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Empowering enterprising families to thrive. Together.

Economic and Investment Outlook For 2021

Economic weakness in 2020, due to Covid-19, will likely be recovered in 2021 as unprecedented stimulus has been injected into the global economy. Real GDP in the U.S. is likely to have been down 3.5%-4% and estimates for 2021 are for 4%-6% growth. Forecasts put U.S. GDP back to its high-water mark sometime in the 2nd half of 2021. A 4% growth rate would be the highest since the late 1990's and over 6% would be the highest going back to 1984. While vaccines have proven effective, getting them out to the right people in a timely and efficient manner has been bumpy. The strong projections for strong economic growth are dependent on most of the U.S. population being vaccinated by mid-to-late Spring. The first quarter is expected to see slower economic growth due to the pick-up in cases and longer lockdowns in the Northeast and California with the second and third quarters to come in very strong. Unemployment will continue to decline below 6%, but the longer lock-downs are likely to increase the duration of unemployment and the deterioration of skills that will need to be built back.

Fiscal policy will likely be increased with Democrats controlling the Federal Government and looking to deliver on electoral promises. The narrow majority will likely lead to a smaller injection, but not as extreme of tax increases as anticipated. There appears to be bipartisan support for infrastructure spending whose support depends on how aggressive the progressives want to be on the "Green New Deal". Monetary policy will continue to remain loose as the Federal Reserve has indicated their intentions of keeping rates low for the next 12-24 months. While 2021 is likely to see a strong bounce back to peak GDP levels, it will remain to be seen how the U.S. can maintain a growth rate above the trend of 2%-2.5% that we have seen over the past decade.

With the injection of liquidity into the economy, the U.S. is now at its highest level of Debt to GDP since WWII. Projections are for that level to continue to increase to record levels, as the Democrats are likely to experiment with Modern Monetary Theory (MMT) which is based on the theory that countries that issue debt in their own currency won't default and interest rates won't rise to unsustainable levels. If businesses and the financial system can be bailed out, why not disadvantaged individuals? Expectations of inflation have been on the rise as well as concerns about the debt, but due to record low interest rates, the interest coverage is manageable. While we are likely to see inflation (CPI) rise above 2% in the 2nd quarter it will be hard to stay above that level for very long. What history has proven out (Japan, Europe) is that more debt has led to lower interest rates, as adding more debt doesn't translate into more growth that heats up the economy.

On the investment front, we expect equity markets to have momentum with strong global growth and higher earnings. We also expect to see elevated volatility as we approach herd immunity and low interest rates continue to push investors into risky assets. Bond yields are at historical lows and the ability of bonds to hedge an equity portfolio in a down market has diminished. We continue to look at adding to strategies such as covered call writing, absolute return hedge funds, commodities, and long volatility/convexity.

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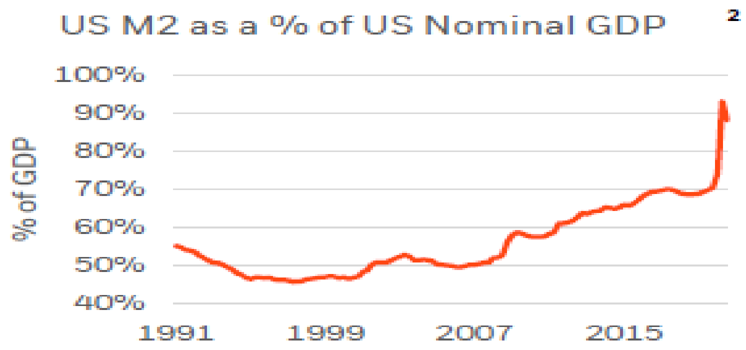
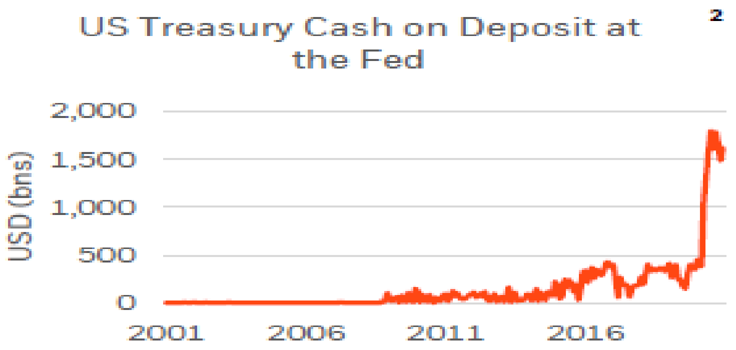
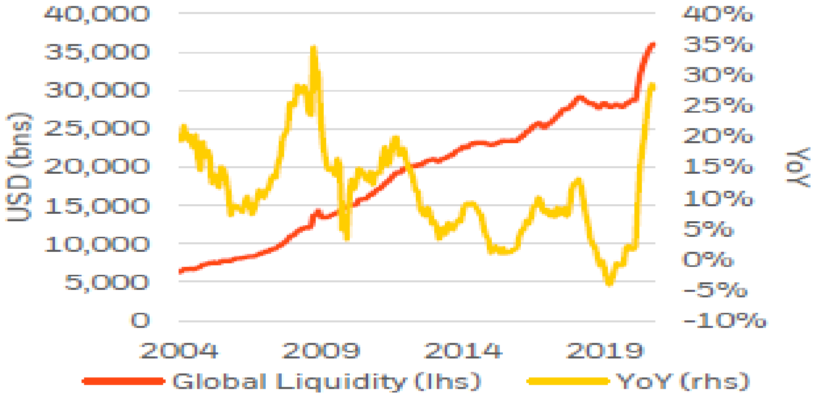
Unprecedented Liquidity

Elevated liquidity levels will produce strong global and U.S. economic growth. We are likely to get back to 2019 GDP levels in the 2nd half of the year, assuming a successful vaccine delivery plan and full opening of the economy.

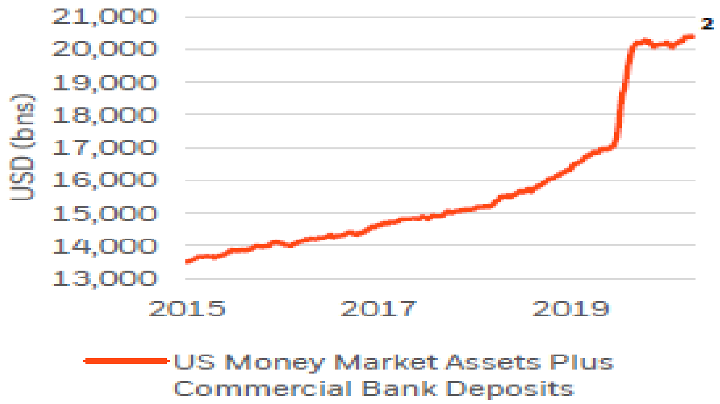




Global liquidity* has grown more over the last 12 months than the total amount of liquidity that existed prior to the GFC! [2]



