THE PRIVATE CLIENT GROUP
WEALTH MANAGEMENT

ECONOMIC & MARKET INSIGHTS

Year-End 2020

EXECUTIVE SUMMARY

After a year of unprecedented turmoil, 2020 ended on a high note for investors. Although the coronavirus crisis triggered one of the deepest and swiftest market declines in history, stocks and other risky assets recovered quickly and at year-end had reached new highs. The durable market rally was fueled by sweeping Federal Reserve intervention that lowered policy rates to near zero and provided liquidity to financial markets in distress. U.S. Treasuries and other high-quality bonds were buoyed by falling interest rates, creating a cushion during the market downturn.

Government stimulus spending, resulting in payouts to consumers, businesses, and local governments, also helped to support financial markets by balancing the sharp drop in income as the economy contracted. The potential for a new wave of fiscal spending under the Biden administration and more robust economic growth as the pandemic ends has increased inflation expectations and led inflation-sensitive assets to outperform. Although inflation will likely rise in the months ahead, structural unemployment, slow population growth, and anticipated higher tax rates should keep long-term inflation in check.

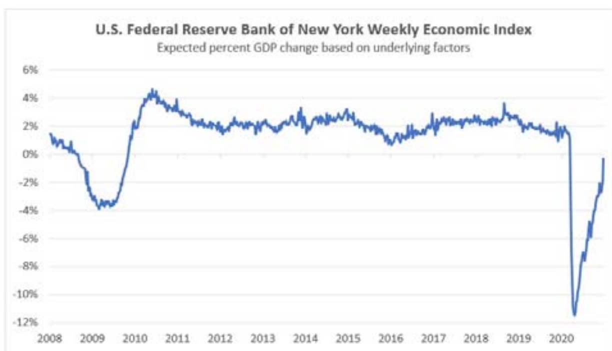
By most valuation measures, the U.S. stock market is expensive relative to historical norms. However, the performance of large U.S. growth companies has far surpassed other market segments for many years. This divergence became even more pronounced during the COVID pandemic as investors piled into a handful of technology companies with growing demand for their services and avoided sectors such as energy and banks that were hardest hit by the economic crisis. These value-oriented cyclical sectors showed positive momentum at the end of the year and may be poised to outperform as the economy recovers. Companies with positive ESG (environmental, social, and governance) characteristics also did well this year and may be buoyed by the emphasis on social welfare, health care and environmental regulation under a Biden administration. Emerging markets, with higher expected growth rates, compelling valuations and strengthening currencies relative to the U.S., also have a favorable outlook. Recent trade agreements and improved relations between the U.S. and its trading partners should also be a boon to emerging countries.

As we look forward to 2021, the uncertain path of the coronavirus will drive the economy and financial markets. Vaccine distribution, rapid testing, and improved therapeutics have created optimism, but second and third waves are again forcing some countries to impose restrictions and vaccine distribution is proceeding slowly. However, the potential for growth and innovation in a post-COVID world may present exceptional opportunity. Disciplined asset allocation and diversification across investments with different sensitivity to growth and volatility is the best approach to portfolio design.

ECONOMIC INSIGHTS

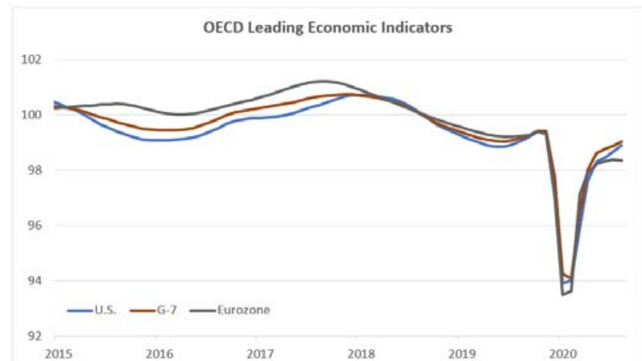
It's almost hard to believe, but the U.S. was within its largest economic expansion on record entering 2020. GDP growth was robust and unemployment figures hit multi-decade lows. While many postulated that we were approaching late cycle, there were limited areas of clear excess within the economy. Any semblance of calm quickly dissipated as the world was struck by a public health pandemic that uprooted most aspects of daily life. Supply chains were disrupted, unemployment skyrocketed, oil prices collapsed, and many economic indicators reached levels never seen before in history. The following months were volatile but substantial progress has since been made towards an economic recovery.

