OVERVIEW

It's Easier to See the Other Side of a Valley Than a Mountain

ECONOMIC DASHBOARD

- POSITIVE
- NEUTRAL
- NEGATIVE

PUBLIC HEALTH

Mass vaccination may end the large-scale threat from Covid-19 by the third quarter of this year.

ECONOMIC GROWTH

Rapidly improving public health and substantial fiscal stimulus will boost 2021 growth to 6%.

JOBS

Strong economic growth will bring strong job growth and reduce unemployment to 5% by year end.

INFLATION

Prices are likely to rise throughout 2021 before settling back to near the Fed's 2% average target.

THE DOLLAR

2020's slow erosion in the dollar's value will likely continue in 2021.

INTEREST RATES

The Fed will keep the policy rate at near zero throughout 2021, but economic growth and short-term inflation will raise longer-term interest rates.

OIL

Global economic growth will raise demand and push crude prices higher subject to increased Saudi and U.S. shale oil production.

Last year was a classic reminder that the economy and the capital markets can and frequently do go in different directions. The economy shrank 3.5% in 2020, but U.S. stocks returned more than 20% and bonds returned 7.5%, as measured by the Russell 3000 index of U.S. stocks and the Bloomberg Barclays US Aggregate Bond index, respectively. Six months ago, we explained the divergence by pointing out that capital markets are not driven by near-term conditions but by longer-term perspectives.

Keeping the proper perspective is especially important today as the economy continues to recover from the impact of the Covid-19 pandemic and a return to normal appears near. What the new normal will be remains to be seen, but we expect it will be free of the restraints on social gatherings and travel that have depressed jobs and the economy. A sense of optimistic relief appears to be widespread—which has led to expectations of robust economic growth and strong revenue and earnings acceleration. These expectation spurred a broad increase in stock prices along with some inflation worries and higher interest rates. But as we detail below, we foresee nothing like runaway inflation.

Why We're Optimistic About This Year

Two factors support our hopeful expectations. The first is the rapid progress being made to suppress the pandemic here and abroad. Multiple vaccines have proven highly effective at eliminating serious illness due to the coronavirus and appear to be effective at suppressing virus transmission by the vaccinated. The United States may achieve herd immunity by the third quarter, much sooner than expected at the start of the year.

The second factor is the $1.9 trillion American Rescue Plan, passed into law in March, which will provide up to $1,400 per person in stimulus payments for Americans making less than $75,000 per year in AGI or married couples making less than $150,000 (and partial payments for those making more, up to certain income limits). On top of the more than $1 trillion of savings Americans

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stockpiled last year, these stimulus checks are likely to stoke a substantial acceleration in consumer spending, including a rebound in expenditures on services—the hardest-hit industries in the pandemic.

Not surprisingly, recent market performance has reflected these economic expectations. Stock prices have moved higher, albeit not uniformly: Tech stocks, which drove the market in 2020, are relatively out of favor, at least for the time being (the Nasdaq tech-heavy index was in correction territory in early March). But importantly, market gains have not been concentrated in a small number of growth stocks (see John Traynor's feature article), as they were recently. Rather, they've been shared by a broad range of equities, including small-cap and value (bargain-priced) stocks that were laggards throughout most or all of 2020.

Is Growth a Double-Edged Sword?

Growth expectations have not been without concerns, and the dominant one is that demand will be so strong that prices will rise sharply and the resultant pick-up in inflation will cause bond prices to fall and interest rates to rise. The bond market has already anticipated this, with 10-year Treasury yields rising from 0.91% at year-end 2020 to above 1.50% at mid-March—though the most-recent inflation readings remain well below 2.0%.

So, where are we headed?

Barring the emergence of a vaccine-resistant coronavirus variant, we believe that the U.S. economy is in for rapidly accelerating growth in 2021. Real U.S. economic output is likely to grow by 6% in 2021 and exceed its pre-pandemic peak level by nearly $700 billion by year-end 2021. This growth will replace many of the jobs still missing from the Covid-19 recession—which number in the many millions. But it is likely to raise the inflation rate as demand outstrips supply in the near term.

