WESTEND Advisors

Economic and Market Commentary

Q4 2020

From Rebound to Recovery

Amid global economic recovery from the COVID-19 pandemic, we see early-cycle opportunities for select U.S. sectors and overseas geographic regions in 2021.

SUMMARY

- Global economic recovery should continue in 2021, amid ongoing U.S. consumer strength and business investment as COVID-19 vaccinations help release pent-up demand in certain industries.
- We anticipate positive equity market returns this year as rising earnings expectations for cyclical stocks should offset a likely decline in valuation multiples, which is typical early in a cycle.
- Sector allocation will be increasingly important in 2021, in our view, as the recovery and expansion progress.

2020 AND Q4 REVIEW

In 2020, the COVID-19 pandemic brought an end to a decade-long U.S. expansion and bull market. The resulting recession and bear market came on with unprecedented speed, but so, too, did recovery. The global economic recovery continued in Q4, though slowed by a new surge in COVID-19 cases. By November, U.S. manufacturing output had recovered over 20% from its April low and was down less than 4% year-over-year. Unemployment remained elevated, but the economy had regained more than half the jobs lost in the downturn. With job losses concentrated among lower earners, wages and salaries had essentially rebounded to February levels and were actually up 2% year-over-year. Consumers, bolstered by stimulus, savings, and rebounding wages, pushed retail sales to a 7% gain year-over-year (ex-food service), above pre-COVID levels since 2011.

Internationally, Asian economies rebounded sharply in the back half of 2020. While Asia was the initial epicenter of the pandemic, China and other key Asian economies like South Korea and Vietnam proved relatively effective at containing the virus and were among the first to approach normal economic activity. Europe, in contrast, faced a resurgence of COVID-19 cases in Q4 and renewed lockdowns, even as longer-term economic headwinds from Brexit uncertainty and structural inefficiencies persisted.

Global stocks continued to rebound in Q4, reaching new record highs in most regions. Returns were particularly strong in November as trial results from two separate vaccine candidates were released showing roughly 95% efficacy. Markets also saw a potential reduction in political uncertainty and legislative risk as the 2020 U.S. election initially seemed likely to result in divided government (before Senate runoffs in Georgia). International stocks generally outpaced U.S. equities in U.S. dollar terms in Q4 as the exchange value of the dollar declined in the quarter. U.S. stocks were led in Q4 by early-phase, cyclical sectors such as Energy, Financials, Industrials, and Materials, as well as areas of the market that are likely to benefit from reopening, including some travel, hospitality, and traditional retail businesses. Late-phase, defensive sectors generally lagged, including Utilities, Consumer Staples, and Health Care.

Portfolio Positioning:
We continued to increase the expected economic sensitivity of portfolios in Q4 amid ongoing recovery and better-than-expected vaccine results.

Overall, the market recovery in 2020 outpaced the economic recovery. This is not surprising, as markets are anticipatory and, thus, it is common for stock prices to rise before earnings in the early stages of the economic and market cycle.

OUTLOOK

We expect global economic recovery will continue in 2021, though initially tempered by the current wave of COVID-19 infection. Some major parts of the economy, like consumer goods spending and tech investment are ahead of pre-COVID levels while others, such as restaurants and travel have significant room for upside. The apparent efficacy of vaccines and the rapid pace of approvals, with accelerating deployment, should support increasing resumption of economic activity throughout the year. Fiscal stimulus should help bolster growth until vaccination is widespread, and then provide added support for fundamental recovery. Economic recovery, in turn, should help support a rise in earnings expectations, particularly for more cyclical sectors, which we expect to be a key driver of positive equity returns in 2021, even as extended valuation multiples contract.

In the U.S. we expect above-trend economic growth in 2021, as healthy consumer spending and improved business investment extend the recovery. Growth in wages and salaries, fiscal stimulus (both unemployment relief and direct payments), and nearly $1.5

trillion in above-trend savings (~10% of annual spending) that consumers accumulated in 2020 should provide fuel for personal consumption growth. Similarly, we expect rebounds in demand and corporate profits, with near-record-low interest rates, should underpin increased business investment.