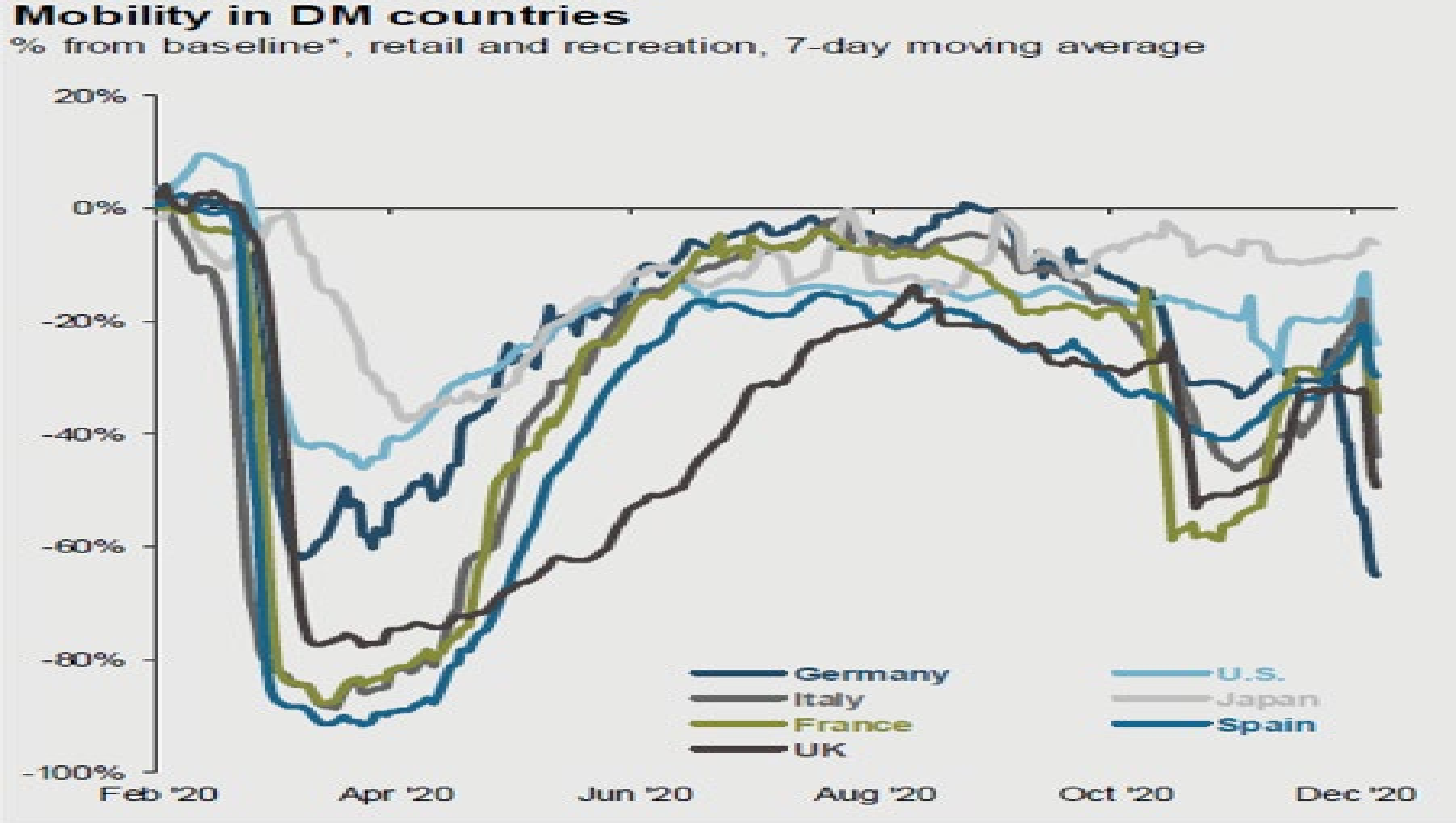
With a lot of USD cash "sitting on the sidelines"



Source: Blackrock

Weak 1st Quarter

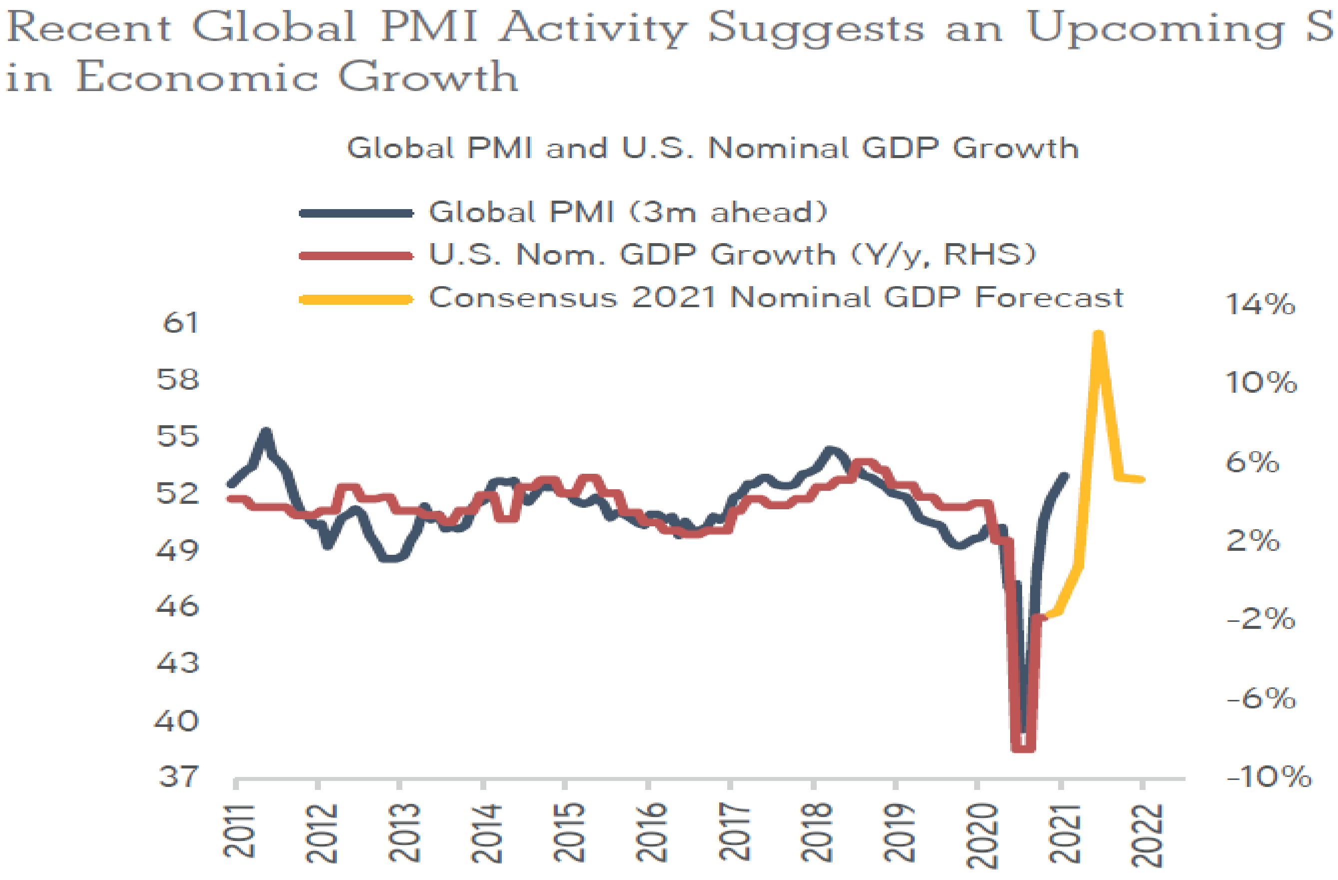
The first quarter is likely to be weaker than the rest of 2021, due to a delay in reopening from peak Covid cases in the U.S. and Europe.



