



POLITICAL, ECONOMIC AND CAPITAL MARKETS REVIEW & OUTLOOK FOR 2021

- In 2021 political division in the United States will persist.
- Globally, certainty regarding the Brexit agreement, implementation of the Abraham Accords, conquering of the pandemic, and more predictable U.S. foreign policy will foster a less tumultuous year ahead.
- The global economy will continue an uneven rebound from its pandemic-induced recession.
- Investors will face choppy and low investment returns as the business environment normalizes.

Political Considerations

2020 was a year dominated by the COVID-19 pandemic, political division, and social turmoil in the United States, as well as positive breakthroughs on the world stage with the “Brexit” agreement and Abraham accords. We expect these events will continue to play out and dominate the headlines throughout 2021.

COVID-19 quickly transformed the world and has affected each of us in some way. The pandemic moved beyond being the most significant health care crisis of our time to exerting a major influence on economic, social, and geopolitical issues. The introduction of several vaccines has been received with great relief throughout the world, yet we will continue to face challenges with vaccine nationalism, distribution, and efficacy. Another unknown is how many individuals may refuse to even take the vaccine.

Here in the United States the murder of George Floyd caused riots across the nation with a focus on the Black Lives Matter movement. Much of the nation has recognized the election of the Biden-Harris administration. The process of changing presidential administrations has had challenges. We remain a deeply divided nation, and seeking consensus will continue to be difficult.

Abroad, President-elect Biden has announced plans to hold a Summit for Democracy. His *Why America Must Lead Again* essay points to a world in which the United States seeks to rebuild confidence in its leadership, strengthen its traditional alliances, and play a leading role in issues

from democracy to trade, climate change, and social equality. The Paris climate treaty and the Iran nuclear deal are other areas that look to be handled differently than by the Trump administration. Nations that have had challenges with the style and approach of the Trump administration may remain cautious towards full engagement with the United States, knowing that the policy emanating from Washington could change again in four years.

On the global stage we enter 2021 with some new found certainty. The past year closed out with Great Britain and the European Union having negotiated a long, drawn out effort to reach closure with “Brexit”. Hope has arisen that stability will come to portions of the Middle East as Arab nations normalize relations with the state of Israel.

China’s growth as a world power will continue to influence and dominate politics both in the region and with the United States. Biden’s pick of Katherine Tai as U.S. Trade Representative points to ongoing rivalry with China. This dynamic will continue to play out throughout 2021 among the European Union, China, and the United States.

In 2020 the investment markets reacted dramatically to political events. The greatest sensitivity in the markets was connected to the pandemic, policy disputes and response from Washington D.C., the U.S. presidential election, and the uneven economic recovery. We remain constructive for the year ahead, yet based on our collective experience on how events can change rapidly, we remain watchful of areas that can devolve and negatively impact investment markets. The items of highest concern to us in 2021 include social justice, climate change, wealth inequality, and pandemic restrictions. The coming year promises to be one of heightened sensitivity in the investment markets, given the interactions among the pandemic, an uneven economic recovery, and fractious geopolitics.

Economic Review and Outlook

Economic activity was a roller coaster in 2020, due to the COVID-19 Pandemic. The U.S. economy entered the year at full employment, with prospects for decent economic growth of a little over 2%. With full employment, inflation-adjusted wage gains for the bottom quartile of U.S. households were expected to be 5%, which would have reduced overall wealth inequality, particularly for minorities. Instead, we experienced a year of economic gyrations, with full-year GDP figures likely to reflect a decline of 4% in the U.S. and slightly worse globally.

During the early days of the pandemic, we considered the economic situation as a “medically induced” shutdown – not dissimilar to putting a patient in a coma with the hope that by providing time, the patient will be ready later for treatment and recovery. Numerous health-related mandates imposed in the U.S. and abroad had the immediate effect of putting the global economy in a sudden and deep recession. In the U.S., the economy contracted by an annualized

rate of 31.4% in the second quarter (or 9.1% on absolute terms). Other major economies recorded similar declines.

Later in the year, as health-related closures were lifted, most economies bounced back. As of this writing, the fourth quarter appears to be more mixed. Many countries were forced to reinstate health restrictions due to rising cases, leading to another decline in business activity, while others that did not experience increasing COVID cases had modest gains.

