



POSITIONING FOR 2021



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2021 ECONOMIC OUTLOOK

Expectations for the Economy: A Return to Normalcy

- ▶ What happened in 2020 was unprecedented due to the COVID-19 pandemic and shutdowns of businesses.
- ▶ 2021 could see a return to normalcy later in the year as vaccines become widespread.
- ▶ Economic forecasts are being revised up due to passage of the \$900 billion relief package.

Recent Political Developments

- ▶ After the November elections the most likely outcome appeared to be political gridlock.
- ▶ However, Democrats are now in control of both houses after winning two Senate seats in Georgia, but the margins in both houses are very thin.
- ▶ Republicans are also more divided following the assault on Congress.
- ▶ These developments raise the possibility of more of Biden's economic agenda being enacted.

Priorities of the Biden Administration

- ▶ Biden's top priority is to obtain further COVID relief. He favors upping transfer payments to eligible recipients up to \$2,000 and providing support to state and local governments.
- ▶ He also favors an infrastructure bill that can marshal bipartisan support.
- ▶ He is likely to encounter greater resistance to his green energy initiative that could cost \$1.6 trillion over the coming decade.
- ▶ It is unclear whether he will press for quick passage of tax hikes for corporations and wealthy individuals.
- ▶ The bottom line is the federal budget deficit will be substantial in FY 2021, but not as large as last year's record.

Biden's Regulatory Agenda

- ▶ Biden is also committed to reverse much of the deregulation that occurred in the Trump era.
- ▶ Areas that are likely to be most impacted include:
 - Energy. Biden favors incentives to supplant use of fossil fuels with alternative sources of energy.
 - Pharmaceuticals. Biden is also seeking to lower drug prices by subsidizing Medicare.
 - Big Tech. There has been bipartisan support to seek greater regulation of leading tech companies, and recent developments have caused social media companies to step up control of content.

Conclusion: The priorities of the Biden administration are the polar opposite of the Trump administration. We expect a partial rollback of what occurred in the Trump era, but not a complete reversal.

ECONOMIC EXPECTATIONS DRIVE FISCAL & MONETARY POLICY

Fiscal Policy

- ▶ Economic activity moderated throughout the fourth quarter of 2020 as a resurgence in the corona virus interrupted activity in the most exposed areas of the economy. Employment in sectors directly impacted by COVID-19 declined, and this resulted in downside risks to overall growth. At that point, there was also doubt that Congress would be able to agree on additional assistance packages.
- ▶ In sharp contrast to the short-term risks, the long-term outlook for the economy was bolstered by the beginning of vaccinations around the country, putting the end of the pandemic in sight. This comforted markets, but the economy was still facing difficult prospects.
- ▶ The \$900 Billion package passed in late December impacted the economic outlook substantially in that it is designed to sustain economic activity through the winter virus surge. Reinstatement of jobless benefits and stimulus checks will put money directly in the pocket of those who need it.
- ▶ Previous bills had helped maintain consumer incomes/spending through the summer months, and the goal with the most recent package is to bridge the gap for consumers until vaccines are widely distributed.
- ▶ Results of Georgia runoff elections, giving Democrats control of the Senate, represented a game-changer in terms of future fiscal stimulus.
- ▶ Expectations are for an additional package of \$1 Trillion or more to be passed in early 2021, with the potential for substantial infrastructure spending later in the year.
- ▶ Consensus expectations for 2021 GDP growth are 4-5%. More optimistic expectations, taking into account the full impact of fiscal spending, have moved above 6%. This is substantially above trend-growth and would return the U.S. back to previous levels of economic activity around mid-year.

Monetary Policy

- ▶ In March 2020, the Fed responded to the pandemic with unprecedented speed and magnitude of policy accommodation. Low interest rates and healthy financial markets have significantly eased financial conditions, encouraging consumers and businesses to spend and invest.
- ▶ The Fed made a key change to their framework in late 2020 that will have significant impacts to their policy. The first change was to their inflation target. The Fed now targets an average level of 2% inflation, meaning that they will tolerate an overshoot of 2% following a period of undershooting. Also, the goal of “full employment” was revised to incorporate other factors beyond traditional measures of unemployment. Essentially, the Fed will aim to maximize the number of people employed as long as inflation remains in check.
- ▶ These changes are important as we consider the economy and markets in 2021 and beyond.
- ▶ In previous cycles, the Fed would pre-emptively tighten policy to ward off future inflation. With the framework change, they will be more willing to let the economy “run hot” until the goals are in sight.
- ▶ Right now, those goals are far from being achieved. Inflation has remained persistently below 2% for years and employment is substantially below prior levels (10mm less people employed today than pre-pandemic). As the economy rebounds over the next few years, the Fed will maintain accommodative policy until these goals are met. Even with a relatively positive outlook, market expectations are for the Fed to maintain purchasing assets at the current pace through 2021 and keep interest rates near zero until at least 2023. For markets, the prospect of accommodative and stable Fed policy combined with above-trend growth is a tailwind for risk assets.

Interest Rates

- ▶ Interest rates have increased slightly since late-2020, but still remain historically very low.
- ▶ The near-term outlook for interest rates is a combination of opposing forces:
 - The Fed’s continued asset purchases and expectation of keeping short-term interest rates extremely low for an extended period will exert downward pressure on both short- and long-term Treasury yields.

