Q1 2021 | Capital Markets Outlook

Robert J. Schoen
Chief Investment Officer,
Global Asset Allocation

James A. Fetch
Co-Head of
Global Asset Allocation

Jason R. Vaillancourt, CFA
Co-Head of
Global Asset Allocation

The market's potential sugar high

In this issue

Despite optimism around COVID-19 vaccines, near-term economic data could remain mixed.

Expect to see a tug-of-war between negative effects of renewed pandemic lockdowns and positive impulses from fiscal stimulus and pent-up demand.

We believe it is best to remain flexible, as the path of the recovery might not follow historical patterns.

Asset allocations

Shading in the table indicates the change from the previous quarter

	Underweight	Neutral	Overweight
EQUITY		○	●
U.S. large cap		○	●
U.S. small cap		●	
U.S. value		●	
U.S. growth		●	
Europe		●	
Japan		●	
Emerging markets		●	
FIXED INCOME		●	
U.S. government		●	
U.S. investment-grade corporates		●	
U.S. mortgage-backed			●
U.S. floating-rate bank loans		●	
U.S. high yield		●	○
Non-U.S. developed country		●	
Emerging markets	●		
COMMODITIES		○	●
CASH		●	

Currency strategy

U.S. dollar versus	Favor other	Neutral	Favor dollar
€ **Euro**	●		
£ **Pound**	●	○	
¥ **Yen**	●		

As we finally flip the calendar on what at times felt for many like a never ending year, it appears as though we might be approaching the beginning of the end of the pandemic. As of December 31, 2020, the United States had vaccinated 3.49 million people with a combination of the Pfizer/BioNTech and Moderna vaccines. Many experts believe that life in most developed-market economies can return to a semblance of normal by the third quarter. But financial markets will likely have to contend with at least another month or two of mixed economic data before we see a clear bounce driven by the unlocking of pent-up demand. Getting through this difficult period will be easier thanks to the bridge created by the last-minute passage of a second fiscal stimulus package. This $900 billion bill will extend unemployment benefits, provide another round of direct payments to households, and fund a new round of Payroll Protection Program loans for small businesses impacted by renewed lockdowns. As we have written over the course of 2020, the size of the policy response around the world has been a key feature of this unique economic crisis.

Signs of lingering weakness

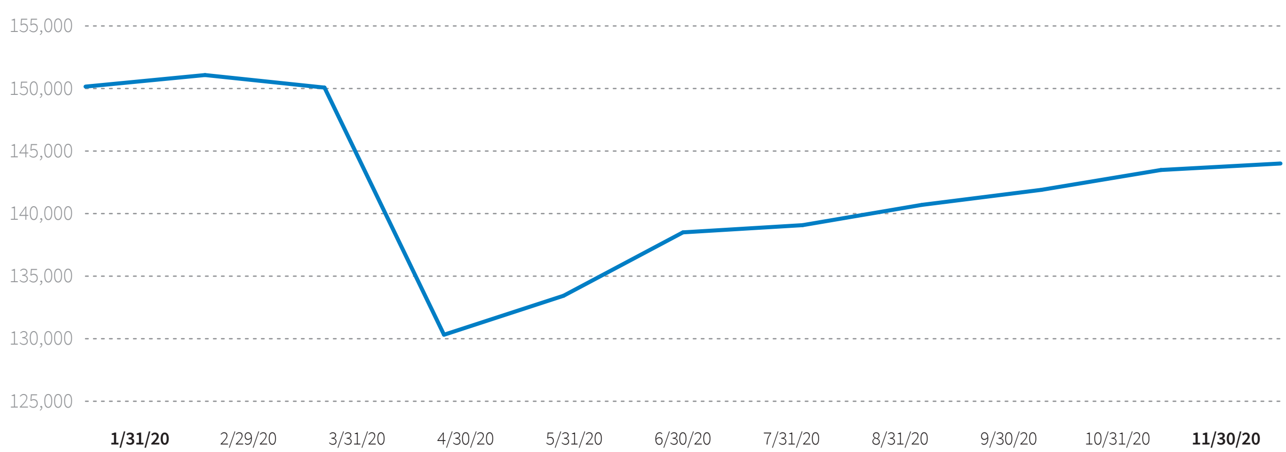
The Fed's new framework to pursue average inflation targeting likely means that short-dated interest rates will stay near zero for the foreseeable future. This pins borrowing costs at historically low levels. The pre-pandemic U.S. U-3 unemployment rate was 3.5%, and we expect it will take longer than the consensus believes to reach that level. Small businesses have likely experienced scarring effects as a result of the pandemic. The labor market recovery slowed in late 2020, even before new lockdown orders or reopening rollbacks began to address the December case surge.

