2020 Year in Review and 2021 Economic Outlook

By Hancock Whitney Asset Management

January 2021

2020: A Mosaic of Disaster

For asset management professionals, the memory of the Financial Crisis of 2008-09 does not easily fade away. During those dark days, we spent much of our time discussing the many 'firsts' or 'worsts' used to describe the economy, markets, and employment. Client conversations were plentiful and many advisers also doubled as therapists all the while themselves secretly worrying how it may end. As it became apparent that the global economy wasn't going to collapse and stock markets would eventually heal, we had hoped this would be a 'once in a career' experience. Enter the Pandemic of 2020.

As 2019 ended, we felt like U.S. – China trade relations would be the top issue of 2020. Little did we know at the time how insignificant a topic that would become. Our attention was still on China, but for a much different reason. A virus that scientists knew little about was spreading quickly through the population taking a toll on life, commerce, and mental and physical health. Weeks later, this was not just a China issue - it was a global issue. Many 'firsts' or 'worsts' would soon be recorded and the way we live, work, shop, and socialize would all change very quickly. We all know the story.

If you've spent any time on social media, you have definitely run across a meme or two (or a hundred), telling 2020 just how we all felt about it and how we were anxiously awaiting to flip the calendar with 2021 at the top. If only it were that simple. Unfortunately, January 1, 2021 was not a light switch. As we all know now, the dark days of the Pandemic are still here. However, there are still many reasons to be hopeful. Medical researchers have made tremendous strides in treating and, in time, preventing the spread of the virus through effective vaccines that should bring us back to a more 'normal' world. Spring is coming.

In this issue, we briefly review some of the key market, policy, and economic highlights of 2020 followed by a more in-depth look at 2021 and the reasons to be hopeful.

2020 BY THE NUMBERS

Employment[1]

Unemployment Rate (U.S)

3.6%	14.8%	6.8%
Start of Year	Peak of Pandemic (April 20)	End of Year

6.87 Million Initial jobless claims for U.S. week of March 27

25 Million U.S. workers receiving unemployment benefits in May

Pandemic

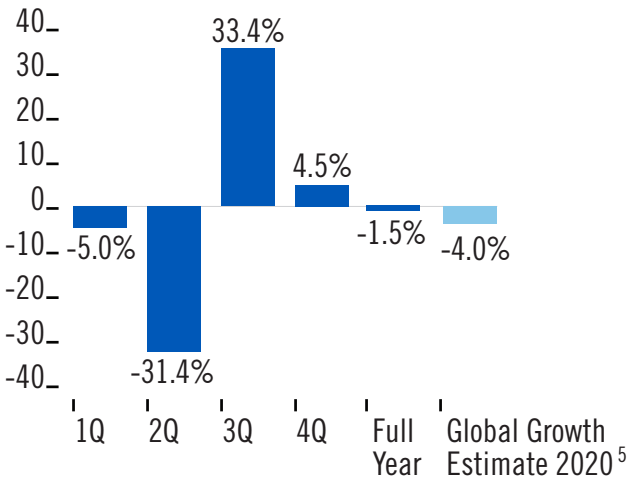
20 Million People with COVID-19 in 2020[2]

10 months to develop and distribute the first COVID-19 vaccine[3]

35% of employees switched from working in office to remote in April / May 2020[4]

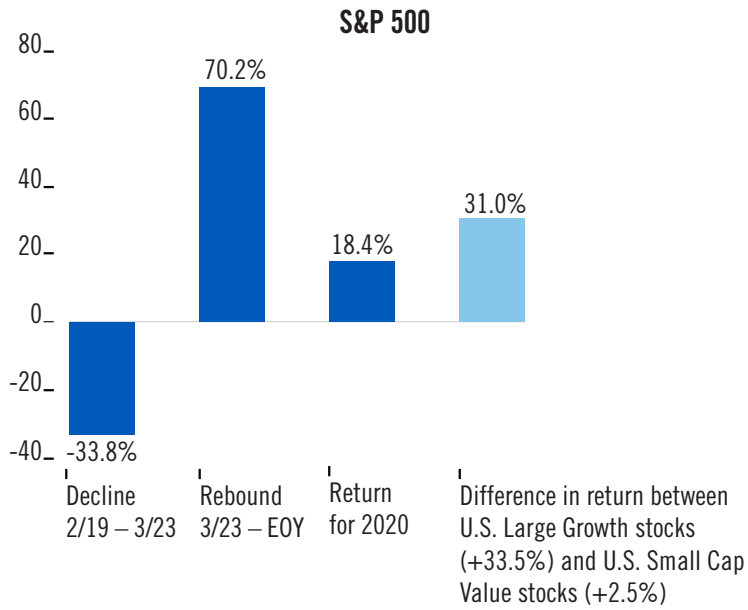
Economic Growth

U.S. Annualized QoQ Real GDP[1]



Stocks[1]

40 Number of years the S&P 500 was positive out of the last 50 years



Policy / Government

$4 Trillion Amount of Coronavirus Fiscal Aid / Relief passed in 2020[1]

155 Million Votes cast in the U.S. Presidential election – most ever[1]

US DEFICIT[6]

$1 Trillion for 2019

$3 Trillion for 2020

The Fed and Interest Rates[1]

$3 Trillion Amount of debt securities purchased by the Federal Reserve through Quantitative Easing (QE) program in 2020

Fed Funds target rate (upper bound)

