



2021 Outlook: The Recovery Year

Summary:

- 1. The economy is in recovery, but the expansion phase of the cycle (where economic output exceeds its prior peak) isn't likely to begin until 2022. We look for weak first quarter growth followed by more notable strength for the remaining three quarters as the COVID-19 vaccines are distributed.
- 2. Monetary policy has made a historic shift:
 - a. Volcker's policy of pre-emption to prevent the return of inflation expectations has ended. Thus, policy tightening won't occur until there is clear evidence of sustainable inflation.
 - b. The Fed is actively taking steps to prevent asset runs across the non-bank financial system. This policy will stabilize the financial system at the cost of creating moral hazard.
 - c. To address inequality, the Fed will actively try to extend the business cycle.
- 3. The liquidity injection into the economy is unprecedented. Determining the flow of this liquidity is the key element to forecasting the economy and asset markets.
- 4. Inflation may rise in H2 2021 if vaccine distribution triggers pent-up spending. But we don't expect a rise to exceed 3% of core PCE and it won't bring a reversal in monetary policy. We also don't expect the rise to be sustained due to the underlying factors dampening inflation.
- 5. Our forecast for 2021 S&P 500 earnings is \$147.84 with a multiple of 26.5x. The forecast range for the index is 3918-4050.
 - a. Given the level of liquidity, there is a substantial likelihood of exceeding this forecast.
 - b. We favor small and mid-caps over large caps.
 - c. The growth/value ratio is at an extreme, favoring the former. If the economy improves as we expect, a reversal of this ratio is likely, although it may not favor the entire spectrum of value stocks. Cyclical stocks should perform well.
 - d. Our expectation of dollar weakness should support international stocks for dollar-based investors.
- 6. In fixed income, we favor investment-grade corporates. High yield appears fully valued and duration risk should be avoided.
- 7. Commodities should be supported by better economic growth and a weaker dollar. Oil prices will likely lag, holding in the low \$50s for WTI. We favor other commodities, and view gold as attractive at current levels.

The Economy

After a record 10-year expansion, the economy fell into recession in 2020. The COVID-19 pandemic and consequent measures to reduce infections caused a sudden stop to the economy, leading to a record decline and rise in real GDP. The pandemic caused unusual patterns to develop in the economy and thus the recovery will be affected by the impact of COVID-19 as well.



After a 31.4% drop in growth in Q2 2020, the economy rebounded with a 33.1% rise in Q3. Despite the jump, the economy remains well below the previous peak.

This chart shows the level of real GDP, set to the percentage of the recent peak. We have put numbers on each business cycle showing the number of quarters from the trough to a new peak. Making a new

peak is a signal of a new expansion. The last recession had an unusually slow recovery. Despite the rise in Q3, we are still near the trough of the last recession, thus it is reasonable to expect that this recovery will likely be slow as well. Of course, much of the path of the recovery will depend on policy.



The pandemic has led to other changes in the economy. Consumption of services has come under pressure, while goods consumption has increased.

One of the features of the postwar U.S. economy has been a steady rise in services consumption relative to goods consumption. As household wealth rose, goods satiation was achieved, and more spending was dedicated to services. In addition, as women entered the workforce, services like restaurant food and childcare were consumed in greater amounts. The pandemic dramatically reduced services consumption; most services require some degree of direct human contact, which was discouraged to slow infection rates. At the same time, massive fiscal stimulus led to a lift in household income. The increase in income coupled with the lack of



services consumption led to a countertrend rise in goods consumption.

One of the features of 2021 will likely be a return to trend. When widespread distribution of a vaccine occurs, which we assume will be in H2 2021, airlines and restaurants will see a return of patrons. In addition, the durable consumer goods purchased in 2020 will effectively bring forward potentially years of purchases. At the same time, although there will be pent-up demand for services, those lost in the pandemic will never be completely recovered. This situation will likely lead to a slow return to peak levels of GDP.

However, there is one area of the economy that may benefit from permanent changes caused by the pandemic. Residential housing was adversely affected by the 2008 Financial Crisis. Homeownership rates rose, boosted by lax lending standards; in the wake of the crisis, homeownership rates fell steadily. However, we have seen a dramatic recovery since 2016.

After reaching a nadir in Q2 2016 at 63%, homeownership rates have increased to 68% in four years. This rise is occurring with a jump in household formation, suggesting that the millennial generation has finally moved into the household-building stage. The pandemic fostered this development because it accelerated the "work from home" alternative. Working from home is expected to be at least partially maintained even after the pandemic passes. Workers can buy homes farther from urban centers if they can avoid a daily commute. Firms benefit because they can conduct business with a smaller commitment to office space.