Source: JP Morgan

Strong Back Half of 2021

Manufacturing activity has picked up due to inventory needing to be built back. Strong global PMI(Purchasing Managers Index) levels lead to strong GDP growth over the next quarter.

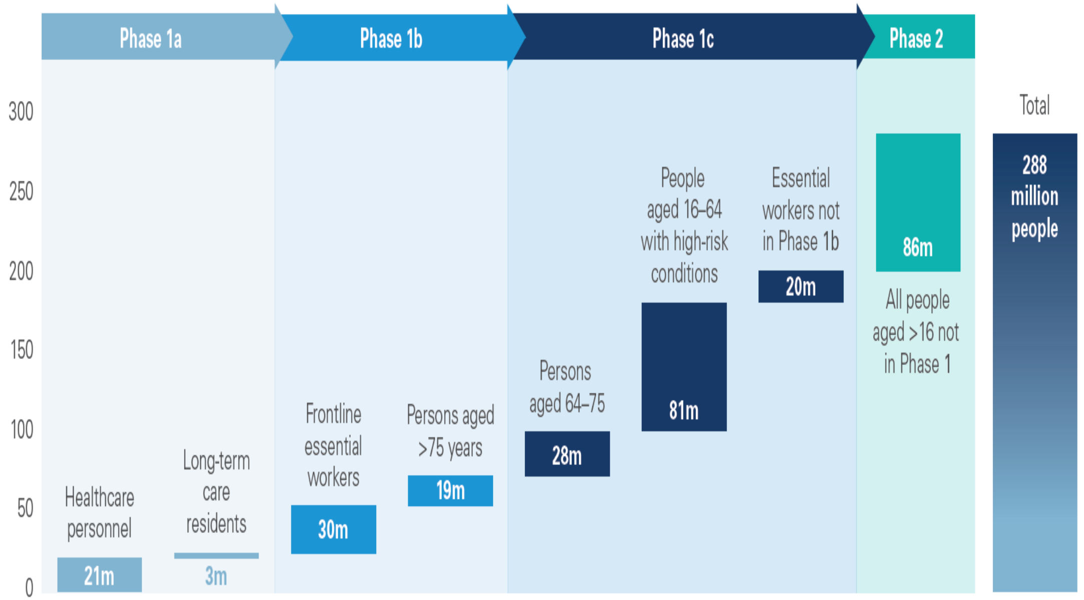


Data as at November 30, 2020. Source: Bloomberg.

Vaccine Rollout

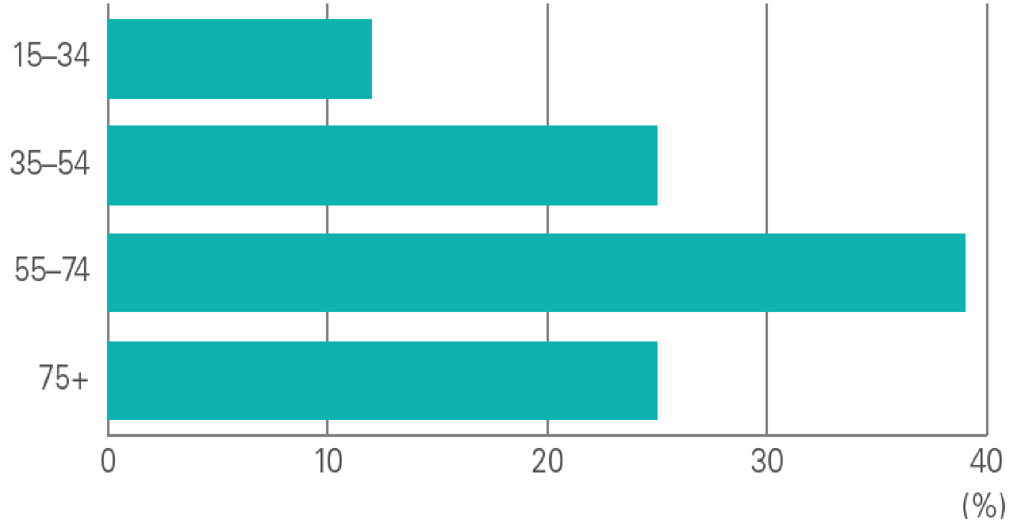
Most positive economic estimates are based on a successful rollout of the vaccine. Once the population over 65 gets vaccinated, we will see hospitalizations reduced by over 50%. This will allow for most cities to be fully re-opened. The rollout plan should achieve this by the end of Spring.

Exhibit 3
Vaccine Rollout Plan



As of 20 December 2020
Source: Centers for Disease Control ACIP COVID-19 Vaccines Work Group

