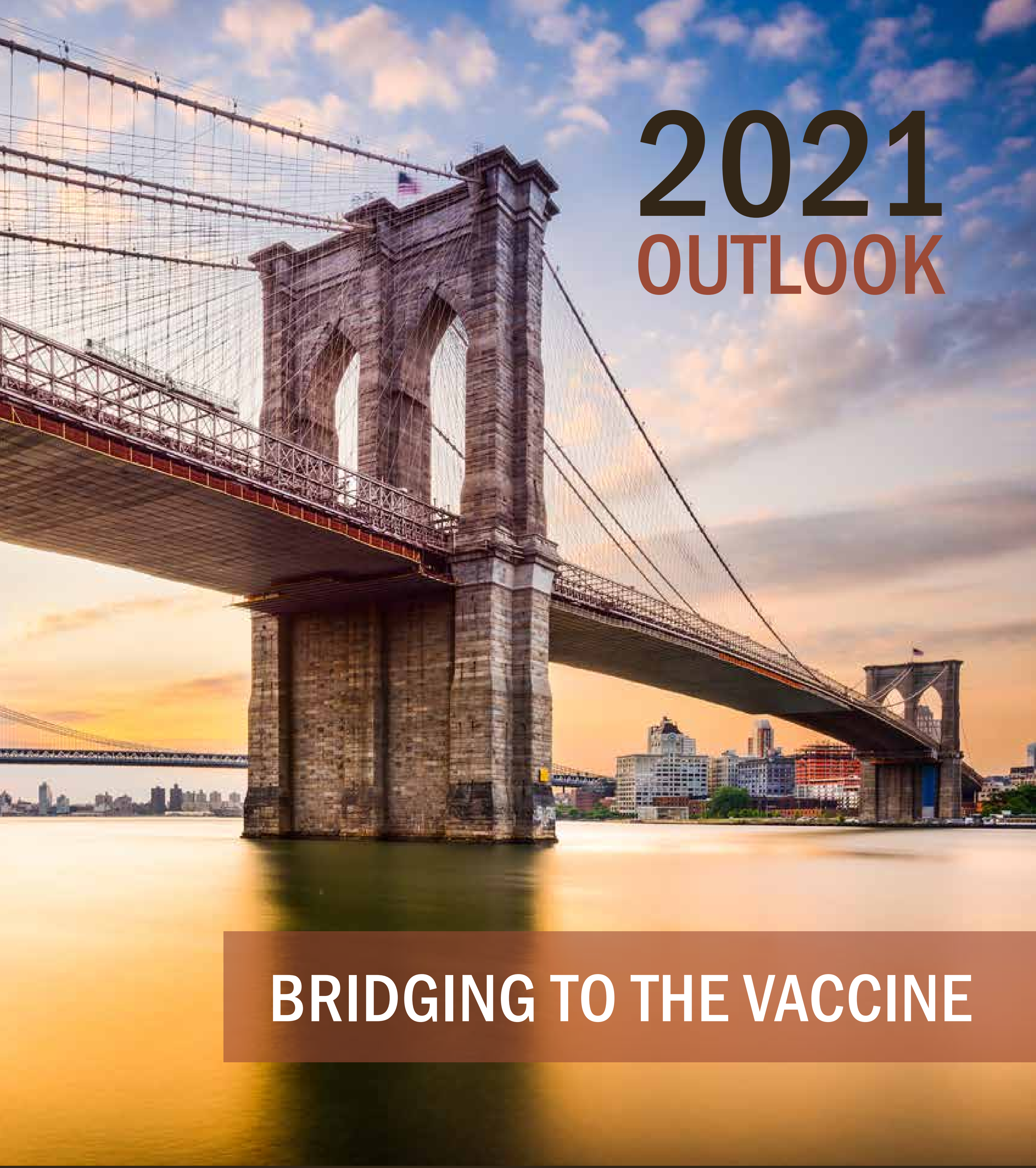


# 2021 OUTLOOK

## BRIDGING TO THE VACCINE

Commerce Trust Company
Wealth | Investments | Planning®


# EQUITY MARKETS SOARED TO NEW HIGHS ON POSITIVE VACCINE RESULTS

**The cavalry arrived in the form of at least three potentially successful coronavirus vaccines announced in November, and there is definitely light at the end of the tunnel. During the winter months, however, the economic tunnel could darken and narrow considerably before we squeeze through.**