Now entering 2021, there are reasons for balanced optimism. A variety of vaccines have been approved and are in the process of being distributed. Although cases remain high in many nations, the pandemic should gradually (and eventually) come to an end as more of the population is inoculated. Economic activity has dramatically improved in many areas but still remains below pre-pandemic levels. Things should continue to recover as life slowly returns to normal and the economy more fully reopens. Additionally, certain areas of the economy should benefit from pent-up demand as people are eager to resume missed elements of their prior lives (such as travel). 2021 is likely to be a transition year, paving the way for additional growth and a fuller recovery in 2022.



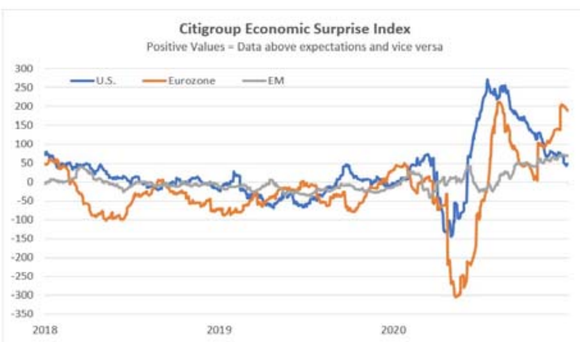
Federal Reserve Bank of New York

The Weekly Economic Index, which measures the expected change in GDP factors such as unemployment claims and gasoline sales, hit unprecedented lows in April and May, reflecting draconian lockdown measures. Since then, economic activity has steadily improved, as many portions of the economy reopened.



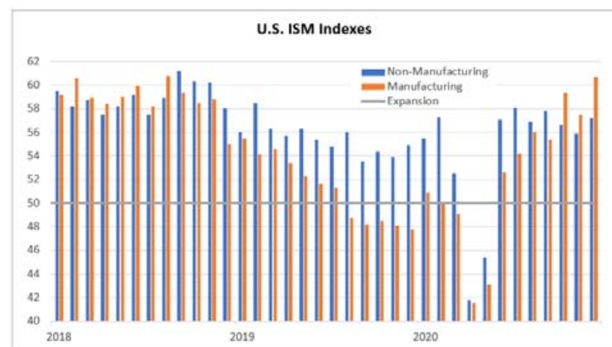
Organization for Economic Cooperation and Development

Following a rapid recovery from pandemic lows, leading economic indicators (LEIs) continued to improve but the pace of improvement has leveled off. This reflects recent coronavirus spikes and subsequent lockdown and containment efforts.



Citigroup

Economic surprise indexes were highly volatile throughout the year, first falling to historic lows and then rapidly recovering. More recently, index levels have come down as estimates are falling closer in-line with expectations. Eurozone data also has steadily surprised to the upside lately.

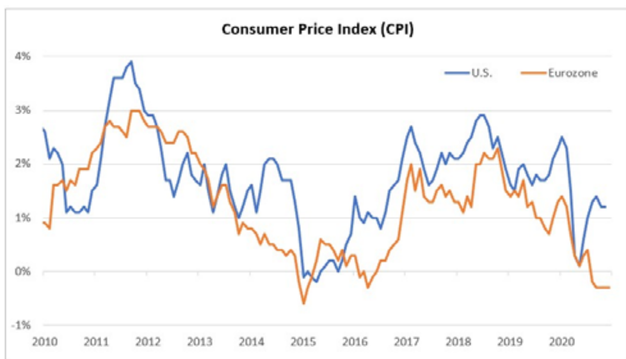


Institute for Supply Management

Since May, the ISM indexes for manufacturing and services (non-manufacturing) have both sustained levels well above 50, the inflection point between expansion and contraction. Relative to one another, the manufacturing portion of the economy has come back more quickly based on demand for durable goods and limitations for the service sector to fully resume.