Homebuilding supports many areas of the economy, from furnishings to employment. Housing starts tend to lead residential construction employment by about a year; the current level of starts should add around 150K to 200K of jobs next year.

For 2021, we are assuming that the delay in another round of fiscal stimulus and a persistent drag from COVID-19 will delay the economic recovery. We are not expecting a "double-dip" recession but we anticipate a weak start to the year with a steadily improving economy after Q1 as (1) a vaccine is distributed, and (2) another round of stimulus occurs that will lift the economy later in 2021.





We do not expect a new expansion to begin until H1 2022.

Policy

The pandemic has triggered significant policy changes. Fiscal policy, as measured by the budget deficit scaled to GDP, shows that the current deficit is the widest since WWII.

Soon after the 2008 Financial Crisis, fiscal policy tightened. Interestingly enough, the deficit began to rewiden in 2016 and accelerated with the tax cuts. It is unusual for the deficit to widen late in a business cycle. We did see some widening in the late 1960s due to the funding costs of the Vietnam War. The CARES Act led to a sharply widening deficit; the Congressional Budget Office does not expect the deficit to narrow much as the economy improves.



Although fiscal stimulus will be a nearly permanent feature of the economy in the upcoming decade, the more profound change in policy has come from monetary policy. There have been two significant changes. The first is tied to the management of the Fed's explicit congressional mandate. The Federal Reserve has a dual mandate; it is expected to keep inflation under control and support full employment. Since Volcker, the FOMC has used preemptive policy actions; it attempted to tighten policy before clear evidence of inflation developed. This measure was adopted to increase the policy credibility of the Federal Reserve which would keep inflation expectations in check. Preemptive policy gave inflation control priority over full employment. The Fed would usually begin a policy tightening cycle before full employment was achieved.

The lower line on this chart shows the U3 unemployment rate less the Non-Accelerating Inflation Rate of Unemployment (NAIRU). When this measure is above zero, it is estimated that there is slack in the labor market. The upper line indicates fed funds. The vertical green lines show policy tightening cycles that began before full employment was achieved. Since the mid-1970s, there has only been one cycle when the labor markets were allowed to achieve full employment.



Chair Powell, in a series of speeches, has ended policy preemption. Instead, the Fed will allow unemployment to fall to any level and won't begin to tighten policy until there is clear evidence that inflation has moved above its 2% target. In addition, the Fed has signaled that it won't necessarily use 2% inflation as a ceiling. Instead, it will allow inflation to rise above target especially if it has been below-target for a period of time. The FOMC has purposely left its reaction function vague to give it maximum flexibility. Given that the core PCE deflator, the Fed's preferred inflation measure, has been at or below 2% for 80% of the time since 1995, it would be reasonable to assume that the policy rate will be stable for a long time.

A major factor behind the Fed's decision to jettison preemption is that it wants to address income inequality. As shown on this chart, history suggests the spread between minority unemployment tends to narrow in long expansions. Ending preemption should support that goal.



The second change affects the Fed's common mandate with all central banks—the responsibility to maintain financial stability. The Fed has a series of tools to maintain order in the financial markets. Regulation and interest rate levels have traditionally been the primary tools to prevent financial problems. After the Great Depression, the federal government implemented a series of regulations. Glass-Steagall separated investment banking from commercial banking, in theory, "ring-fencing" the riskiest elements of the financial system from depositors. Deposit insurance for commercial bank accounts reduced the odds of ruinous bank runs. Although these measures brought stability to the U.S. financial system, they also created an inefficient financial system. Financial actors had an incentive to engage in regulatory arbitrage. This process began in earnest in the early 1970s with the evolution of the Eurodollar market. Because of the dollar's reserve currency status, Europeans accumulated U.S. dollar balances throughout the 1950s and 1960s. European bankers realized they could lend these balances; in addition, dollar depositors were able to get interest rates above capped U.S. commercial bank deposit rates, which were fixed by Regulation Q. Throughout the 1970s, the Eurodollar market was causing disintermediation for the U.S. commercial banking system. This issue culminated with the development of the money market account. Banking regulation prevented banks from paying interest on demand deposits. As inflation and interest rates rose, the lack of interest on demand deposits became costly. Using the technology of sweep accounts and by lending to the commercial paper market, the money market account was able to effectively pay interest rates on demand deposits. Commercial banks not only faced the loss of demand deposits, but they also lost the market for short-term loans to businesses. By the mid-1980s, Regulation Q had been essentially rescinded, and banks could pay market rates for deposits and pay interest on demand deposits. This opened up the commercial banking system to a new element of risk-funding costs now rose (no more zero-rate deposits) and a growing market for financial market lending threatened bank lending. In response, in 1999, Congress passed the Gramm-Leach-Bliley Act, which repealed Glass-Steagall and allowed both commercial and investment banks to operate in the same areas.

