ECONOMIC OUTLOOK

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unique investment insight

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Pinning Our Hopes On Vaccines and Stimulus

It is likely we will never forget 2020 although we may want to. The Covid-19 pandemic continues to take a toll on economies and societies around the world. After the pandemic ground the global economy to a halt and into recession in March, few would have predicted that both the global economy and equity markets would rebound strongly, even with unprecedented fiscal and monetary support. Prospects for a path out have improved with encouraging news on effective vaccines, but the outlook remains uncertain. Progress with vaccines has lifted expectations for a return to "normal" in the U.S. sometime in mid to late 2021. With the help of government and central bank support, global activity has recovered in many sectors, but remains well below the levels early in 2020. Dining out, art & entertainment, travel, and other in-person activities remain impaired by physical distancing. The collapse in employment has reversed, but 10.7 million people are still unemployed, 5 million more than in February. Finally, as we enter the new year, virus cases and deaths are surging in yet another wave, with new virus strains contributing to an increase in infections. The number of world-wide virus deaths has doubled from 1,000,000 at our last update in September to close to 2,000,000.

The key challenges for policymakers will be to stop the current outbreak, aid people who have been disrupted by the pandemic, and speed up distribution of the vaccine. National governments took bold steps to save lives and put a floor under the world economy with nearly $12 trillion in fiscal spending and about $7.5 trillion in monetary actions. In late December, Congress passed a $900 billion stimulus package. The agreement provides $600 checks for millions of adults, a revival of the Paycheck Protection Program for businesses, rental assistance, and additional funds for testing, tracing, and vaccine distribution. The additional stimulus will buttress the economy for a few months, but it is likely that more support will be needed. On the monetary side, the Federal Reserve will continue its policy of near zero percent interest rates and monthly purchases of $120 billion in Treasuries and mortgage securities. With recent reports that the economy is slowing, the Fed's accommodative policy aims to make interest rates sufficiently low to ease lending and spur economic growth to prevent unemployment from rising.

We finished the year with the disorderly transfer of power in the U.S. Fueled by social media and the President, we witnessed with horror and sadness rioters violently attack the U.S. Capitol on January 6th in an effort to stop Congress's certification of the presidential election. In the same week, Democrats won both Senate seats in the Georgia runoff and control of the Senate. At the end of the week, the payroll report showed a drop of 140,000 jobs in December, the first decline since April. In addition, the U.S. set new records for daily virus fatalities. One would believe that these events would cause the stock market to fall, but in a sign of the frothiness in valuations and unwavering government fiscal support, the market held its gains. Unbelievable!

U.S. Economy

The U.S. economy clearly weakened toward the end of 2020. The primary driver of GDP over the next few quarters is likely to be the country's physical health as the nation battles the pandemic. After a second quarter gross domestic product decline of -31.4%, growth soared 33.1% in the third quarter. Fourth quarter GDP is expected to range from 4-6%. Personal income and consumer spending both declined in November and some measures of housing activity weakened after many months of stellar performance. The weakness likely resulted from the impact of the massive surge in the virus. Meanwhile, in December, Congress finally passed a $900 billion spending package. It includes extended unemployment insurance, cash for households and businesses, and money for education and medical care. Fiscal and monetary support has proved crucial, and the benefits will continue to accrue as the savings rate remains high and household credit has improved. This provides some optimism for how economic activity will respond to a potential winter seasonal surge in new infections. Fed officials now foresee the economy contracting 2.4% this year, less than the 3.7% decline they envisioned in September, and a rebound to 4.2% growth in 2021.

Consumer and Manufacturing

Consumer spending, which led the rebound in GDP in the third quarter, slipped -0.7% in December and -0.4% in November, marking the first drops since April. Personal consumption expenditures have increased for six months in a row. Total retail sales, which include retail purchases in stores and online as well as money spent at bars and restaurants, rose 0.5% in October from the previous month, and were even up 5.7% year-over-year. Consumption appears to have since slowed, with retail sales declining December, as household incomes fell with the expiration of a weekly unemployment subsidy. Consumer confidence has improved from the April lows, but has weakened in recent months as new virus waves emerged. Auto sales have started to weaken with sales of 15.8 million units, down 8% in November year over year. This was the first turn down in six months, but still up from the low of 7.7 million units in April when auto plants were closed.

Employment

The employment environment is struggling and still far from pre-pandemic levels. Job creation came to a halt in December as restrictions brought on by surging Covid-19 cases hammered virus-sensitive industries. Weekly first-time jobless claims are stuck at a high level with last week's claims of 945,000, far worse than expected. December payrolls fell by 140,000, the first monthly drop since April. The unemployment rate was unchanged at 6.7%. Unemployment for discouraged/part-time workers is still about 12%. Since the rebound that started in May, the economy had recovered 12.3 million of the jobs lost in 2020. The largest hit has come in the hospitality industry with a plunge of nearly 500,000 positions in December. Overall, hospitality is down 3.9 million jobs since January, a 23.2% drop.

Housing

The housing market remains strong and a pillar of the economic recovery. Existing home sales, which were down 32% in May from January, have been rising consistently since spring and are close to doubling since the low in May. Building permits, which are a leading indicator for the industry, peaked in January 2020 at 1.55 million units and are now back above that level. The Commerce Department reported that new home sales, which were down 33% in April from January, have now recovered to 10-year-high levels of more than one million sales per year. Realtors expect home demand to remain strong post pandemic as potential homeowners seek outdoor space and a yard.

World Economy

Europe and U.K.