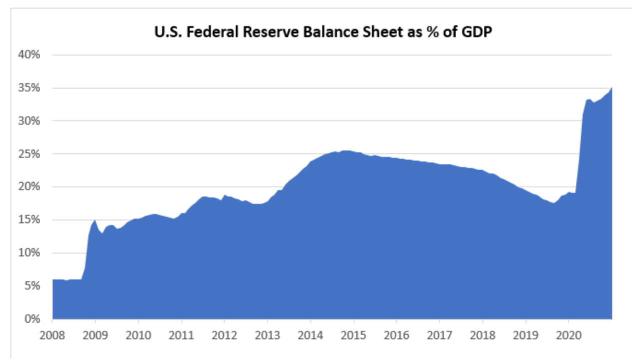
After completing 'policy adjustment' rate cuts in 2019, the Fed came into the year with a continued dovish stance. Soon after the potential extent of the pandemic was better understood, the Federal Reserve in conjunction with most major central banks acted swiftly to support the rapidly eroding global economy and markets. The Fed quickly cut its policy rate to 'near-zero' in the U.S. and introduced a series of lending facilities to bolster deteriorating bond markets. Other global central banks followed suit. As a result, central bank balance sheets have ballooned. The Fed also modified its mandate where it now seeks to achieve average inflation targeting. This means that it will attempt to keep inflation above two-percent to compensate for being below this target in prior years. In addition to vast amounts of monetary policy, fiscal policy was enacted to increase unemployment benefits and deliver direct payments to citizens on multiple occasions.

Government assistance has helped bridge the significant economic gap left by the pandemic but has also inflated asset prices. While U.S. corporate earnings have recovered, they remain below prior all-time highs with the potential to reach new records in 2021. Already low inflation initially fell at the onset of the pandemic following lower prices for core consumables such as oil. Since then, inflation has stabilized and has even shown signs of rising. Some of the increase reflects the additional costs of delivering goods in a post-pandemic society in addition to easy money.



U.S. Bureau of Labor Statistics

Inflation, as measured by CPI, drifted lower throughout much of the year. The decline reflected the fall in the price of oil and other goods as demand quickly diminished. Since the peak of the pandemic, inflation has recovered and it's possible that massive easing efforts and increased input costs could trigger a surprise to the upside.



Bloomberg

The Federal Reserve meaningfully increased the size of its balance sheet over 2020. Since the start of last year, Fed assets have increased by approximately $3 trillion which includes about $2 trillion of Treasury bonds. A mandate to keep inflation low for the foreseeable future paired with expectations for additional fiscal policy will continue pushing government debt to record levels.

U.S. Federal Reserve and Bloomberg

2020 was a volatile year for the U.S. dollar. Early in the pandemic, a flight to quality caused the USD to spike as it remains the global reserve currency. Since then, extensive fiscal and monetary policy has pushed the USD lower to levels not seen since mid-2018.

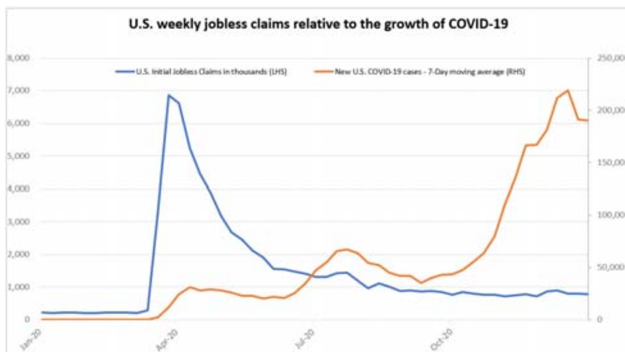
Bloomberg

U.S. corporate earnings fell substantially over the first half of 2020. Earnings have recovered but are still below prior highs. It's possible that new highs will be reached in 2021 as several core sectors (tech, healthcare, etc.) have been resilient and some productivity improvements are realized.