Senate runoff wins in Georgia have given Democrats a very narrow 2020 election sweep. This does not materially change our broad outlook for economic recovery or shift our views on current portfolio positioning. While single-party control typically increases legislative and regulatory risks, the narrowness of Democratic control, Biden's relatively moderate advisor picks to date, and likely prioritization of pandemic recovery suggest that extreme legislative actions are unlikely in the near-term (though additional stimulus is more likely).

For **U.S. equities,** we believe sector positioning will have increased importance in 2021, as economic recovery and expansion should particularly benefit economically cyclical, early-phase sectors. Thus, we are overweight U.S. Industrials, Financials and Energy. We are also overweight to the U.S. Consumer Discretionary sector, given ongoing consumer strength and the potential for a recovery in spending in areas that were hit hard in 2020. We expect these sectors will be earnings growth leaders in 2021 and 2022. Conversely, we are largely avoiding U.S. Utilities and Consumer Staples, which have lower economic sensitivity. We expect pandemic-driven demand for staple products will ease in 2021, presenting an unusual risk to Staples sector earnings. Separately, we are overweight to U.S. Health Care, which has relatively attractive valuations and could see Medicare expansion benefits offset increased regulatory risk. We also hold Info. Tech. and Comm. Services exposure, which should benefit from ongoing secular trends in online retail, media, and business investment.

Path to Earnings Recovery: Abundant fuel for consumer and business spending, with a release of pent-up demand as widespread vaccination is achieved, should drive a cyclical earnings rebound.

While **equity valuations** appear high on an absolute level (e.g., before adjusting for the interest rate environment), this is normal for the early stages of an economic cycle, when cyclical company earnings are typically depressed. Ultimately, the path of earnings will determine whether current valuations are justified, and we have confidence in the potential for a significant earnings rebound.

U.S. interest rates remain near historic lows, with Fed Funds at essentially zero and the 10-year Treasury yield just over 1%. This helps support equity valuations, but could also contribute to equity volatility in 2021. We anticipate Treasury yields could rise 50 basis points or more in 2021, driven by rising real yields and inflation expectations, though inflation should remain benign, given ongoing slack in the economy. In fixed-income allocations, we are overweight to corporate bonds, which have a roughly one percentage point yield spread vs. Treasury bonds. We expect spreads will persist in 2021 (or compress modestly as the recovery continues), and, along with lower durations, drive corporate bond outperformance.

Internationally, we see opportunity in **Emerging Asia**, where we established an overweight in global portfolios in Q3 of 2020. Asia's relative success in containing COVID-19 has allowed China to return to essentially pre-COVID levels of economic activity, with some measures like exports and industrial profits up more than 20% year-over-year. Meanwhile, Emerging Asia equity valuations are relatively in line with historical norms, which we view as attractive given a likely cyclical recovery in earnings. **Developed Asian markets**, like Japan, are less attractive, in our view, given their greater economic reliance on domestic demand, which is still muted.

We also view **Europe** less favorably than the U.S. or Emerging Asia, and thus maintain an underweight in global portfolios. Europe's near-term economic growth is likely to be below the U.S. due, in part, to renewed lockdowns as infections resurge. High frequency economic data shows less overall recovery than in the U.S. to date, and European earnings had a larger decline than U.S. earnings. Thus, while near-term European earnings growth may outpace the U.S., it has farther to go to justify current valuations. Further, fiscal stimulus efforts in the EU is more limited in their scale and effectiveness than in the U.S. due, in part, to the structure of the economic union. Additionally, while the U.K. and EU reached a last-minute Brexit deal that largely avoids tariffs, the process of implementation, new restrictions on travel, a more burdensome customs regime, and new regulation of cross-border finance should likely present ongoing economic headwinds for the region.

In summary, we expect continued economic improvement in 2021 globally, with likely outperformance in more cyclical areas of the markets. As always, we continue to evaluate opportunities and risks relative to our outlook and will adjust portfolios accordingly.

WestEnd Advisors Investment Team | January 7, 2021