**The U.S. is already out of a recession that began in February, as the employment picture improved from May through October and the stock market recovered in a remarkable "V"- shaped fashion. While this was the deepest recession this country has experienced from peak to trough since World War II, it's also likely been the shortest (the National Bureau of Economic Research officially dates the end of a recession well after the fact).**

## MARKET SUMMARY

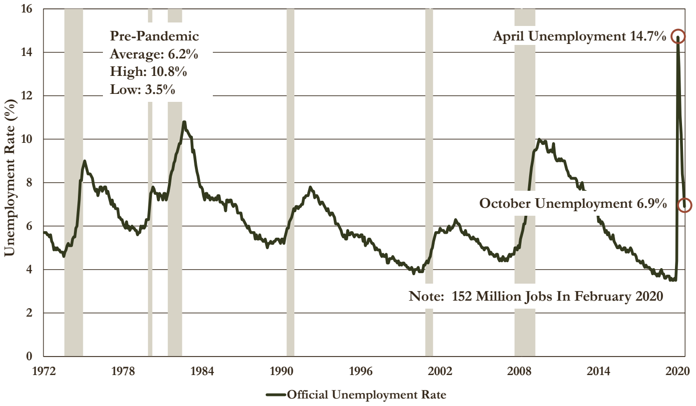
- The stock market is already looking past the virus -- stock prices will likely trend higher with the massive monetary and fiscal liquidity poured into the financial system.
- After the election and with the announcement of several promising vaccines, we now recommend being overweight equities versus your target level.
- We project a full economic recovery either in the second or third quarter of 2021.
- Municipal bond default rates are expected to increase from their extreme lows of the past several years, so bond selection will be critical for 2021.
- The dramatic decline in interest rates provided positive returns for all fixed income sectors in 2020.

# ECONOMIC OUTLOOK

How bad was it? Unemployment peaked at its highest level since the Great Depression (Figure 1). GDP fell a bit over 10% during the first half of the year (Figure 2) paced by a staggering 9% drop in economic activity during the second quarter alone (the worst quarter on record ever) as the nearly universal stay-at-home mandates and non-essential service provider shutdowns to fight the onset of the coronavirus in April and May exerted enormous pressure on daily activities.

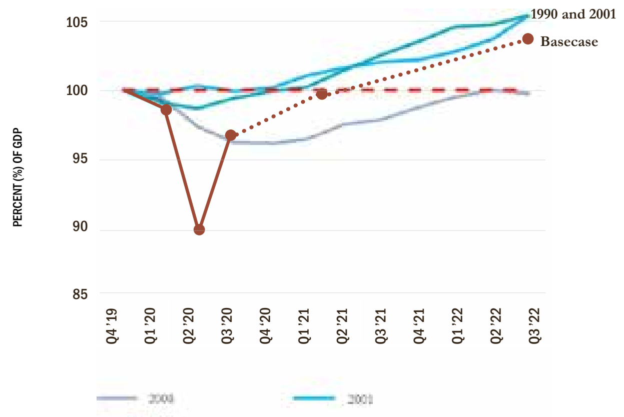
Fortunately, easing restrictions and massive government stimulus led to a nominal 7.4% bounce back in the third quarter. While estimates for fourth quarter GDP vary widely, we expect continued modest progress despite the resurgence of the coronavirus globally. The bad news is by the end of the year the economy will likely still be operating 2% lower than where it began 2020. The good news is that it has been (like the stock market) a V-shaped recovery so far. While the rebound will start to slow significantly, we would project a full recovery sometime between the second quarter and third quarter of 2021, much sooner than economists thought during the depths of the collapse.

