Q1 2021 Economic Outlook

By CIO Gino Perrina & LNWM Investment Strategy & Research

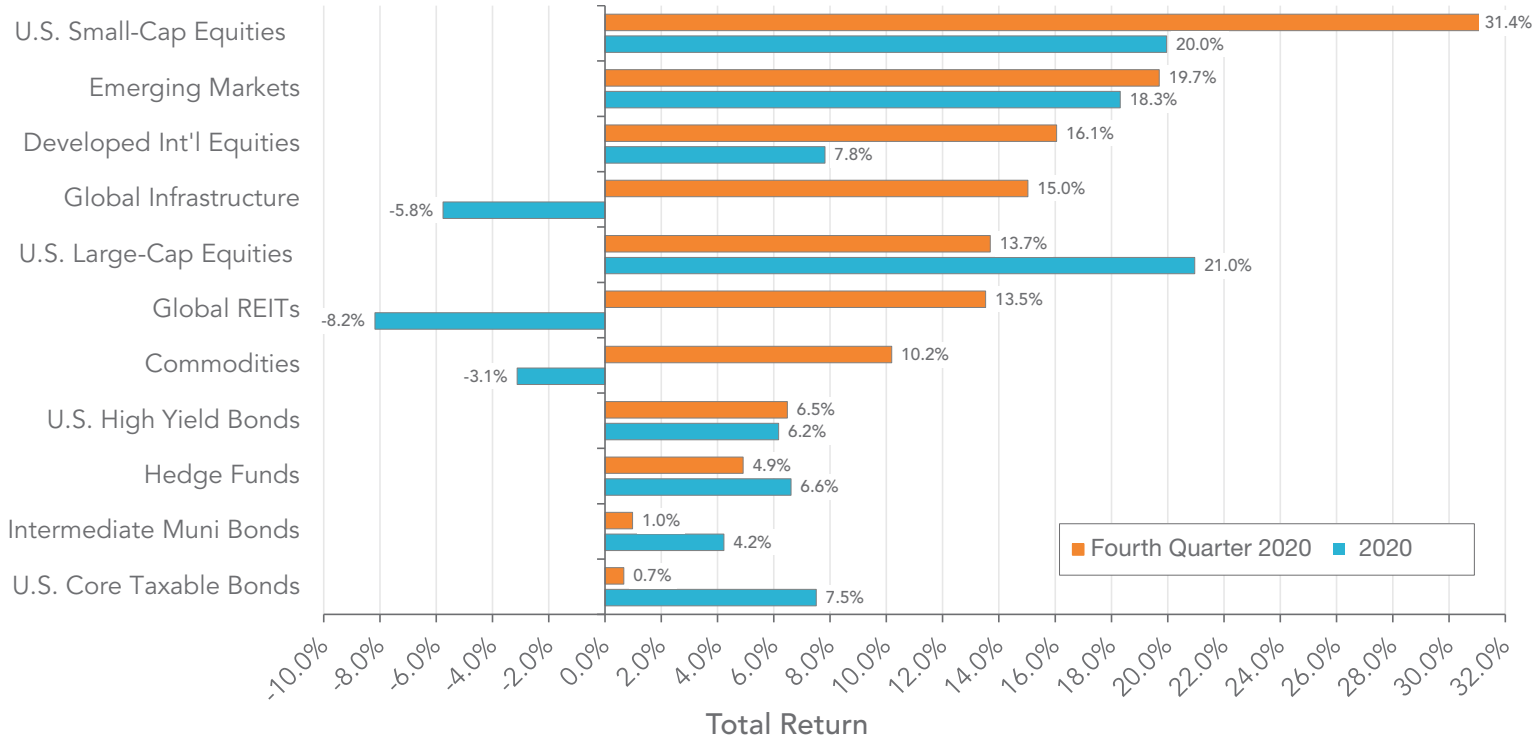
TIME FOR PATIENCE AND VIGILANCE

> "Hoping for the best, prepared for the worst, and unsurprised by anything in between."
> **– Maya Angelou**

Looking back on 2020, I find myself trying to avoid using the word "unprecedented" not because it's not justified but because I think most of us are tired of hearing it, including me. We're all longing for a sense of normalcy in our daily lives and especially in the lives of our children. Yet we continue to get stress-tested on many different levels – as individuals, as families, as communities, as an economy and even as a country, including the recent shocking events at our nation's Capitol.

On the economic front, 2020 was a white-knuckle rollercoaster ride. Not only was the depth of the recession extraordinary, but the subsequent recovery was also much quicker than most anticipated, thanks to truly unprecedented monetary and fiscal stimulus, whose long-term effects are yet to be seen. Certainly in the near term the results have been astounding: US equity markets have reached new record levels while U.S. Treasury yields remain historically low.

PERFORMANCE OF ASSET CLASSES 2020: 4TH QUARTER AND FULL-YEAR 2020



Source of Data: Morningstar, Bloomberg, Hedge Fund Research, ICE Data Services.

I am thankful that during a period of massive macroeconomic disruption, ranging from Fed policy to shifts in consumer spending, our investment team here at LNWM continued to focus and deliver on the long-term goals and objectives of our clients. In fact, many of the adjustments we made in LNWM portfolios throughout 2020 have been beneficial for our clients even beyond our initial expectations.

At this point, we are concerned that equity prices seem to be largely driven by policy rather than fundamentals. But the fundamentals could improve markedly in the coming year. Instead of trying to predict whether we're in a bubble or a boom, we will continue to focus on maintaining resilient, fully diversified portfolios while making tactical shifts to take advantage of near-term opportunities.

LOOKING FORWARD

We begin 2021 in a very different state relative to a year ago, when the economy was supported by full employment and stable growth. Unemployment remains three percentage points higher, and the US economy is estimated to have contracted 3.5%, even if the picture has improved dramatically since the nadir of the spring. As US President-elect, Joe Biden has telegraphed a set of policies and priorities that are dramatically different from the outgoing administration and there is still a long road ahead in defeating Covid-19, even if multiple drug manufacturers have developed effective vaccines.

Corporate regulation, taxation, and environmental issues are all areas where we should anticipate changes in the year ahead. I think that even though Democrats control Congress and the presidency, because of the 50/50 split in the Senate (tie breaking vote going with the Vice President), meaningful legislation will still be difficult. This new state of affairs will make moderate members of the Senate more impactful, and hopefully lead to more cooperation among lawmakers, something that we haven't seen in a decade or more.

Top-of-mind as we head into 2021 are these two macroeconomic drivers: Covid-19 and US fiscal policy.

Covid-19 – The path of the virus, including efforts to control its spread, has been the key driver of capital markets for nearly a year; it seems logical this will continue at least through this winter and spring. Several drug makers are now manufacturing vaccines, giving societies hope. But distribution and administration have both proven more difficult than anybody could have expected, even as infections are spiking, causing stress on healthcare systems around the globe and additional lockdowns.

While many market forecasters are predicting a full economic recovery in the second half of 2021, we remain less sanguine. Consider that global GDP shrank more than 4% in 2020, per the World Bank, matched only by the great Depression and the two world wars. Vast resources have been diverted to fighting Covid-19, and it will take time to revert these to their previous uses. Combine this with massive job losses, especially in the services sector: the current US unemployment rate is just under 7% but that likely understates the true level as nearly 4 million people have dropped out of the labor force. It therefore seems difficult to envision a full recovery by late 2021, though we remain hopeful. Optimistically, many of the industries hit hardest by Covid-19 are also the most capable of ramping up quickly to meet rising demand.

US Fiscal Policy – In our previous Outlook (October 2020), we mentioned that any meaningful legislation will depend as much on the Presidency as on which party controls the Senate. The November elections led to January runoffs in Georgia, which resulted in a 50/50 split of the Senate between Democrats and Republicans. As I mentioned earlier, a Senate split down the middle is likely to limit the Biden agenda, given that many reforms will require a super majority. Moderate Democrats have been known not to vote along party lines, which I believe will increase their prominence. This will hopefully lead to greater cooperation and compromise among our politicians, although I reserve judgment until I see results.

