Investment Outlook: 2021 & Beyond

January 2021

The Outlook

For 2021 and beyond, we think a reasonable base case is for a global economic recovery starting in the second or third quarter once the widespread distribution of effective vaccines gets the pandemic under control.

The Economy: The International Monetary Fund, the Federal Reserve, and independent research services we subscribe to are all currently forecasting above-trend economic growth in 2021. This compares to the mid-single-digit economic decline last year. The consensus assessment seems to agree with our near-term base case.

Monetary Policy: Even with an economic recovery, central bank monetary policy is almost certain to remain very accommodative, for the next two years at least. The Federal Reserve for example doesn't expect to raise rates until 2024. It has telegraphed its intention to allow inflation to run a bit before acting.

Fiscal Policy: With Democrats now controlling both the executive and legislative branches of government, we expect more fiscal stimulus.

All this will support global economies and provide a positive macro backdrop for equities and other financial risk assets to continue their strong rebound.

The Market Implications

U.S. Stocks:

- Consensus estimates are for S&P 500 operating earnings-per-share growth of 38% in 2021, after a 23% drop in 2020.
- As long as bond yields remain very low and corporate earnings growth is meeting or exceeding expectations, U.S. stocks can continue to perform well.
- High absolute valuations imply subpar medium-term absolute returns in our base case, but they don't mean a U.S. bear market is imminent.
- We are currently reassessing the fundamental assumptions for U.S. stocks in our base and upside cases. We don't expect our work to result in changes to our current positioning, but it could impact our trigger for increasing U.S. stock exposure in a future selloff or decreasing exposure if valuations become more extreme.
- In a reflation scenario, we expect market leadership to pass from mega-cap tech stocks (which have benefited from low growth, low inflation, and low rates) to more value and economically sensitive stocks.

Non-U.S. Stocks:

- We believe there are better opportunities in non-U.S. stocks, especially in emerging markets, based on relative and absolute valuations.

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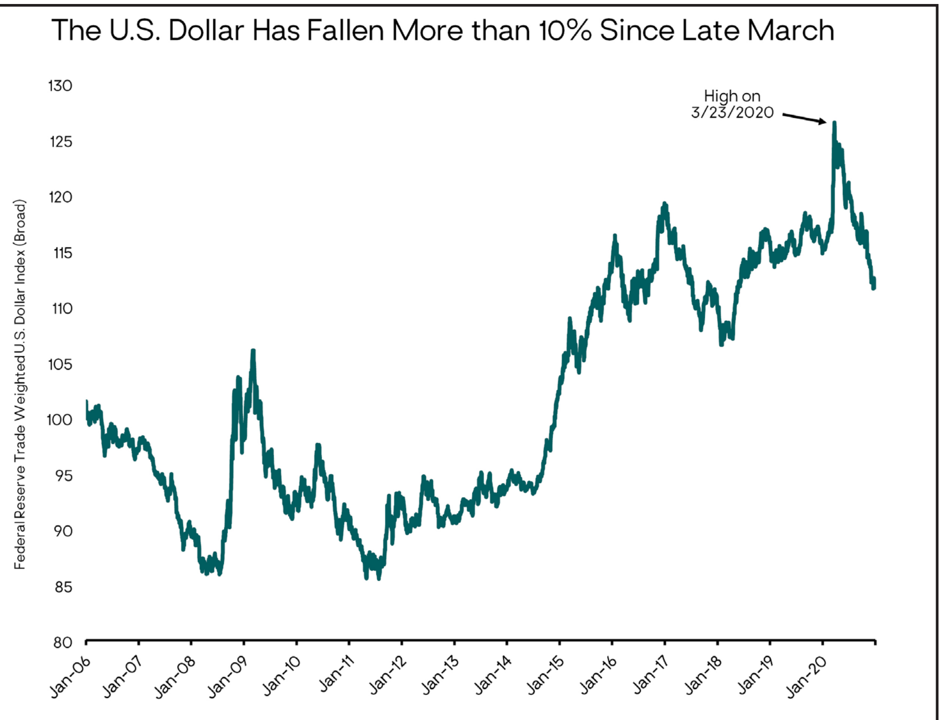
- Stocks are even more attractive versus bonds overseas where interest rates are negative in many places.

- Non-U.S. stocks should be even stronger beneficiaries of a global recovery, given their generally higher cyclical sensitivity to global growth.

- Longer term, they have significantly lower valuations than U.S. stocks implying much higher expected returns.

- And since the U.S. dollar tends to move in the opposite direction of the business cycle, higher global growth should lead to a continued decline in the dollar providing an additional currency return to U.S. investors in international assets.



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Fixed-Income:

- With the yield on U.S. core bonds not much higher than 1%, we have a high degree of confidence that their five-year return will be around that level. After 2% assumed inflation, that is a negative real return.

- Core bonds still play a vital risk management role in our balanced portfolios as a potential safe haven during a deflationary or recessionary shock.

