Strong Economy, Nuanced Markets

We have a very positive economic outlook for 2021, but we believe allocation decisions are key to balancing market opportunity with nuanced risks this year.

SUMMARY

- The sharp U.S. economic recovery and expansion should continue in 2021 with vaccine-enabled reopening and consumer strength.
- We expect positive equity returns in the U.S. from strong earnings growth partially offset by contracting valuations.
- Sector allocation should be especially important in 2021 amid risks from rising interest rates and potential tax increases.
- International fundamentals are mixed, but we see opportunity in Emerging Asian markets.
- Rising interest rates are a risk to bonds, but we believe fixed income still plays a role in controlling risk for balanced strategies.

Q1 REVIEW

The post-COVID U.S. economic expansion continued in Q1 2021. Key measures of consumption and investment reached new highs in January, including retail sales and core capital goods orders. COVID-19 vaccinations accelerated, the U.S. began distributing its third fiscal stimulus package, and the Federal Reserve continued to signal highly accommodative monetary policy. There was some pull-back in economic activity mid-quarter, in part, due to a mix of winter storms and volatility in spending patterns tied to stimulus checks, but we still see underlying economic trends as strongly positive in aggregate. Real GDP, which grew at a 4.3% annualized pace in Q4, is estimated to have accelerated to 4.7% in Q1 and to reach a 7.0% pace in Q2.

Equity markets seemed to look past the softer, and likely temporary, mid-quarter data. The S&P 500 returned about 6.2% in Q1 2021, led by the Energy, Financials, and Industrials sectors. Defensive sectors, like Health Care, Consumer Staples, and Utilities lagged along with Information Technology. Small-cap stocks, which tend to be economically sensitive, also outperformed. Broad international equity markets performed in line with the U.S., with outperformance in local currencies largely offset by dollar strength.

While U.S. interest rates remain low by historical standards, intermediate and longer-term interest rates continued to rise in Q1. Higher rates reflected an increase in inflation expectations, fueled by economic recovery and record amounts of monetary and fiscal stimulus. Longer-term bond yields also reflected an uptick in real interest rates, though real rates remain negative. Corporate yield spreads were fairly stable in Q1, leading to modest corporate outperformance versus Treasury securities as bond prices fell.

OUTLOOK

U.S. Economy: A sharp economic recovery is underway in the U.S., and we believe the economic expansion will continue throughout 2021, driven by stimulus-fortified consumers, business investment, and increased economic reopening. Key parts of the U.S. economy have rebounded rapidly from their lows in the first half of 2020. Retail sales (ex-gas stations) are growing faster year-over-year than at any point in the last expansion. Business investment, as measured by non-defense capital goods orders (ex-aircraft), is up about 9% from pre-COVID levels. Even aggregate wages and salaries have recovered their pre-COVID peak, despite still-elevated unemployment.

Fuel for growth: We estimate U.S. consumers have built up extra savings equal to about 10% of GDP, which could support spending that boosts GDP growth significantly.

We see significant fuel for continued economic expansion in the U.S., driven, in part, by the consumer. The rebound in wages, combined with direct payments from the first two stimulus packages and reduced spending on services, have allowed households to accumulate roughly $1.9 trillion in above-trend savings during the pandemic through February. The new $1.9 trillion stimulus bill passed in March should further bolster savings and consumption. As we enter Q2, we estimate that consumers have built up extra savings equal to about 10% of nominal GDP. If even a fraction of that is spent in 2021, it could be a big boost to GDP growth.

Further, continued economic reopening, particularly for service and hospitality industries hard-hit by lockdowns, should help release pent-up demand. COVID-19 vaccinations have accelerated past our prior base-case assumptions. It now seems likely that the U.S. will achieve herd immunity by early summer. We expect that, overall, people's eagerness to resume travel, attend sporting and entertainment events, and dine out will outweigh lingering fears over COVID.