Still, the new Senate will likely approve additional Covid-relief spending in the months ahead and begin debating ambitious programs (infrastructure, clean energy, healthcare) as well as a tax plan to help fund all that. Market reaction has been as expected, with the Treasury yield curve steepening significantly (longer-term rates climbing faster than shorter-term) and inflation expectations rising as already-high US federal debt levels are set to increase.

As tax proposals begin to be unveiled, we will evaluate and advise you accordingly. During the campaign, the Biden team spoke about capital gains and estate taxes frequently. Any changes in these will certainly have an impact on our clients and we will evaluate different strategies for navigating those changes. As always, if you have specific concerns, please contact your LNWM advisor.

WHAT WE'VE DONE/ARE DOING

Most important for the 4th quarter was our determination of portfolio asset allocations for 2021. We completed our modeling early in December allowing for advisors to work with clients on tax-loss harvesting opportunities in conjunction with making any necessary allocation adjustments.
From an asset manager perspective, we reduced our allocation to liquid hedge funds and core fixed income in 2020 in favor of increased allocation across global equities. Looking to 2021, we plan to maintain our current exposures and, as always, will remain focused on long-term goals while taking advantage of what we believe are inefficiencies as they present themselves.

ESG Investing – Discussions with current and prospective clients over the past year have shown me two things: 1) Demand for values-based investing is increasing; 2) The events of the past year have caused many to refocus their goals and include capital allocations to areas not previously considered. Even beyond our clients, investors broadly have begun to reconsider socially responsible investments and you've seen that in some asset repricing. We think this will likely continue given the stated priorities of the new administration in the White House.

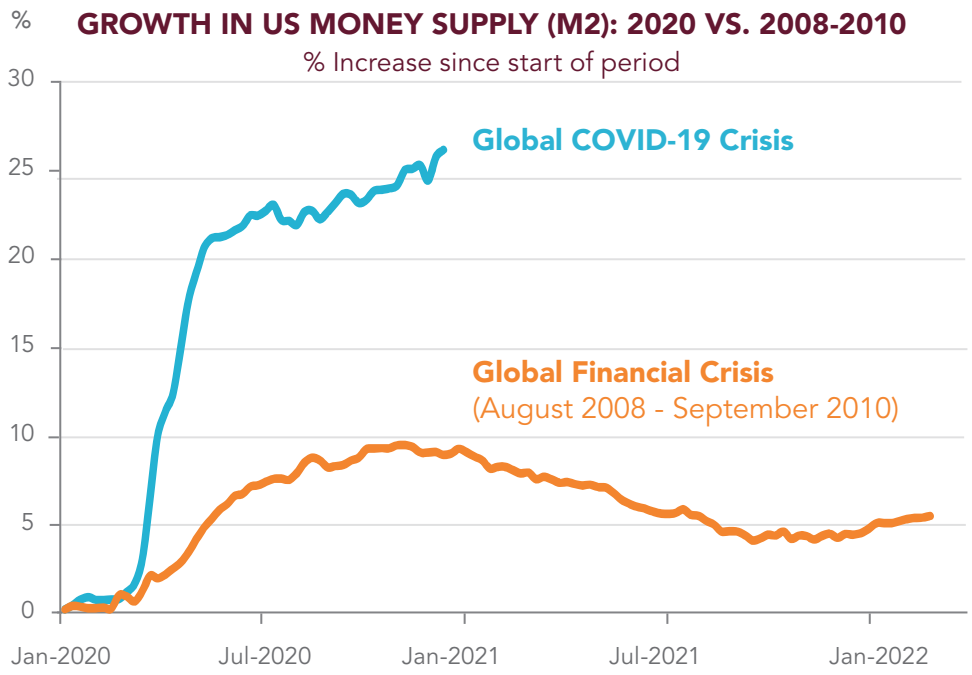
For many years, we have quietly been very active in our efforts in ESG (Environmental, Social and Governance) investing and feel ahead of the curve; to stay there, we will continue to seek innovative ways to meet our clients' priorities. Each investor defines ESG differently and at LNWM we have always taken the view that it is our role to create portfolios that most closely match our clients' definition, to the greatest extent possible. All the asset managers with whom we work have a stated ESG policy even if the underlying portfolios are not invested relative to an ESG benchmark. We have long been invested in renewable power ventures and have recently allocated to several affordable housing projects. You should expect this trend to continue both in the broader market and at LNWM.

IN SUM

We think 2021 will be a year that requires extra levels of vigilance, patience, and preparedness. We are therefore pleased to have the very experienced investment team of Filament LLC joining us, thanks to our recent merger. As our asset size has grown, so has our ability to negotiate with asset managers and other service providers regarding fees and investment offerings. Our team has also grown and we are especially better prepared to analyze and invest in alternative assets, including private market offerings, which will be an expanding area of focus for us in the coming year. Just as important, both LNWM and Filament share similar investment philosophies, including objectivity and independence in all our recommendations to clients.

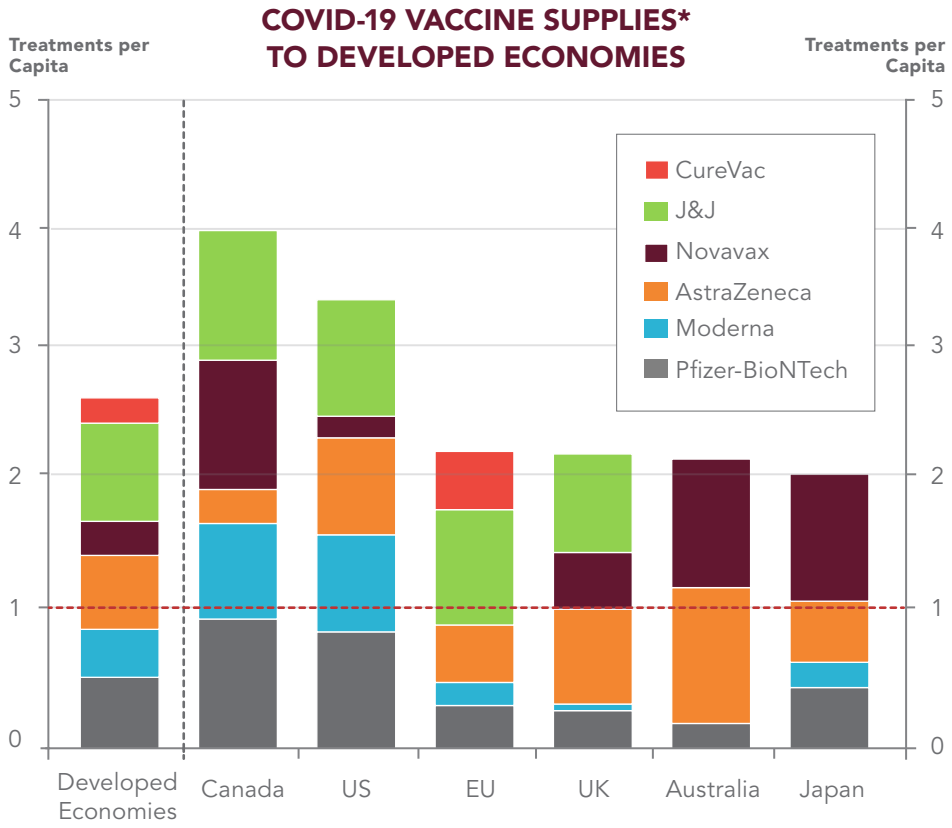
Q1 2021 KEY ECONOMIC DRIVERS

- **Covid-19.** The pandemic and reactions to it have been the key driver of capital markets for the last year. Progress toward a return to normalcy will also drive economic recovery. Vaccines, while giving hope, have proven difficult to administer and have been met with some resistance. Vaccinations will give people the confidence to interact again and will ultimately lead to a more complete economic recovery.
- **Fiscal/Monetary Policy and the US Federal Deficit.** Monetary policy by the Federal Reserve and US government fiscal policy are interrelated and largely driving the growing US federal deficit. A recent Congressional Budget Office report showed a record-high budget as a percentage of GDP, which is likely understated given the newly planned stimulus. Of course, this doesn't take into consideration that the 2017 tax cuts could be partially reversed with the new administration. It is likely that the US federal deficit will see another new record relative to GDP in 2021. Most concerning to us is the lack of a plan to address this going forward. In any event, the increasing deficit is of concern and we think it could cause the value of the US dollar to fall further and inflation to move higher.
- **US Regulatory Policy.** Federal regulation under the Biden administration is likely to change, particularly as it concerns environmental standards. The new administration has been very vocal about reversing many of the changes made during the Trump era. Related to this, we are likely to see some change in corporate tax rates and policy as it seems there is enough support from both sides of the aisle to pass effective legislation regarding this.



