services activities to recover, driving a rebound in leisure spending and further economic expansion.

Exhibit 3: GDP is expected to sharply rebound globally in 2021



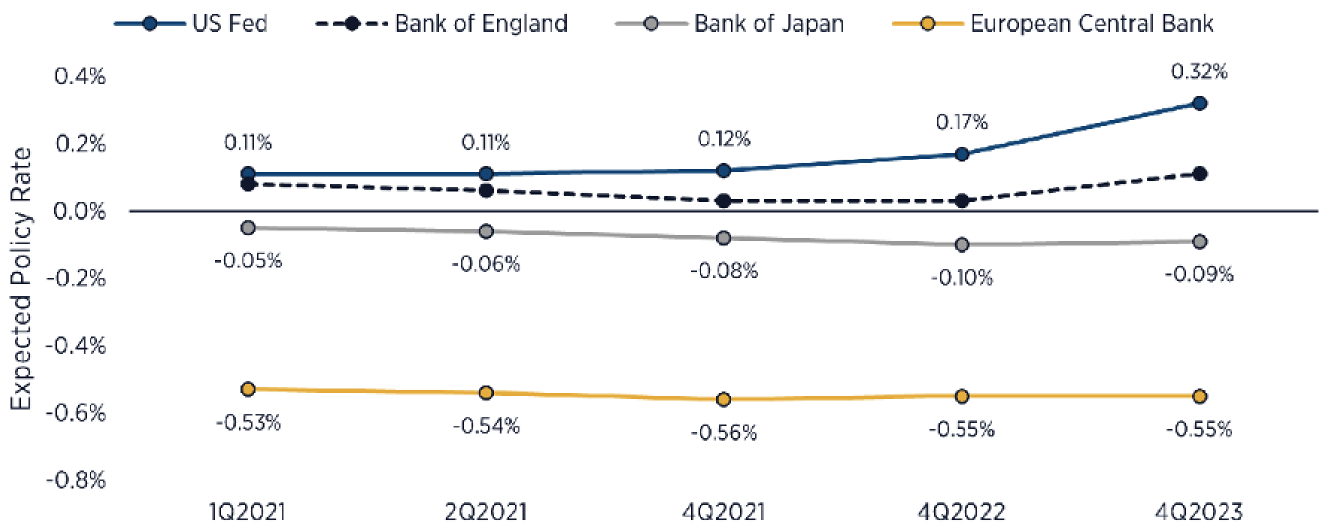
Source: Goldman Sachs, JPMorgan, IMF, Trading Economics. As of 12/2/2020.

2. Persistent fiscal and monetary policy support should keep markets stable

Heading into the Biden presidency there is uncertainty around the direction of fiscal policy going forward. We expect with Yellen as Treasury Secretary the new administration will favor easing measures, providing additional fiscal support measures to aid the economic recovery.

On the monetary policy front we look for the Fed (and most global central banks) to hold rates low well past- 2021 in support of market stability. The Fed has committed to not raising US rates until inflation *averages* 2%, and employment reaches maximum levels. And with the availability of the Fed's emergency facilities (if needed), we expect markets to favor risk-on investing, especially equities in cyclical sectors and lower quality credits.

Exhibit 4: Central banks are expected to keep benchmark rates low for the next 3 years



Source: Bloomberg. As of 12/2/2020.

