Financial Markets Perspective

January 2021

A Look Back and A Look Ahead

Two years ago, we forecast that only an unexpected event of substantial magnitude could interrupt the long-term secular bull market in stocks. The COVID-19 virus was that event -- as was the government's response by forcing a lockdown to stop the spread of the disease that resulted in a mini-recession and a momentary collapse in the stock market and segments of the bond market. By year end, the economy was recovering, government reversals of lockdowns fostered a resumption in economic growth and the stock market rally was bifurcated between virus winners and losers. With all this turmoil, we can look back and see if any of our forecasts a year ago came near the actual results.

One Year Later:

One year ago, we made the following forecasts about the global economy and financial markets. Here is what we expected (with follow-up commentary):

"Domestic economic growth in a range of 2-3%"

Current forecasts for economic growth in 2020 are running around -3.9%, a seemingly modest difference from our forecast given the record 31% decline in the second quarter and the record 34% rebound in the third quarter. These historic swings in economic activity demonstrated the disturbing impact of the coronavirus on economic growth.

"Oil prices in a range between $55-65 per barrel"

The virus also had a crushing effect on oil prices driving the price per barrel to a -$37 on April 20th during the lockdown. In other words, owners of oil had to pay someone to take that oil off their hands. By year end, the price rallied into the high $40s, well below our forecast and is trading above $50 at this writing.

"Domestic inflation in a range between 1.75-2.25%."

The brief economic downturn and fall in oil prices kept inflation low for all of 2020. For most of the year, the inflation rate was in the 1% range.

"10-year Treasury bond likely to remain below 2%."

Although the yield on the 10-year Treasury bond started out the year around 2%, the Fed's low interest rate policy pushed the yield to below 1% for most of the year.

"Accelerating growth in foreign economies."

The global spread of the coronavirus sent virtually all economies into a tailspin. Developed country governments followed the monetary and fiscal policies of the U.S. and most of those industrial economies began to recover. Towards the end of the year there were additional lockdowns due to the discovery of new virus strains that challenged vaccine development globally.

"Improving corporate earnings and revenue growth domestically and abroad."

The coronavirus introduced a new distinction when identifying the impact on corporate profits. The lockdown was especially destructive to companies that benefit from group encounters such as restaurants, arenas, theatres, cruise ships, and airline travel. Companies that implemented a "survival of the fittest" policy were able to shift business models to meet consumer needs. These companies' earnings grew as did their stock prices. By year end there were still clear winners and losers, but the gap was narrowing as more businesses adapted to forced closures.

"A continued rally in global equity markets."

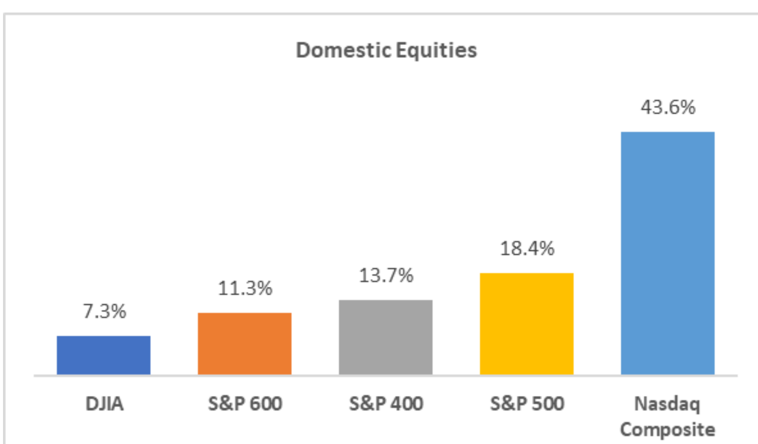
Equity markets anticipated a global recovery from the virus. Most stock markets turned in better than average performance, but some markets such as the NASDAQ 100 did especially well.

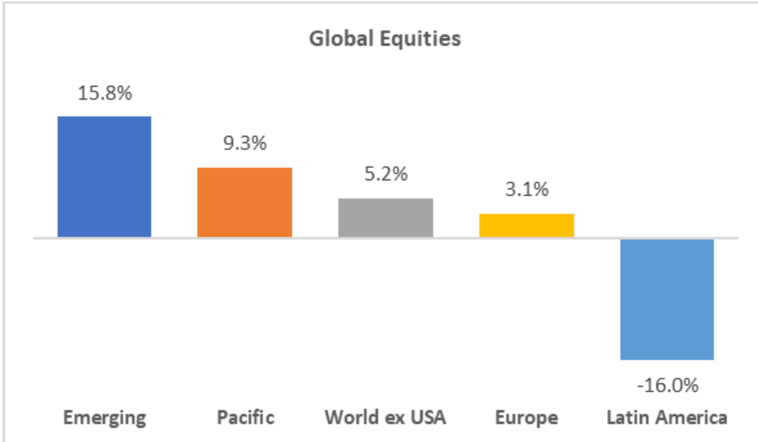
"Continued volatility until global uncertainties unwind (Brexit, Trump, etc.)."