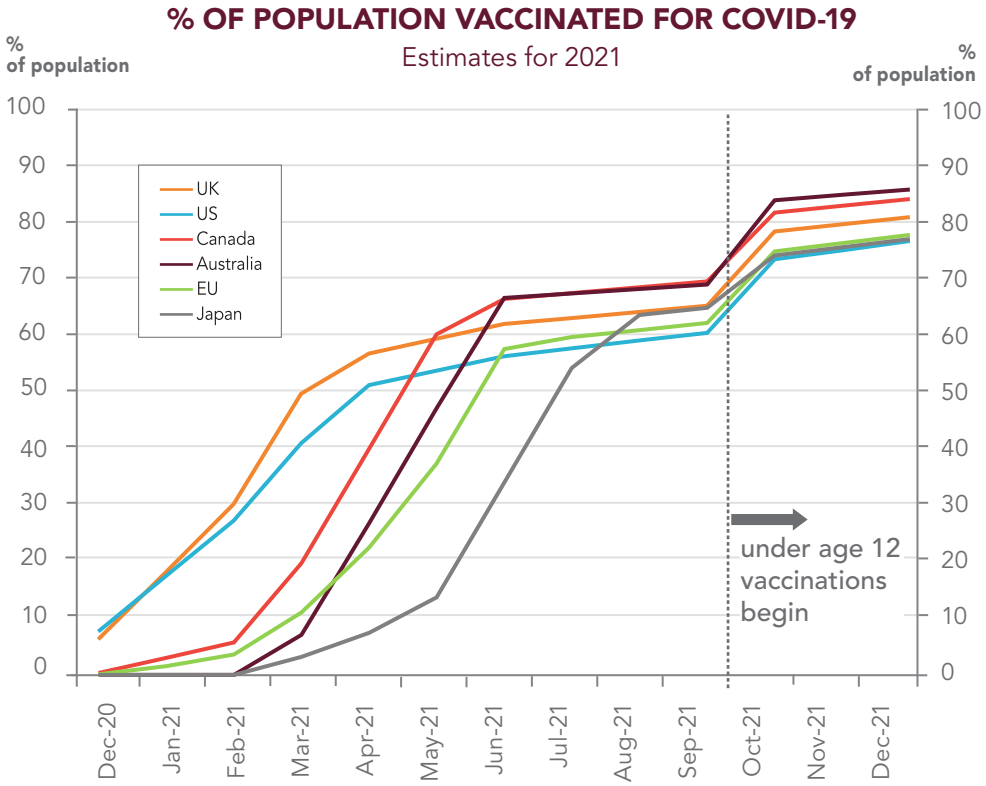
Source of Data: St. Louis Federal Reserve, J.P. Morgan Asset Management.

The amount of support provided by the Federal Reserve and the US government to financial markets and the economy in 2020 has been dramatically higher than during the global financial crisis of 2008. To date, tremendous liquidity remains available – see growth in money supply at left – to fuel the economy and asset prices, as well as inflation.



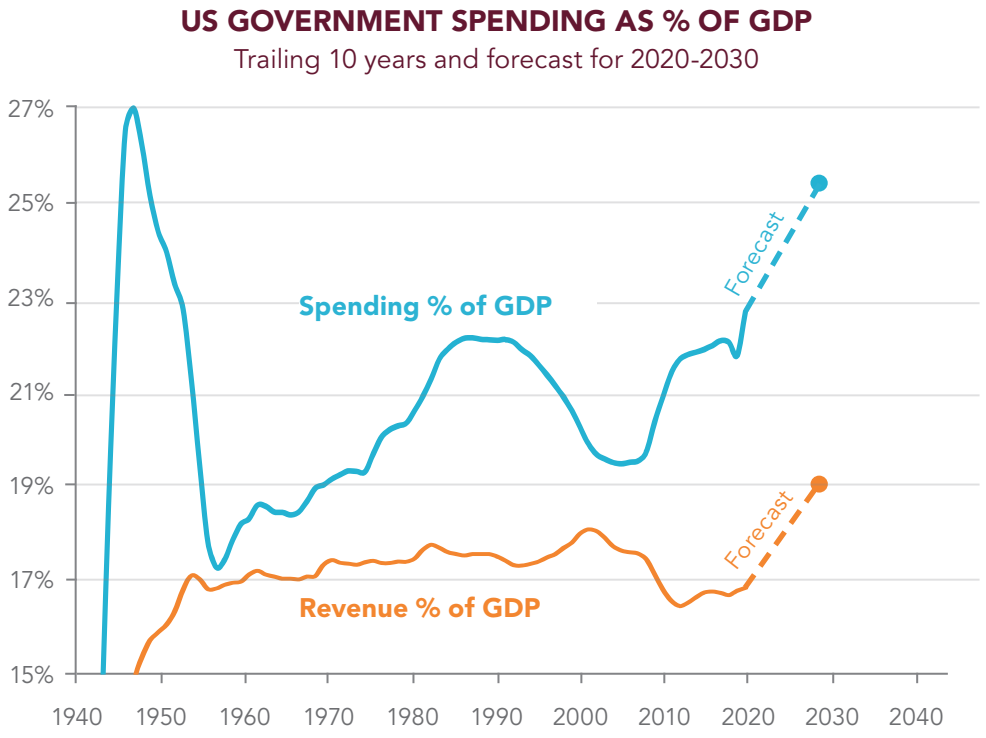
*Based on current and optioned purchases. Treatments are 2 doses per capita apart from J&J which is 1.
Source of Data: iBoxx, Golman Sachs Global Investment Research.

Based on current purchases and options for purchase, there should be sufficient Covid-19 vaccine doses available to the developed economies to vaccinate their populations. The question becomes how quickly and effectively the vaccines can be administered worldwide so the global economy can reopen fully.