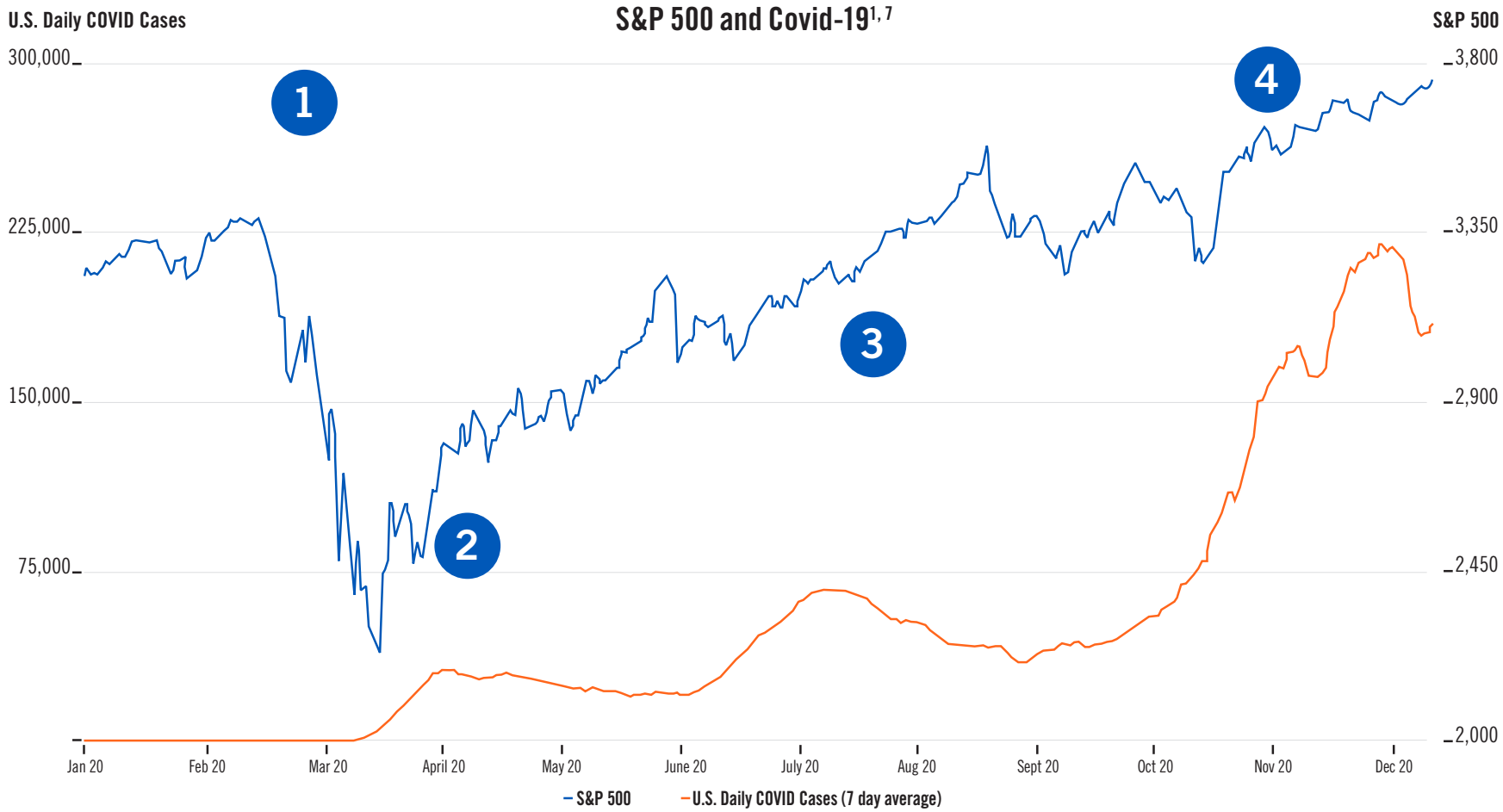
1.75% at 1/1/20 **.25%** at 12/31/20

10 year U.S. Treasury

1.9% 1/1/20 **0.5%** 8/20 **0.9%** 12/31/20

2020: A Mosaic of Disaster

After a difficult Spring, Markets and the Economy Rebound in the Face of a Difficult Environment



1 The Dark Days of Spring

- Global Pandemic
- Stay in place orders are issued
- Unprecedented Global Economic Collapse (U.S. GDP -31.4% 2Q)
- Stock markets plunge (major market indices fall more than 30%)
- Money floods into U.S. Treasuries for safety (10 year U.S. Treasures fall to near 0.5%)

2 Relief and Hope

- The Fed moves into action
- Massive fiscal stimulus near $3 trillion – CARES Act
- Better treatment options for COVID patients emerge
- Pharmaceutical companies begin to work on a vaccine
- Restrictions are eased - governments try to balance both safety and commerce

3 The Rebound

- Stocks roar back off March lows
- Economic Growth soars (U.S. GDP +33.4% 3Q)

4 Success Amidst Stress

- Election
- The race – vaccine distribution vs. soaring cases
- More fiscal stimulus
- Markets close strong (Many indices finished the year up double digits)

2021 – Spring is Coming

In forming our annual outlook for the upcoming year, we typically review the current macroeconomic and market trends to help formulate our expectations for future economic growth, stock market outcomes, and the direction of interest rates. While those fundamental items are still very important, for 2021 there are two other arguably more important considerations. If and when the pandemic ends and how the 2020 election may change government policy are both very critical backdrops that will likely play a large role in shaping the economy and markets in 2021. Hancock Whitney Asset Management's senior leaders present their key investment themes and more commentary on the outlook for 2021.

2021 Key Investment Themes

PANDEMIC

- Vaccine distribution - enthusiasm meets reality
- Herd immunity is on the horizon

GOVERNMENT POLICY

- Slim majority limits range of policy choices
- Further Federal support programs expected

ECONOMY

- Back to 'normal' economic growth
- The recovering economy likely to reach relatively full employment by year-end
- Inflation expected to remain muted