Exhibit 4
Percentage of Hospitalized Patients by Age Cohort



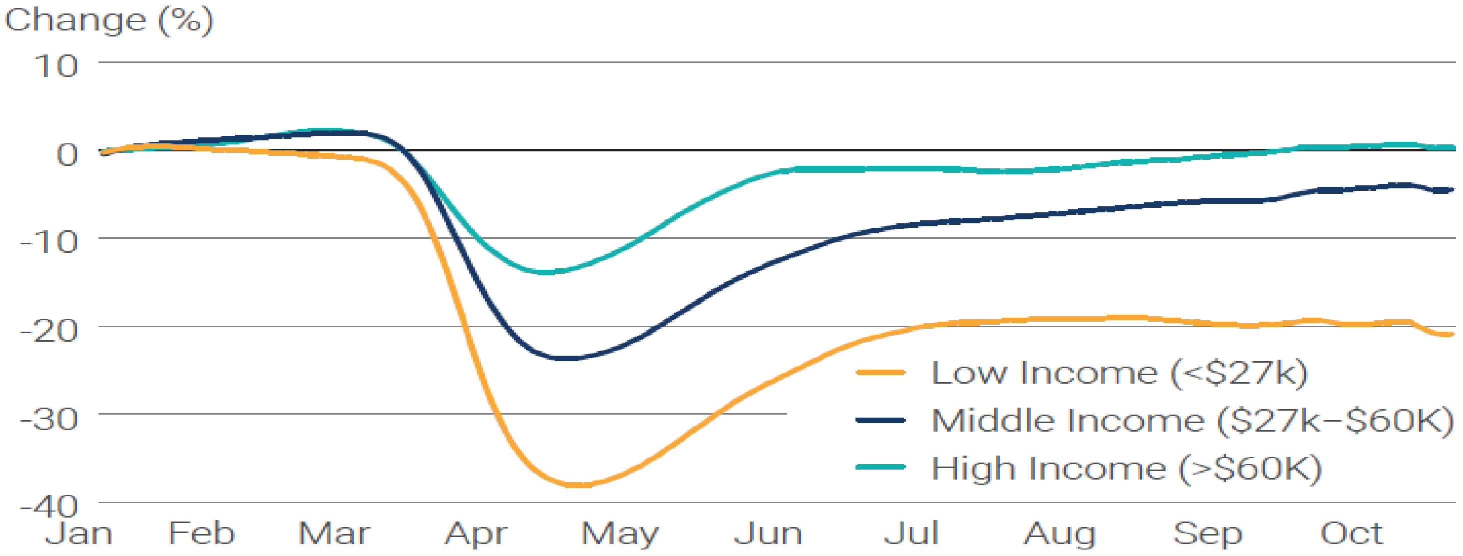
As of 20 December 2020
Source: Centers for Disease Control ACIP COVID-19 Vaccines Work Group

Reopening

Most of the currently unemployed are in lower paying service/hospitality jobs. They are the most likely to be behind on rent and the most likely to spend. The cares act and reopening will produce strong consumer spending by this group.

Exhibit 8
Employment for Low-Income Workers is Down 20% This Year

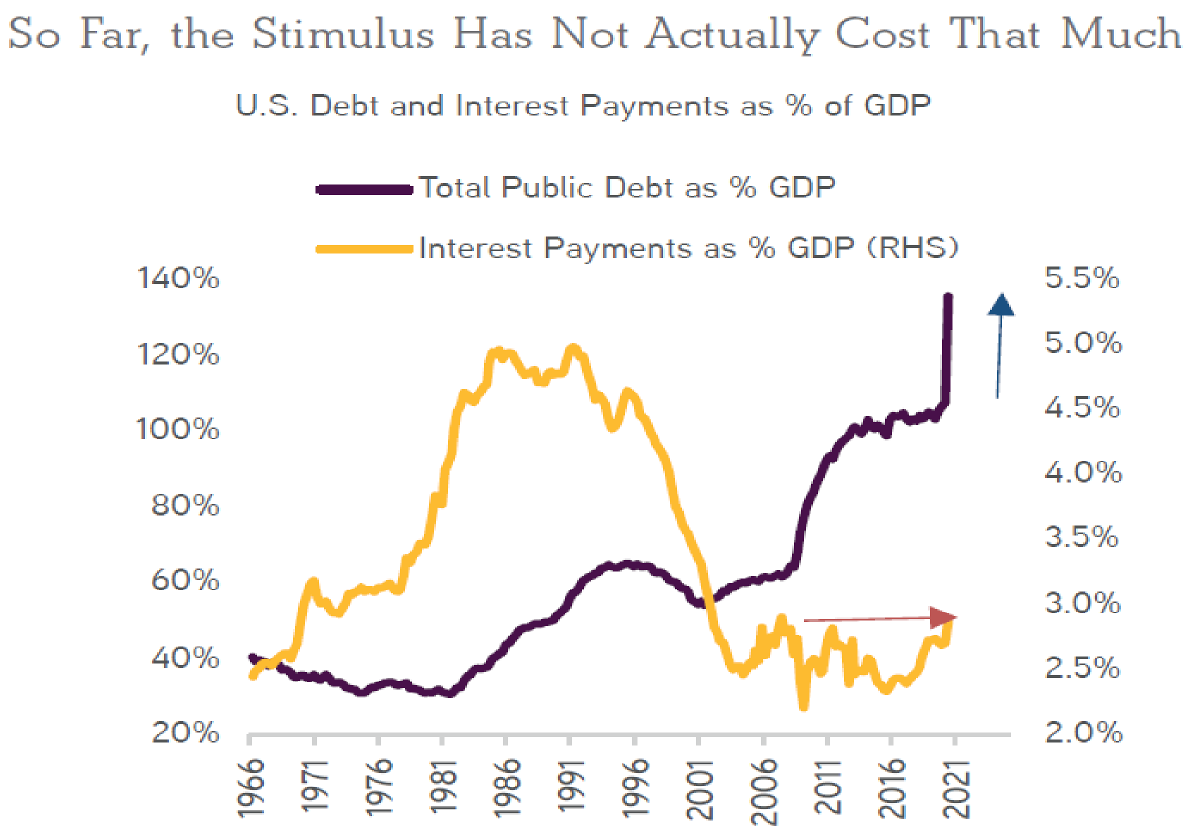
Employment Rates by Income Bracket Compared to January 2020



As of 19 November 2020
Source: tracktherecovery.org

Inflation Expectations

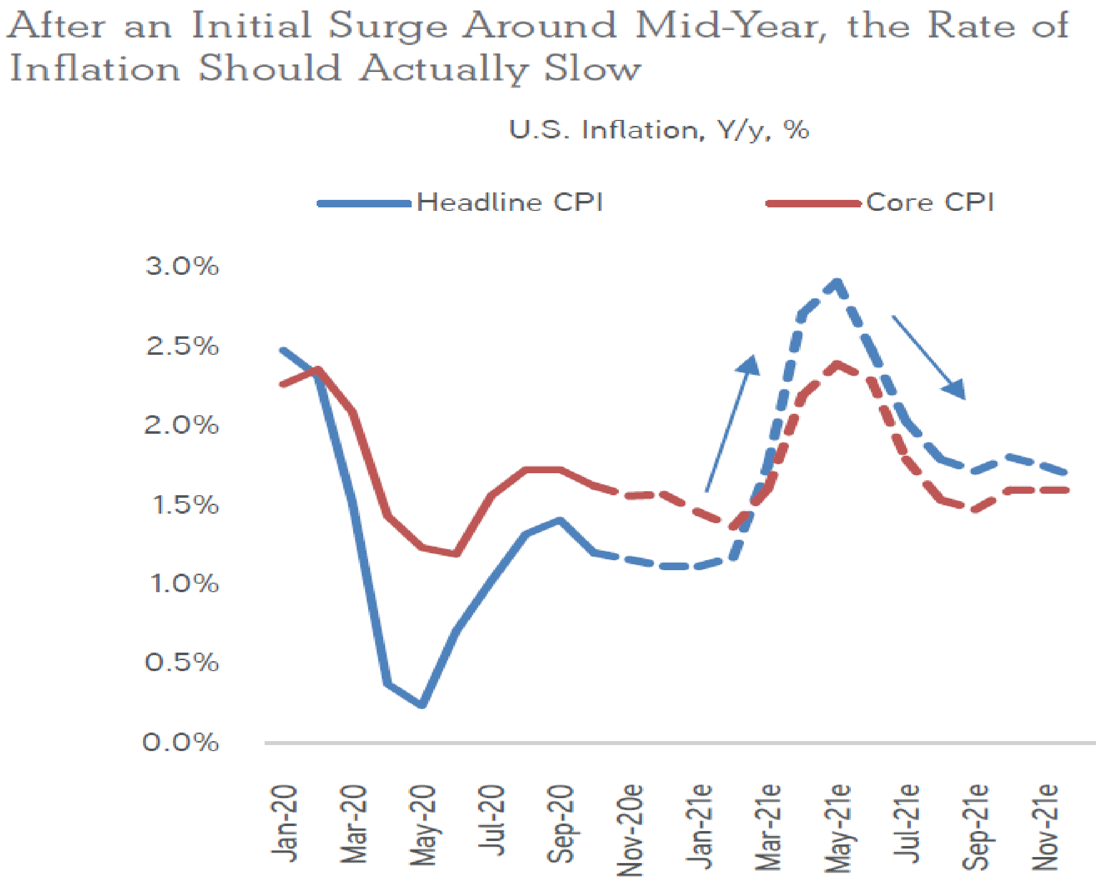
With the dramatic increase in debt, concerns of higher inflation have increased. So far, due to historically low interest rates, interest payments as a % of GDP are manageable.