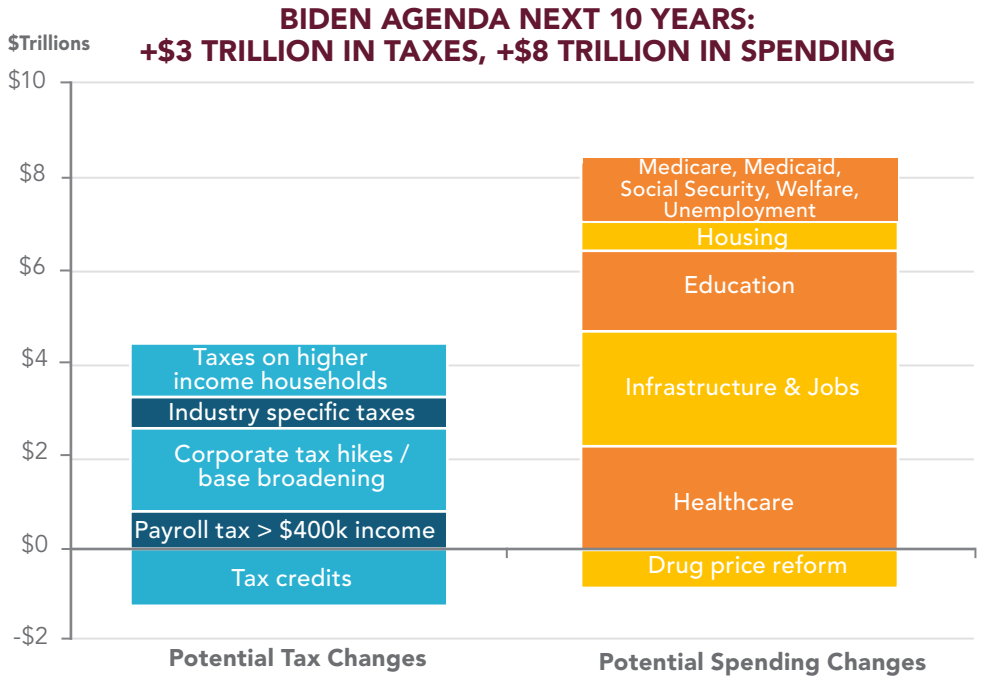
Source of Data: iBoxx, Golman Sachs Global Investment Research.

Current analysis suggests that developed nations should be able to have a majority of their population vaccinated against Covid-19 by the fall of 2021, even if initial vaccine distribution has been slow and disjointed. What this suggests is there are still months of economic constraints ahead of us and that the process of reopening will be gradual.



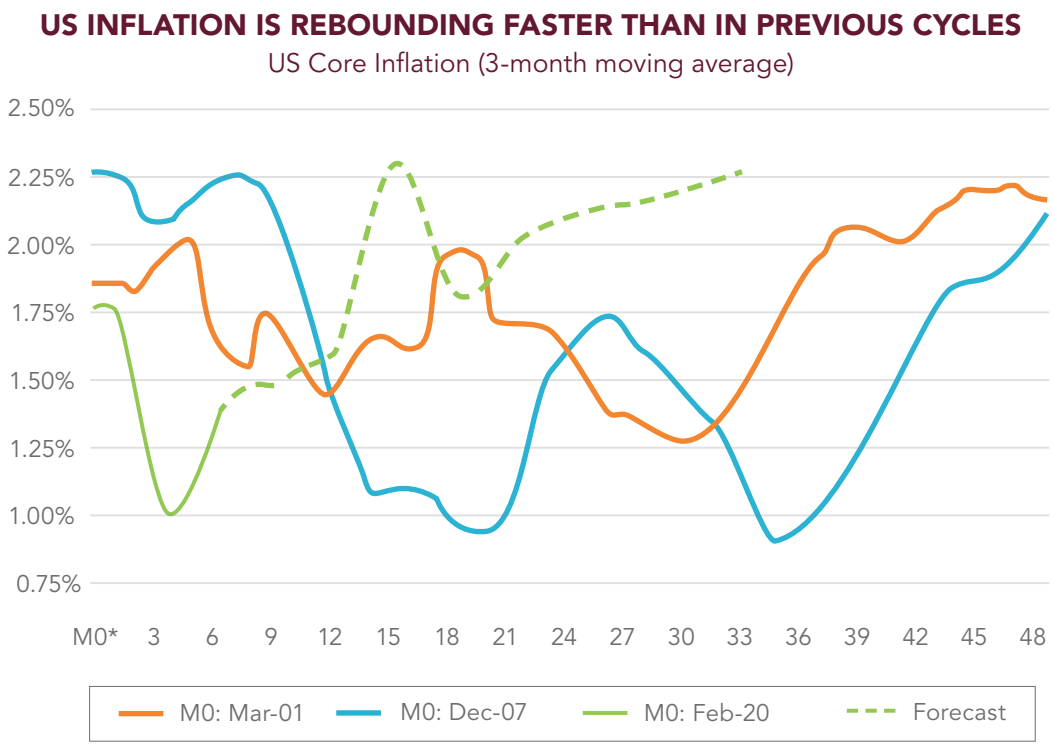
Source of Data: OMB, CBO, Cornerstone Macro Research, J.P. Morgan Asset Management.

US government spending is likely on an unsustainable path as federal revenue is not keeping up with expenditures. The gap between spending and revenue is expected to increase under the Biden administration, which could further stretch the government's long-term ability to borrow at cheap rates and could lead to an inflationary environment.



Source of Data: Cornerstone Macro Research, Tax Policy Center, Tax Foundation, University of Pennsylvania, J.P. Morgan Asset Management.

Current expectations are for sizeable increases in US government spending and taxation in the coming years. While the Democratic Senate wins in Georgia should help increase the probably of some of these policies being enacted, we believe that many proposals will be amended or shelved as a result of difficulty passing them through Congress.



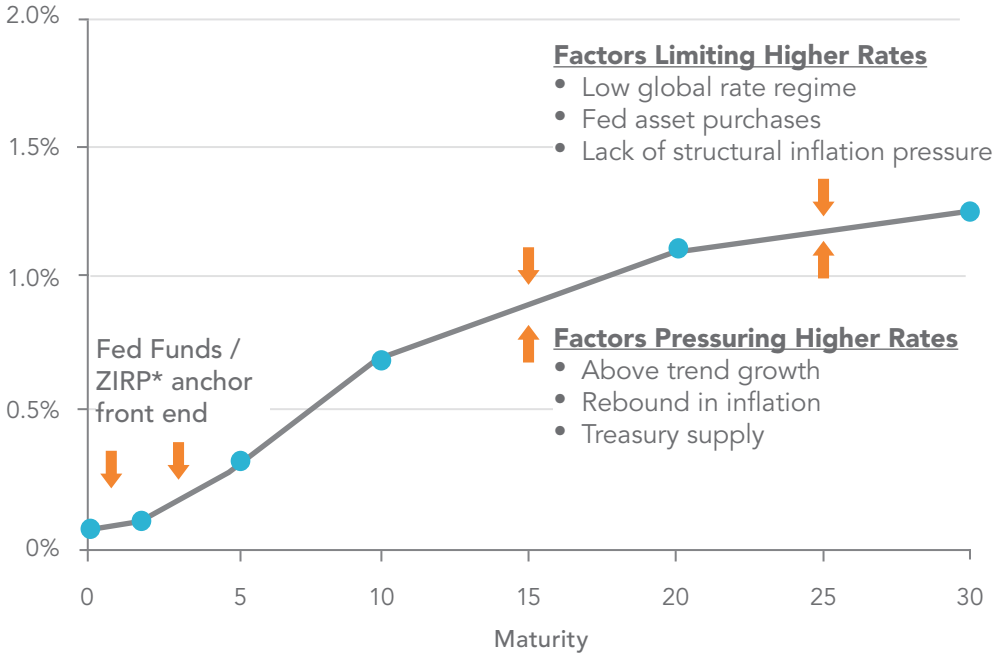
*M0 = Starting month (month zero).

Source of Data: Haver Analytics, Morgan Stanley Research forecasts.

Inflation is one of our top concerns as we head into 2021 and beyond. We believe the herculean level of stimulus we saw in 2020 and future spending measures are likely to accelerate inflation even further and lead to a more inflationary environment than we saw during the recoveries from the last two recessions.