STOCK MARKET

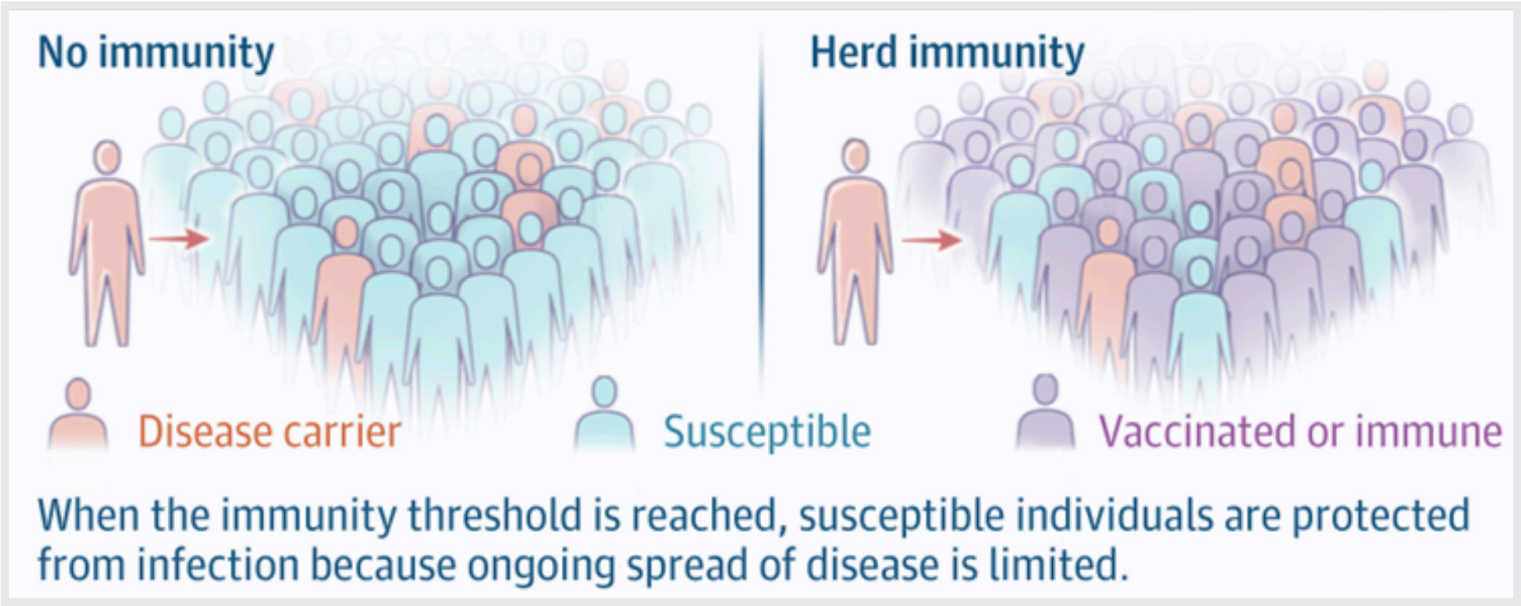
- The global growth imperative and ample liquidity will likely drive U.S. large cap stocks performance higher
- Cycle resets – expansion ended
- The rally for Large Cap Value and Small Cap stocks will likely be transitory

FEDERAL RESERVE & INTEREST RATES

- Long-term interest rates are likely to migrate higher
- Debt and deficits are anticipated to continue to rise
- The Federal Reserve has indicated that it will keep short-term interest rates anchored near zero
- We anticipate Anti-QE clamor by year-end

Herd immunity

Works to control the spread of disease within a population when a specific amount of that population (threshold) becomes immune to the disease through vaccination or infection and recovery.



Journal of the American Medical Association; "What Is Herd Immunity?" by Angel N. Desai, MD, MPH1; Maimuna S. Majumder, PhD, MPH2, October 19, 2020

Americans are anxious to return to normal activities and for the economy to operate as it did during "normal" times. However, for it to perform up to its full capabilities the population must acquire herd immunity – the level of widespread protection from infection that stops the virus from being transmitted. Fortunately, the availability of vaccines is growing, potentially offering the much- preferred avenue to achieving herd immunity - a vaccination rather than recovery from an infection.

Current trends in infection transmission and testing results indicate the U.S. is not close to achieving herd immunity. A reputable data scientist, Youyang Gu, estimates the percentage of the population that has been infected and has achieved immunity, at least temporarily, at a midpoint of around 21%, or 69.8 million people. This equates to one out over every five people.[8]

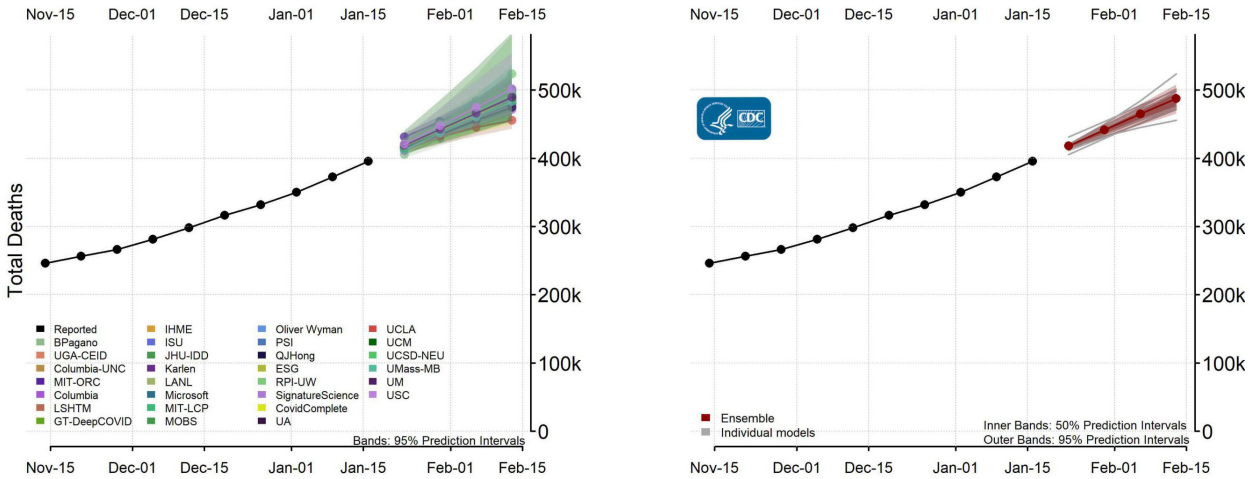
The percentage of the population required to be immune to stop the spread of a disease varies by disease. A highly contagious disease such as measles requires a very high percentage of people to be immune in order to prevent further spread. COVID-19 is highly contagious, leading public health experts to estimate that around 70% of the population may need to be immune, either from prior infection or a vaccination, to stop its spread. Vaccines offer a chance to speed up this process, though they may not be a panacea. Coronaviruses are known to mutate, meaning that vaccines may offer just partial protection and may not protect everyone.[9]

THE ENSEMBLE OF COVID-19 FORECASTING MODELS

COVID-19 was the dominant factor impacting the economy in 2020. No economic forecast could be made without reference to the course of the pandemic as it surged and ebbed in large geographic areas and densely populated cities. We are interested in understanding how impactful the spread of COVID-19 will be to economic progress in 2021. With that goal in mind, we will make several observations and assumptions.