EMPLOYMENT AND THE CONSUMER

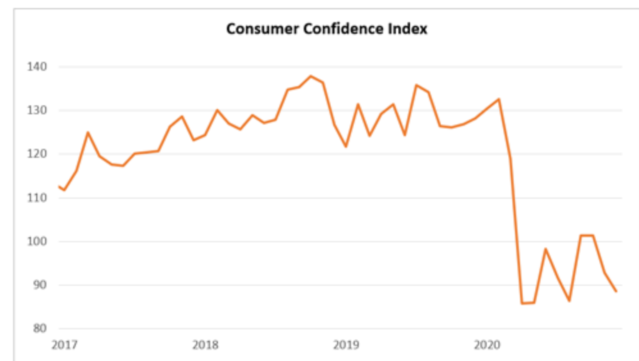
There are many factors for a nation to consider when deciding what type of economic recovery is underway following the pandemic. Aside from GDP and financial markets growth, employment stabilization is widely considered a barometer of success. In the past year, the U.S. managed its overall unemployment to the best of its ability, but progress remains to reach full employment. The unemployment rate fell to 6.7% at the end of the year, which is almost double what it was pre-pandemic but less than half of the rate spike from the second quarter. Surprisingly, businesses have figured out ways to cope with outbreaks for the most part given the recent surge in new cases through the fourth quarter. Amazingly it was not matched by a proportionally equal rise in jobless claims, indicating companies have developed processes to handle the pandemic's effects. An interesting factor that likely contributed to this dynamic is that an increasing number of companies are creating the ability for their employees to work remotely. Additionally, the CARES Act was passed by Congress that provided Paycheck Protection Program loans to qualified small businesses in need of support. From a recent Deutsche Bank survey, at least 70% of respondents indicated they'd like to work remotely at least one day per week post-pandemic which will likely alter how businesses and real estate operates in the long term. The winter months may provide a headwind to some recovery efforts, but hopefully as the vaccine is distributed, severely affected companies will continue to recover, and employment trends improve.

The pandemic presented many unforeseen elements that needed to be quickly handled by businesses if they were to stay afloat, but one of the hidden byproducts was its effect on wages. After a decade of steady economic growth, the labor force participation and wage growth were expanding. When the pandemic hit, millions of Americans lost their jobs and widespread wage growth ceased. Ironically, the recovery has been uneven across society and industries. Employment in professions that pay above the median is back to pre-pandemic levels, but low-wage professions (likely unable to take advantage of remote work) are still suffering. The speed and degree to which the recovery will continue probably depends on future stimulus packages provided by the government and policymakers' ability to target the most vulnerable groups and businesses.



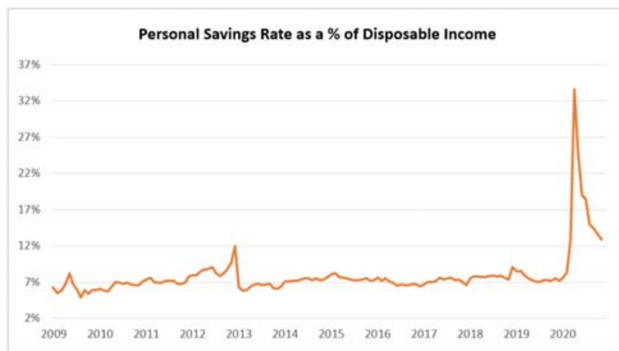
Labor Department and Centers for Disease Control and Prevention

The surge in new COVID-19 cases has not resulted in another spike in initial jobless claims, to the benefit of companies and the economy in general.



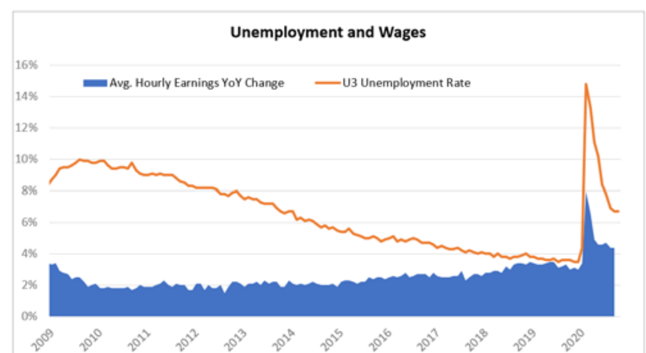
Conference Board

Consumer confidence has not efficiently recovered to pre-pandemic levels, reflective of the expected volatility ahead.



U.S. Bureau of Economic Analysis

Consumers' level of savings is still higher than its long-term average and is steadily declining from the initial spike triggered during the second quarter amidst localized lockdowns throughout the country.