YIELD CURVE FOR US TREASURY BONDS: GETTING STEEPER

As of 12/31/2020

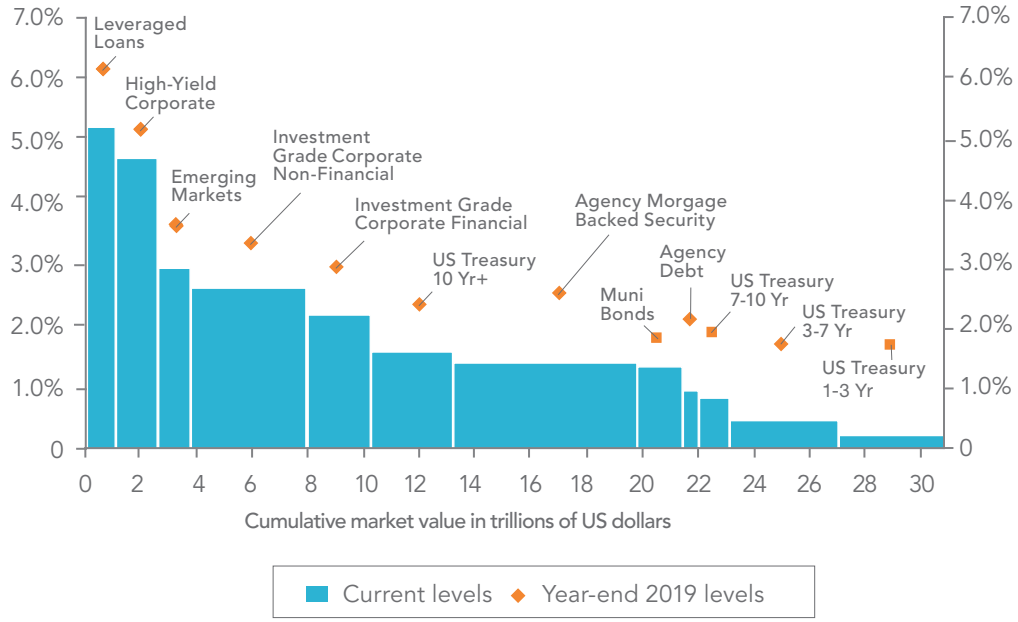


*Zero interest-rate policy.
Source of Data: Bloomberg Barclays and Voya Investment Management.

We anticipate US interest rates will remain low in 2021 but are likely to rise modestly for longer maturities, as accelerated Treasury bond issuance, economic growth and a pickup in inflation put upward pressure on yields. This will be offset to a significant extent by low rates abroad and Fed bond purchases as well as structural changes that prevent US interest rates from achieving escape velocity.

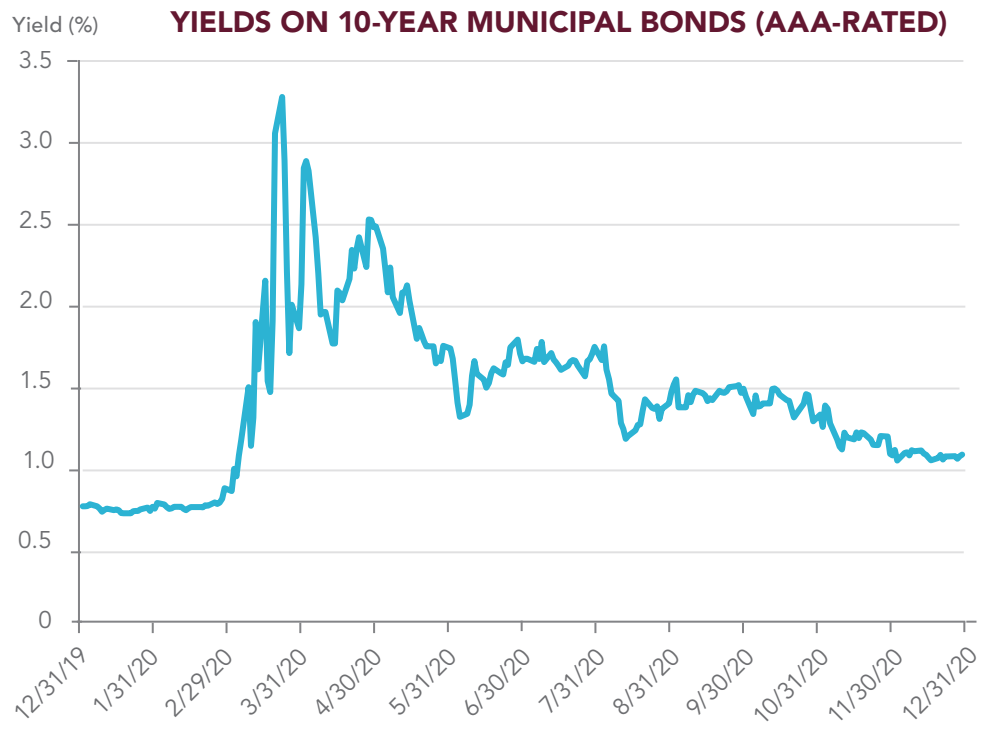
AVERAGE BOND YIELDS AND MARKET VALUATIONS BY SECTOR

For fixed-income issuance in US dollars



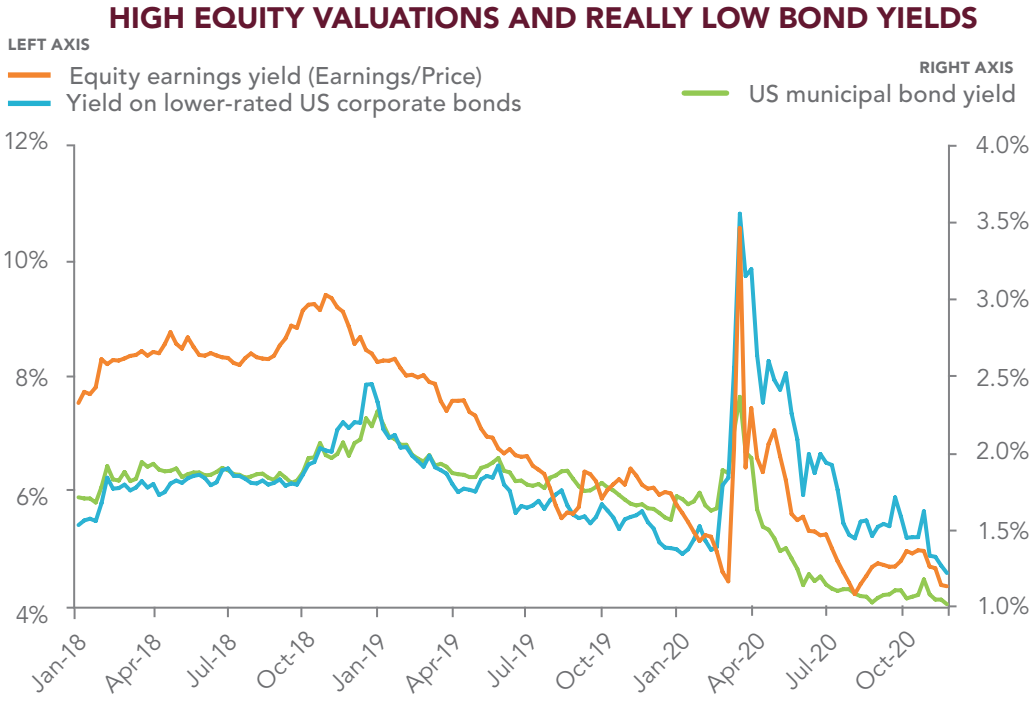
Source of Data: iBoxx, Golman Sachs Global Investment Research.

Yields on most fixed-income investments remain well below their levels at the beginning of 2020. We anticipate demand for both investment-grade and high-yield bonds to remain high, with little relative supply available as suggested by the chart. As such, investors will continue to pursue alternatives to traditional bonds for income.



Source of Data: Bloomberg, MMD.