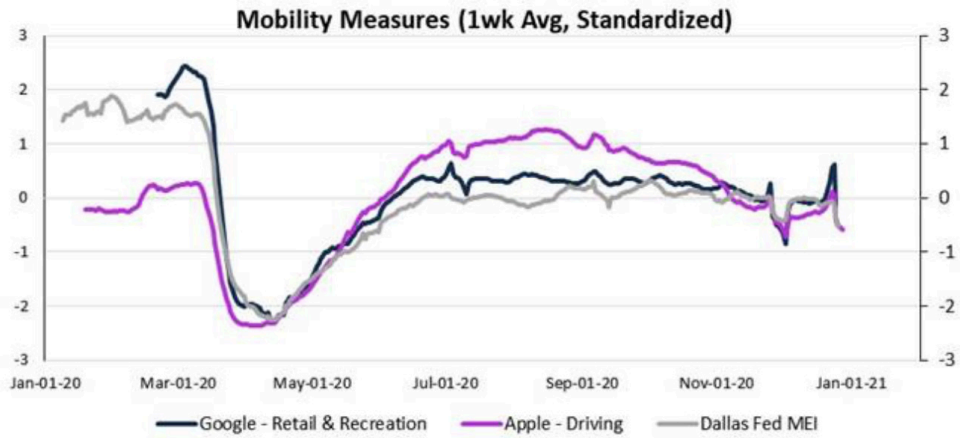
1. **The current level of cases, hospitalizations and deaths will get worse before it improves.** The ensemble of 34 models shown on the CDC's website figures in Chart 1 show the number of total COVID-19 deaths in the United States each week from October 24 through December 26 and the forecasted number of total COVID-19 deaths over the next 4 weeks. The ensemble predicts that a cumulative 383,000 to 424,000 COVID-19 deaths will be reported by January 23. (Chart 1). Thus, the risk of an economic stall or contraction cannot be ruled out due to voluntary or mandated restrictions on population mobility.[7]

Chart 1



2. **Behavior of the population may change in response to these results, but probably less so than in the early months of the pandemic.** Behavioral change has been observed recently according to some mobility measures, as shown in Chart 2. However, the Dallas Federal Reserve's Mobility and Engagement Index (MEI), which correlates with economic activity (Chart 2, grey line), indicates economic activity has remained fairly steady in the face of rising case growth. The recent dip during the Christmas holiday is similar to that seen at Thanksgiving, from which there was a quick recovery. Mobility has held up better than expected considering the surge in COVID case growth.[10]

Chart 2

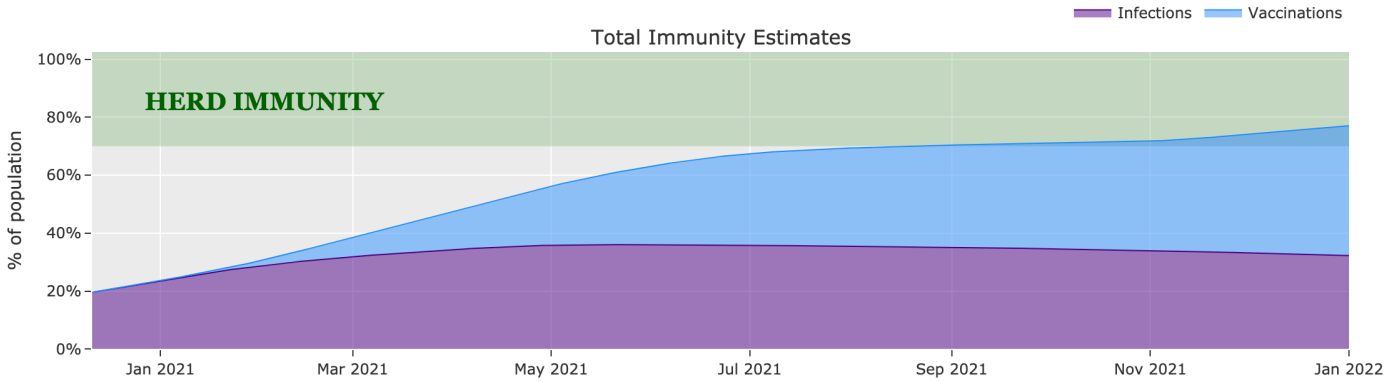


Source: Evercore ISI

3. **The current surge will run its course and weaken, as has occurred in every surge globally.** Youyang Gu estimates that by the end of 2021, around one third of the population (~ 105 million) will likely have been infected, compared to a current estimated percentage that have already been infected of around 23%.[8]

Chart 3

PATH TO HERD IMMUNITY ILLUSTRATION-U.S.



Source: covid19-projections.com

For this positive outcome to occur, a number of things must go right:

- Sufficient vaccine doses available for the U.S. population
- Immunity does not wane too quickly
- Vaccine safety is proven, building confidence
- Distribution is prioritized, efficient, and timely
- Public information campaign boosts uptake, preventing a delay in achieving herd immunity

Based on current conditions and the improved clarity regarding the prospective timing of vaccine approvals, production and distribution, we can make some projections for the coming year. Immunity achieved via vaccinations should ramp up in the first quarter of 2021 and become a meaningful percentage of the immune population by the end of the second quarter. By the end of 2021, vaccinations may become the major source of immunity, and 70% of the U.S. population could obtain some degree of protection, through a combination of inoculations and prior infection (Chart 3).[8] This outcome will allow the nation to approach herd immunity. As the nation approaches that level, new infections will be in decline. Importantly, as the high-risk population are prioritized in the early stages of vaccine distribution, deaths should decline even faster than new infections, and that could result in restrictions on mobility being removed in some locations even before herd immunity is achieved. Even though herd immunity doesa not mean there will be no new infections, population mobility can recover, allowing industries that have suffered the most from pandemic restrictions to restore jobs as revenues rebound.

While we have limited this section to potential outcomes in the U.S., the vaccine rollout internationally is even more complex, with numerous uncertainties and potential shortfalls. A significant risk exists that the Covax program, a global initiative to help people in all countries get rapid, fair and equitable access to safe and effective vaccines, will run short of funds. There is a danger that the plan fails to deliver, or that the roll-out for poor countries is delayed.[1]

Bloomberg Economics projects that 16 major countries have the potential to quickly achieve herd immunity in 2021, which offers the chance to boost the U.S. and global economies materially in 2021. These countries represent more than half of world GDP and therefore can provide the largest boost –estimated at 3.2 percent - to the world economy though they represent about one third of the world population. Another group of mainly emerging market countries, representing about 9 percent of global GDP has ordered enough vaccine supply to cover their vulnerable populations. If they can close 75 percent of the lost GDP compared to pre-crisis levels, they could add another 0.5 percent to global GDP growth next year.[1]

While the national and global efforts to vaccinate populations in a fair and equitable manner are not likely to go flawlessly, as evidenced by the disappointing rollout to date, we like the prospects for the COVID-19 pandemic to have a diminishing impact on the course of the economy as 2021 unfolds.