A Golden Age Ahead? Time Will Tell

The challenge for investors is to look beyond the near term, just as it was last year—even if it is easier to see the other side of a valley than a mountain. Two key questions pose themselves: What will happen to growth following the 2021 surge? And will the higher inflation we expect to accompany the growth surge persist?

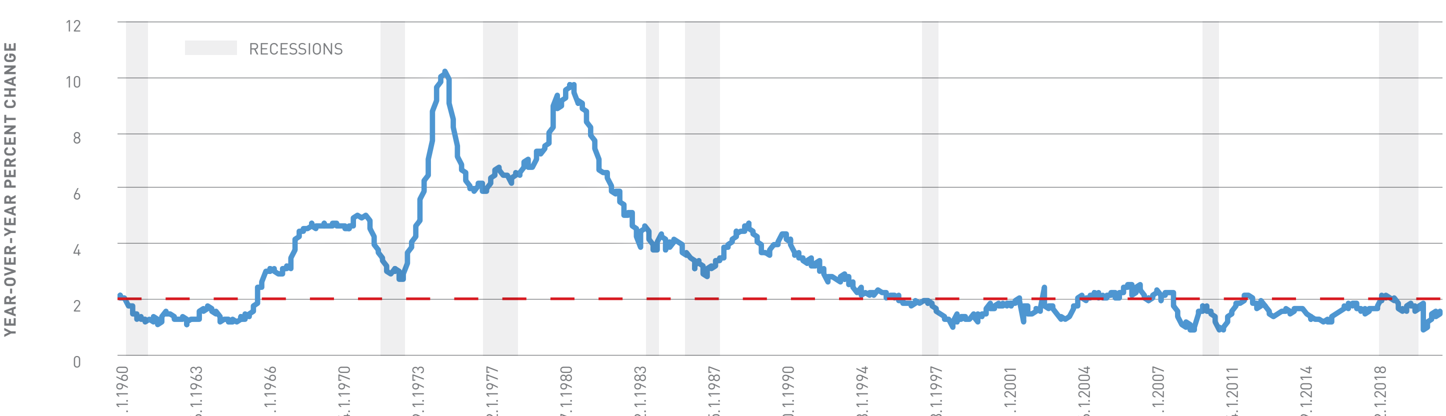
The answer to the second question is clearer. The long-term prospects for inflation remain low. Even if growth pushes inflation above 2% in 2021 after being very subued *(Figure 1)*, it's unlikely to remain there. The same factors that kept inflation low before the pandemic will keep it subdued after the economic surge: technology, automation, communication, declining union participation, and globalization. The weight of some of these factors will be different in the new normal, but all will likely remain significant, and after supply conditions adapt to the surge in demand, they will continue to keep prices in check.

Once the growth push from pent-up demand and stimulus checks subsides, will the U.S. slide back into the slow-growth pattern that prevailed before the pandemic? If so, investors will need to be prepared to shift the orientation of their investments back toward the large-cap and growth stocks that drove the market prior to the pandemic. We can't rule out that scenario. And indeed, the economy faces challenges in sustaining a high growth rate—an aging population, a slow-growing labor force, and an uncertain future for productivity.

The first two of those challenges are subject to little or no change. But paradoxically, the changes wrought by the pandemic may prove to have made the economy more efficient and labor more productive, thereby ushering in a new regime of higher growth (though not 6% long-term), revenues, and earnings. This would be a true Golden Age for investors. The next two years will tell the tale. For now, investors can look forward to robust growth in at least 2021.

FIGURE 1: U.S. INFLATION: SUBDUED FOR DECADES NOW

PERSONAL CONSUMPTION EXPENDITURES CORE PRICE INDEX



Source: Federal Reserve Economic Data