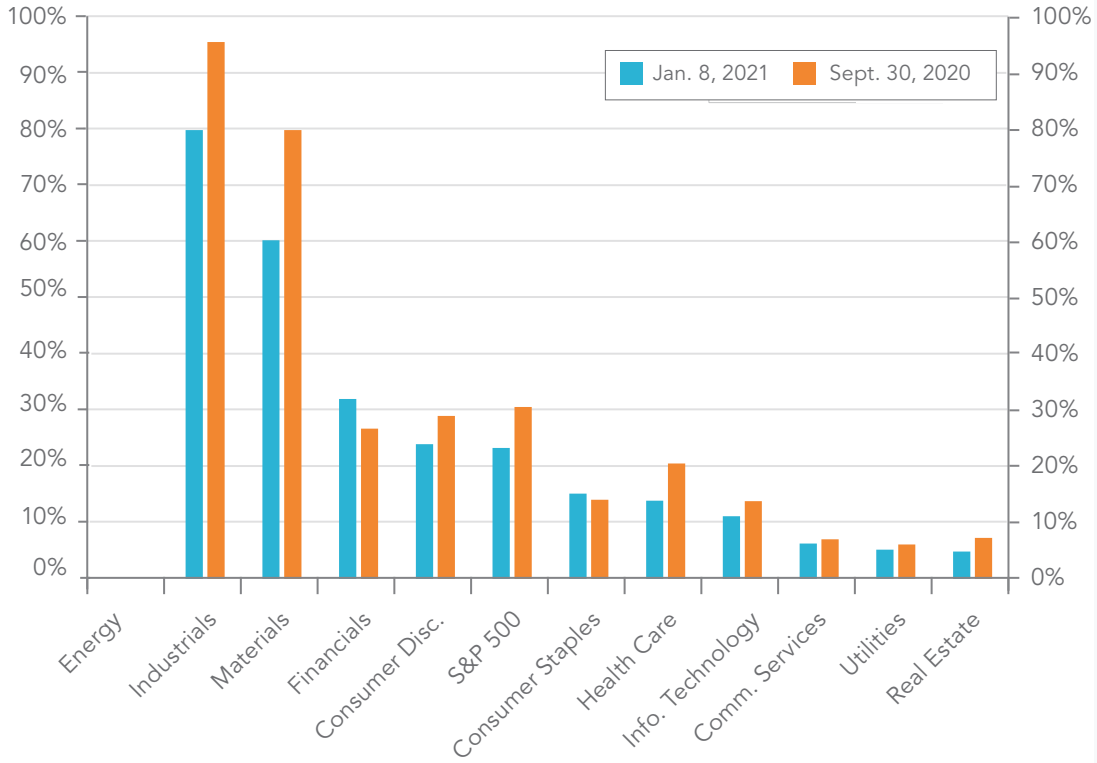
Municipal bond yields spiked early in 2020 as concerns mounted over state and local government budgets. Since the worst forecasts never materialized and additional federal support now appears more likely, the ratio of municipal bond yields to Treasury yields has almost fully normalized, as we anticipated.



Source of Data: Bloomberg Barclays Municipal Bond Index.

Comparing bond yields with equity earnings yields (the inverse of the P/E ratio) we can see how most assets suffered substantial losses in March as those yields all spiked. However, we now find ourselves with yields that have generally compressed to levels lower than they were at the beginning of 2020 (pre-Covid). This is causing some investors to question whether financial markets have gotten ahead of themselves and are due for a pullback.

2021 S&P 500 EARNINGS GROWTH FORECASTS BY SECTOR



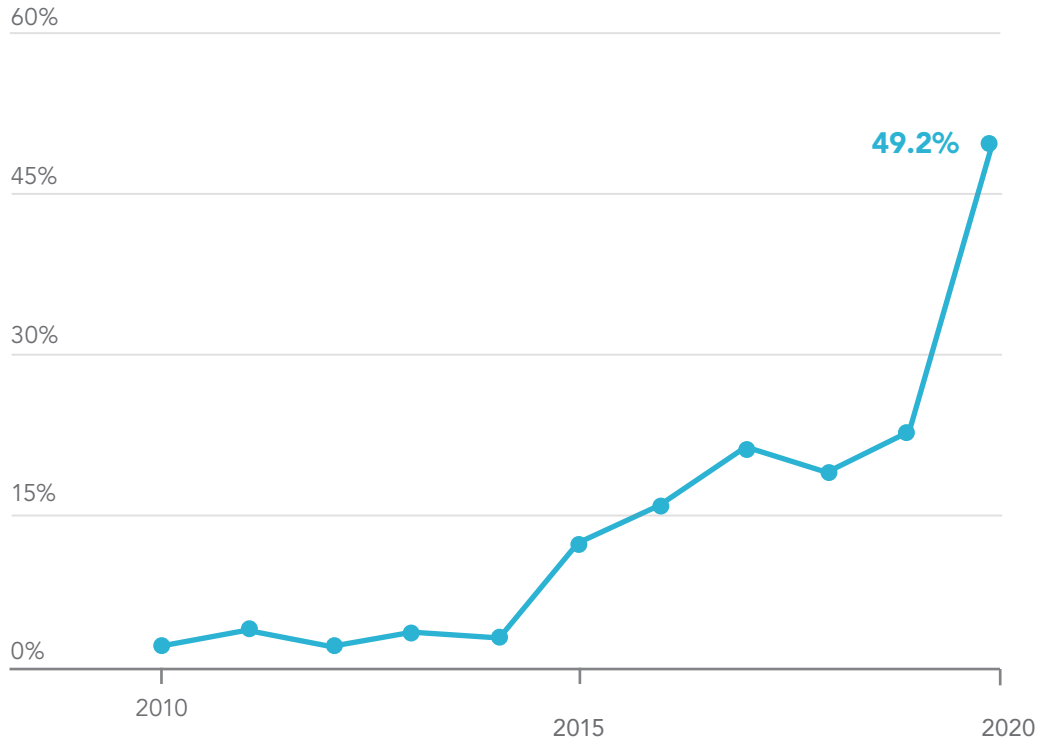
Source of Data: Factset.

While S&P 500 earnings are expected to be down 13% in 2020, a 23% rebound is anticipated by analysts for 2021.

Industries hurt the most by the pandemic and lockdowns are expected to have a significant rebound in earnings as the US economy recovers. Industrials are likely to see the largest rebound in earnings given the destocking of inventory in 2020 that resulted in supply constraints and better pricing during this year.