A risk returns

A key risk we will be watching over the course of 2021 is one that we discussed exactly one year ago: the possibility of a melt-up in risk assets. It would be driven in part by the very same policy stimulus that has helped protect the global economy from collapse. In a world starved for nominal yield, large and growing pockets of savings still need to find a home. Capital will gravitate toward any asset that provides income. Global high-yield corporate credit, securitized credit, and emerging-market debt are all candidates for those flows. Large and growing pockets of "dry powder" in the private equity and venture capital arena are also looking to be deployed in an effort to front-run the recovery. As we discussed in our Q1 2020 outlook, the relatively rich starting point for valuation in the U.S. equity market has the potential to limit the market's upside potential.

The trajectory of new jobs flattened in late 2020

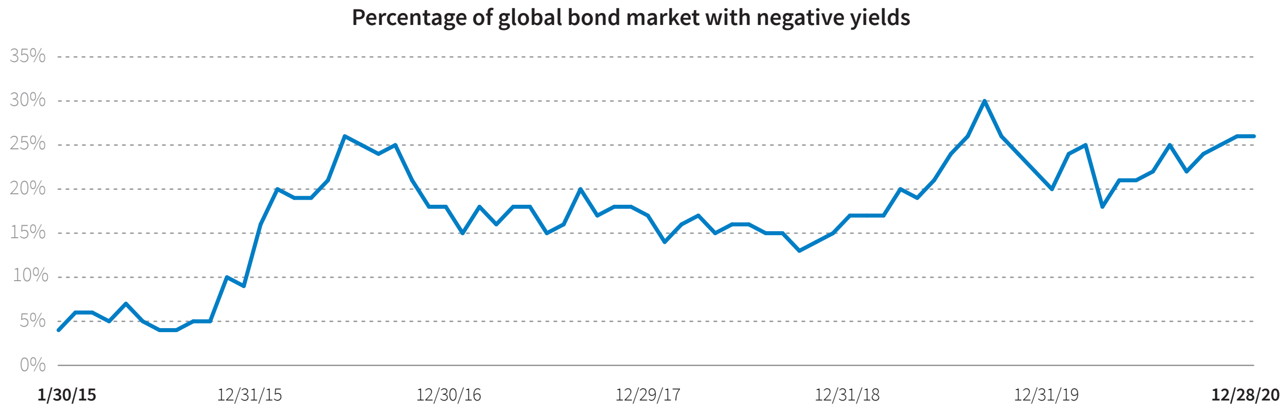
Total nonfarm payrolls, NSA in thousands



Source: Bloomberg, Bureau of Labor Statistics.

Starved for income: More than 25% of global debt has negative yields

Market value of debt with negative yields divided by total debt in BBG Barclays Global Aggregate Index



Sources: Bloomberg Index Services Limited. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). BARCLAYS® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approves or endorses this material, or guarantees the accuracy of completeness of any information herein, or makes any warranty, express or limited, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

However, pockets of attractive value can be found outside the United States and in lower tiers of the capitalization spectrum. Given the unusual nature of the crisis, it will be important to have tactical flexibility and open-mindedness to the idea that the recovery is also likely to be unusual.

It's not 1999

While it's possible risk assets could rip higher for all the reasons we describe, the mere mention of the term "melt up" conjures images of late-1999/early-2000 excess. But, at this juncture, it is likely too early to worry about speculative frenzy. Two key lessons of the tech bubble were that some of the best price gains come late in the game and that financial asset froth can persist longer than you expect. That late-game period demands additional vigilance. The warning signs that things have finally gotten silly are often ephemeral. Nobody rings a bell at the top. But, we believe our team, which has managed money together through more than two decades, will probably recognize it when we see it.

As we begin the first trading days of 2021, the things that bear watching have strong parallels with those heady dot-com days: special purpose acquisition companies (SPACs) are raising large sums of capital in the IPO market, companies with little to show for revenue are being assigned multi-billion dollar valuations, corporate insiders are selling equity, and new technology is being billed as set to change the world (cryptocurrencies, perhaps, but are batteries really new?). These all sound familiar. Although worth noting, it still strikes us as not yet having entered the realm that we would label "crazy."

Having said that, we still think that markets have not fully digested and priced in the extent of the economic damage from the renewed lockdowns and temporary border closings in the final weeks of 2020. We finished the year at substantially reduced portfolio risk levels versus November, respecting what we viewed as somewhat overbought conditions accompanied by signs of excessive optimism. We would likely dial our risk posture back up if those conditions were to abate. One possible catalyst for position squaring could come from downbeat management commentary from the fourth-quarter earnings season, which will begin in earnest in mid-January and may also temper some enthusiasm. Any Biden administration discussions of a rollback of corporate tax cuts or pursuit of Big Tech regulation could temper that froth, but our expectation is that the immediate policy priorities will be on additional stimulus and fighting the pandemic.

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