## OFFICIAL UNEMPLOYMENT RATE (FIGURE 1)




Source: Bloomberg

## IN OUR BASECASE, THE LEVEL OF ACTIVITY PLUNGED, BUT RECOVERED MORE QUICKLY THAN ANTICIPATED (FIGURE 2)




Source: Citi Research

# 2021 OUTLOOK

## KEY TAKEAWAYS: ECONOMIC

- **GDP fell a bit over 10% during the first half of the year paced by a staggering 9% drop in economic activity during the second quarter alone.**
- **Easing restrictions and massive government stimulus led to a nominal 7.4% bounce back in the third quarter.**
- **Vaccines are near and will eventually provide the lift the world needs to slowly get back to normal as 2021 unfolds.**

The rebound was clearly sparked by aggressive monetary and fiscal policy not only here but around the world. While the Federal Reserve (Fed) quickly slashed interest rates to zero and embarked on their quantitative easing strategies gleaned from the last Great Recession, Congress passed in two phases a combined $2.6 trillion Coronavirus Aid, Relief, and Economic Security (CARES) Act fiscal package, representing more than 12% of yearly domestic GDP. All combined, the massive monetary and fiscal stimulus worldwide represented about three months of global GDP (Figure 3).

This stimulus has come at a very high fiscal price, leaving the economy with the highest aggregate debt to GDP ever and limited flexibility going forward. And post-election gridlock complicates any near-term passage of additional governmental help just as temporary relief measures regarding forbearance and foreclosure on delinquent loans are about to expire.

## GLOBAL MONETARY AND FISCAL STIMULUS TO FIGHT COVID-19 IMPACT FEBRUARY – JUNE 2020 (FIGURE 3)

| | CENTRAL BANK LIQUIDITY INJECTION | | GOVT FISCAL STIMULUS | | CENTRAL BANK LIQUIDITY INJECTION AND GOVT FISCAL STIMULUS | |
|---|---|---|---|---|---|---|
| | **$ Tln** | **% GDP** | **$ Tln** | **% GDP** | **$ Tln** | **% GDP** |
| **U.S.** | $6.21 | 29.0% | $3.30 | 15.4% | $9.51 | 44.4% |
| **Eurozone** | $1.78 | 13.3% | $4.02 | 30.2% | $5.80 | 43.6% |
| **Japan** | $1.03 | 20.0% | $2.08 | 40.3% | $3.11 | 60.3% |
| **U.K.** | $0.37 | 13.6% | $0.23 | 8.3% | $0.60 | 21.8% |
| **China** | $1.33 | 9.3% | $1.22 | 8.4% | $2.54 | 17.7% |
| **Others*** | $0.68 | | $2.38 | | $3.05 | |
| | | | | | | |
| **TOTAL** | **$11.39** | **13.2%** | **$13.23** | **15.3%** | **$24.62** | **28.4%** |

* Incl RoW and ADB, IMF, WB

Source: Cornerstone Macro

Still, even without additional government help we think the residual effects of the stimulus (some of it still working with a lag), lower borrowing costs, higher net worth on the back of the surging stock market, low inflation and less unemployment will provide enough economic momentum this winter to get us across the bridge we've built to the vaccine.

An additional financial booster shot would have been welcome as protection from a double-dip recession and loss of some of the progress we've made. But even if the recovery slows to a crawl for a bit, the vaccines are near and will eventually provide the lift the world needs to slowly get back to normal as 2021 unfolds. The stock market is already looking past the virus, and we think your portfolios should, too.

## EQUITY OUTLOOK

Let's begin with a table (Figure 4) depicting the wild ride the equity market has taken so far in 2020. As we begin December, why are equity markets around the world so strong and the S&P 500 near all-time highs? With coronavirus cases exploding, isn't the equity market set up for another decline?

Remember, the equity market discounts six to nine months into the future. So, while headlines look dim, the announcement of several promising vaccines has certainly improved the economic outlook by mid-year 2021. On the political front, the market is assuming the Republicans will retain the majority in the Senate (with one or two Republicans winning in the runoff in Georgia early next year). Higher taxes seem far less likely in 2021. While some near-term bumps over the next few months may occur for the economy, the outlook continues to brighten.