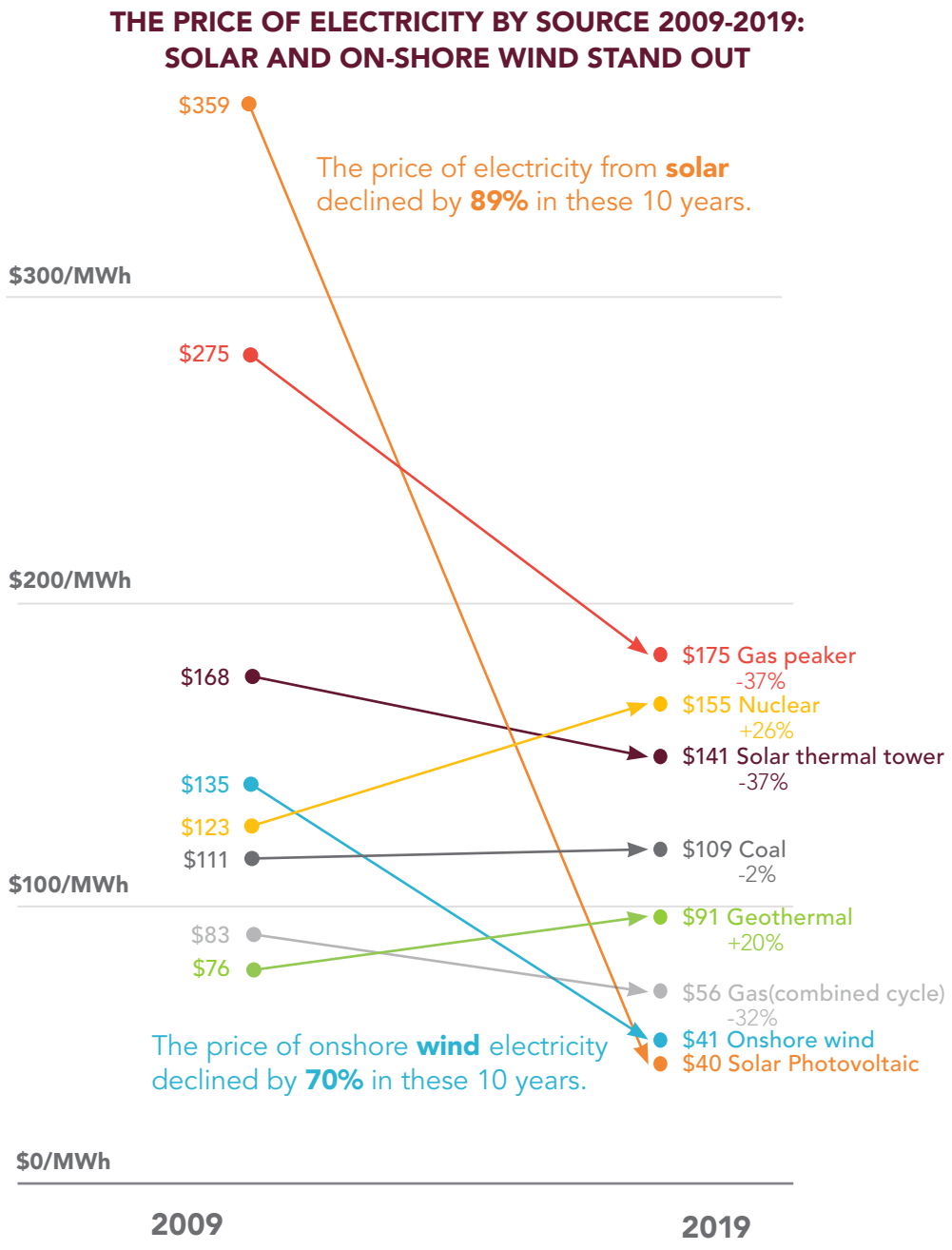
NOTE: The energy sector does not appear in the chart because it posted losses in 2020.

NEARLY HALF OF IPOS IN 2020 WERE SPACS



Source of Data: Dealogic.

Special Purpose Acquisition Vehicles, aka SPACs, have been the top way to take companies public in 2020, bypassing traditional brokerage houses that would promote IPOs to institutional investors. While our investment in these vehicles has been rather limited, the increased opportunity set for many of our small-cap managers has produced some outsized returns in some cases. We believe SPACs could produce meaningful opportunities in 2021 and beyond as many private companies go public and have additional access to capital in order to grow their business.

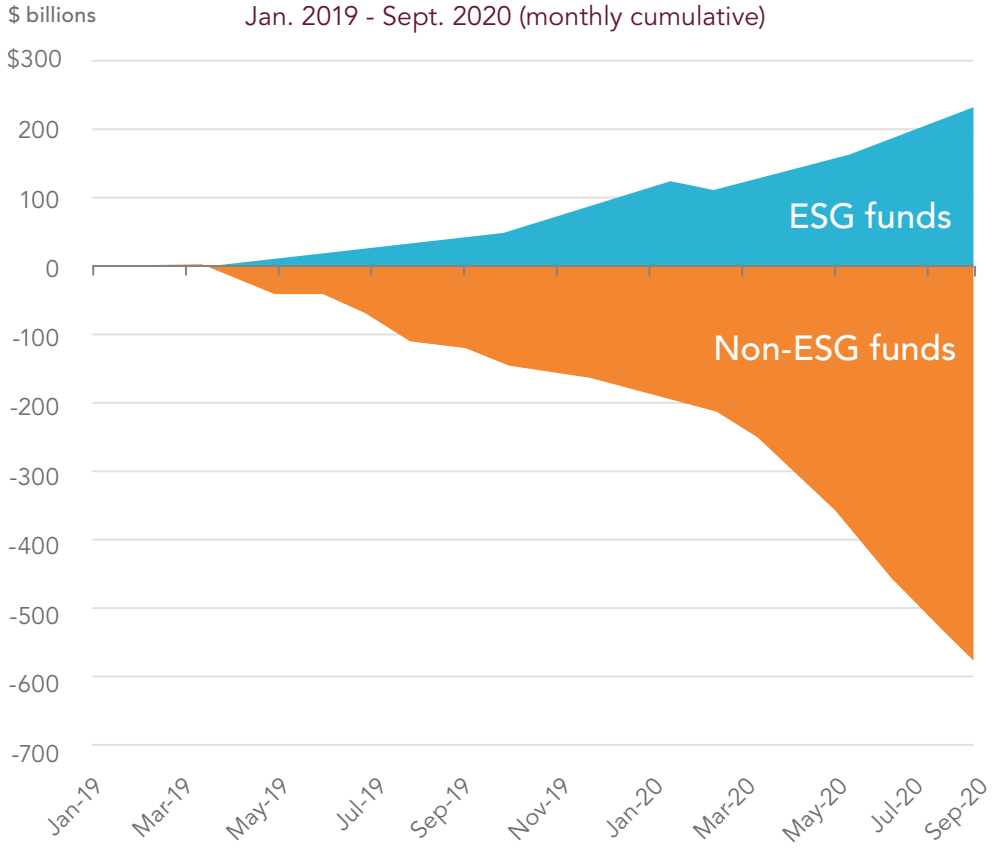


Source of Data: Roser, Max. "Why Did Renewables Become so Cheap so Fast?", OurWorldinData.org, 1 Dec. 2020.

As the production of solar panels and wind turbines increased over the past decade, renewable energy prices have dramatically dropped. Despite the pandemic, it is projected that renewables accounted for 90% of new capacity added globally in 2020. We believe renewable power investments today stand as much on their attractive financial fundamentals as on their ESG principles.

MONEY FLOWS INTO ESG VS. NON-ESG EQUITY FUNDS

Jan. 2019 - Sept. 2020 (monthly cumulative)



Source of Data: Goldman Sachs and Morningstar.

There have been significant outflows from non-ESG mutual funds during the past two years. Meanwhile, ESG funds have seen tremendous growth as investors become more concerned about how their money is invested and whether it is making a difference for social issues such as climate change, women's rights, and/or minority board representation. We view this as a long-term trend that is likely accelerating with strong ESG capabilities being a necessity for investment fund managers.

A DIVERSIFIED PORTFOLIO CAN WORK WELL EVEN THOUGH IT NEVER FEELS GOOD

(40% US stocks, 10% foreign stocks, 5% small-cap stocks, 5% emerging market stocks, 30% US high-quality bonds, 10% high-yield bonds)

Years	S&P 500	Diversified Portfolio
2000 - 2002	-18.4%	-6.8%
2003 - 2007	82.9%	80.1%
2008	-37.0%	-24.0%
2009 - 2019	351.0%	195.9%
1/1/2020 - 3/23/2020	-30.4%	-20.7%
3/24/2020 - 9/30/2020	51.8%	30.0%
Total Return	247.1%	253.5%
Growth of $100K	$347,100	$353,530

Source of Data: Blackrock.

In strong equity bull markets, investors with a diversified portfolio (see definition in the chart) may feel some FOMO when looking at stock returns. Likewise in a bear market, although their portfolio held up better, investors likely feel upset at losses. However, over the long run, a diversified portfolio can outperform stocks, even when it doesn't feel like it!

THE BENEFITS OF DIVERSIFICATION

Total return by asset category relative to a diversified* allocation.