The spread of loan securitization allowed for bonds to be created from arrays of loans. Mortgages, both residential and commercial, credit cards, business debt, etc. could be created from lending activities. No longer did banks or other financial institutions make loans and hold that asset to maturity. The combination of loan securitization and money markets allowed for the development and expansion of the non-bank, or "shadow" banking system. Essentially, this system borrows from money market funds through repurchase agreements (repo) and buys financial assets with an interest rate higher than the funding cost. Overall, the financial system is engaged in a carry trade which can be accomplished through repo which encourages leverage. And, it is nearly unregulated.

This chart shows the dilemma the Fed currently faces. Prior to the repeal of Glass-Steagall, there was a tight correlation between the level of fed funds and financial conditions. As the central bank raised rates, financial conditions would deteriorate, as shown by a rising level of the Chicago FRB's Financial Conditions Index. Since mid-1998, the two variables have become uncorrelated. The Fed can't use financial stress to reduce lending activity, and, perhaps even more unsettling, cutting rates has less impact on reducing stress. Another factor behind the change in correlation is the increased transparency surrounding Fed policy. As policy direction signals have



become clear, markets easily discount changes and thus policy action tends to have less of an impact.

Sudden changes in correlation patterns, like the one above, are usually tied to specific events. However, increased transparency has played a role as well.

In March, responding to clear evidence of rising stress, the Fed announced a series of backstops to various markets, including commercial paper, municipal and corporate bonds, and some elements of high yield bonds, and offered to provide funding for small business lending. The measures successfully reduced financial stress but at the potential cost of increasing moral hazard. In the shadow banking system, the Fed does not have a tool like deposit insurance to stop asset runs. Consequently, the measures announced in March have clearly provided confidence to the financial markets.¹ Unfortunately, it is not obvious that the Fed has any measures to constrain lending. As a result, policymakers have created something that could be construed as "one direction" policy, which is to provide liquidity and support. If this is the perception of policy, it is highly likely that market participants will become increasingly bold, driving up asset values. Unfortunately, as 2008 shows, reining in this sentiment will be difficult. But, for 2021, we doubt there will be much need to do so.

The Fed's policy of protecting the shadow banking system has led to a couple of historic conditions. First, the Fed's balance sheet has increased to extraordinary levels.

This chart compares the Fed's balance sheet to GDP beginning with the formation of the U.S. central bank. The current level is unprecedented.





The increase has led to a plunge in velocity.

The combination of fiscal largess and accommodative monetary policy has led to a historic shift in savings.

¹ Although the Treasury has rescinded several of these programs, the fact that they have been instituted once means that it is almost certain they will return during the next financial crisis.

Net saving is a macroeconomic identity; like a balance sheet, the sum total of saving in an economy will always be zero. One sector's saving is offset by another sector's dissaving. Foreign saving is the inverse of the current account; if a nation is running a current account deficit, it is "importing" foreign saving. Government saving is its deficit or surplus. Business and household saving are self-explanatory. Although the sum of saving is not terribly enlightening, the shifts in saving are very informative. The problem is that it is not always easy to determine the causal factor. For example, one oft-repeated narrative is that the U.S. is a spendthrift nation that must attract savings from abroad, making the U.S. dependent on foreigners. However, it is also possible that foreigners are oversaving and thus dump their savings on America, forcing our domestic sectors to adjust and causing distortions. Although it is unlikely both narratives are true, it does appear that, at certain points in history, one or the other may be a better explanation. In other words, just because the U.S. imports savings doesn't necessarily mean the cause of that fact is consistent.² There may be some periods when U.S. policy creates a domestic savings gap and needs foreign savings (the early 1980s is a possibility), whereas at the turn of the century, the

inflows of foreign savings were more likely caused by dumping (the "<u>savings glut</u>" described by Ben Bernanke).

This chart shows a massive level of government dissaving; although all other sectors absorbed some of the flows, it is evident that households absorbed the vast majority (86.1%). This is because the fiscal support mostly went to households in the form of unemployment insurance and direct payments to households. If we compare this latest fiscal expansion to the one in 2008, it is evident that households and businesses captured roughly an equal share of the government's dissaving. The most recent fiscal event is materially different.



Although there are many critical factors that will affect the economy in 2021, including the path of the virus and the outlook for a vaccine, the disposition of household savings is one that bears watching. This disposition is a complicated issue. Households have various paths to use this savings. It could use the savings for consumption, which is, to some extent, the goal of the stimulus. Of course, if this is the path, it increases the potential for inflation. But spending isn't the only path. Households could simply continue to save the money; given fear levels due to the pandemic, it is possible that households could maintain elevated savings levels for a considerable period. Another avenue could be debt reduction; household debt levels are elevated, and it is possible that households could use this fiscal windfall to address balance sheet issues. Finally, households could invest the savings balances into financial assets.