- But we continue to believe investors need to diversify their bond allocation to include non-traditional sectors and flexible strategies, whose longer-term returns are expected to be much higher than core bonds.

Alternatives:

- The stretched valuations and very low return prospects for both U.S. stocks and core bonds emphasize the need for alternative sources of returns going forward.

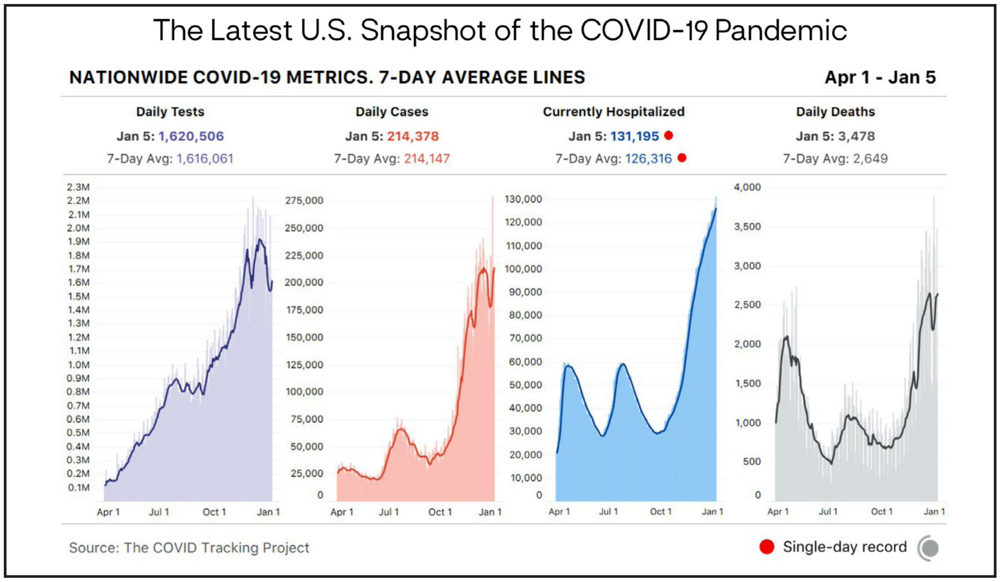
- We think select marketable alternative strategies can deliver attractive returns as well as valuable diversification benefits across a wide range of macro scenarios.

The Near-Term Risks

There are a few risks near term that could challenge the consensus expectation for a cyclical recovery.

The Pandemic: The biggest threat is COVID-19. In the next few months, there could be a sharp economic slowdown from pandemic-induced lockdowns and, potentially, inadequate supplemental fiscal relief. This is already showing up in the economic data. But once we see an end to the pandemic in 2021, we expect a release of pent-up demand and a continued economic and market bounce back.

Extreme Optimism: In contrast to the concerning public health situation, investors are extremely optimistic right now—typically a contrarian short-term indicator. This leaves the market vulnerable to disappointment. According to Ned Davis Research, when their sentiment poll has been at or falling from current extremes, stock returns have been negative or very low.



Politics: We thought we had a political resolution with the elections behind us. But the recent riotous violence at the Capitol shocked the nation. Hopefully, political turmoil does not escalate further. So far markets have taken it in stride. Still, political crisis remains an unpredictable variable in our calculus.

The Medium-Term Risks

Over our five-year tactical horizon, the most significant risks that we are monitoring are the specter of inflation and China.

Inflation: While the risk today is low, looking out over the next few years, it increases. The economic recovery could unleash spending at the same time that deglobalization constrains supply (demand starts outstripping supply). Combined with very easy money, this could eventually lead to an inflationary spiral. However, we have several asset classes and strategies in our portfolios that should do well in an inflationary environment (flexible bond strategies, floating-rate loans, alternatives, stocks). And there are others at our disposal, such as commodity futures and inflation-protected bonds (TIPS), should we feel the need for additional inflation protection.

China: China is both a big opportunity and a big risk. We could see a pullback in stocks there, especially as China reins in excesses and reduces stimulus. We also expect trade and tech conflicts with the United States to continue. But longer term, we remain bullish on China and emerging-market stocks in general. Our fundamental assumptions are quite conservative in our opinion. And we think we are in the early stages of investors adding more emerging-market exposure. The trade war and the potential reversal of globalization have only underlined the importance of global diversification for equity investors.

Prepare to Be Surprised

Financial market history teaches us: expect the unexpected; expect to be surprised. And positive surprises happen too. That's why we prepare to be surprised. Although our base case is for a cyclical recovery, our balanced portfolios are built to be resilient across a wide range of potential scenarios. We accomplish this through broad diversification, stress-tested tilts toward more attractive investments, and the right risk profile for your organization's funding needs. That said, we'd be happy to see our formerly contrarian views become the consensus in 2021 and beyond.

—Litman Gregory Investment Team (1/15/21)

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