### S&P 500 INDEX PRICE CHANGE (FIGURE 4)

| S&P 500 INDEX PRICE CHANGE - 2020 | | | | | |
|---|---|---|---|---|---|
| | Peak 12/31 – 2/19 | Trough 2/19 – 3/23 | Recovery 3/23 – 9/2 | Consolidate 9/2 – 11/24 | Year-to-Date 12/31 – 11/24 |
| S&P 500 | 4.8% | -33.9% | 60.0% | 1.2% | 10.7% |

Source: S&P 500


## KEY TAKEAWAYS: EQUITY

- **Just a few months after the stock market bottomed, with some help from rising home values, consumer net worth rebounded to record levels by June 2020.**
- **Stocks are looking attractive as an income source with the dividend yield on the S&P 500 at 1.8% and a potential for payouts to increase in the future.**
- **We have reduced our overweight to growth over value, but still favor growth over the short term.**

Corporate America has been able to keep costs constrained under this difficult operating environment and has been delivering much stronger earnings than thought possible just six months ago.

Let's focus on how investors have weathered the pandemic. We commented last summer that one big difference relative to past recessions was consumer confidence. This was especially true in consumers' outlook for the future, which never did collapse. Just a few months after the stock market bottomed, with some help from rising home values, consumer net worth rebounded to record levels by June 2020. During the Great Recession in 2008 and 2009 it took five years for wealth to recover.

As we approach 2021, investors are finding zero percent interest in money market funds and bond yields in the zero to three percent range, prompting them to look for places to earn a higher return. Stocks are looking attractive as an income source with the dividend yield on the S&P 500 at 1.8% and a potential for payouts to increase in the future. With the massive monetary and fiscal liquidity poured into the financial system over the past eight months, we feel more of it will find its way into the stock market over the next year, driving stock prices higher.

After the election and with the announcement of several promising vaccines, we now recommend being overweight equities versus your target level. To fund the increase in equities we recommend reducing your core bond exposure. One equity bias we have maintained is growth stocks over value stocks, which has worked well over the past several years. With the vaccine news and hope the economy will be fully re-opened soon, economically sensitive stocks have started to perform better. We have reduced our overweight to growth over value, but still favor growth over the short term.

International investing underperformed domestic equities consistently over the last ten years. We are maintaining our underweight position to international stocks, but do acknowledge the short-term outlook is improving. First,

EAFE (Europe, Australasia, Far East) and emerging markets have a value tilt which will be beneficial as economies reopen. Another tailwind for international returns is the falling U.S. dollar against other world currencies. A declining dollar improves international returns, due to currency translation.

## ALTERNATIVE INVESTMENTS OUTLOOK

Many investment professionals believe that a traditional 60% Equity and 40% Fixed Income portfolio can provide the desired portfolio attributes of strong performance, capital protection and diversification. In 2020 a portfolio with a 60% S&P 500/40% Barclays Aggregate Bond mix returned 10.43% through Nov. 23. Positive fixed income returns offset the negative returns of equities in the second quarter. As the year unfolded, equities responded positively to monetary and fiscal stimulus and hope for scientific progress on COVID.

Our outlook for the next year is for low returns for high quality fixed income investments. For investment strategies with a balance of equity and fixed income we source our alternative investments in hedge funds from a portion of the fixed income allocation. We expect the hedge fund strategies that we employ to outpace fixed income returns in 2021 as the global economy improves and interest rates rise later in the year.

REITs were going through a transformation prior to COVID. Traditional retail malls were already in decline and with rising tenant bankruptcies and store closures, we expect more repurposing of real estate in the future. Office space needs by corporations are being re-assessed as working from home has been popular with employees and technology has enabled worker productivity. REIT returns are still negative for 2020 and require a return to a more normalized economy to fully recover from their setbacks.

## FIXED INCOME OUTLOOK

The bond market appears to be on its way to finishing the year with reasonable returns despite the instability caused by the pandemic. Thanks to massive monetary and fiscal stimulus, stability returned quickly to the bond market. An economic recovery was able to gain a footing and continues to improve as we are about to enter 2021.


## KEY TAKEAWAYS: FIXED INCOME

- **The dramatic decline in interest rates provided positive returns for all fixed income sectors in 2020.**
- **With tight spreads and low interest rates lingering into the start of the new year, high quality bonds (Treasuries, MBS, and Corporates) will struggle to provide coupon returns for 2021.**
- **Some opportunities in the High Yield sector could develop as the bond market reacts to a rise in default rates.**

Performances for all fixed income sectors are on pace to finish 2020 in positive territory (Figure 5). The Barclays Aggregate Bond Index has generated a 7.28% year-to-date return (as of 11/27/2020) with Treasuries being the top performing fixed income sector. Investment grade sectors have been able to outperform High Yield and Emerging Market Debt year-to-date. In the first half of 2020, bond markets across the globe reacted to the spread of COVID with dramatic declines in the interest rates. Improving credit conditions helped offset a more gradual rise in interest rates over the second half of 2020.