U.S. Bureau of Labor Statistics

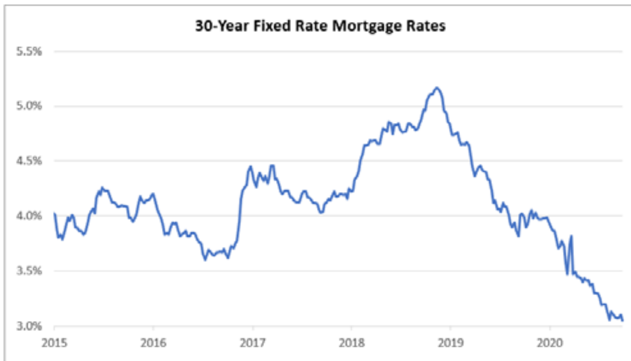
Progress to reach full employment remains a lofty goal but is a critical component of the recovery. The current level of unemployment was last seen almost seven years ago in early 2014.

RESIDENTIAL AND COMMERCIAL REAL ESTATE

Like many areas of the economy, the 2020 pandemic created stark winners and losers within the real estate sector. The residential portion of the market was resilient throughout, fueled by several factors. First, mortgage rates fell to record lows making homeownership more attainable for many. Second, those that maintained employment reaped greater savings paired with a desire for more space. Aside from a brief pause in activity during the height of the pandemic, the housing market was active throughout the year and stood out as one of the strongest portions of the economy. Building activity recovered swiftly to meet demand and home values reached year-over-year gains not seen since 2014.

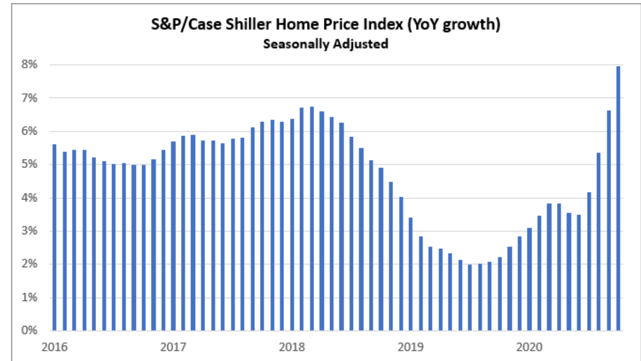
Nowhere was the impact more varied than the commercial portion of the market. For office, retail, and hospitality & leisure, the result was likely negative to some degree. Within office, a global test run of remote work has led many companies to reconsider their office space needs. Within retail, strict social distancing requirements paired with a push forward in the digitization of commerce have led to extensive store closures. The travel and leisure industry remains partially closed until the health crisis can more fully be brought under control. At the same time, the same trends that are hurting the retail sector are providing a powerful tailwind to portions of the industrial market as e-commerce companies look to rapidly expand their logistics and fulfillment footprint.

While 2020 has turned the corner, the book is still being written on the longer-term impacts of the pandemic. In many cases, trends that were already in motion (such as the shrinking of physical retail) accelerated. Other recent trends might prove more temporal and the coming months should offer greater clarity in how things will progress over the longer-term.



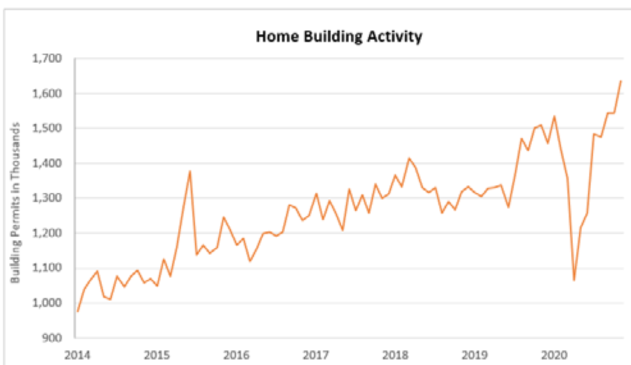
Mortgage Bankers Association

Except for a brief spike in March, mortgage rates started low and trended lower throughout the year. This culminated with the benchmark 30-year fixed mortgage rate finishing the year near record lows of 2.9%.



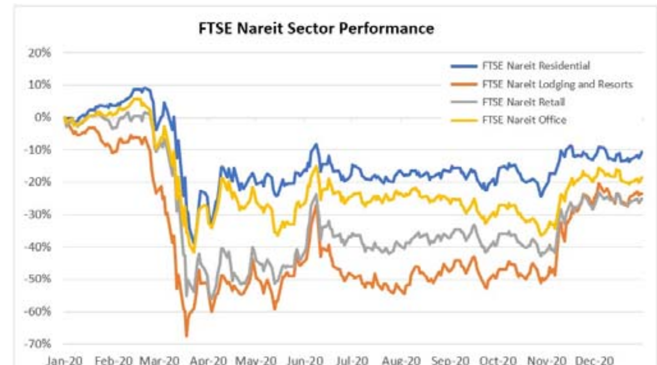
S&P/Case Shiller

The extensive demand for single-family homes paired with historically low mortgage rates pushed year-over-year home price gains to the high single-digits. This pace of growth was last seen in mid-2014.