Our economic outlook for 2021 is greatly influenced by the sharp contraction in 2020 due to the COVID-19 global health pandemic. Recessions are usually caused by excesses in the business cycle, which then get reined in either by rising interest rates or by collapsing asset bubbles. Neither was the case this time, which makes predictions about the economic recovery more challenging. In our view, the decline of GDP in 2020 was caused by government-mandated restrictions and by reluctant consumers choosing to forego activities outside their houses. Looking ahead, we see three drivers for the economy in 2021.

The first is developing immunity, which can occur via vaccination or from those who have already contracted the disease. A healthy economy will begin with a healthy population. Once a certain threshold of the total population is immune, the virus will slow its spread. We anticipate this will occur toward the end of 2021. The failure in the United States of creating a comprehensive COVID testing regime makes us more pessimistic than the majority of Wall Street analysts' summertime estimates. But we have a high confidence that herd immunity will be achieved, the primary risk being that another strain of COVID could emerge that is resistant to the vaccines currently approved or in development.

The second driver to the economy in 2021 is how quickly consumers return to customary out-of-home activities. As more and more people are vaccinated, gain immunity after contracting COVID-19, or see the levels of infection drop to very low levels in their communities, consumers will return to more normal behaviors. Yet the timing and character of this change is difficult to predict. One of the largest unknowns is what criteria local or national governments will use to lift COVID-related shut-downs. And, once mandated restrictions are lifted, it is uncertain whether people will be hesitant to engage in out-of-the-house activities, such as eating at restaurants, attending live events, and traveling.

The third, and last, criterion is how quickly hiring takes place. A well-studied correlation exists between the length of time a worker is detached from an employer and how quickly the worker returns to work at the same or different job. While the PPP (Paycheck Protection Plan) was not perfect, it kept the connection between employees and employers. Europe generally has a similar structure, where unemployment benefits can be given to workers who are furloughed or reduced to part-time work. We believe that the strength of the economic rebound in the third quarter of 2020 was partially due to the fact that many businesses could easily reopen with all their employees in place. However, as more time elapses and a growing number of businesses

close permanently, more workers will need to find new places of work. This takes time and has the effect of lowering the worker's salary. Unfortunately, the statistics being reported by the U.S. Department of Labor show that unemployment has particularly hit women, who not only work in more face-to-face industries but also left the labor market because of the lack of childcare or schooling during the pandemic.

Overall, our view regarding the economic landscape is positive but comes with a few caveats. We see many health-related tailwinds to the economy in 2021 as vaccines are disseminated and life becomes more normal. The strength of the tailwinds depends upon how successful vaccination efforts are globally. The pace of growth may also be subdued due to temporary job losses turning into permanent ones. We anticipate that U.S. GDP will grow by 3% in 2021. Global GDP will be more uneven, though overall should be in the 4-5% range. Both predictions result in growth still below their peak in 2019, and are also lower than most Wall Street economists' estimates. U.S. total employment should also remain below its pre-Covid level into 2022 or beyond.

2020 Investment Markets Review

2020 brought unparalleled market behavior in reaction to the COVID-19 pandemic. The year started off with modest gains while COVID-19 was still seen as a minor issue similar to MERS, SARS, or the Avian Flu. Then, as the virus spread and more information about it became available, global stock markets fell in unprecedented fashion. The S&P 500 recorded its fastest ever bear market (a decline of greater than 20%) in just 16 days. The total decline from peak to trough was 34%, with foreign markets falling similarly.

The flight-to-safety reaction to the stock market's decline, in conjunction with the U.S. Federal Reserve's and other central banks' policy actions, resulted in interest rates dropping to negligible levels. As a result, bond markets posted a robust 7.5% return for the year. (Interest rates and bond prices move in opposite directions.)

Commodity prices, except for gold, plunged during the first half of the year due to the global freeze of activity caused by the pandemic. Most notably, demand for oil dropped precipitously as nearly everyone stayed home. Oil production continued because oil wells are not easily turned off. The situation was exacerbated by an output rivalry between Russia and Saudi Arabia. The result was a glut of oil never seen before. Here in the U.S., due to a variety of tumultuous market forces, investment instruments that set oil prices fell at one point to *negative* \$37 a barrel. This outlandish negative price, however, only took place in the financial markets and no physical oil was ever sold at a negative price.