Impacts of the Election

Democrats have scored come-from-behind wins in both of this year's Georgia Senate elections and will control the White House and both houses of Congress moving forward in 2021. This has led some to suggest that a major working of the tax code as well as important Senate procedural changes are in the works. However we believe the actual scope of change may be much smaller than many commentators expect.

With a 50-50 tie in the Senate, a party-line vote will leave Democrats dependent on a tie-breaking vote from Vice-President Kamala Harris. Since Senator Joe Manchin, a West Virginia Democrat, has publicly pledged to oppose major structural changes – such as the elimination of the Senate filibuster, the inclusion of additional states in the Union or expansion of the Supreme Court – those proposals look to be off the table. Further with a very narrow margin in the House of Representatives, Democrats will likely need to make any major policy changes acceptable to more moderate members of their party – particularly those in districts likely to be vulnerable in the mid-term elections. In general, moderates of both parties, particularly Democrats, are likely to have substantial leverage in this Congress.

One of the earliest actions of the newly seated government may be to increase funding for COVID relief as there were several popular provisions – including increased support both to individuals and to states and municipalities – that did not make it into the final version of the bill passed in December. There also appears to be bipartisan support for infrastructure spending and there is some discussion of including this in early stimulus. We expect, instead, it will take time to hammer out details and this discussion may extend to overlap with a focus on the national debt ceiling which is likely to be lifted in the summer. Among the likely beneficiaries of an infrastructure bill are alternative energy companies.

> "A key concern for investors heading into the November elections, tax reform is likely to be limited even under a Democratic Congress."

A key concern for investors heading into the November elections, tax reform is likely to be limited even under a Democratic Congress. More moderate House members from wealthier districts are likely to rein in the full agenda. We would expect some moderate increase in corporate taxes and on the highest-income individuals – almost certainly more than a Republican Senate would have delivered. Key for individual investors, the repeal of a step-up in cost basis at inheritance alongside a rollback of estate tax exemptions seem likely to be palatable to Congress. An increase in the capital gains rate along with ordinary rate for top earners is very much on the table as these would all address the goal of decreasing wealth inequality.

A Democratic Senate may make a significant difference in Cabinet selection, but we do not anticipate any changes in the team already announced prior to the Georgia results, which are generally viewed as acceptable to a Republican Senate. The prospective Biden team was chosen with an eye toward government experience and a moderate regulatory stance. In roles of key concern to the market (such as Janet Yellen as Treasury Secretary, Jennifer Granholm in Energy, and Katherine Tai as U.S. Trade Representative) should remain on track and face relatively smooth paths to confirmation in a Democratic Senate.

Similarly, a Democratic Senate opens the door to expansion of the current form of the Affordable Care Act. This would most likely benefit service providers, but drug cost control is likely to be part of this discussion as well. This could be a notable revenue growth drag for pharmaceutical companies.

We expect the Biden administration to act more aggressively in areas where no legislative action is necessary: trade and regulation. We anticipate the Biden White House will move to normalize trading arrangements with traditional partners. However, that does not necessarily mean a rapid embrace of open trade or an immediate end to Trump-era tariffs. Indeed, we believe Biden may prefer to keep some protections for U.S. industry and workers in place while also redomesticating critical portions of supply chains related to medical goods and other security-related items.

On the regulatory front, we expect that attention will be turned to strengthening environmental and public health rules that were loosened during the Trump administration. However, imposing new regulations will take time so any actual policy changes won't emerge in the first few months, but we are likely to see more enthusiastic enforcement action across a broad set of issues.

2021 Economic Outlook: Onward Through the Fog[1]

The U.S. economy rebounded dramatically in 3Q20 with an unmatched quarter in modern U.S. history, a 33.1% annual rate of reboot. At this writing with roughly 2/3 of data available for 4Q20, we estimate a relatively robust follow-on at a 4-5% annual rate of growth in Real Gross Domestic Product (RGDP), strong by post-2009 standards anyway. Our central projection for 2021 is that U.S. economic growth gradually decelerates to pre-coronavirus norms of 2% trend growth. Stated broadly, we expect the annual average -3.6% rate of decline in 2020 RGDP to reverse to 3.3% growth in 2021 and 1.5% in 2022. Our 2021 forecast includes a 1.0% soft patch in 1Q21, owing to heightened COVID concerns and restrained business in some locales; recovering to a 3.0% annual rate of growth by 3Q21 as vaccines become widely administered.

The U.S. experienced in 4Q20 an alarming surge in COVID-19 case growth, hospitalizations and fatalities; associated with reduced mobility, intensified social distancing and lockdowns of non-essential business in some more impacted areas. However, we note an abundance of anecdotal evidence of popular resistance to mandated restraint of commercial activity; as many businesses, large and small, face an existential struggle and are determined to remain open to the extent possible. While 15 million workers furloughed by the Spring lockdowns have returned to work, another 8 million remain displaced and dependent on pandemic assistance programs and eviction moratoriums. Congressional passage in December of the 2021 federal budget, which includes $900 billion for extension of COVID relief programs, goes a long way toward ameliorating immediate anxiety among displaced workers and hobbled businesses. Our baseline assessment is that the U.S. economy trudges back toward full employment over the next 18 months, barring unforeseen externalities and unforced policy errors.

One of the less obvious benefits of the super-charged economic rebound in the second half of 2020 is that it accelerated the timeline of the U.S. return to peak economic activity and full employment. U.S. RGDP peaked in 4Q19 at a $19.3 trillion annual rate of output and our previous expectation was that it would take until 3Q23 for activity to return to that level. Our current projection is that the U.S. economy returns to that level in 2Q22, just a little more than a year ahead. If RGDP surprises on the upside in 4Q20, 6.0% growth is a plausible outcome, that would advance peak RGDP forward to 1Q22. We interpret the Federal Open Market Committee's (FOMC) standing dot-plot projection to mean that the Fed Funds rate will remain anchored to the zero lower bound through 2023 as more messaging of determination to assist the recovery as long as it takes than a hard coded forecast.