² One clue to the direction of causality is interest rates. If the U.S. imports savings without having to raise interest rates, it would suggest that foreign nations are dumping their savings on the U.S., most likely to boost employment in the foreign nation. See Pettis, Michael. (2013). *The Great Rebalancing: Trade, Conflict, and the Perilous Road Ahead for the World Economy*. Princeton, NJ: Princeton University Press.

One clue to the disposition of this "lump" of savings may be how it is distributed. The Federal Reserve publishes a data series called the "distributional financial accounts," which looks at household assets and liabilities based on income distribution. The Fed creates four categories—the top 1%, 90% to 99%, 89% to 51%, and the bottom 50%. In our analysis, we create three categories—the top 10%, the middle 89% to 51%, and the bottom 50%.

Equities dominate the holdings of the top 10%. All other categories are currently less than 20%, with fixed income and residential real estate rounding out the bulk of the rest of this category's assets.

The middle group of 89% to 51% is shown to the right in the middle.

This group's assets are mostly in residential real estate. Equities hold second place with fixed income in third.

For the bottom 50%, real goods dominate. Residential real estate is the majority of their assets, with consumer durables next. Financial assets are a minor part of their holdings.









If the FOMC's goal is to reduce income and wealth inequality, then reducing mortgage interest rates would support that goal. As the above charts show, the bottom 50% of households hold the bulk of their wealth in their houses. In addition, the upper 50% made a conscious effort to reduce their leverage to real estate. As real estate asset values have increased, this group has not increased their liabilities. That is not the case with the bottom 50%; as real estate assets have appreciated, their leverage has increased, although at a slower pace than asset values. This rise in liabilities may reflect increased purchases of homes rather than refinancing. *This situation argues for the Fed to engage in yield curve control; if it allows long-duration Treasury rates to rise, it will increase mortgage rates, which will tend to harm the bottom 50% of households.*

The other element of monetary policy has been the decision by the Fed to keep policy rates "lower for longer." The dots plot shows there will likely be at <u>least two years of steady</u> monetary policy. The "lower for longer" policy is designed to (a) support the economy, and (b) ensure that the shadow banking system remains supported. Low interest rates create a situation that John Maynard Keynes referred to as the "euthanasia of the rentier." Just as a landowner benefits by renting out his land and benefits from its scarcity, under conditions where cash is scarce, cash owners benefit by lending it out. Risk adverse investors benefit during periods of cash scarcity; when cash becomes plentiful, investing becomes more complicated.

In general, we assume the connection between cash and equities is the retail money market fund (RMMK). In other words, if an investor sells equities, the first stop is the RMMK; after that, it can go elsewhere. Readers familiar with our research will recognize this chart.

The gray bars indicate recessions, and the orange bars designate when RMMK falls to \$920 billion. The orange bars represent when RMMK falls to a level where there is inadequate liquidity to support a rally in stocks. Since 2018, we have seen a rapid rise in RMMK; this hasn't stopped the S&P from rising, but it likely slowed the rally. What



prompted the rise in RMMK? We believe it was a signal of increasing fear on the part of investors. The trade war with China accelerated in early 2018 and concerns about that plus tightening monetary policy

led to a drive to boost liquidity. The pandemic, the recession, and the impact of policy lifted RMMK this year.

The excess cash is not earning much in terms of interest now or likely in the future. Thus, with the recession likely over, a vaccine on the way, and uncertainty surrounding the election lessened, we would expect this liquidity to seek higher returns in 2021. Although all the classes of households have seen cash levels rise, the top 10% has seen the bulk of the increase into RMMK. This development means there is liquidity available for equities.



So, the bottom line is that the saving held in higher income households will likely go to equities. Saving in lower income households will probably go to debt reduction and real estate.

Inflation

Ample liquidity, expansive fiscal policy, and accommodative monetary policy create conditions that could trigger inflation. In fact, we do expect inflation to develop at some point; the issue isn't *if* as much as *when*. If the past 70 years have taught us anything it's that mechanical models of inflation really don't work very well. The rise in inflation in the 1970s was brutal but also mostly unanticipated as was the decline in inflation seen from the early 1980s. The velocity chart on page 7 pretty much undermines the MV=PQ relationship (Money supply * Velocity = Price [inflation] * Quantity [supply] of goods & services); we have seen a massive rise in M, with some increase in P&Q, but a virtual collapse in V. Therefore, because households and firms are *willing to hold cash and other financial instruments*, rising prices for goods and services have been contained. Other factors have contributed to low inflation as well. Globalization and deregulation have expanded supply and reduced the power of labor to boost wages. Paul McCulley, the former economist at PIMCO, has argued that the rate of inflation reflects the balance of power between labor and capital. We tend to agree with this position.

