Bell
Institutional Investment Management

2021 ECONOMIC OUTLOOK

2021 Outlook: What to Look for in U.S. and Global Economy

Anybody can report about what happened in past markets. These reports usually include perspectives on how and why historical events occurred – but aside from "macro" themes, like the pandemic, "how and why" pontificating is really just speculation.

What does that say about forecasts for the coming year? You guessed it: this is really our speculation about what may develop. In a way, it's similar to a novel – fun to read and at times involving a hero who saves the day – but penning these outlooks is more about setting boundaries for measurement than about being correct. After all, there are two potential outcomes for any forecast: lucky or wrong.

Before we summarize high-level themes and then expand on individual topics … We are grateful to all the investors who looked beyond last year's turmoil and continued to focus on long-term investment goals in the face of unexpected and extreme volatility. This was no simple task. *Thank you!*

Major Themes for the Year Ahead

Accurately forecasting last year's events would have been something akin to the probability of monkeys composing a Beethoven score. Still, we'll give this a shot: What do the prospects for 2021 look like?

For starters, the word "better" comes to mind. Economic growth should move back into the positive range, with nominal GDP expected to increase 3 to 5%. That growth likely will be aided by continued federal deficit spending that includes additional direct stimulus payments to portions of the U.S. population – and perhaps expanded stimulus payments to states and local governments as well.

The Federal Reserve is likely to keep short-term rates low, with indications they will consider yield curve control measures to hold down longer-term interest rates.

Vaccines may give people the confidence to re-engage in more normal day-to-day activities, but we don't expect the effects to be as immediate as we all had hoped. Looking at inflation as the fabled "boy who cried wolf" might be right this year, as the consumer price index (CPI) is positioned to rise above the range of the last several years.

S&P 500 corporate earnings are expected to improve, with forecasts calling for 20% earnings increases for 2021, which would put full-year earnings above the record level recorded at the end of 2019. This year's economy will likely roll out with a lackluster first quarter, then pick up some steam. Prognosticators see S&P 500 gains in the range of 8%. Developed foreign stocks have better underlying fundamentals, but we expect them to perform behind the U.S. stock market, with returns around 7%. Bond market returns represented by the Bloomberg Barclays Aggregate Index look to be in the area of 2%. That estimate could come up against negative pressure if inflation presents itself in a stronger light, which in turn could lead to the Fed targeting yield curve control measures. Any "artificial" influence could expand the potential range of unexpected outcomes in either direction – an outlook that spills over into the stock markets as well.

News from Washington

As the incoming administration presented its agenda items for President Biden's first 100 days in office, we saw two items related to the economy: COVID relief stimulus checks and tax increases. We believe that while targeted corporate and personal tax increases may not be on the front burner, they are percolating. Current economic struggles argue *against* increasing taxes.

A COVID-19 relief plan, designating $1.9 trillion to combat the pandemic, includes additional $1,400 stimulus checks to financially qualified individuals to stimulate the economy. If we want to be pragmatic and go straight to the calculator, we can divide $1,900,000,000,000 by 330,000,000 (that is. $1.9 trillion divided by the U.S. population of 330 million). That comes to $5,757 per person in new government spending. Let's make the math easy and assume every person in the U.S. receives this $1,400 stimulus

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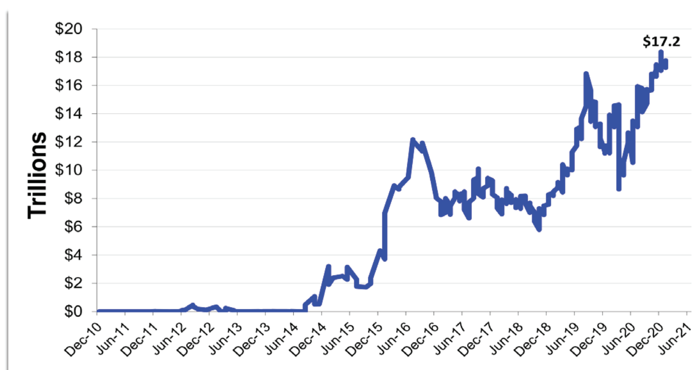
check. That leaves $4,357 per person going to other programs and beneficiaries broadly outlined as healthcare and education. (Yes, the population figure includes children and individuals otherwise not financially qualified to receive the stimulus checks – so obviously, not every person in the U.S. would receive a check – but our point is, the government is proposing to spend nearly $6,000 per person in this latest COVID-19 relief plan, with a large portion going elsewhere than to consumers.)

