In 2021, we expect to see robust economic growth and consumer spending, lower volatility in the financial markets along with lower than average returns and no new Federal Reserve activity.

**2021 FORECAST**

**Economy**

In 2021, we expect robust economic growth; specifically, a 4.7% increase in real GDP, which is better than average. The average real GDP after the Great Recession, from 2009 to 2019 (a period we call the Great Moderation), is 1.8%. 2021 will be much better than that for the following reasons:

1) The economy will still be in recovery mode. As we have cited previously, history tells us it has taken two years to recover from material economic events. Following are the U.S. total GDP numbers (total economic activity, annualized):

   - Fourth quarter, 2019 $21.747 trillion
   - First quarter, 2020 $21.520 trillion
   - Second quarter 2020 $19.520 trillion
   - Third quarter 2020 $21.157 trillion
   - Fourth quarter 2020 $21.400 trillion (estimate)

   You can see that we are still in recovery mode, with total GDP lower than that seen in 2019. Given our forecast of 4.7% real GDP growth in 2021, total GDP will be $22.4 trillion at the end of the year, passing the GDP high-water mark set back in 2019. At the beginning of the crisis, historical evidence suggested it would take two years to recover, and lo and behold, it looks like it will be average, as we forecasted.

2) 2021 may go down in the history books as the year the world beat the COVID-19 virus. Even though we will enter the year with spiking cases and new restrictions on activity, vaccines are being broadly distributed. Pent-up demand along with a high
savings rate will boost consumption beginning in the second quarter of 2021.

3) Stimulus will continue to drive economic activity. It’s amazing what $5 trillion can do to an economy. The CARES act, passed in March 2020, gave the economy a $2.2 trillion crutch. The second $900 billion stimulus program (4.3% of GDP) will support consumption and economic growth in 2021. In addition, President Elect Biden supports more stimulus if required.

Due to COVID-19, vacations were canceled, we couldn’t go the to the movies – in general, discretionary spending was curbed. That resulted in an additional $1.3 trillion of savings, just waiting to support consumption in 2021.

4) Monetary policy remains accommodative. The Federal Reserve (Fed) has demonstrated that it is willing to support financial markets regardless of the disruption. The Fed has telegraphed its intentions to keep rates close to zero for as long as needed to get the economy back on track and indicated three factors that will influence its decision to change interest rates:
   a. An average inflation rate above 2% for some time.
   b. Maximum employment. An unemployment rate below the estimated natural level (NAIRU) may not be a signal of looming inflation. We think NAIRU is 4.0% so we have a long way to go.
   c. Meeting both longer-term goals mentioned and ensuring their sustainability.

Therefore, we see no change in Fed policy in 2021.

FINANCIAL MARKETS

Equities

Economic growth, stimulus and accommodative financial conditions will all be part of the formula driving corporate earnings. We expect earnings to grow 25% in 2021 and most equity markets will post positive returns. However, much of this may be already priced into the market and, as previously mentioned, due to above average returns over the last two years, we do expect 2021 returns to be modest, in the 7-10% range, below the five-year average. We expect the S&P 500 to end the year between 3,950 and 4,100.

There are many tailwinds supporting stock prices. Low interest rates and the need to optimize profits will drive merger and acquisition activity. This may keep valuations a bit frothy. Banks and credit are the lifeblood of the economy. In late 2020, the Fed allowed banks to buy back stock. This will provide more fuel for the equity fire, increasing the relative attractiveness of risk-based assets.

Of course, risks remain. The COVID-19 virus remains a risk, as perhaps we’re not able to control it as hoped. Another risk is whether the Fed changes its guidance on the balance sheet or interest rates, just like in 2013, when we saw a “Taper Tantrum” and the equity market debacle. This could happen late in 2021 or in 2022.

Fixed Income

In 2021, the Fed will control the entire yield curve, keeping short-term interest rates unchanged throughout the year and if necessary, keeping a cap on longer rates by buying longer-dated securities. This would keep the yield of the 10-year Treasury in check. Short-term rates will remain at 0.25% and the 10-year Treasury yield will move modestly higher to close the year at 1.25%.

Conclusion

Much of the economic momentum that was building in the second half of 2020 will continue into 2021. Economic growth will remain above average as we return to a state of normalcy. We expect GDP to be in the 4.4% to 4.9% range in 2021.

Risk-based assets are expected to produce positive returns, yet lower than the 5 and 10-year average. Our S&P 500 target at end the year is between 3,950 and 4,100. We do expect to see volatility in the equity markets. A new administration with a new agenda enters the White House in January, which may cause some short-term uncertainty. And given the strong performance of the market over the past nine months, a correction would be normal and healthy.

Interest rates are expected to be stable as the economy recovers. We don’t expect inflation to be a threat in 2021.

There is light at the end of the tunnel, however its a long tunnel, and currently we are still in it.

KC Mathews, CFA
Chief Investment Officer

DISCLOSURE:
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