U.S. Bureau of the Census, U.S. Department of Housing and Urban Development

After dramatically declining in March and April, home building activity came roaring back in the second half of the year. Even into the new year, demand continues to outstrip supply in certain areas of the country.



Nareit

Performance of the different real estate sector indexes quickly shows the winners and losers from this pandemic. Residential has the strongest recovery while the other sectors remain meaningfully below late-2019 levels.

MARKET INSIGHTS

EQUITY MARKETS

Equities had quite an unexpected ride over the past year. The S&P 500 Index recorded the shortest bear market in history, lasting just over a month spanning February into March, then quickly rebounding for a positive total return for the year. This return was heavily influenced by "FANGAM" (Facebook, Apple, Netflix, Google (in two share classes), Amazon, and Microsoft) which accounted for more than 20% of the index's weight but almost 60% of the return, evidence this was a year of extreme winners and losers. Internationally, emerging markets bested developed markets largely because China was able to expediently handle its COVID-19 outbreak and outperform. Looking forward, many companies' higher starting valuations could contribute to lower medium-term returns.

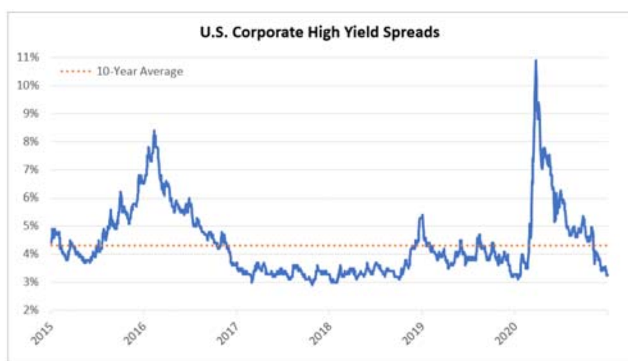
Embedded in the markets were starkly different outcomes when evaluating various sectors and styles. In the U.S., eight of the eleven S&P 500 sectors recorded positive returns for the year with technology leading them all. This sector's stocks capitalized on businesses and consumers' sudden shift to the "work and shop from home" environment. On the contrary, energy stocks suffered as their level of demand vanished given the massive decline in travel (for business or pleasure). Growth dominated value globally since many companies able to take advantage of the virtual environment were growth companies. After a volatile first quarter, small-cap stocks recovered and ended the year on par with both large- and mid-cap stocks in the U.S. and globally.

The 12-month trailing price-to-earnings ratios are the highest they've been since the Global Financial Crisis. These may moderate in one way or another, either by declining future prices or as future earnings increase.

FIXED INCOME AND ALTERNATIVE MARKETS

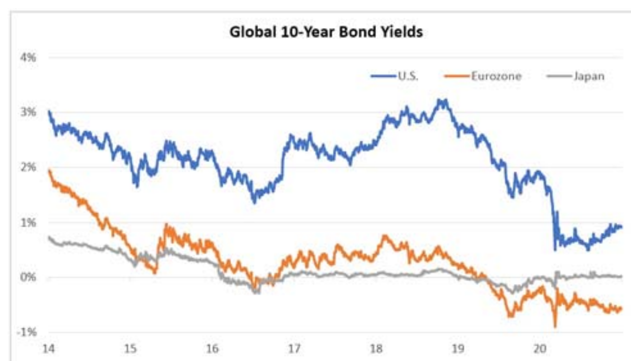
All fixed income sectors posted attractive returns in 2020, despite facing headwinds during the year. As the coronavirus pandemic unfurled, Federal Reserve policies intended to stabilize the economy and support liquidity put downward pressure on interest rates and propped up prices in both the government and credit sectors. A massive shift by investors into the safest government assets at the start of the healthcare crisis sparked a liquidity crunch in riskier bond sectors but eventually gave way to renewed interest in corporate credit and municipals bonds. Both sectors experienced strong investor demand during the last half of the year. The Federal Reserve's announcement that it would allow a higher inflation rate, the promise of further fiscal stimulus, and improving growth expectations created demand for Treasury Inflation Protected Securities (TIPS) from investors that wanted an inflation hedge.