In Europe, fourth quarter GDP growth slowed considerably. The severity of the latest virus wave is leading to more restrictions and pressuring authorities to speed up vaccinations. Unfortunately, similar to the U.S., there are logistical hurdles in many countries and distribution is slower than planned. Analysts warn that the current wave of infections will take its toll on Europe's weakened economy, forcing governments to take further steps to support households and businesses until vaccines begin to slow the pandemic. Many governments in the European Union extended unemployment support well into 2021 to help avert further economic distress. After vaccinations begin this year, there is likely to be an upturn in growth. The Eurozone recorded a 45.1 PMI manufacturing reading (below 50 indicates economic contraction) in November, up from 13.6 in April, but down from October. Nations that have heavier exposure to industrial activity, such as Germany, have reported more consistent PMI readings. The European Central Bank will continue to provide support to the market for government debt, especially as long as inflation remains muted.

The year 2021 begins with Britain finally separated from the EU. The deal allows trade in goods between the U.K. and the EU to take place without tariffs or quotas. However, trade will now involve bureaucracy and border controls, adding costs and reducing speed. The U.K. reported a November manufacturing PMI reading of 47.4. Though a recovery from 8.2 in April, it's still down from 52.1 in October. The passage of a deal is a relief to many observers, but the British budget office says that in the long run, the current deal will reduce GDP by 4% versus if the U.K. had stayed in the EU.

Japan

The pandemic triggered a major recession and GDP is projected to fall by around 5% this year. The economy is gradually strengthening although growth remains sluggish due to difficulties in bringing the virus under control. As restrictions are lifted in the near term, consumption is expected to recover, supported by government subsidies and incentives. On the other hand, private investment is set to remain relatively subdued. Overall, GDP is projected to expand by 2.3% in 2021 and 1.5% in 2022, assuming further economic stimulus. Fiscal policy reacted forcefully to the shock and the government has been trying to balance the need to reduce infections while keeping businesses open. A sustainable economic expansion will need further policy support.

China

While the global economy is expected to contract 3% for 2020, China's GDP grew 2.3% in 2020. China has led the global recovery - its $14 trillion economy represents about 16% of the $86 trillion global economy. Consumer spending has been boosted by confidence that the virus is under control. In February, China's PMI reading was 40.3, but ended the year at 51.9. Fixed asset investment has been helped by substantial funding for state-owned enterprises as well as regional governments. Exports have performed well, in part owing to China's global competitiveness in areas for which demand has accelerated during the pandemic. This includes personal protective equipment (PPE) and technologies used for remote interaction. Yet the strength of China's economy has come with a cost in terms of rising debt. The government is trying to avoid the kinds of financial trouble that can emerge when credit creation is excessive including higher levels of defaults.

As a result of the rebound from the pandemic as more of the population is vaccinated, the global economy in 2021 is projected by the World Bank to rise 4.0% and grow by 3.8% in 2022.

Investment Perspective

Heading into 2021, the economy faces headwinds as the coronavirus continues to wreak havoc. Retail sales declined -1.4% in November and -0.7% in December as states reinstated measures to curb the latest virus outbreak. The labor market recovery stalled in December as employers cut 140,000 jobs and in early January there were 965,000 new unemployment claims, the highest in five months. The federal deficit topped $3.3 trillion for 2020, the largest deficit as a percentage of GDP since 1945. Although the economy has partially rebounded from its worst downturn since the Great Depression, a new wave of infections, along with possible lockdowns to contain the virus and waning stimulus relief, threaten to undermine growth through early 2021.

The markets, ever forward looking, are shrugging off the gloom and the turmoil. There are a few reasons investors remain positive: 1) The pandemic is the main cause of the global economic trouble and, with vaccinations underway and rapid progress on additional vaccines, economic growth is expected to surge later in the year. 2) The recently passed relief legislation will pump $900 billion into the economy in the next few months. Additional stimulus is now more likely as the new administration seeks to deliver more aid to families and state/local governments. 3) Interest rates remain extraordinarily low and costs for borrowing are low. 4) The saving's rate remains high. November's rate was 12.9% vs. an average of 7.5% in the prior year. This will boost spending after people feel safe to return to pre-pandemic life.

As we analyze the investment markets, we return to the concept of "fair value." As renowned investor Jeremy Grantham said recently, "The one reality that you can never change is that a higher priced asset will produce a lower return than a lower priced asset. You can't have your cake and eat it. You can enjoy it now, or you can enjoy it steadily in the future, but not both…" At 22.5 times earnings, the S&P 500 is the most expensive since 2000 and the Shiller price/earnings ratio of 33.9 is extremely high. These metrics make sense only when compared with 0% interest rates – low rates force investors to search for more risky alternatives. For investors, when markets are at high-end of the valuation range, the probability of generating longer-term returns is lower.

So where does this leave investors? Bonds, with negative real returns (after inflation), are still even more over-valued than stocks. However, shorter-term higher quality fixed income, Treasury inflation protected securities (TIPS), and cash help balance volatile equities. Gold, up 24% in 2020, has been a beneficiary of the Fed's determination to engage in unlimited quantitative easing and leave rates near 0% for the foreseeable future. In equities, we are focused on areas that continue to offer growth such as healthcare, technology, and industrials while under-weighting financials. Dividends remain an important component of total return. With the economy rebounding mid-to-late 2021, we will be on the lookout for price inflation already reflected recently with the price of wheat and soybeans at their highest level since 2014. We continue to focus on long-term growth of capital by building high-quality portfolios while preserving purchasing power. Although vaccine distribution will take time to coordinate, jabs will eventually reach sufficient arms, and along with protective measures such as masking, testing, and tracing, will help contain the surge. We also look forward to the warmth of spring! Stay positive, safe, and healthy while we remain vigilant.

December 31, 2020
DJIA: 30,606.48
S&P 500: 3,756.07

About Bounty Management
Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. Since 1971, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.

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