ECONOMIC OUTLOOK

bounty management

unique investment insight

Bounty Management Corporation
The Rice Building
10 High Street, 5th Floor
Boston, Massachusetts 02110
t 617.357.8285 *f* 617.451.9064

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Global Outlook Improves With Divergent Recoveries

The anniversary of the first wave of Covid-19 in the U.S. marks a year of unbelievable suffering. A year ago, the pandemic initially led to a collapse in the economy and world trade as in-person activities came to a halt. Today, economic forecasts remain uncertain with new virus mutations that are more contagious as well as the resulting human strain of over three million deaths, severe illness, and elevated unemployment world-wide. Recoveries are diverging across countries, communities, and industries, reflecting pandemic disruptions, vaccine rollouts, and levels of government support. Prospects for recovery are high in the U.S. and U.K. where a growing percentage of the population is vaccinated. Economic losses have been particularly large for countries that rely on tourism and commodity exports. Industries such as travel, arts and entertainment, sports, and hospitality have operated at a fraction of their capacity. Many parts of the world including India, South America, Japan, and parts of Europe, are seeing a surge of new cases and slow vaccine roll outs with limited supply. For all of 2020, global GDP fell by 3.3%, the worst annual decline in more than 60 years.

On the positive side, the U.S. is set to become the main engine of world growth fueled by an accelerated vaccine program, ultra-low interest rates, and consumer/government spending. Daily vaccinations averaged about 350,000 does at the start of January and are now over 3 million shots per day. According to the CDC, over 80% of the U.S. population over 65 has received at least one dose or is fully vaccinated. Since the start of the pandemic last spring, Washington has pledged to spend about $5 trillion to reduce the economic impact of the pandemic. Spending includes the $2.2 trillion CARES Act (March 2020) and the $1.9 trillion American Rescue Plan Act (March 2021). These programs include direct checks, unemployment payments, forgivable loans for business, and forbearance on mortgage/student loans and evictions. Pent up demand in the U.S. for in-person activities such as travel and arts & entertainment will likely add 3-4% in growth over the next couple of years. Retail sales jumped 9.8% in March. U.S. spending in turn will lift demand and growth in other countries. New forecasts from the International Monetary Fund show global growth for 2021 in the +6.0% range with the U.S. at 6.4%, followed by sustained higher growth rates in 2022 and 2023.

Of course, the global outlook is not worry free. The pandemic continues to wreak havoc and is not under control in most of the world. With massive government spending, there is concern for the level of debt around the globe. The worry is that the additional fiscal and monetary support, spending, and tax cuts may lead to untenable debt and inflation. The latest debt wave is the most broad based in the past 50 years with debt/GDP at 120% in the U.S, the highest since World War II. The Fed believes that any inflation from growth will be fleeting since a full recovery is distant and jobs are still about 8 million below pre-pandemic levels. While the economy rebounds, we will keep a close watch on inflation, debt, and the Fed's ability to support the economy.

U.S. Economy

Following the 2.3% decline in GDP in 2020, analysts forecast GDP growth of over 6% for 2021 with the first quarter estimate at +5.2%. These rates of growth are considerably higher than the 2.3% rate the country averaged during the recovery from the financial crisis between 2010 and 2019. The forecast expects GDP to surpass its 2019 peak by the end of the third quarter of 2021. Recent data points to improving economic conditions. Rising consumer confidence is leading to growth in consumer spending. Auto sales have recovered, the housing market remains strong, and businesses are again expanding. In addition, the employment environment is in better shape than it was nine months ago, though not back to pre-pandemic levels. Although economic conditions are improving, the U.S. is still below the $21.7 trillion in GDP at the end of 2019. Technically, the U.S. is still in recession according to the National Bureau of Economic Research. Fed officials now forecast the economy growing 6.5% in 2021, and 3.3% in 2022, before returning to the pre-pandemic trend of about 2%.