- The economic recovery, bolstered by fiscal spending and effective vaccine distribution, is likely to be quite strong and accelerate throughout 2021. This above-trend growth will put upward pressure on interest rates as confidence in the expansion grows.
- ▶ Our expectation over the near term is that rates may increase somewhat, but remain relatively close to current levels. In our opinion, a more substantial rise in interest rates is more likely in the second half of 2021. As the economy recovers and markets expect upward pressure on inflation, combined with the expectation that the Fed will reduce or end asset purchases, long-term interest rates are at risk to rise above current ranges.

WHAT DOES THE ECONOMIC OUTLOOK MEAN FOR INVESTORS?

Valuations

- ▶ Valuations in securities markets generally reflect our positive economic outlook.
 - Within fixed income, credit spreads have retraced almost all of the spread widening induced by the global pandemic, and are back to levels last seen pre-crisis.
 - Broadly speaking, valuations in fixed income are near their tightest quartile – meaning, compared to history, they have only been tighter, or more expensive, 25% of the time. This should limit the upside for credit markets this year. We view the downside as being contained as well, however, supported by the improving economic backdrop and reduction in defaults.
 - Interest rates, both nominal and real, are near their all-time lows. While this is good for growth and risk assets, it doesn't bode well for future fixed income returns. Although it's tough to predict the level of interest rates in the near term, we believe rates will move modestly higher over the course of the year.
 - Within equities, we view valuations as fair. We prefer to take a relative view to equity valuations, and when compared to the risk free rate, or U.S. Treasuries, they are trading at median levels compared to history. Even though equities suffered negative earnings growth in 2020 of about -17%, markets viewed that as transitory and looked through to the rapid growth that is expected in 2021. As a result, equity markets will likely still move higher this year in our view, but returns won't match what we have experienced in the past two years. The consensus target return for the S&P 500 in 2021 is only 6% (range of 1% to 17%), compared to 18% in 2020 and 31% in 2019.
- ▶ In summary, we feel valuations are fairly priced and already reflect much of the broad economic recovery we're anticipating in 2021.

Portfolio Implications

- ▶ Based on our positive economic outlook, supportive financial conditions, and fair to slightly expensive valuations, we are targeting 50% of the risk budget within our portfolios. This means we are using about half of the allowable risk tolerance in each portfolio. We are positioning portfolios for solid economic growth in 2021 and a return to normalcy by the second half of the year.
- ▶ Our view is that equities are fairly valued and likely to move higher in 2021, and with fixed income markets fully valued as yields are at all-time lows, we prefer an overweight to equities compared to fixed income. We believe future returns across most asset classes will be lower than what we've experienced over the past few years, with equities outperforming bonds.
- ▶ Within our equity portfolios, we are maintaining a balanced approach but favor more economically sensitive, cyclical sectors that are trading at what we feel are fairly attractive levels. These include more value oriented sectors such as financials, industrials, and consumer discretionary, as well as small and mid-cap stocks. In 2020, growth stocks returned 39% compared to only 3% for value, resulting in record outperformance of 36% for the year. We believe the composition of equity market performance in 2021 will look much differently than 2020.
- ▶ Within our Fixed Income portfolios, we have maintained a meaningful overweight to risk since March of last year. Going forward, we are inclined to moderately reduce risks as we see valuations as fully reflecting the positive economic outlook, but we still favor credit over Treasuries.

Strategies Positioned for 2021

- ▶ Based on record low yields investors are faced with today, we're having more conversations with clients about higher income oriented strategies that might perform well given the current economic backdrop.
 - Within equities, Fort Washington has both value and income oriented strategies that we believe are well positioned to benefit should an economic rebound in 2021 come to fruition. In fact, we feel they will provide a higher stream of income compared to most fixed income markets. It's important to note, however, the key to income investing within equities is to not reach for yield in the highest yielding stocks. Instead, investors should be focused on high quality companies that can grow their dividends over time while remaining diversified to avoid unintended exposures.
 - Within fixed income, we favor multi-sector, active strategies that have become more prevalent as investors seek alternatives to traditional core fixed income strategies. These strategies allow for a much more active approach to investing, with the potential to generate higher returns from both security selection and asset allocation.

Value vs Growth in 2021

- ▶ One of the biggest trends in the U.S. stock market during 2020 was the dominance of growth stocks versus value. It was a record year where growth returned 39% compared to only 3% for value.
 - There were a few reasons for this outperformance, but the biggest driver was the shift to digital as a result of the COVID-19 pandemic. This boosted earnings for growth-oriented tech companies relative to their more cyclically sensitive value counterparts that saw their earnings drop as the economy plunged into a recession.
- ▶ As we look forward to 2021, there is reason to believe value could stage a comeback.
 - Value tends to perform well in economic recoveries due to their economically sensitive earnings and cheaper valuations. Our base case is for strong economic growth this year as we return to normalcy, bolstered by the prospects of additional fiscal stimulus. This could be a valuable tailwind for value.
 - Conversely, we see Growth as facing several headwinds over the coming years, largely due to the change in the political landscape, focused on increased regulation and higher taxes.
- ▶ These considerations make it reasonable to believe that value could indeed return to favor in 2021. We would recommend investors maintain a balanced approach to equity investing in 2021, but favor a resurgence in value-oriented stocks.

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