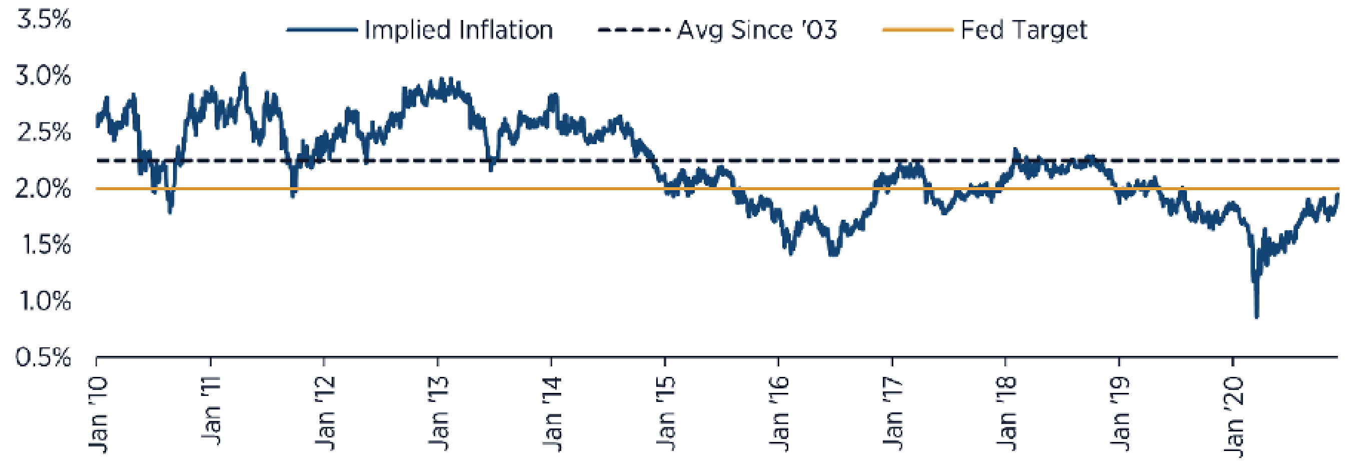
3. Inflation isn’t a concern right now, but could start to pick-up in 2H21

Inflation uncertainty remains prevalent across investors and markets. While inflation expectations (looking out five years) have recovered from their COVID-lows, inflation (and expectations) remain low by historical measures. Near-term with labor market slack prevalent, easing/accommodative monetary/fiscal policy, and the ongoing shift to digitization/remote-work across industries likely to persist, we think inflation catalysts are minimal.

However, as the labor market continues to recover in 2021we think the Fed may start to reduce its use of emergency facilities. In doing so we think markets maybe begin to price in higher inflation *expectations* which would likely drive yields higher in 2H21 (even as the Fed keeps benchmark rates low).

Near-term we see opportunities for investors seeking yield to increase exposure to high yield bonds, while also making strategic allocations to cash flowing real assets such real estate and infrastructure.

Exhibit 5: Inflation expectations have rebounded from COVID-lows, but still remain historically low



Source: Five year forward inflation expectations - St. Louis Fed, FRED. As of 12/2/2020.

4. Equity markets will likely run higher as economic conditions improve

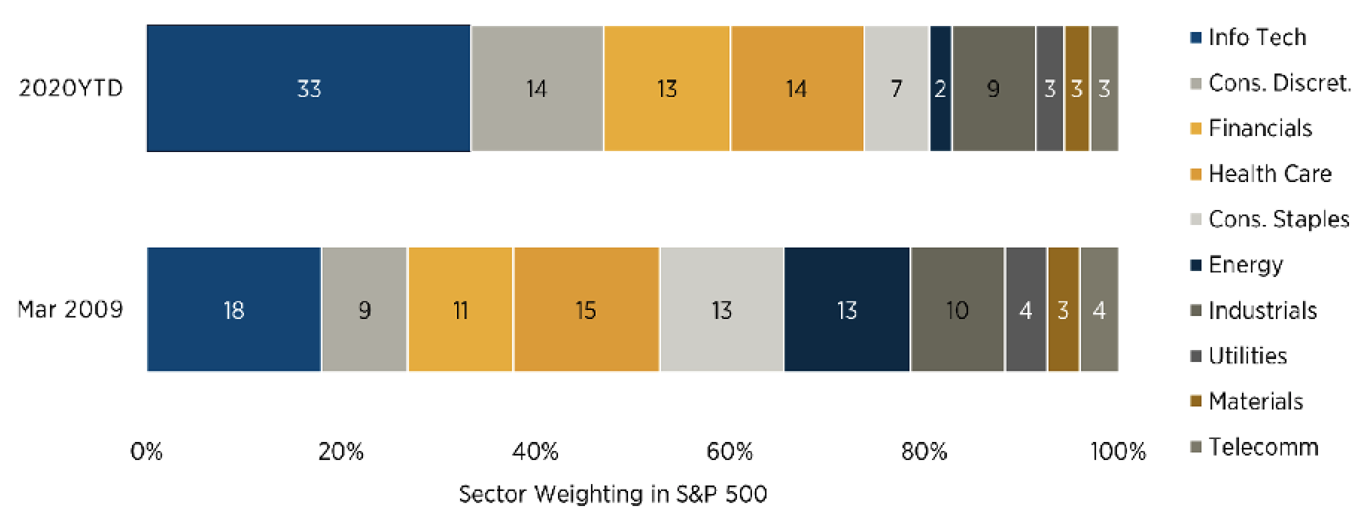
As the economic expansion broadens in 2021 we expect the equity market rally to continue, but with broader sector participation than in 2020. Specifically, we think services sector businesses will start to experience greater participation in the rally. Cyclical businesses, and especially those more technology focused, will likely still outperform amid consumer and business emphasis on adaptable business models, and those favoring remote/virtual operations.