One of the key factors for the path of inflation is the equality/efficiency cycle. The tension between the two was <u>outlined by Arthur Okun</u>. Essentially, without efficiency, economic growth stalls and inflation tends to rise. But, increasing efficiency tends to increase the income and wealth gaps among households. Eventually, excessive inequality becomes politically untenable. Using Okun's work, we have postulated that equality and efficiency are not just in tension but act in a cycle; efficiency ruled policy from 1870 to 1932. The New Deal triggered an equality cycle, which lasted until 1978. Efficiency has dominated ever since, although there is growing evidence that we are likely heading toward an equality cycle. The table below shows policy differences between equality and efficiency.

Equality	Efficiency
High & Progressive Tax Rates	Low Taxes
Job Protection via Regulation	Job Disruption via Deregulation
Trade Impediments	Open Trade/Globalization
Restrictions on Outsourcing	Outsourcing Supported
Restrictions on Technology	Open Acceptance of New Technology
Unionization Supported	Unionization Undermined

We are already seeing some movement in the direction of equality. Trade impediments are rising and there are threats against technology in the form of antitrust. Although outsourcing has generally not been made illegal, it is falling out of popular favor. On the other hand, tax rates remain low (we would define high as a federal top marginal tax rate above 50%) and the introduction of new technology has generally been allowed. Regulation is also not rising in a manner consistent with past episodes of higher inflation.



The chart on the right shows the yearly levels of the number of pages of the Federal Register; this is a proxy for regulation. We have colored the last equality cycle in cornflower and the current efficiency cycle in blue. In terms of yearly change, there have been two periods of significant increases in regulations, the New Deal/WWII period and the late 1960-70 period. The chart on the left looks at the five-year average of the yearly percentage change in Federal Register pages and the yearly change in CPI. Although the fit isn't perfect, there is a clear "rhyming" pattern; a rise in regulation tends to cause higher inflation. The fact that the Federal Register isn't growing suggests the regulatory factor that would trigger higher inflation probably isn't in place, at least for now.

There is also one other important element of the equality/efficiency cycle. Each cycle has a new theory that gives governments a reason to implement the desired policy. The 1870-1932 efficiency cycle had the support of classical economics and the notion of unfettered markets for capital and labor. The 1932-78 equality cycle was an outgrowth of Keynesian economics. The current efficiency cycle came from supply side economics, along with rational expectations theory. We suspect the next equality cycle will use

Modern Monetary Theory for its rationale. The equality cycle isn't upon us yet, but the path to getting there is visible.

Another factor that suggests inflation will remain subdued is the difference of GDP to its long-term trend.



The chart on the left shows the level of annual real GDP, log-transformed. We regress the data against a time trend; the lower line shows the deviation from the long-term trend. Although not perfect, the regressed trend is a proxy for the economy's capacity. An economy with GDP above trend is likely straining resources and is susceptible to inflation. According to the data, current GDP is well below its long-term trend. The yellow area, which uses the forecast from the Philadelphia FRB's survey of economists, shows that GDP is likely to remain below trend. In fact, the last time the economy was this far below trend was during the Great Depression. The chart on the right looks at the level of average inflation compared to GDP's deviation from trend. The data shows that deflation tends to occur when GDP is this depressed. It hasn't occurred this time most likely due to persistently easy monetary policy. Given how far GDP is below trend, the economy will likely be able to absorb significant levels of fiscal and monetary stimulus before GDP returns to trend and inflation becomes an issue.

Overall, we may see a rise in core PCE inflation above 2% in H2 2021 as pent-up spending is unleashed with the distribution of a vaccine. We don't expect this inflation to take hold and view it as temporary. Until we see a rise in regulation and enough growth to return to trend, the economy will likely absorb stimulus without triggering inflation...for a few years.

The Outlook for Markets

Equities

Although the liquidity situation complicates the forecast, it makes sense to start with the basics. Usually, margins contract during recessions. Although that is true in this one as well, the degree of contraction looks to be less than in previous business cycles.

This chart shows the 4Q-trailing earnings of the S&P 500; the red line is the fair value level of earnings from a model that regresses earnings against nominal GDP. In other words, the red line shows the level of earnings explained by overall economic activity. When the blue line is above the red line, it suggests strong margins as earnings are outpacing economic activity. Usually, recessions lead to a sharp drop in earnings; however, this recession may be short enough to prevent a decline to the GDP forecast line.