At year-end, high quality U.S. bonds in aggregate were yielding roughly 1%. With rates near historic lows and credit spreads well below average, there is little potential for bond price appreciation. Non-traditional sectors including high yield and international bonds come with additional credit and liquidity risks but can add return potential and diversify bond sectors largely driven by rate changes. The U.S. dollar has declined materially over the past year, but subdued growth and mounting government debt is expected to lead to further weakening. This favors emerging market debt which is typically highly correlated with local currency returns. However, currencies can be volatile and a reversal in the U.S. dollar would negate the higher yields available outside the U.S. Active fixed income managers that can make tactical moves in these sectors may lead to better outcomes than a strategic allocation.



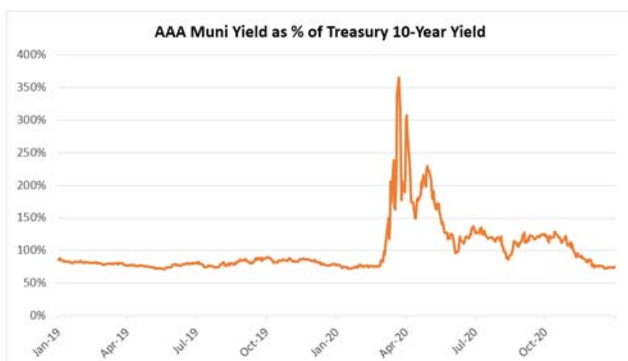
Barclays Capital

Credit spreads spiked in March, but Fed intervention quickly brought yields down to normal ranges. Spreads across the credit spectrum are below average and far off the peaks seen earlier this year. Corporate default rates rose as the economy slowed but seem to have stabilized.



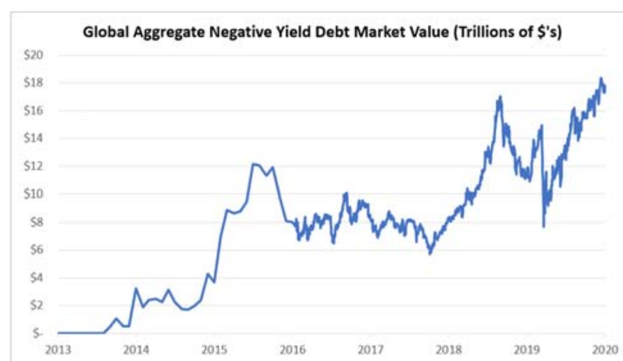
Bloomberg

Central banks quickly lowered policy rates as economies shut down. Yield curves flattened worldwide when global recession began to take hold. Muted inflation has kept rates fairly stable internationally. The U.S. yield curve has steepened recently due to higher inflation expectations.



Bloomberg

Municipal spreads spiked in March. Fed intervention and a resurgence in demand supported prices and brought yields lower. The yield on high quality 10-year bonds fell below comparable Treasuries during the fourth quarter. New issue supply prior to the election has tapered off.

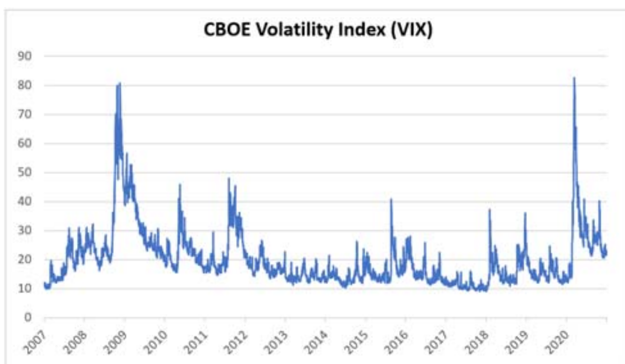


Bloomberg Barclays

The share of bonds with negative yields seems to have stabilized for the time-being. Yields are negative in many developed countries but are generally positive in emerging countries. Higher yields and potential currency appreciation are raising demand for emerging market debt.