Data as at September 30, 2020. Source: BEA, Haver Analytics.

Inflation Expectations

Inflation will likely increase more than 2.5% in the second quarter, due to the year-over-year comparison to the second quarter of 2020. After that, it will return to its sub 2% level.



Data as at November 30, 2020. Source: Bureau of Economic Analysis,

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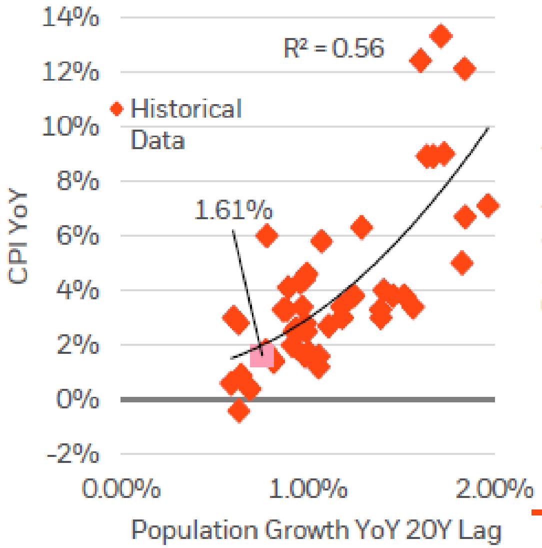
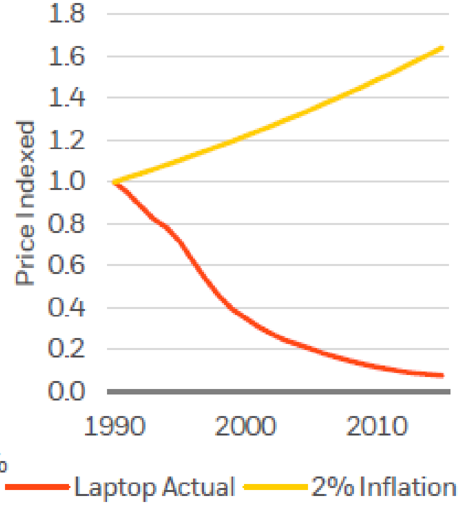
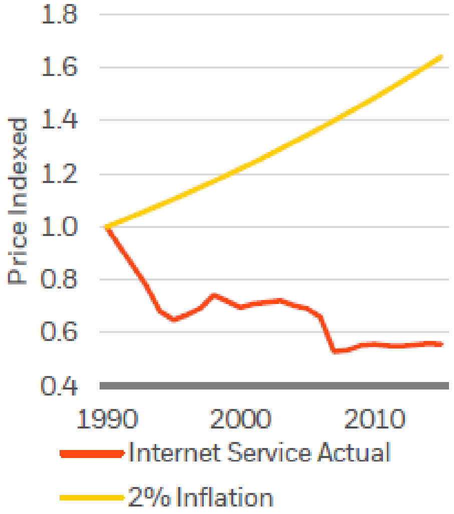
Inflation Expectations

Inflation has been hard to elevate above the 2% level due to: 1) Population growth declining 2) Technological advances have put downward pressure on prices, and 3) Education and Medical prices have grown exponentially, which will slow.

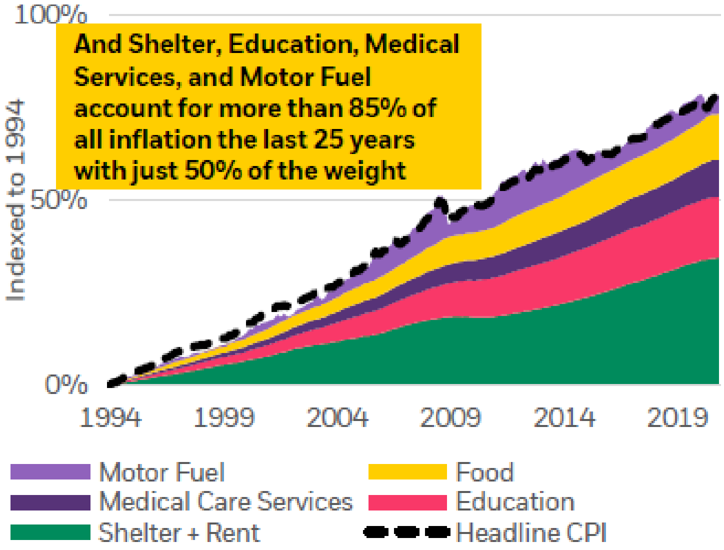
We have shown the demographic and technological headwinds to inflation many times… To put it simply, there has not been enough demand to drive escalating inflation and technology has only served to further reduce costs and expand capacity…