Consumer and Manufacturing

Consumer spending and confidence has improved in the past few months. Personal consumption expenditures, the main driver of total GDP, increased for six months in a row in 2020 and rebounded sharply in the first quarter of this year. Retail sales, including purchases in stores and online, were up 6.3% in February Y/Y. Auto sales have recovered from pandemic lows with sales in the U.S. at 16.6 million units in January, about the level in 2019, and a large rebound from the 8.7 million units in April 2020. The Conference Board's Consumer Confidence index for March rose above expectations to 109.7 from 90.4 in February. Businesses are expanding again with the Institute of Supply Management's manufacturing index at 64.7 (readings above 50 indicate expansion), the highest level since 1983.

Employment

The U.S. economy added 916,000 jobs in March, above expectations, and the unemployment rate dropped to 6.0%. The industry with the strongest employment growth was leisure/hospitality while sectors such as education, construction, and professional services also added jobs. The labor market continues to feel the impact of the pandemic as the current number of jobs is down 8.4 million from February 2020. The labor force participation rate remains low at 61.5%, below the historical average of 65%. The Labor Department recently reported total continuing unemployment claims of 4.0 million, down from 4.4 million a month earlier. Though trending in the right direction, unemployment will take some time to come down as many people who left the labor force re-enter and search for work

Housing

In a sign of the hot real estate market, there are currently more real estate agents than homes for sale in the U.S. This phenomenon reflects both tight supply and surging prices. In March, there were 20% fewer homes for sale than last March and the lowest inventory on record going back to 1982. The Commerce Department reported that new home sales rose last August to a 10 year high and remain elevated. Building permits were up 70% in January compared to last April, according to the Census Bureau. Prices remained strong with bidding wars common as the Case-Shiller Home Price Index gaining 11.2% Y/Y in January, the highest recorded since February 2006. Covid has encouraged buyers to move to the suburbs although some purchases may represent accelerated purchases that would have happened anyway over the next several years.

World Economy

Europe and U.K.

The pandemic in Europe is worsening despite a significant increase in the number of people being vaccinated. Among major eurozone economies, France now has the highest number of daily cases. Lately there have also been sizable increases in the number of daily infections in Italy, Sweden, and the Netherlands. At the same time, the death rate in the eurozone has declined and the number of vaccinations each day has risen sharply. Following the strong rebound in growth in the third quarter of 2020, eurozone GDP declined by 0.7% in the fourth quarter. To support the recovery, the European Central Bank (ECB) remains very accommodative with low interest rates and purchases of government debt. Euro area annual inflation increased sharply to 0.9% in January and February 2021, up from -0.3% in December 2020. Despite the rising cases, the latest PMIs suggest that manufacturing activity in the eurozone is growing at a record pace. Looking at the full year, GDP is estimated to have contracted by 6.6% in 2020, with the level of economic activity for the fourth quarter of the year 4.9% below its pre-pandemic level. Incoming economic data points to continued economic weakness in the first quarter of 2021, but the IMF forecasts a rebound in 2021 growth of 4.5%.

The United Kingdom economy suffered its biggest slump in more than three centuries last year as GDP fell 9.9% in 2020. The pandemic has effectively wiped out all growth in the U.K. over the last 7 years. The slump in GDP was less severe than expected, but still surpassed the 9.7% collapse experienced during the Great Depression in 1921. There were some signs of improvement in the final months of 2020, with GDP estimated to have increased by 1% in the fourth quarter, following record growth in the third. The U.K. is currently vaccinating at twice the rate of the eurozone and has administered vaccines to 62% of the country's adults.

Japan

With the Summer Olympics only a few months away, Japan is attempting to win the trust of participating nations by putting together an effective Covid testing and vaccination program. Japan's economic recovery in 2020 was relatively strong. By the fourth quarter, GDP was down only 1.3% from a year earlier due to a rebound in consumer spending and foreign demand. However, the strong start to the recovery was upended this year as the pandemic worsened. As a result, economic activity in Q1 likely contracted. As Japan waits for more vaccines to be distributed, domestic demand will likely remain sluggish into the summer, though accelerating growth in the rest of the world will provide support for Japanese exporters. In the second half of the year, growth will likely accelerate with ample monetary and fiscal stimulus.