Valuations for most investment grade fixed income sectors in general are expensive as we approach next year. Within each sector there are various holdings that have not fully recovered, as found in certain asset-backed securities (ABS) and select Corporates in the leisure and entertainment industry. Some weakness remains in the High Yield sector as reflected in the Moody's speculative grade default rate reading of 6.5% at the end of October (historic average is 4.1%). The default rate has taken a breather recently but is expected to regain momentum due to the recent COVID resurgence. Some opportunities in the High Yield sector could develop as the bond market reacts to a rise in default rates.

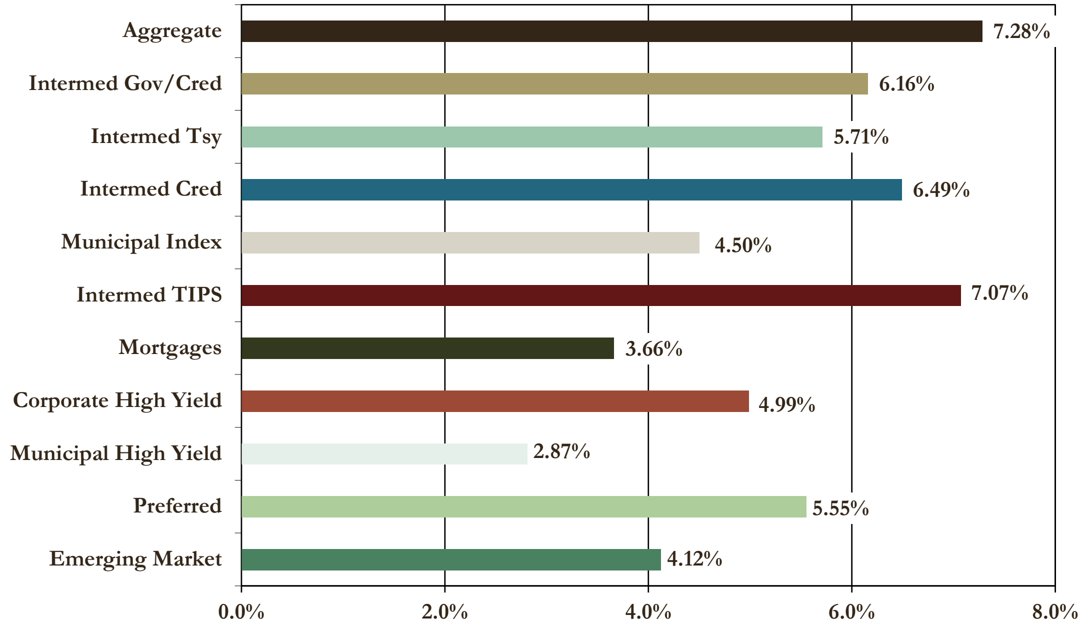
As the U.S. economy began to mend in the second half of 2020, municipal bond investor demand and risk appetites returned. Lower quality bonds outperformed their higher quality counterparts. The Bloomberg Barclays Municipal Bond Index is up 4.5% year-to-date (as of 11/27/2020) despite a pandemic looming over the market. Municipal bond credit pressure takes time to build, with downgrades and defaults lagging these effects on the economy at large. Municipal bond default rates are expected to increase from their extreme lows of the past several years while remaining elevated in the coming years, potentially reaching above the 1% threshold. Further fiscal stimulus is still up in the air which will add to budget pressure at a time when revenue growth is particularly vulnerable.

We expect far less municipal bond issuance in December and the first quarter of next year, as supply was pulled forward to September-October, as issuers came to the market to get ahead of any election-related volatility. Further improvement in municipal bonds will depend on the extent of additional fiscal stimulus and the expected scenario of investor demand exceeding supply.