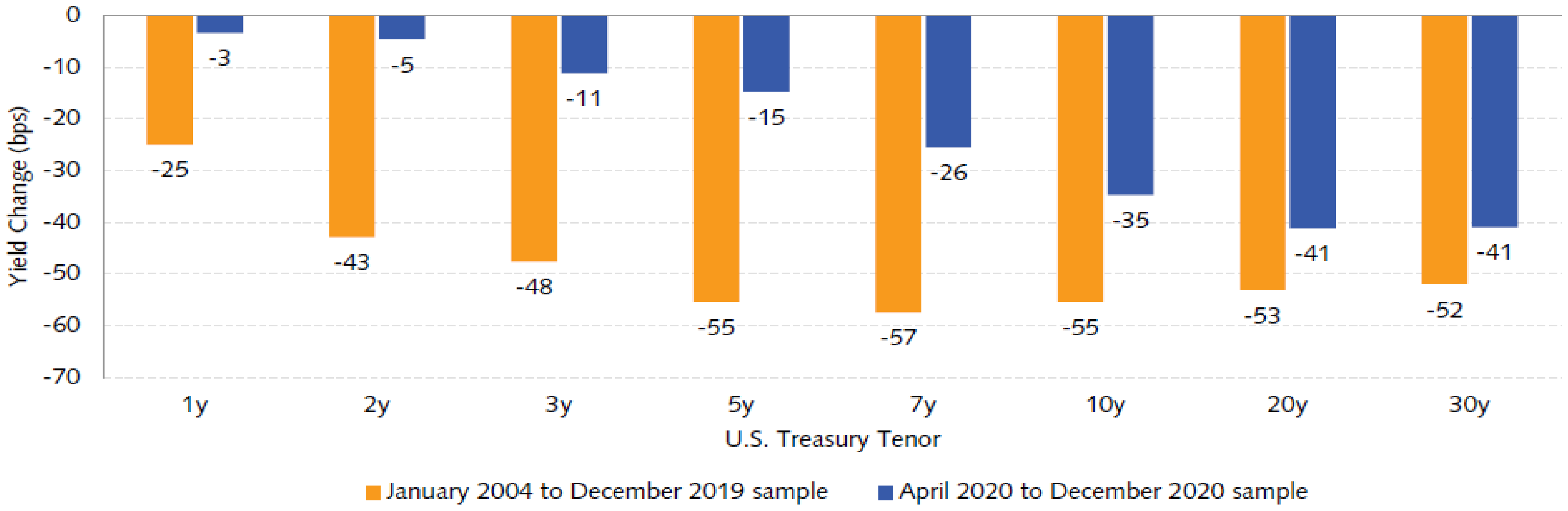
In fact, just 5 categories (Shelter, Education, Medical Services, Food and Motor Fuel) account for more than 100% of all inflation over the last 25 years… despite being just 64% of the weight



Source: Blackrock

Fixed Income Challenges

The low-rate environment has made U.S. Treasury Bonds less useful as a hedge. A 7–10-year Treasury will only provide half of the yield decline (price appreciation) today versus the previous 15 years. Investors will have to invest in riskier bonds or barbell purchases of 20–30-year bonds with cash.



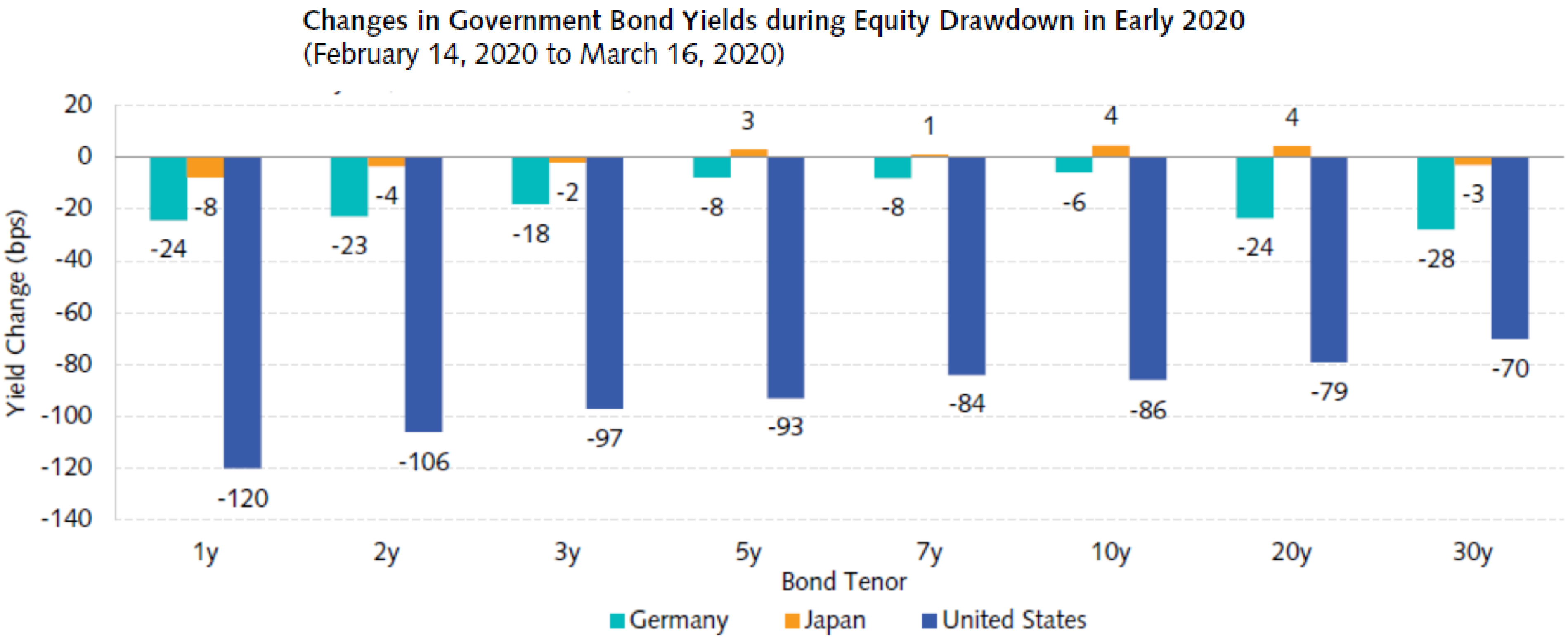
The graph above reflects predicted changes (in basis points) in constant maturity U.S. Treasury yields during an equity market drawdown of the same magnitude as that considered in Figure 1. Predicted changes were calculated by the D. E. Shaw group using typical betas from regressions of daily changes in U.S. Treasury yields on daily changes in the S&P 500® based on an unweighted sample from each of the periods (i) January 1, 2004 through December 31, 2019 and (ii) April 1, 2020 through December 31, 2020.

Sources: Bloomberg (U.S. Treasury yield and S&P 500® data); the D. E. Shaw group. Applicable data are used with permission of Bloomberg.

[2] In our earlier paper *Positively Negative: Stock-Bond Correlation and Its Implications for Investors* (available here), we argued that the correlation between Treasury security prices and equity prices depends on the underlying shocks in the economy, and that the greater importance of changes in the growth outlook and risk aversion (relative to inflation) had pushed the correlation negative. Based on that perspective, we would expect the favorable correlation properties of Treasury securities to remain in place in the absence of a significant inflationary shock.

Fixed Income Challenges

Japan and Germany saw virtually no hedge benefit in their Government Bonds during the Feb/Mar Selloff. 5-year to 20-year Japanese Bonds actually went up in yield (down in price).