But now with peak RGDP feasibly just a year or so ahead and vaccines being distributed, an acceleration in growth this Fall as the economy re-opens full steam will likely force the Fed to offer a more informative projection for 2022. Later this year, a variety of signals will likely paint a mosaic of a maturing economic recovery; including rising commodity prices, the U3 unemployment rate falling below 5% and possibly even core inflation rates inching up to or through 2%. The markets will clamor for clarity and pressure the Fed to account for such extraordinarily accommodative monetary policy concurrent with an expansive economy. We expect the Fed to foreshadow rising Fed Funds rates and an end to the bond buying program, known as quantitative easing (QE), by the end of the year.

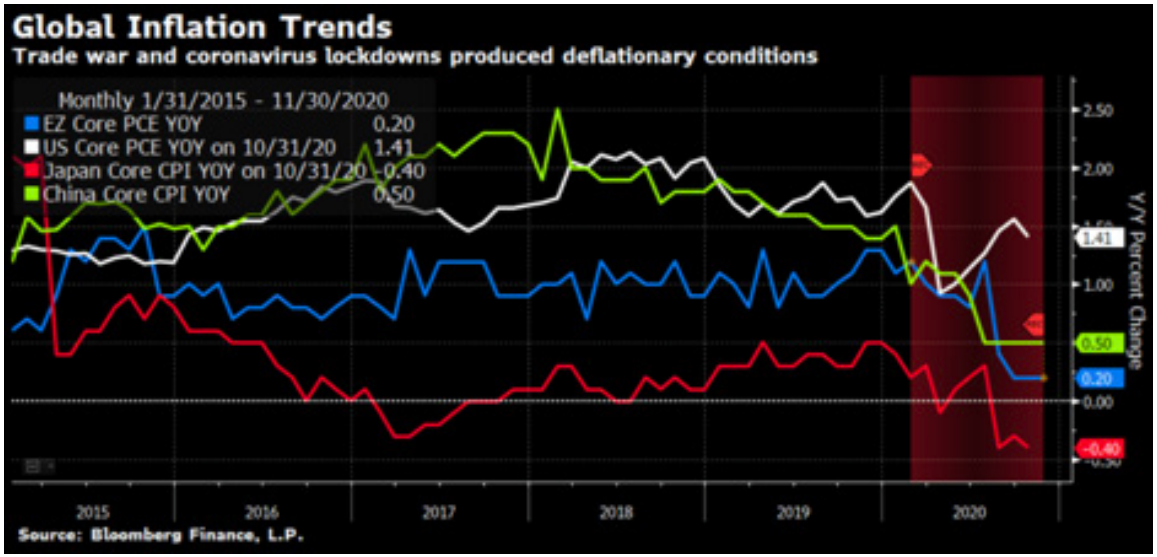
> "The unemployment rate dropped to 6.7% in December."

The unemployment rate dropped to 6.7% in December. It is worth recalling that in May 2013 when former Fed Chair Ben Bernanke first uttered the word "taper," signaling to the markets that a gradual phase-out of QE would commence at some point, the U3 unemployment rate was 7.5%. When the Fed actually began the phase-out in January 2014, the unemployment rate was 6.6%. The U.S. economy is at the point, in terms of labor force employment, one of the Fed's primary policy objectives, at which the Fed terminated monetary stimulus in the last cycle. Our assessment is that the time will likely arrive this Fall when the FOMC will see the need to guide market expectations toward the prospect that monetary policy will start a gradual normalization phase in 2022. Thanksgiving would be good timing, when we can reflect on the expertise of our central bank in navigating our economic ship through treacherous currents. However, the market implications for longer-term interest rates will be significant at that point, when the markets begin to discount the end of QE while the Treasury continues to run historically large federal budget deficits.

The European Central Bank (ECB) doubled down with an additional €500 billion of projected QE in December, reflecting its struggles to stabilize the European economy and ignite demand. In contrast, we expect the Fed to be the first of the developed economies' central banks to step away from QE, same as the last cycle, when the ECB trailed the Fed's normalization strategies by over three years. That contrast was a major support for the dollar's value from 2014 through 2016 and we expect the growing likelihood that the Fed will project a phase-out of QE later this year will similarly buttress the Dollar's value.

The trade war with China, so disruptive in 2019, took a holiday to the back burners of policy interest in 2020 as virtually all countries focused on reignition of their economic engines. However, it is notable that of all the levers of monetary and fiscal stimulus pulled last year, tariff reduction was not among them. The planned Phase 2 trade negotiations with China, perhaps aspirational from inception, will be in abeyance while the incoming Biden Administration evaluates its policy positions. Already though the transition team is signaling that any tariff reductions will be contingent on reformed Chinese trade practices. It is clear that Chinese disregard for intellectual property rights, aggressive cyber theft of sensitive information and illegal protection of domestic industries did not start during the Trump Administration, but are deeply rooted behaviors of the last two decades. The Trump Administration illuminated Chinese unfair trade practices as unavoidably objectionable and gave voice to the economic damage inflicted on American communities from our burgeoning trade deficit with China. These realities are enduring. Our view is that it will not take long for China to remind U.S. policymakers of the imperative to confront China on unfair trade practices and counter its geo-political ambitions.

A synchronized global recovery in the developed economies is unfolding, led, as in the last recovery from a disastrous recession in 2009, by a vigorous rebound in the U.S. Our confidence in the vibrant U.S. capital markets and our dynamic and innovative economy remains undeterred by the prevalence of negative interest rates, a scary pandemic, and the arrival of domestic political realignment. However, despite our expectation that inflation may creep upward in the U.S. this year, deflationary conditions continue to hobble monetary and fiscal policies in Europe and Japan, and even China lately. Our assessment is that deflationary conditions did not take a vacation during the global COVID recession but rather intensified. Growth is the antidote to deflation and we expect growth to be scarce globally this year, outside of the U.S., China and some of its emerging market trading partners. As in much of the last decade, we expect the U.S. to be distinguished globally by relatively strong growth and attractive investment opportunity.