Overall, central banks and politicians responded with dramatic and near-term effective measures to the pandemic. Lessons learned from the global financial crisis of 2009 resulted in central

banks' acting swiftly and with all available tools to ameliorate the economic destruction caused by the pandemic. Central banks lowered short-term interest rates to zero and long-term interest rates to ultra-low levels through bond buying (quantitative easing). Further, in the U.S., Europe, Japan, China and several other countries, central banks supported corporations and bond markets by purchasing corporate bonds directly from companies, as well as in the markets. Though drastic and anti-capitalistic, it likely staved off financial contagion like that experienced in the depths of the financial crisis. Politicians likewise enacted massive fiscal stimulus plans and provided increased safety nets to citizens and corporations alike.

The resulting fiscal and monetary stimulus, combined with the development of vaccines, created an improbably strong year for stocks. The S&P 500 gained 18.4%, while the NASDAQ was up an astonishing 43.6% for the year. Foreign markets were also positive, with the MSCI EAFE index, composed of large companies in developed countries, rising 7.8%. The discrepancy in stock market returns was due almost entirely to the outsized returns of the 6 largest technology companies, all of which are headquartered in the United States.

Investment Markets Outlook & Strategy

After steady gains in stock prices throughout the last 8 months of 2020 and the development of multiple effective vaccines for COVID-19, we point out that we are still in the midst of a pandemic. We anticipate that 2021 will bring additional market swings, as investors speculate about how, when, and where the pandemic will be brought under control. Further, how the overall economy and specific industries will fare in 2021 is even more difficult to predict.

In 2021 our baseline expectation for the economy, both here in the U.S. and abroad, is fairly strong. With the continuation of ultra-low interest rates, 2021 appears to be a favorable environment for stocks. However, coming off of last year's strong returns, much of the favorable environment may already be priced into stocks, which leads us to pare back our 2021 return estimates. Our baseline scenario for U.S. stocks is for mid-single digit returns, with market gyrations along the way.

We expect foreign stock markets to perform a few percent better. Our favorable view on foreign equity markets is due to their relatively lower valuations and our expectations for a modestly falling U.S. Dollar. Due to wide differences between foreign countries in their ability to rein in COVID, we also predict a larger than normal range of foreign market stock returns.

The math is unfavorable for bond markets in 2021. Short-term interest rates are already at zero, and the 10-year U.S. Treasury bond began the year with yields under 1%. We expect short-term interest rates will remain at their current levels. Longer-term rates will likely move up during the year, though we expect the Federal Reserve's quantitative easing will limit how high they go. This creates a new paradigm in that small changes in interest rates now have a much larger

negative economic impact. This “low-interest-rate trap”, which once seemed to be a solely a Japanese phenomenon, has taken hold throughout the developed world. The result of ongoing low interest rates will be bond market returns of less than 3%.

In this current environment our investment strategy for U.S. investors is as follows:

- Increase global exposure in both bonds and stocks;
- In accounts where tax considerations are secondary – increase TIPS allocation as a hedge against the possibility of inflation;
- Avoid U.S. government debt (except for TIPS), due to their ultra-low yields;
- Seek out individual stocks in companies that may benefit under the new U.S. presidential administration or that can take advantage of the ultra-low interest rate environment;
- Be flexible in the event of changes to the U.S. tax code;
- Modestly tilt portfolios toward equity income stocks, in the U.S. and abroad, that can deliver reliable dividend payments.

2020 was a difficult year for everyone. Paradoxically, investors were rewarded with strong returns in the midst of a pandemic. 2021 will surely bring a continuation of challenges seen last year. COVID will still ravage communities, political divisiveness in the U.S. will persist, and existing geopolitical tensions will remain. In the United States, racial and gender inequity remain obstacles to a more perfect union. Globally, wealth inequality continues to grow, which constrains economic potential and increases social unrest. Despite all these concerns, we believe the outlook for investors remains favorable and that the world will get better in 2021.

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