U.S. Equities: We anticipate positive U.S. equity returns in 2021, with strong earnings growth partly offset by P/E multiple contraction (which is normal early in an economic cycle). The sharp economic recovery is expected to drive strong earnings growth. Consensus estimates compiled by FactSet currently show S&P 500 earnings per share (EPS) growth is expected to exceed 25% in 2021 and15% in 2022. Our own analysis suggests consensus estimates may be conservative, with upside potential from accelerated reopening.

While we believe the U.S. economic and earnings picture is likely to be very positive this year, the market outlook is not uniformly so. Current equity valuations are reasonable, in our view, when adjusted for the low level of interest rates and given the current stage of the economic cycle. However, we do anticipate that interest rates will continue to rise modestly due to rising inflation expectations and real interest rates as economic growth continues. That said, a sharp sustained increase in core inflation seems unlikely, given continued slack in the economy. For example, unemployment remains elevated, particularly when accounting for workers who left the workforce during the pandemic, which should limit inflationary wage pressures. Further, rising inflation and real interest rates should be largely a reflection of stronger economic growth, which can offset their impact.

Additionally, we see risk to earnings growth from an increase in corporate taxes. However, a corporate tax hike is likely to be paired with a large infrastructure bill, which could have economic benefits that partly offset the impact of a tax increase.

We believe sector allocation is especially important in 2021. The benefits of a broad economic recovery and risks from rising interest rates and tax rates do not impact sectors equally. More economically-sensitive sectors and certain areas of the market hardest-hit by lockdowns should see greater benefit from expansion and reopening.

Positioned for expansion: Our outlook for the U.S. economic recovery to progress in 2021 warrants significant allocations to economically-sensitive sectors like Industrials, Financials, and Energy.

Accordingly, our portfolios are overweight the economically-cyclical U.S. Financials, Industrials, and Energy sectors. We are also overweight Consumer Discretionary, which is both economically sensitive and includes various industries likely to benefit from reopening. In global portfolios we have an allocation to U.S. small-cap stocks, which also tend to be economically sensitive.

We are avoiding large-cap U.S. Consumer Staples and Utilities, defensive sectors with limited potential benefit to earnings from reopening and higher sensitivity to rising interest rates. Additionally, we expect an easing of pandemic-driven demand for Staples goods.

International: We continue to see headwinds for Europe from economic and political challenges. The European economy is expected to *contract* at a 3% annualized pace in Q1, compared with anticipated 4% *growth* in U.S. , due to renewed lockdowns, a slow vaccine rollout, and political and administrative headwinds. Structural issues have limited the impact of Eurozone fiscal stimulus, and the post-Brexit trade deal leaves European Financials (one of the region's largest sectors) with debilitating uncertainty over cross-border rules.

The global mix: In global portfolios, we are overweight the U.S. and Emerging Asia, where cyclical recoveries are evident, and underweight Europe and Japan.

Emerging markets in Asia lead other regions in economic recovery and the transition to early-cycle expansion. China has proven its ability to limit economic fallout from pandemic, and its exports were trending around +20% year-over-year in December and January. Emerging Asia EPS are expected to be up 29% in 2021 compared to 2019, while EPS in Japan are projected to be down about 8%. We view Emerging Asia valuations as relatively attractive, given its cyclical recovery, secular tailwinds, and favorable sector composition–Info Tech and Consumer Discretionary make up about half of the region's equity market.

Fixed Income: Our outlook for a modest continued rise in interest rates suggests flat or slightly negative fixed income returns in 2021. In balanced portfolios, we moved to an underweight of fixed income in Q1, but we believe fixed income still plays key role in risk control. Our outlook for equities is positive, but includes significant risk of volatility. Fixed income typically has low or negative correlation to equities, and we believe the evidence indicates that relationship has not changed.

Within fixed income allocations, we are emphasizing short-duration securities to reduce interest rate risk. We are also overweight investment grade corporate securities, as credit spreads could benefit from economic growth, and corporate securities' higher yield than Treasuries helps offset give-up in yield of short-duration positioning.

WestEnd Advisors Investment Team | April 1, 2021