2021 Equity Outlook[11]

After a year of unprecedented turbulence and volatility, equity investors are approaching 2021 with visions of a return to normalcy dancing in their heads. The uncertainty that dominated the market throughout 2020, birthed at first by the emergence of the novel coronavirus in Wuhan, Hubei Province, China, and then boosted by pandemic-infected election-year politics in the U.S., should fade somewhat as a vaccinated world can get back to business-as-usual. 2021 will nevertheless be an unusual environment for investing, because no investor alive has experience navigating an economy emerging from a global health scare and the deep, albeit brief, economic contraction brought on by it.

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A reset of sorts happened in 2020 for equity markets. Amidst the extreme selloff in prices in February and March, the new work-from-home environment accelerated the pace of change in human behavior. The kinds of companies – and technologies – that support that change in behavior became ever more dominant in the global marketplace. Additionally, consumers and homeowners took advantage of the situation to make long-needed or desired improvements to their homes. The different types of companies supporting that kind of consumer behavior, solidified and grew their long-established place of prominence.

From that reset, which is roughly characterized by the low in stock market prices on March 23rd, stock markets have now climbed to record highs on a seeming abundance of encouraging news. Yet despite the good mood prevailing in equity markets at the present time, investors face a number of questions that promise to make 2021 interesting, albeit likely less volatile than 2020. While usually true any year, this year's questions have a different caste, driven, as they are, by the massive change the world experienced in 2020. Will we really be getting back to normal or will something new emerge? Amid changing politics, will regulatory and governance policies revert to previous (i.e., pre-Trump Administration) trends or send our economy in a new direction (for example, "public benefit" corporations)? How will underlying fundamentals, and expectations for changes in those fundamentals, trend in 2021 and will they provide support for the continuation of positive returns? Finally, are valuations a cause for concern?

BACK TO NORMAL OR ONWARD AND UPWARD

Leading the market higher currently (since the end of October mainly) has been a resurgence in the types of stocks that underperformed the most in the earlier part of 2020, and even prior to that. Some of these stocks or sectors could be characterized as back to normal sectors (housing, energy) while others are merely formerly beaten down extreme value opportunities (banks). Take energy companies, for example. More and more, as mobility comes back to pre-pandemic levels, the economy needs energy to drive forward; a growing economy demands more energy. On the other hand, new methods of living and conducting business have come to the fore, and so mobility, portability, and communication methods have all evolved leading to dominance by companies that barely had a market for their offerings in the early part of 2020. America, and the world at large, are retooling.

Going into 2021, with the odd combination of hope associated with a vaccinated population, along with the persistence of the virus in said population and the eagerness of politicians to "fix" the problem, it is prudent to assume a good bit of both a return to normal as well as a persistence of new ways of getting along. Further, investors should also be keen to the near term risks of more virus problems, which could upset the entire apple cart again. The portfolio implication is that investors should be both nimble and diversified, adjusting and adapting their evaluation methods and being mindful of sources of risk. Stock selection will be a critical component of success in the year(s) to come. However, factors as sources of returns (value versus growth, small versus large) may yet come back to the fore after a long period of domination by one segment of the market – large U.S. growth company stocks. Investors will therefore benefit from diversification among broad sub-groups of stocks.

WORLD IN TRANSITION

Among the more overlooked trends in the recent past, and one that perhaps received a boost in the recent socio-economic turbulence, is a growing belief that the world should move beyond owner-centered capitalism. While some radical

anti-capitalist beliefs have been around a long time, there has been a surge recently in companies adopting a public benefit corporation (PBC) structure. The over-simplified explanation of the difference between a traditional (or "C") corporation and a PBC is the inclusion in the company's charter of a public benefit purpose, which means the board of the company has a fiduciary obligation that goes beyond a purely financial, shareholder oriented one.

This evolution in corporate thinking does not imply, in itself, that profits are not important, but it does give management of such companies leeway to consider other things in evaluating their investment decisions and their performance. A sample of language that might be found in a proxy filing to change their charter includes: the company's "proposed public benefit purpose is to help make the industries it serves more productive and create high-quality employment opportunities." While sufficiently vague as to not obligate the company to do anything other than do what it currently does (i.e., be a provider of a product to make its customers more productive and be a good place to work), the diversion of attention away from purely rational financial evaluations and management could have a very long-term, or secular, impact on aggregate corporate profitably.

"While sufficiently vague as to not obligate the company to do anything other than do what it currently does (i.e., be a provider of a product to make its customers more productive and be a good place to work), the diversion of attention away from purely rational financial evaluations and management could have a very long-term, or secular, impact on aggregate corporate profitably."

This is a new trend and a rapidly developing and evolving one, which equity investors should be aware of but which does not likely have any significantly exploitable investment opportunities or risks just yet.

BASIC CORPORATE FUNDAMENTALS AND EVOLVING EXPECTATIONS

In addition to those broad themes, a key driver for 2021 will be the continuing recovery in underlying fundamentals from the extreme contraction of last summer. Analysts' aggregate expectation for S&P 500 EPS growth for the full year of 2021 is currently a very robust 22%. Even though the comparison should be quite favorable after the 2020 earnings recession which accompanied the economic recession, that 22% level is an attractive one. More impressive is the expectation of 8% growth in S&P 500 sales.

These levels of growth are quite achievable and reflect an expected strong recovery in overall economic activity. Growth is also likely to be supported and boosted by corporate investing activities. Corporations in the aggregate are sitting on a mountain of cash. Merger and acquisition activity is picking up, as are actions to return capital to shareholders (such as dividends and share buybacks). More investing and more fluidity of corporate funds will be a strong catalyst for fundamental growth.

Analysts' estimates are also likely to be currently flavored with a good bit of caution as a) analysts have not yet caught up from the 2020 collapse and b) analysts do not want to get burned by overestimating pandemic recovery growth. The implication of this is that the likelihood for positive surprise is still high. If both hold, that is, if expectations of growth remain high and move higher and then are exceeded by actual results, that will be a strong support for equity prices.

VALUATION

Investors have bid up stock prices since the pandemic bottom to a level that, for many, is hard to digest. Standard measures of valuation point to overvalued equity markets. The P/E for the S&P 500, based on the previous 12 months' earnings, at the end of 2020 stood at 27.9. This level is unusual to be sure; it was last this high in the 1999-2001 period. At that time however, the robust 1990's economic expansion was coming to an end and a recession was looming on the horizon. At the start of this year, markets are looking in the rear-view mirror at a deep, albeit short, recession. Strong underlying corporate performance in 2021 should support, or at least offset, extended valuations.