The direction for interest rates is expected to remain ill-defined until election results are all in, especially regarding the Senate race outcomes in Georgia. The base case is that the Republicans maintain control of the Senate (splitting Congress) and Biden becomes President. In the interim, markets will attempt to handle a contentious presidential transition and the timing of vaccines for COVID. Treasury yields are likely to be volatile during this period. With yields already well below 1.00% for 2- through 10-year maturities, there is not much upside potential for Treasuries. Until uncertainty abates, the chances for a large fiscal stimulus remain, putting upward pressure on

## FIXED INCOME – YTD RETURNS

AS OF 11/27/20 (FIGURE 5)




Source: Bloomberg


interest rates. With the gap between U.S. Treasury yields and abroad growing, foreign investor demand could help offset some of this upward pressure.

With credit spreads approaching pre-COVID levels, the risk premium on investment grade corporate credit of 134 basis points (bps) is back below its 20-year average of 162 bps. This leaves little room for upside improvement in the performance for corporate bonds from spread tightening. Focus should be on select sectors and issuers that have lagged the recent recovery, in such areas as leisure and entertainment.

With tight spreads and low interest rates lingering into the start of the new year, high quality bonds (Treasuries, MBS, and Corporates) will struggle to provide coupon returns for 2021. If the vaccines perform better than expected, economic recovery should come quicker leading to lower than expected default rates. The High Yield and Emerging Market Debt sectors will be the beneficiaries of these conditions. Improvement for the Municipal Bond sector is expected as new issuance shrinks and steady demand puts upward pressure on prices. With additional fiscal stimulus being discussed, portfolio duration targets are being moved to slightly below their corresponding benchmark's duration.

## CONCLUSION

Few of us will miss 2020's volatility in any way, shape or form. Yet the outlook as we close out the year is encouraging.

If someone predicted last spring during the initial stages of the pandemic and massive business shutdowns that we'd likely finish with double-digit stock market gains, you might have labeled that person as not in touch with reality.

Yet here we are. While the coronavirus will continue to dominate global economic news and political gridlock may be the norm, we still expect the economy and equity markets to rebound, propelled by positive news regarding

the promising vaccines and the tailwind of low interest rates and latent stimulus.

Despite a sharp and unprecedented fall in second-quarter GDP, the economy will have recovered much of the contraction by the time readers receive this publication.

With exceedingly low bond yields and increasing optimism about gaining control of the virus throughout 2021, we are recommending an overweight to stocks and underweight to bonds. While there is still much uncertainty as to control of the U.S. Senate as we go to press, we are not currently recommending any extraordinary repositioning for tax purposes at this time.

## KEY STATS

**3.5%**
2021 U.S. GDP GROWTH FORECAST

**14.52%**
S&P 500 YTD*

**5.0%**
2021 UNEMPLOYMENT (ESTIMATE)

**0.839%**
10-YEAR U.S. TREASURY YIELD*

**7.28%**
BLOOMBERG BARCLAYS AGGREGATE BOND INDEX YTD RETURN*

**4.5%**
BLOOMBERG BARCLAYS MUNICIPAL BOND INDEX YTD RETURN*

* AS OF 11/27/20

**INVESTMENT POLICY TEAM - NOVEMBER 30, 2020**

# 2021 OUTLOOK
# COMMERCE TRUST COMPANY AUTHORS


## SCOTT M. COLBERT, CFA®
EXECUTIVE VICE PRESIDENT, CHIEF ECONOMIST AND DIRECTOR OF FIXED INCOME MANAGEMENT

## JOSEPH C. WILLIAMS III, CFA®
EXECUTIVE VICE PRESIDENT, DIRECTOR OF INVESTMENT STRATEGY

## BARBARA TURLEY, CFA®
SENIOR VICE PRESIDENT, DIRECTOR OF INVESTMENT RESEARCH

## WM. MICHAEL CODY, CFA®
SENIOR VICE PRESIDENT, DIRECTOR OF FIXED INCOME TRADING

## CYNTHIA RAPPONOTTI, CFA®, CAIA®
SENIOR VICE PRESIDENT, SENIOR PORTFOLIO MANAGER

## MADISON MCCARTY
SENIOR VICE PRESIDENT, SENIOR PORTFOLIO MANAGER



Commerce Trust Company
Wealth | Investments | Planning®

1-855-295-7821 | commercetrustcompany.com





CTC1120-PC1378