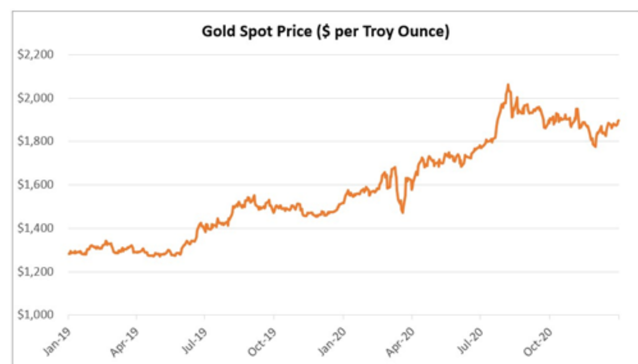
Despite the rebound in stocks and other risky sectors, investors continued to pile money into defensive assets such as bonds over the past year. With interest rates historically low, cash and short-term bonds are yielding less than inflation and are now a less powerful tool to protect investment portfolios from volatility and the erosion of purchasing power. At the same time, the valuation of public stocks has climbed, and elevated stock market volatility makes for a bumpier ride. These factors have increased interest in alternative investments.

Hedge funds had a stellar year, although the largest gains were experienced by high beta strategies, particularly those with exposure to the technology and cryptocurrency sectors. Market neutral and other low volatility strategies delivered more modest performance. Private real estate offers attractive yields as well as price stability relative to public REITs. The dislocation and rapid innovation in many businesses should create a compelling opportunity set for private investments and the current vintage year is expected to be the best since the global financial crisis. Traditional lenders have pulled back as the liquidity needs of borrowers swelled, creating opportunities for private lenders. There has also been growing interest in digital assets which have experienced large price increases and can be useful as an inflation hedge. Although more institutional investors are researching this burgeoning asset class, it remains unregulated, subject to security risks and marred by bouts of extreme volatility. But development of a regulatory framework and infrastructure enhancements may create a new investable asset class down the road.



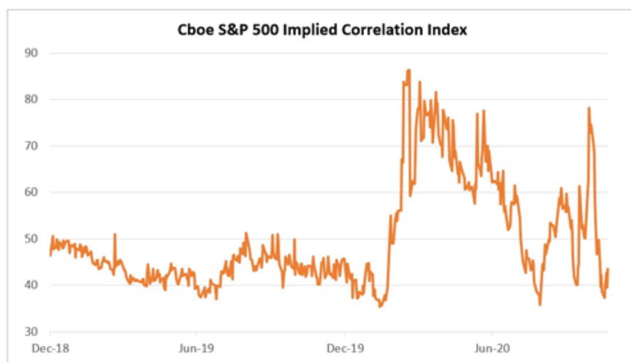
Cboe, Bloomberg

Expected stock market volatility, as measured by the VIX Index, was elevated for much of 2020. The VIX level reached an historic high earlier in the year. Over 85% of trading days were above the long-term average. Realized daily return volatility was elevated also, with most returns greater than +/- 1%.



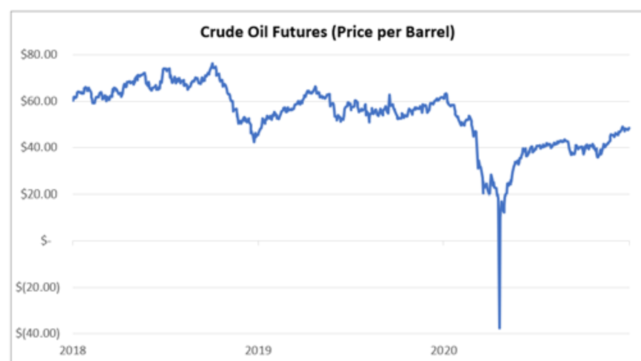
Bloomberg

The price of gold reached a record high in 2020. Gold benefited from a falling U.S. dollar and its dual role as a safe haven asset and inflation hedge. As hopes for an economic recovery emerged, gold was surpassed by cyclical commodities such as copper.



Cboe, Bloomberg

S&P Correlation has recently been unstable, experiencing sudden upward shifts during bouts of market volatility. The correlation between stocks tends to rise during market corrections and periods of heightened volatility. Correlations within other markets also rose during the coronavirus pandemic.



U.S. Energy Information Administration

The price of crude oil futures was negative for the first time in history in April due to a sharp drop in demand and storage capacity constraints. The price soon recovered as supply slowed and the economic outlook improved. The oil price affects the inflation rate and is a bell-weather for global growth.

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