China

China's economy surged over 18% in the first quarter reflecting both a recovery from the -6.8% contraction in the 1Q 2020 and the continued strength of the world's second largest economy. However, when compared with the final three months of 2020, growth decelerated to 0.6% in the first quarter from 2.6% quarter over quarter rate. The Chinese recovery faces many challenges including inflation, corporate debt defaults, and rising geopolitical tensions that could affect trade. Inflation has been surging with rising prices for many commodities including oil, copper, and steel. The government reported that March producer prices were up 4.4% from a year earlier, the fastest in two years. After a long hiatus due to the pandemic, consumers have started to spend on travel and dining and consumer sentiment returned to pre-pandemic levels for the first time in March. As more of the population is vaccinated, the IMF projects 2021 global GDP growth of 6.0% and 4.4% in 2022.

Investment Perspective

With the effective end of the pandemic in sight, at least in the U.S., the economy is likely to post its strongest growth in decades. The growth numbers will seem particularly high since the economy was depressed in 2020. Investors are struggling with how much optimism is already priced into the current market. For now, the narrative is around an economic and earnings rebound, based on vaccinations, continued monetary support from global central banks, government support, and low interest rates. Recently there has been a surge in consumer spending, retail sales, housing, and manufacturing. However, there will be bumps on the road to recovery. The U.S. still has over 8 million more unemployed than before the pandemic. The pandemic will take more time to suppress outside the U.S. as vaccines are not as widely available, or available at all, in the rest of the world. All this growth may lead to inflation, at least in the short term. Inflation and growth usually lead to higher interest rates which in turn make equities less attractive.

The investment markets are also showing several signs of froth or even bubbles in some assets. As stocks and real estate became more expensive over the past year, some investors have reached for even riskier non-traditional assets including digital media, cryptocurrencies, collectibles like trading cards, and even sneakers. A digital artwork by the artist known as Beeple (Mike Winkelmann) sold at Christie's for $69 million after bids started at just $100. A Tom Brady rookie card sold for $2.25 million - one of 100 of its kind - in April topping the $1.3 million record for another of his cards in March. Sneaker reselling has exploded with a famous pair of Nike Dunks selling for a record $33,400. For now, the bubble behavior in these non-traditional assets do not appear to pose a risk to the broader financial system and while the euphoria may last a while, history shows these manias usual end with a crash.

Where should investors look to invest? Fixed income, particularly longer-term bonds, remain overvalued. With interest rates at historically low levels in the U.S., and negative in Europe and Japan, any increase in rates leads to losses and raises the cost of funding for corporations and governments. For now, we prefer shorter-term, higher quality fixed income. Despite concerns on the economy, volatility, stretched valuations, and the possibility of higher inflation, equities are still preferred over bonds at least until the Fed changes direction. We look for equities in attractive markets, companies with sales and earnings growth, strong management, and financial discipline, that are a reasonable value. We favor industrials, healthcare, energy, and communication services. Real assets and commodity type investments, such as companies related to agriculture or raw materials, are also attractive. Precious metals have a place in portfolios as governments around the world print enormous amounts of money. Our focus remains preservation of purchasing power. For years, the Federal Reserve and global central banks have had the monetary spigot turned all the way up with quantitative easing and low interest rates. With the pandemic, fiscal policy has added to the flood of money as governments decided any amount of spending is allowed because interest rates are low. The economic rebounds in countries around the world are diverging based on the path of the virus, government support, and vaccination rates. We look forward to the time that markets are priced based on economic expansion and not inexpensive financing from the Federal Reserve. As always, we remain vigilant.

March 31, 2021
DJIA: 32,981.55
S&P 500: 3,972.89

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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