To determine our forecast for 2021 earnings, we start with our earnings projection. Our model is completely top-down. We first calculate S&P 500 total earnings.





The latest data available, Q3, shows a rapid recovery in S&P earnings relative to GDP. Our forecast, shown by the red line on the left graph, shows a more modest forecast of total S&P 500 earnings of 5.5% of GDP. The chart on the right highlights one of the key variables, the level of profits from the GDP data.³ That variable shows overall profits for all corporations. It is very common for NIPA profits to lag the S&P in the late stages of the business cycle. However, the variable has a good history of capturing the recovery in profits after a recession. We use the Philadelphia FRB's survey forecast for NIPA profits; economists are expecting a slower recovery in overall corporate profits next year.

There are other variables in the margin model that include unit labor costs, exchange rates, interest rates, oil prices, credit spreads, and net exports. Note that in the overall margin model shown on the left, these variables tend to lift the forecast late in business cycles even if the NIPA profit data is showing signs of weakening. It is possible that the level of industry concentration in the S&P 500 stocks has reduced the explanatory power of the NIPA profits data. But, for now, we are going with the model forecast.

³ Known as the National Income and Product Accounts, or NIPA.

²⁰ Allen Avenue, Suite 300 | Saint Louis, MO 63119 | 314.743.5090 WWW.CONFLUENCEINVESTMENT.COM

To determine the earnings per share, the divisor is applied to the overall S&P operating earnings.

One of the key features of the last business cycle was a steady decline in the divisor. That reflected, for the most part, share buybacks. In recent quarters we have seen the divisor stabilize; we suspect that a similar decline in the divisor is less likely in the next expansion. Thus, for now, we are assuming a steady divisor for 2021. Given that assumption, we are forecasting S&P 500 earnings of \$147.84 per share.⁴





The next step is to address the multiple. Although most models of the P/E focus on interest rates, our research shows that inflation volatility is the most important variable.

The two variables are inversely correlated at the 70% level. So, it's not just low inflation that lifts multiples but low volatility of inflation. This makes sense; an investor will be more inclined to own financial assets if the prices of goods and services are mostly stable. Our expectation is that, given the degree of slack in the economy, inflation and its volatility should remain low.



⁴ We use operating earnings as defined by Standard & Poor's because we have a longer-term track record of that data. It's now more common to use Thomson/Reuters for operating earnings. Converting the Standard and Poor's measure to Thomson/Reuters yields operating earnings of \$159.36.

The full model incorporates the yearly change in CPI and its five-year rolling standard deviation, fed funds, the yearly change in M2, the family GINI coefficient, and the difference between the GINI coefficient and M2 velocity. The latter variable may be the most critical factor for 2021.

The GINI coefficient is a measure of inequality; 0 means perfect equality, while 1 represents perfect inequality. The higher the number, the greater the degree of inequality. We are in a period that is generally unprecedented—we have unusually low velocity, meaning there is far more money being put

into the economy than is required to purchase goods and services, along with elevated inequality. This chart suggests that much of the injected cash is probably going to upper income households; if so, that would imply there is ample cash available for investment. Although we have attempted to employ this variable in the model, it's possible it won't affect the P/E in a linear fashion and may lead to an even higher multiple. For 2021, our range for the P/Ewould be 26.9x to 27.4x.



Given this level of uncertainty, we are going to forecast a range for the S&P 500 in 2021. Our range is 3918 to 4050 for next year. We are leaning toward the upper end of the target range because we expect there will be ample liquidity available to investors with few options for the cash to be deployed.

One final thought—although it is not our primary model for forecasting the S&P 500, we do use one that incorporates inflation-adjusted M2 and M2 velocity. In that model, we logtransform both the S&P 500 and real M2. The model suggests there is ample support for higher equity values.



We are not expecting an S&P 500 of over 7500 anytime soon. But this model does show that there is ample monetary policy support for higher equities and cautions against premature bearishness. It also warns that a removal of monetary stimulus could have an adverse impact on equities of unusual scale.

This chart shows the ratio of large caps to small caps. Although the performance of large caps hasn't exceeded all time levels, it is extended.

Large caps tend to underperform coming out of recessions; since the 2020 recession likely ended in the summer, we would expect to see small caps perform better in 2021. There is some evidence that the reversal is in its early stages.

Growth/value appears poised for a reversal as well.

This is a simple regression of the value and growth indices. Growth has been outperforming since 2007 but has reached an extreme level. Growth rates between the two styles suggest a similar situation.

With growth's outperformance reaching an extreme, it would be reasonable to expect value to do better in the future. For this to occur, we would usually need to see a pickup in economic growth. But another factor is the dollar.