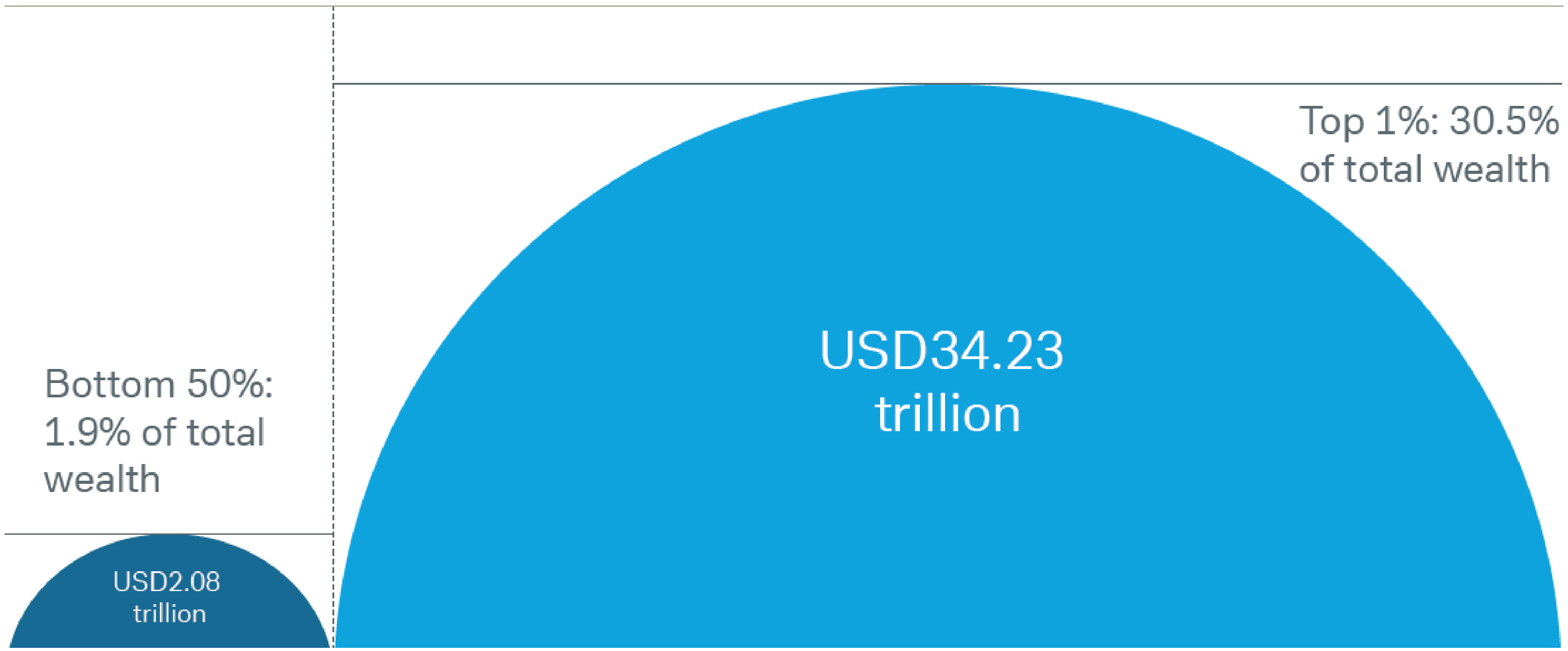
Source: Bloomberg (German Bund, Japanese Government Bond, and U.S. Treasury yield data); the D.E. Shaw group. Applicable data are used with permission of Bloomberg.

Wealth Disparity

The top 1% continued to gain extraordinary wealth while the bottom half of households fell further behind. Asset price increases benefit fewer people while higher housing prices along with lower-to-flat income put middle-to-low-income households further away from home ownership. Across history, extreme wealth disparity has eventually led to social turmoil.

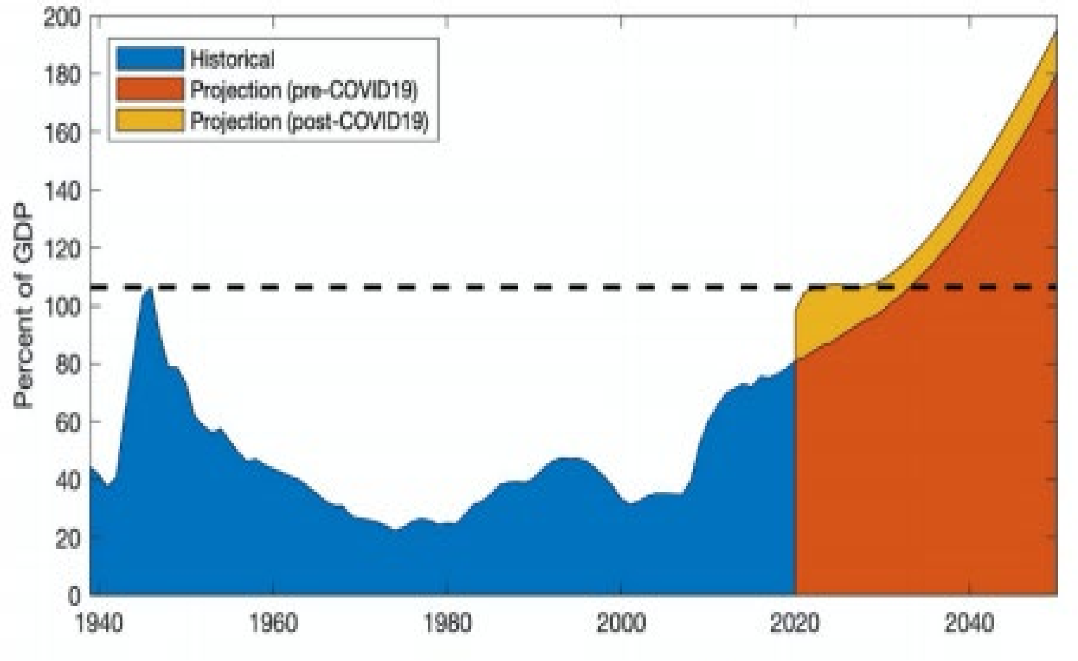
U.S. household distribution of wealth by percentile, Q2 2020

Source: U.S. Federal Reserve, Deutsche Bank AG. Latest available data (based on census returns) of December 1, 2020. Total U.S. wealth in Q2 2020 is recorded as USD112.05 trillion.