EQUITY OUTLOOK OVERVIEW

Equity markets, along with the economy overall, experienced a reset in 2020. The rapidity with which equity prices collapsed in the face of a looming pandemic was unprecedented. While governments drove the shutdowns that sunk economic activity, governments and central banks responded with extraordinary actions to combat the slowdown and markets reacted accordingly, rebounding based on optimism about both the hoped-for end of the pandemic as well as the shortness of the recession. Fundamental performance (sales growth, profit growth) turned out to be not nearly as bad as the worst expectations in late May. As 2021 rolls along, economic growth and corporate fundamental growth is likely to outperform expectations, providing support to stock prices.

2021 Fixed Income Outlook[1]

The bond market's behavior of 2021 will look nothing like the rollercoaster ride investors experienced in 2020. With the U.S. and global economic recovery of 2021 squarely underway, the fixed income markets begin the long journey back to pre-pandemic order. The economic triage of 2020 in the form of lower interest rates and free government stimulus money served their purposes well but will be increasingly less necessary as the Real GDP returns to normal. While there will certainly be twists and turns along the way the overall trend in the fixed income markets is clear. The longer term cost of money (interest rates) will creep moderately higher in 2021 on heavy government borrowing, rising inflation expectations and improving economic activity. Trend indicators confirm a downtrend in effect since late 2018 in the U.S. Treasury 10 year note yield has recently completed a reversal and turned higher.

Despite the trend higher however, longer term interest rates should remain relatively low by historical comparison. We anticipate the 10 year U.S. Treasury note yield will return to the 1.25% to 1.50% range by yearend. Short term interest rates will remain near zero in 2021 as dictated by the Federal Reserve. The net result will be a modestly steeper yield curve as is common in an economic recovery.

Among the fixed income sectors, corporate bonds and inflation protected securities will likely outperform government securities in the improving economy. Looking ahead to 2021 bond investors would best prepare for more modest returns where coupons are collected but market values erode due to rising interest rates.

The Federal Reserve played a historic role in averting a virus induced economic and financial disaster of biblical proportion in 2020. In 2021 the Federal Reserve will be much lower profile as almost all of the emergency program "facilities" implemented during March 2020 are winding down. The Fed will mostly return to its traditional role of monitoring the pace of the economic growth, progress in employment gains and inflation. While there has been no formal announcements yet, all indications are there will be no change of Chairmanship at the Federal Reserve under the Biden administration and likely no immediate change to Fed policy. The annual two person rotation in 2021 among the all-important Federal Open Market Committee (FOMC) voting members should nudge the committee in a slightly more dovish direction. The Fed Funds target interest rate will likely remain near zero for all of 2021 as has been telegraphed by Chairman Powell. The Fed's new and more tolerant inflation averaging policy announced in September 2020 will provide ample leeway (justification) for keeping overnight interest rates unchanged for the coming year. The Fed will view periodic surges in inflation above the 2% level as short term "transitory" occurrences that do not require an immediate response. In addition to current inflation measures the Fed will also be watching long term inflation expectations to gauge investor attitudes. Currently the Fed's preferred long term inflation expectations measure is pointing to investor expectations approaching 2% annually.

The area of greatest uncertainty regarding Federal Reserve policy in 2021 relates to its asset purchase (quantitative easing) program. As we enter 2021, the Fed is purchasing $120 billion per month in U.S. Treasury notes, bonds and agency mortgage debt in an effort to keep longer term rates lower and spur the economy. The recent trend at the U.S. Treasury Department to shift more borrowing from short term T-Bills to longer term Treasury coupon securities will put additional upward pressure on longer term interest rates in 2021 and possibly slow the economy unless the Fed compensates with a "twist" to larger purchases of longer term debt and less short term debt as well. The Fed will likely tolerate a moderate and orderly rise in interest rates but a sharp rise in longer term interest rates in 2021 will probably bring action by the Fed to mitigate the move. With the return of the U.S. economy to more normal growth in the latter half of 2021, Chairman Powell will need to begin the delicate task of preparing the bond markets for the eventual start of "tapering" its quantitative easing program sometime in 2022.

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The prior Federal Reserve Chairperson Janet Yellen is widely anticipated to take over as Secretary of Treasury under the Biden administration. We anticipate given Yellen's recent tenure at the Fed and her longstanding relationship with the current Chairman Jay Powell that there will be unprecedented coordination between the Treasury and the Federal Reserve on economic recovery efforts and monetary policy. A working relationship made all the more important given the massive amount of new Treasury debt in the pipeline and the Federal Reserve's slower

balance sheet growth. Estimates are the general public (excluding Federal Reserve) may need to purchase a record $1.8 trillion in Treasury notes and bonds to absorb the 2021 glut of new supply.

For the credit markets the year 2020 was the worst of times and the best of times. It was a tumultuous year where intermediate term investment grade yield spreads to U.S. Treasury securities skyrocketed 5 fold in the market chaos of February and March only to reverse course in late March and decline to the lowest spread since early 2018 and nearly the lowest on record. For the calendar year 2020 the Bloomberg Barclays Intermediate Corporate Bond Index returned a whopping 7.47% total return far outperforming intermediate Treasury securities at 5.77%. Looking ahead to 2021 and the improving global economy, intermediate investment grade corporate bonds should again outperform government investments albeit with much lower total returns. For similar reasons, high yield bonds will also be a better fixed income performer though again with much lower returns than 2020.

A DISCIPLINED APPROACH IS KEY

Markets clearly still have many hurdles to overcome and political and pandemic risks remain elevated. While this environment can be volatile and stressful for many in the short term, successful investors are able to remove emotion from the process and stay disciplined in their approach.

We hope 2021 proves to be a prosperous year for all!

About Our Authors

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FOOTNOTES:

1 Bloomberg

2 Worldometers

3 Moderna

4 National Bureau of Economic Research (NBER)

5 International Monetary Fund (IMF)

6 Congressional Budget Office (CBO)

7 Centers for Disease Control (CDC)

8 covidprojections.com

9 Mayo Clinic

10 Evercore ISI

11 Factset

Except as otherwise indicated, all All economic data cited is based on information provided by Bloomberg.

All employment data cited is based on information provided by the United States Bureau of Labor Statistics.