The green areas on this chart represent dollar bull markets, whereas the red areas are dollar bear markets. Although not a perfect fit, dollar weakness in the early part of the century coincided with value outperforming growth. At present, in our asset allocation, we are even-weight both styles with a sector bias toward cyclical stocks. That may change if economic growth accelerates later in 2021 or dollar weakness becomes more pronounced.

With regard to international stocks, a key variable is the dollar. Using purchasing power parity, the dollar has been overvalued for some time.

That outcome is not uncommon with this valuation model, but we expect the change in administrations to lead to an overt policy of dollar depreciation. Adding to this idea is the fact that Europe is about to issue a Eurobond backed by the full faith and credit of the EU. Along with valuation, we also note that dollar cycle changes tend to occur with political or economic events; in general, dollar peaks occur about every 15 to 18 years.

History shows that foreign stocks tend to outperform during periods of dollar weakness. For a dollar-based investor, a weaker dollar creates a tailwind for foreign assets.









In summary, we are optimistic on equities for the upcoming year. As 2021 progresses, we expect that value will begin to outperform growth. Likewise, we expect small and mid-caps will begin to outperform large cap stocks. Finally, we believe dollar-weakening will lead to the outperformance of foreign versus domestic stocks.

Fixed Income

Fixed income allocation boils down to two decisions—credit risk and duration risk. The former is the risk of default compared to the higher yield gained by lending to less creditworthy borrowers. The latter is about how far out on the yield curve one invests; in general, yields are higher with longer-duration instruments and the potential for capital gains is greater for falling yields. We will start with credit risk.

Investment-grade corporates still appear to be offering investors value.





However, high-yield spreads are now below average, suggesting that investors, in the search for yield, have moved out on the credit risk spectrum.

The riskier categories show a similar pattern.

Although high-yield spreads will likely tighten further, investors should exercise caution in the riskier parts of the credit spectrum.

There are two reasons why we are seeing credit spreads narrow. First, it is likely this recession is already over; although we still expect defaults to remain elevated, history would suggest the worst is probably past us. If widespread vaccine distribution emerges as we expect next year, it will likely support risk tolerance. Second, the Fed's unprecedented action in March to buy high yield to support the



market likely prevented a much worse widening of spreads by ensuring a market would exist for highyield bonds. Even with the Treasury's decision to remove these programs, now that they have been instituted once, we expect them to be reinstated during the next crisis and, at some point in the future, become a permanent part of monetary policy.

On the duration front, the 10-year Treasury appears richly valued.

The model uses fed funds, the 15-year average of CPI (an inflation expectations proxy), the IPY/USD exchange rate, oil prices, German 10-year bond yields, and the fiscal deficit. The model suggests the fair value yield is 140 bps.⁵ Although this fair value is historically low, it is well above the current rate of around 85 bps. In the absence of outside interference, it would not be unreasonable to expect yields to continue to drift higher. However, we do expect weaker economic growth in Q4 2020 and Q1 2021, so the pace of increases may slow. As noted above in the policy section, some degree of yield curve



control is likely, which should mean the 10-year T-note yield will likely be capped around 125 bps.

Thus, there is little incentive to accept duration risk. The best risk/reward would appear to be shorter dated investment-grade corporates. Although there is probably still room for high-yield spreads to

⁵ Fair value for the 30-year T-bond yield is 2.00%.

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tighten further, that part of the market has priced in a good deal of favorable news. So, in summary, we prefer investment-grade corporates, followed by high yield. Duration risk should be avoided.

Commodities and Gold

One of the features of capitalism is that there is a steady improvement in commodity consumption efficiency. In general, commodity consumers usually improve their efficiency by using less commodities in the production of goods and services. Since the economy tends to grow over time, demand for commodities tends to rise but at a slower pace than the overall production of goods. Accordingly, the long-term trend in commodity prices is always lower.

This chart shows the CRB commodity index rebased to CPI inflation. Using data starting in 1915, we have regressed it against trend. Note the trend line's long-term decline. On occasion, commodity prices rally above trend; these secular bull markets in commodities are usually caused by two factors. The first is large-scale war. Large wars tend to consume massive levels of commodities for the war effort and global supply chains are often disrupted, leading to higher prices. The second factor is currency debasement. Casual observation of the above chart shows WWI, WWII, the Korean War, and the ending of Bretton Woods in the early 1970s. The off-celebrated secular bull market in commodities in the early part of the century was unusual in the



fact that neither of these factors was involved—it was caused by the massive industrialization of China. At the same time, it was also a very minor bull market relative to the earlier ones.

Although we don't expect a war in 2021, there is a clear path toward currency debasement. As we discussed using the charts above, the expansion of the Fed's balance sheet is an indication of currency expansion. However, we don't expect the bulk of this liquidity to go directly to commodities; rather, it is more likely to flow into equities. That being said, it isn't out of the question that some of this liquidity might make it to real assets. We will focus our comments on two markets, crude oil and gold.