The tariff war, Trump tweets, Brexit drama and the U.S. election resulted in financial market volatility last year. Social and political unrest around the globe was another theme as were the proliferation of natural disasters. Fortunately, both global bond and stock markets shrugged off the bad news and experienced healthy gains except for Latin America.

U.S. and Foreign Financial Markets

The Coronavirus triggered a bifurcation among U.S. equities last year. Once the fears of a financial meltdown dissipated, investors were drawn to growth stocks, especially technology and healthcare as the prospects for these sectors improved while value stocks suffered due to fears about the financial health of many companies in this sector. The "Survival of the Fittest" theme benefited many large companies that shifted business models or garnered the business of smaller companies that were forced out of business. Amazon was one of several larger companies that moved quickly to increase its market share by adapting to the economic conditions related to the virus. Not until the announcement of a viable vaccination did the equity market rally broaden out with a record surge of small capitalization stocks in the fourth quarter.





Looking at global regions, Emerging Markets was the best performer for the year. The recovery in emerging markets equities that began in late March picked up steam in the fourth quarter thanks to COVID-19 vaccine breakthroughs and the U.S. election outcome. The largest contribution to returns came from South Korea and Taiwan that were up 42% and 37%, respectively.

Stock markets in the Asia Pacific region also enjoyed healthy gains last year primarily on the back of China that rose more than 27% as measured by the MSCI China index. Japan had a gain of a little over 12%. Conversely, Hong Kong equities underperformed relative to their Asian counterparts due to ongoing government protests and only returned a little over 2% last year.

European equities posted low single-digit returns due to double-digit losses in Greece, Hungary, Poland, and Russia. European winners were from the northern region with Denmark posted gains of more than 42% and both the Netherlands and Sweden returning more than 22%. Stresses from Brexit weighed on stocks in the United Kingdom that lost more than 13%.

Our neighbors in Latin America suffered double-digit losses as the region was the worst-hit by the coronavirus. Latin America was already the world's slowest growing region before the pandemic due to its own making: central banks in developed economies continue to pump huge volumes of stimulus into financial markets and China's speedy recovery is boosting commodity prices. The region is home to just over 8% of the world's population but has suffered more than a quarter of all coronavirus deaths, despite lockdowns in Peru and Argentina which crippled their economies. As a result, equity markets across the board fell.

The Federal Reserve and Interest Rates:

One of the reasons for an abrupt turnaround in financial markets in the face of a national shutdown and a surging coronavirus was the Federal Reserve that created a monetary safety net under the economy by lowering short-term interest rates to zero and by buying trillions of dollars of government and corporate securities to provide the liquidity needed to avoid a financial meltdown. The Fed has committed to maintain these low interest rates if necessary, until the impact of the virus has dissipated by targeting inflation and allowing for an overshoot of its 2% target before moving to raise interest rates.

The Return of the Entrepreneur

The coronavirus crisis has for the most part been a BIG negative, but there is a slight positive to mention: there has been a surge in people starting their own business demonstrating that Americans are resilient and have adapted to the new environment. Guidant Financial reports from their survey that more people than ever are choosing to pursue small business because of frustration with the way things are and a desire for a better life. There was a 27% increase in the share of small business owners who were motivated to start their own business by their dissatisfaction with corporate America. Last year, readiness to be their own boss was the most common reason entrepreneurs said they started their own business, followed by a desire to follow their passion. With only 18% of small business owners interested in selling their business to employees (compared to a quarter who would rather give their business to a family member), small business owners today are not waiting for an opportunity – they are creating an opportunity for themselves and those they love.

So where do we go from here?

As we peer into our realistic crystal ball, we see the following for the global economy and financial markets in 2021:

- Domestic economic growth in a range of 3–4%
- Domestic inflation in a range of 2–3%
- 10-year Treasury bond yield in a range of 1–3%
- Accelerating growth in foreign economies
- Oil prices in a range between $50–65 per barrel
- Improving corporate earnings and revenue growth domestically and abroad
- Continuing fiscal stimulus until the virus is minimized
- A broad rally in domestic equities
- A rally in foreign and emerging market equities
- Lower political uncertainty under the new Administration

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