We ask questions not to condemn or support any specific plan, but to better understand how stimulus spending realistically fits in with economic growth. Without debating where the other $4,357 per person should be spent, $1.9 trillion of COVID-19 Relief spending represents 8.9% of U.S. GDP. Reconciling this with the general consensus among economists for GDP growth in the 3 to 5% range in 2021, we can anticipate the economy outside government spending to be down a bit.

Role of the Fed and Central Banks

It looks like the Federal Reserve will maintain its accommodative monetary policy and low interest rate campaign with the intent of supporting employment and the economy and pushing inflation higher. Money intended to support the economy as a whole seems to linger in the financial system, resulting in significant asset price inflation. Consumers benefit from low interest rates for housing purchases, but it's harder to see the Fed's consumer economic impact beyond that. Corporations are taking advantage of the low interest rate environment by favoring debt as an increasing portion of capital structures. Funds remaining after deploying business plans are used for company stock repurchase campaigns.

From an investment perspective, Fed control of interest rates blurs the market discovery for cost of capital, normally set by the prospect of utility and productivity. With recent practices remaining in place, there are elevated risks of volatility. This missing element of market price discovery means that market excesses, usually described as "bubbles" in their early stages, can become more extreme. A good example would be the amount of debt around the globe that is trading at negative nominal yields (real yield after inflation and taxes would be even lower).



It's not just the Fed that is interfering with price discovery. Central banks around the world are in the same game, only at a more extreme level. There are 11 countries with negative two-year government debt yields. France, Germany, the Netherlands and Switzerland all have negative yields on their 10-year government debt. Investors are guaranteed a loss if they hold the bonds to maturity.

Saying this another way, investors buying 10-year government debt pay their governments for the privilege of owning this debt, rather than collecting interest on it. Think about it: Investors put money to work intent on losing it! Would rational investors, working in markets where utility and productivity freely determine the clearing interest rate, ever invest at a negative yield? Not in any instance that we are aware of. How long does this continue until something breaks? Apparently longer than we expect. Negative yields began in 2014 and have mostly risen ever since. Our point is that asset prices are less subject to sustained downward movement – as long as global central banks are supporting valuations.

Stock Market Outlook

If consensus GDP growth ends up being 5% for the year, U.S. GDP would go over $22 trillion, a record high. All else being equal, record-high GDP should translate into record corporate profits. In turn, record corporate profits should translate into record corporate earnings, and record corporate earnings should support rising stock prices. Yes, valuations are extended, but investors continue to invest money in the stock market.

Perhaps the best way to explain it is to think of the stock market as a balloon. The more air is blown into the balloon, the bigger it gets. The bigger it gets, the more the elastic gets stretched. The more the elastic is stretched, the greater the risk of the balloon popping. When we're thinking about the stock market, the air equates to money. The stretching elastic is like the price/earnings ratio. Rising corporate profits relieve some of the stretching. Too much money being invested, or stagnant or declining profits, exasperate the stretching.

Our estimate for 2020 S&P 500 full-year earnings from continuing operations (excluding one-time gains, charge offs, etc.) is around $140 per share (fourth-quarter earnings are not all reported yet). That translates to a current price/earnings (P/E) ratio based on trailing earnings of 27. Our estimate for 2021 full-year earnings is around $170 per share, or about 20% higher than 2020, which is also above the $166 earnings per share reported for the full year 2019. This $170 estimate integrates the idea that corporate tax rates remain unchanged. On a forward earning basis, the P/E ratio is about 22. If the market sustains a trailing P/E ratio of 27 and earnings come in to match our estimate, the S&P will be around 4590 at year-end 2021, or about 21% higher than it is currently.