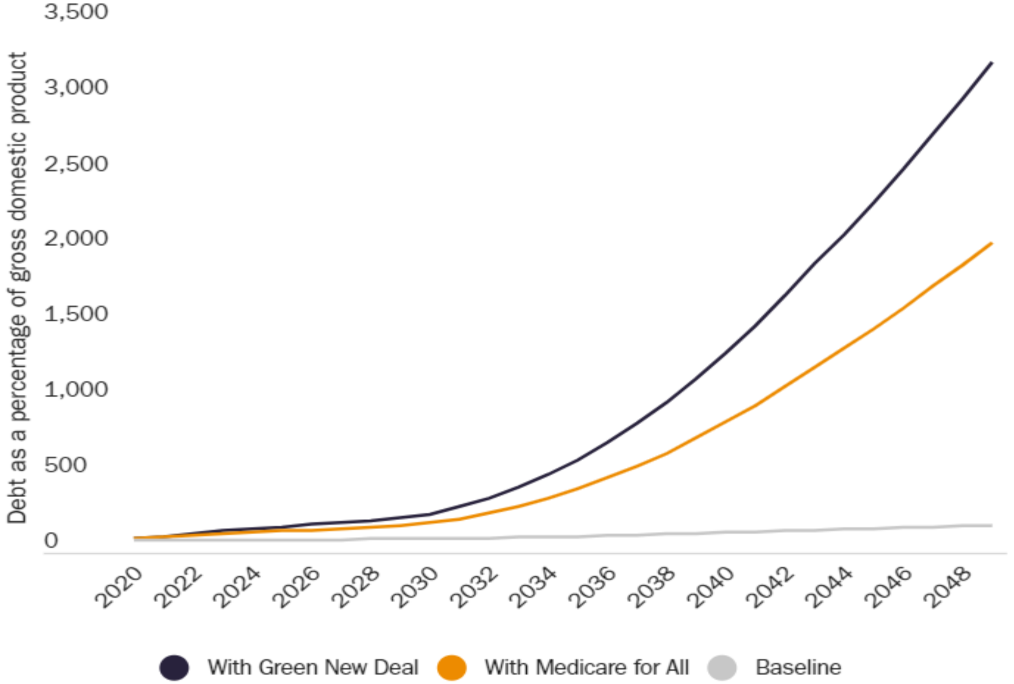
Debt Challenges

U.S. debt is at war time levels and not likely to decline. More debt does not equal more growth. Debt does not generate an income stream to repay principal and interest unless it goes toward something like infrastructure. $1 of debt generates around $.27 of growth.



SOURCES Office of Management and Budget (OMB), accessed via Federal Reserve Bank of St. Louis (FRBSL) and CBO

Debt to gross domestic product ratio, baseline scenario versus Medicare for All and Green New Deal



Source: Author's calculations based on data from "Budget and Economic Data: Historical Data and Economic Projections," Congressional Budget Office, January 2020.

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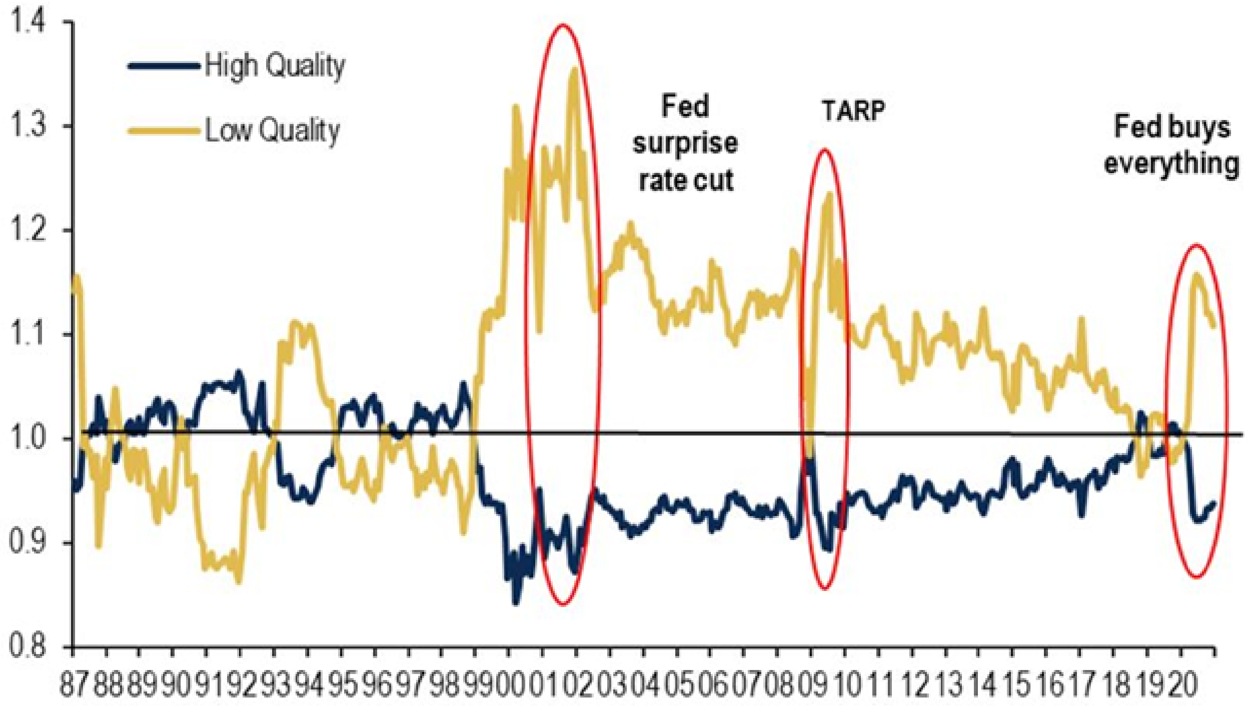
Liquidity And Fundamentals

The injection of liquidity into the system has led to speculation in low quality and low-stocks. Stimulus checks, work from home, and free trading through the likes of Robinhood has created a perfect storm for investing as gambling. This has happened before, with fundamentals eventually taking back over.



High Quality Looks Cheap vs. Low Quality but Expect Re-Rating, January 2021, source BofA US Equity & Quant Strategy.

Liquidity and Fundamentals

Since the March lows, the most shorted stocks in the Russell 3000 have gone up over 350%. Many of them should be out of business. The propping up of weak companies through short squeezes and low interest rates keeps inflation low as profitability is not the most important fundamental.

Source: Bloomberg and JP Morgan

Portfolio Positioning

- With the likelihood for a strong economic rebound in 2021, we have positioned to take advantage of more cyclical exposure in our equity allocations. The optimal place to gain exposure is in the emerging markets. We increased our allocation to emerging markets with over 90% of our exposure in active managers.
- Within our bond portfolios, we maintain a duration in the 4.5-5year range. With intermediate term fixed income not providing the hedge to an equity sell-off as it has historically, we will take a barbell approach (cash or very short and longer maturities). In addition, we are adding exposure to a global active manager who can access less efficient markets.
- Due to the low interest rate environment, we see opportunity with absolute return hedge fund strategies. This includes Event Driven, Global Macro, CTA's, and Long Volatility/Convexity. Long Volatility and Convexity is an area that is less known, but that can provide a good hedge to both equity and fixed income markets. Historically, long volatility has had the flaw of losing money in normal times, then a big mark to market increase when the selloff comes, and finally giving most of it back. We are looking to add to a couple of managers who can manage the negative carry and realize gains rather than giving them back.

Disclosures

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