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Q1 2021 Outlook

January 1st, 2021

Economy: Expect a continued robust global recovery and return to economic normalization.

- Continued GDP growth likely in the mid-4%s.
- Moderate inflation - despite the massive creation of money over the past decade-plus, which was accelerated with the Fed actions taken in March 2020, we have not seen an overshoot in inflation and do not expect a change.
- Turbulence/risk may arise as the authorities figure out how to best deal with COVID's resurgence through the winter months.

Stocks: A continued broad rally with better breadth is likely – target 3,900-4,000 on the S&P 500.

- From an early December 2020 view, the stock market appears overbought technically and overvalued fundamentally - technicals can easily resolve themselves with time, but we question how overvalued the market really is from a P/E multiple perspective.
  - The stock market (prices) leads the economy (earnings) in recoveries from major recessionary events, meaning inflated P/E multiples that appear to disconnect the market from reality are a near certainty early in the recovery.
  - Just as important is the relative value of stocks to investment alternatives, namely Treasuries. With a 10-year return in Treasuries at 1% or less, what is an acceptable current earnings yield (the inverse of P/E) given that earnings are likely to grow over time? With the Fed's continued liquidity and interest rate support, there is room for multiples to stay at current levels or increase, which, in combination with an earnings recovery, would lead to higher prices.
- Traditional market cycle models point to a chance of the target level being surpassed mid-year, as earnings growth really accelerates, with a pull back in the second half.
- There were clearly winners and losers created by the economy that resulted from the pandemic. As the economic recovery evolves, it may be more important to focus on specific styles, sectors, and even particular stocks in some cases.
  - We are looking for small-cap to close its underperformance gap relative to large-cap, and value to catch up to growth after growth hit an historic outperformance extreme this year.
  - We will look at sectors like industrials, financials and materials as well as some specific "re-opening" stocks that have a higher risk/reward profile. Technology may not perform as well as some of these other sectors for a period of time, but, with a long-term mindset, we are unlikely to ever recommend eliminating exposure to this sector that will likely drive the economy in the future.

Bonds and Rates: Rates will remain stable, both at the short end where the Fed has explicit control, and at the long end where control is less direct, as dictated by Powell and the FRB.

- With the Fed's focus on inflation, employment and economic stability, and a lack of concern regarding stock market overvaluation, their accommodation has the potential drawback of causing a "melt-up" in stocks.

- Additional risks lie in international markets and the US Dollar losing favor abroad, creating pressured on Dollar-denominated assets such as Treasuries. This risk is mitigated by the relative attractiveness of US bonds with positive yields in comparison to those of other countries still having negative yields.

- Low yields leave little upside in fixed income, although economic recovery should lead to reduced credit risks and further spread tightening.

- We are seeking out thoughtful alternatives to traditional fixed income allocations to generate better projected returns with less risk of price depreciation as interest rate volatility increases.