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By contrast, let's say that trailing P/E's drop to 24 and corporate taxes are raised to 28%, from 21% presently. That suggests the S&P 500 will finish the year around 3720, or about 1.5% lower than it is now. None of our estimates factor a tightening of Fed policy. Up 20% and down 1.5% is a big range – and not very helpful for planning purposes. However, using the market's long-term average return and applying one standard deviation results in an even wider range, down 5% to up 25%. Our long-range forecast calls for equity returns to be below historical averages, but 2021 does not look like it will fit into that category. Our best guess is for U.S. equity returns to be close to historical averages, in the positive 8 to 10% range.

At Bell Bank, we look globally for opportunities. Our expectation is for developed international stocks to have a slightly lower return than the U.S. stocks. While lower starting valuations, higher dividends and a depreciating dollar benefit international stock returns, we see overall growth challenges as a headwind that will produce a return about 1% lower globally than in the U.S. We look to have an allocation to this sector, but we expect it to remain underweighted throughout the year.

Bond Market Outlook

Our bond market forecast begins with the idea that the Fed has *not* accepted the negative interest rate thesis occurring in some other developed economies. That does not mean it won't happen – it just means that if it does happen, it is at the "fringe" rather than part of the Fed's overall policy. That said, the fixed income arena has proven difficult to navigate. The short end of the U.S. Treasury yield curve has interest rates near zero. The curve is positively sloped, meaning yields are higher for longer-term maturities. The yield on the U.S. 10-year Treasury bond is 1.05%. In comparison, the 10-year yield at this time last year was 1.78% – nothing to get excited about, but much higher than it is today.

It is important to remember that bond prices move inversely with yields. The price of a 10-year U.S. Treasury bond went up about 7% as yields declined last year. The reverse happens if interest rates rise. Shorter-term bonds are less price-sensitive to interest rate changes. Longer-term bonds are more sensitive. For long-term investors who hold bond positions to maturity, the return is determined by the original purchased yield to maturity. Market price appreciation on a bond is equal to the present value of future interest rate payments in excess of current market rates. That means if a bond is sold to realize the increased market value, the yield on the reinvested proceeds drop by a similar amount. These complexities are important, because the bond market also reacts to the prospect of inflation, credit spreads, default probabilities, reinvestment rates and a host of other things.

At about this point, you may be thoroughly confused by the boomerang effects in the bond market, but don't get discouraged – the bond market truly *is* difficult to understand. Let's cut through the fog and just set out a range of return possibilities. 2020 was a good year for bond returns. Our outlook for 2021 returns, assuming no change in current market conditions, is around 2% for the Bloomberg Aggregate Index. Rising interest rates could push that to zero, and falling interest rates could push it to 5%. Before you let the dismal return outlook push you into a larger allocation to stocks, remember that the volatility in bonds is almost always lower than the volatility in stocks. The bond market can be a stabilizer for your portfolio like shocks are a stabilizer for your car. (For a real-life experience of this effect, have a mechanic take the shocks off your car and try to drive it. *Just kidding, don't do that*! Take it from us – it is nearly impossible to control.)

Summing Up Our Strategy

In this type of environment, there is a strong tendency for investors to want to "surf" the market – ride the "big wave" and cut out before it fades into shore. Of course, we would love to provide that type of clairvoyance. However, unlike the surfer who can see the wave approaching shore, the markets have no such indicators. Sure, stock prices are elevated and bond interest rates are low, while other traditional asset classes such as real estate have similar challenges. We look to find the best investment allocation options in the market available today, consistent with client investment allocation parameters and focused on long-term goals. At this point, while there are indications of bumpy spots on the horizon, we anticipate the prospect for a good investment environment in 2021.

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