Shifting composition dynamics within the S&P 500 toward these investor-focused sectors is also likely to provide tailwinds for further market out-performance.

The five largest stocks in the S&P 500 (AAPL, MSFT, AMZN, GOOGL and FB) are all forecast to grow revenues faster than the other 495 names, with similar/better earnings. Furthermore, the combination of a weak USD and labor market slack (as businesses continue to streamline operations) should support corporate margins and drive earnings improvement.

Lastly, we think persistent low rates and a willingness of market participants to pay a premium for consistent topline (and bottom line) growth will help outweigh concerns and potential headwinds over rich valuations.

Exhibit 6: Composition of the S&P 500 today reflects shifting industry growth dynamics



Source: Bloomberg, S&P Moodys. As of 11/30/2020.

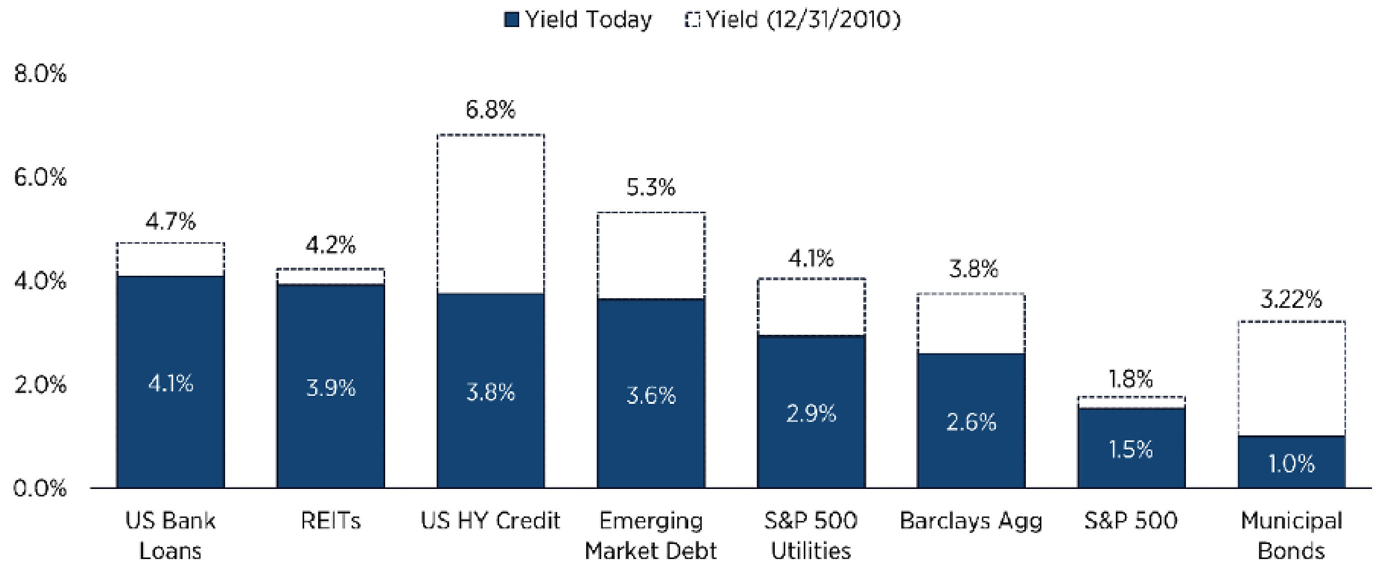
5. Portfolio yield opportunities exist, but from non-traditional sources

With rates near zero generating sustainable portfolio yield is challenging. Opportunities for yield from traditional fixed income investments (e.g. corporate bonds) is low, but the prevalence of accommodative fiscal/monetary policy is creating opportunities to look at lower quality credits for income needs.