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	15-Year Annualized Return	15-Year Annualized Volatility#
Best Performance	MSCI EM 34.00%	Global REITs 42.35%	MSCI EM 39.42%	10yr Treas 20.06%	MSCI EM 78.51%	US Small Cap 26.85%	10yr Treas 17.15%	Global REITs 28.65%	US Small Cap 38.82%	Global REITs 15.89%	Muni Bonds 2.45%	US Small Cap 21.31%	MSCI EM 37.28%	Muni Bonds 1.64%	US Large Cap 31.43%	US Large Cap 20.96%	US Large Cap 10.07%	MSCI EM 21.75%
	COMM. 21.36%	MSCI EM 32.14%	COMM. 16.23%	US Bonds 5.24%	Global REITs 38.26%	Global REITs 20.40%	US Bonds 7.84%	MSCI EM 18.22%	US Large Cap 33.11%	US Large Cap 13.24%	US Large Cap 0.92%	US Large Cap 12.05%	MSCI EAFE 25.03%	US Bonds 0.01%	US Small Cap 25.52%	US Small Cap 19.96%	US Small Cap 8.91%	US Small Cap 20.34%
	Global REITs 15.35%	MSCI EAFE 26.34%	MSCI EAFE 11.17%	Muni Bonds 4.23%	MSCI EAFE 31.78%	MSCI EM 18.88%	Muni Bonds 7.62%	MSCI EAFE 17.32%	MSCI EAFE 22.78%	10yr Treas 10.72%	10yr Treas 0.91%	COMM. 11.77%	US Large Cap 21.69%	10yr Treas -0.03%	Global REITs 23.06%	MSCI EM 18.31%	MSCI EM 6.59%	Global REITs 19.89%
	MSCI EAFE 13.54%	US Small Cap 18.37%	Diversified 10.91%	Illiquid HF -19.03%	US Large Cap 28.43%	COMM. 16.83%	US Large Cap 1.50%	US Large Cap 16.42%	Diversified 15.60%	US Bonds 5.97%	US Bonds 0.55%	MSCI EM 11.19%	Diversified 17.29%	Global REITs -4.74%	MSCI EAFE 22.01%	Diversified 12.50%	Diversified 6.50%	MSCI zEAFE 17.47%
	Diversified 10.39%	Diversified 17.36%	Illiquid HF 9.95%	Liquid HF -23.25%	Diversified 27.48%	US Large Cap 16.10%	Diversified -3.56%	US Small Cap 16.35%	Illiquid HF 9.14%	US Small Cap 4.89%	Global REITs 0.05%	Diversified 7.11%	US Small Cap 14.65%	Illiquid HF -4.75%	Diversified 19.53%	Illiquid HF 11.61%	Global REITs 5.16%	COMM. 16.48%
	Illiquid HF 9.27%	US Large Cap 15.46%	10yr Treas 9.76%	Diversified -30.77%	US Small Cap 27.17%	Diversified 12.00%	US Small Cap -4.18%	Diversified 12.54%	Liquid HF 6.73%	Muni Bonds 4.66%	MSCI EAFE -0.81%	Illiquid HF 5.46%	Global REITs 11.42%	US Large Cap -4.78%	MSCI EM 18.42%	10yr Treas 10.58%	10yr Treas 4.75%	US Large Cap 15.45%
	US Large Cap 6.27%	Illiquid HF 12.89%	US Bonds 6.97%	US Small Cap -33.79%	Illiquid HF 20.01%	Illiquid HF 10.24%	Illiquid HF -5.25%	Illiquid HF 6.37%	Global REITs 4.39%	Diversified 3.79%	Illiquid HF -1.11%	Global REITs 4.99%	Illiquid HF 8.58%	Liquid HF -6.74%	Illiquid HF 10.48%	MSCI EAFE 7.82%	US Bonds 4.74%	Diversified 11.76%
	US Small Cap 4.55%	Liquid HF 9.25%	US Large Cap 5.77%	COMM. -35.65%	COMM. 18.91%	10yr Treas 7.90%	Global REITs -5.82%	US Bonds 4.21%	Muni Bonds -0.32%	Illiquid HF 2.98%	Diversified -2.23%	US Bonds 2.65%	Liquid HF 5.98%	Diversified -7.07%	10yr Treas 8.91%	US Bonds 7.51%	Illiquid HF 4.49%	10yr Treas 6.95%
	Liquid HF 2.72%	US Bonds 4.33%	Muni Bonds 4.79%	US Large Cap -37.60%	Liquid HF 13.40%	MSCI EAFE 7.75%	Liquid HF -8.88%	10yr Treas 4.18%	US Bonds -2.02%	Liquid HF -0.57%	Liquid HF -3.64%	Liquid HF 2.51%	US Bonds 3.54%	US Small Cap -11.01%	US Bonds 8.72%	Liquid HF 6.80%	MSCI EAFE 4.48%	Illiquid HF 6.61%
	US Bonds 2.43%	Muni Bonds 3.74%	Liquid HF 4.24%	MSCI EAFE -43.38%	Muni Bonds 7.18%	US Bonds 6.54%	MSCI EAFE -12.14%	Muni Bonds 3.56%	MSCI EM -2.60%	MSCI EM -2.19%	US Small Cap -4.41%	MSCI EAFE 1.00%	Muni Bonds 3.49%	COMM. -11.25%	Liquid HF 8.63%	Muni Bonds 4.23%	Muni Bonds 3.71%	Liquid HF 5.68%
	10yr Treas 1.99%	COMM. 2.07%	US Small Cap -1.57%	Global REITs -47.72%	US Bonds 5.93%	Liquid HF 5.19%	COMM. -13.32%	Liquid HF 3.51%	10yr Treas -7.83%	MSCI EAFE -4.90%	MSCI EM -14.92%	Muni Bonds -0.10%	10yr Treas 2.07%	MSCI EAFE -13.79%	COMM. 7.69%	COMM. -3.12%	Liquid HF 1.12%	US Bonds 3.19%
Worst Performance	Muni Bonds 1.67%	10yr Treas 1.36%	Global REITs -6.96%	MSCI EM -53.33%	10yr Treas -9.71%	Muni Bonds 3.13%	MSCI EM -18.42%	COMM. -1.06%	COMM. -9.52%	COMM. -17.01%	COMM. -24.66%	10yr Treas -0.16%	COMM. 1.70%	MSCI EM -14.57%	Muni Bonds 5.63%	Global REITs -8.18%	COMM. -4.01%	Muni Bonds 2.85%

*Diversified asset allocation: 25% U.S. Large Cap Equities; 10% U.S. Bonds; 10% U.S. Municipal Bonds; 13% Hedge Funds (6.5% Absolute Returns, 6.5% Market Directional); 22% Int'l Developed Equities; 5% U.S. Small Cap Equities; 9% Emerging Markets Equities; S&P Global Infrastructure 4%; Commodities 2%

Past performance is no guarantee of future results. Data as of 12/31/2020. Returns are for period and index indicated (see Disclosures page for index definitions). "Diversified Allocation" returns assume monthly rebalancing.

Source of Data: Morningstar, Hedge Fund Research.

The chart above highlights annual returns on a diversified portfolio consisting of the asset classes noted in the footnote, for each year from 2005 to 2020 (as of December 31, 2020). The last two columns show 15-year annualized returns and price volatility for the diversified portfolio as well as for the asset classes. Sought out as safe havens amid the uncertainty posed by Covid-19, we've seen the dramatic resurgence of large-cap US equities, with the US tech giants leading the way during the first half of the year. As successful vaccine trials with high levels of effectiveness were announced, cyclical stocks that lagged during the first half of 2020 began to outperform, particularly in the fourth quarter.

ABOUT THE AUTHOR

Gino Perrina, Ph.D., CFA is the Chief Investment Officer at Laird Norton Wealth Management and has more than 15 years of experience in investment analysis, strategy and risk management. Prior to joining LNWM in November 2015, Gino was a Managing Director at BlackRock Inc. in New York City, responsible for managing risk in the firm's alternative asset portfolios (+$100 billion in total investment). He was also Managing Director of Research and Risk Management at BlackRock Alternative Advisors (2006 to 2010), Head of Fixed Income Research at Russell Investments (2010 to 2012) and a fixed income analyst and portfolio manager at Microsoft and IAC/InterActive Corp.

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