Crude oil had a historic year in 2020. In April, oil futures prices fell into negative territory for the first time ever.⁶ The pandemic has hit demand hard and is expected to have lingering effects in 2021. The <u>IEA</u> expects demand to rise to 97.2 mbpd, a significant recovery from this year's 92.0 mbpd but still below a full recovery of over 99.0 mbpd.

Oil is a unique commodity market in that for most of its history it has had an operating cartel. From Standard Oil to the Texas Railroad Commission to OPEC, some group was holding output off the market to prop up the price. This leads to prices being higher than a fully free market would generate but also one with less volatility. The production held off the market acts as a buffer, thus when a supply crisis occurs, this excess production is brought back to market. This system keeps prices dampened.

⁶ It should be noted that cash oil prices have been near negative in the past, but this was the first time a major benchmark fell below zero.

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As the vaccine is distributed and economic growth recovers, we would expect energy demand to rise, which will lift prices. However, there will be two constraints to the rally. First, as demand rises, we would expect OPEC to increase output in a bid to recover revenue lost during production cutbacks. Second, as prices rise, U.S. output will likely recover as well. The increase in supply will tend to dampen the pace of recovery.

The other major factor to consider for oil is the impact of the pandemic on oil demand.

This chart shows U.S. miles driven for cars and light trucks on a rolling 12month basis. Miles driven were running above trend from the mid-1980s into the Great Financial Crisis. However, in the wake of the 2008 recession, miles driven have never recovered to trend. The pandemic has led to a collapse in miles driven. Although we do expect some level of recovery, the experience of the past decade raises the likelihood that demand will not fully recover and will act as a dampener on crude oil demand. For 2021, we look for a recovery for WTI into the low to mid-\$50s per



barrel level, but we would not expect a rise beyond that range.

Based on our gold model, prices are attractive at current levels. The model uses real two-year Treasury yields, the EUR/USD exchange rate, the balance sheets of the Federal Reserve and the European Central Bank, and the U.S. fiscal account scaled to GDP. Based on this model, gold is undervalued.

At the same time, a model based on the amount of gold held by exchangetraded products (ETPs) suggests gold prices have gotten a bit ahead of themselves.



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One of the reasons inflows into ETPs have lagged the price could be tied to the behavior of bitcoin. Bitcoin remains a controversial topic; its value appears to be ephemeral (in theory, one can create scarcity of anything, but it has little value without demand for it). Its initial construction suggested it was a digital currency designed for transactions. It has mostly failed in that endeavor, at least for legal transactions, but it has shown to have store-of-value characteristics. As such, it has similar characteristics to gold without the same issues of storage.⁷ Recently, we have seen a sharp rise in bitcoin prices, which may be siphoning off demand that would usually go to gold.

Since late 2014, gold and bitcoin prices are positively correlated at the 70.9% level. In 2017, we saw a spike in bitcoin that collapsed. The key question is whether we are seeing a repeat in the current situation or something different. It is difficult to tell, but the most likely situation is that bitcoin isn't replacing gold but is a complement. Currently, bitcoin appears a bit expensive compared to gold (a simple model suggests bitcoin should be closer to 12,000), but it had been running below gold for most of this year. Thus, we view the recent rally as more





corrective in nature, although the recent spike suggests bitcoin is now excessively valued. Another item of note is that when we had a financial crisis in February into late March, bitcoin plunged while gold maintained its value. The financial system was in a perilous position in late Q1 and bitcoin was not the safety asset of choice when there were high levels of fear. At the same time, we cannot discount the attractiveness of bitcoin and, if investable products are eventually created, it may have a place in portfolios.

Overall, we remain bullish on gold. The underlying fundamentals, as shown in our base model, are very attractive and suggest current prices are undervalued. We do think bitcoin has taken some of the luster from gold, but in the long run we believe the two assets are complementary. With monetary and fiscal policy remaining expansive, the case for commodities, in general, and gold, in particular, is favorable.

⁷ Both assets require storage, but one is quite physical whereas the other has, in theory, unlimited storage capacity. If one is trying to operate in a failing state, gold may have little value but a cryptocurrency that can be easily transferred is attractive.

Conclusion

The two key factors for investors in 2021 are the path of pandemic recovery and massive levels of household liquidity. On the first count, we look for a stronger economy, especially in H2 2021 as vaccine distribution expands. On the second count, our expectation is that the bulk of this liquidity will flow into equities.

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This report was prepared by Bill O'Grady and Mark Keller of Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change. This information does not constitute a solicitation or an offer to buy or sell any security.

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