For investors willing to extend credit risk we think US high yield bonds provide compelling opportunities for adding yield to portfolios, both on the corporate and municipal side. Outside of traditional fixed income, non-traditional sources such as hard assets, infrastructure, and private debt (including those with multi-year lock-ups) provide compelling opportunities for yield. These investments are supported by the fiscal environment, which we expect will help reduce the risk of corporate defaults.

In seeking yield it's essential investors do not blindly add risk to portfolios, but evaluate and understand all investments. Investors must also re-evaluate their own risk profile to determine the risks they're comfortable taking for income.

Exhibit 6: Generating yield from traditional sources is a challenge



Source: S&P CapitalIQ, Vanguard, Morningstar, FTSE/NAREIT, FRED. As of 12/2/20.

Moving forward from here

Investing is a journey. At the beginning of 2020 many investors looked to de-risk portfolios, fearing the uncertainty of COVID and how the economy would recover. And yet by the fourth quarter markets and the economy staged one of the strongest rallies in history.

Successful long-term investing requires having a plan, patience, and the fortitude to remain disciplined. Staying invested and capitalizing on investment opportunities is essential, as is finding opportunities that can consistently perform across economic environments. The market remains volatile, but as the economy restarts there are trends and opportunities to capitalize on for those willing.

Major asset class views

For 2021 we continue to favor a risk-on tilt across our portfolios. Equity market momentum is likely to persist, driven by technology sector leadership. With interest rates low and the current yield environment unlikely to change near-term, investors requiring yield may need to look to non-traditional asset classes. Real assets and alternatives continue to provide compelling options for income and risk diversification.

Asset Class	Tactical View	Investment Thoughts
Fixed Income	-1	We are negative on fixed income strategically given tight spreads and a challenging yield environment. Strategically we prefer high yield given current income and potential for spread tightening.
Equity	+1	We see opportunity for equity market momentum to persist near-term, especially in cyclical sectors which should continue to benefit as the economy recovers. We think high valuations can persist, and prefer US over International given a weaker USD and recovery momentum in the US.
Real Assets	+1	We are positive on real assets which we see having the potential to provide additional portfolio yield and risk/return diversification, while also providing some inflation protection.
Alternatives (Fixed Income)	+1	Non-traditional fixed income, including private credit, have potential offset income weakness from traditional fixed income. The Fed backstop, low rates, and a recovering economic present opportunity in growth-based private debt lending.
Alternatives (Equity)	Neutral	We are neutral equity-like alternatives (e.g. traditional private equity and hedge funds) as the illiquidity premium has diminished in the current environment. Tactically we see opportunity in niche, middle-market segments.

ENDNOTES

Disclosures

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Glossary

MSCI ACWI-All Country World (ex U.S.) Indexis a market capitalization weighted index designed to provide a broad measure of global equity market performance excluding the U.S. **MSCI EAFE Index** is a free float-adjusted market capitalization weighted index designed to measure developed market equity performance, excluding the U.S. and Canada. **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. **Russell 2000® Index** measures the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. Russell 2000® Growth Index measures the performance of the large-cap growth segment of the Russell 2000 Index. **Dow Jones Industrial Average** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq. **Nasdaq Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. **S&P 500® Index** is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy.

A word on risk

All investments carry a certain degree of risk, including possible loss of principal, and there is no assurance that an investment will provide positive performance over any period of time. Equity investments are subject to market risk or the risk that stocks will decline in response to such factors as adverse company news or industry developments or a general economic decline. Debt or fixed income securities are subject to market risk, credit risk, interest rate risk, call risk, tax risk, political and economic risk, and income risk. As interest rates rise, bond prices fall. Non-U.S. investments involve risks such as currency fluctuation, political and economic instability, lack of liquidity and differing legal and accounting standards. These risks are magnified in emerging markets. This report should not be regarded by the recipients as a substitute for the exercise of their own judgment. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager.

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