Q2 2021 Economic Outlook

By CIO Gino Perrina & LNWM Investment Strategy & Research

SINGING IN THE RAIN

> “A banker is a fellow who lends you his umbrella when the sun is shining but wants it back the minute it begins to rain.”
>
> **– Mark Twain**

I'm a regular reader of *The Economist* magazine, which recently featured this headline: 'America's boom has begun. Can it last?' There's little doubt about the first part of the headline. Recent economic data have been incredibly robust, demonstrating that the pace of recovery in the US has accelerated. Because the US consumer represents nearly 70% of US GDP, the employment picture can often have market-moving implications; the most recent monthly report showed more than 900,000 new jobs were created in March 2021. That is impressive one-month progress toward full employment, even though there are still eight million fewer people working relative to pre-pandemic levels. Other US data relating to manufacturing and retail sales have been equally surprising, positively.

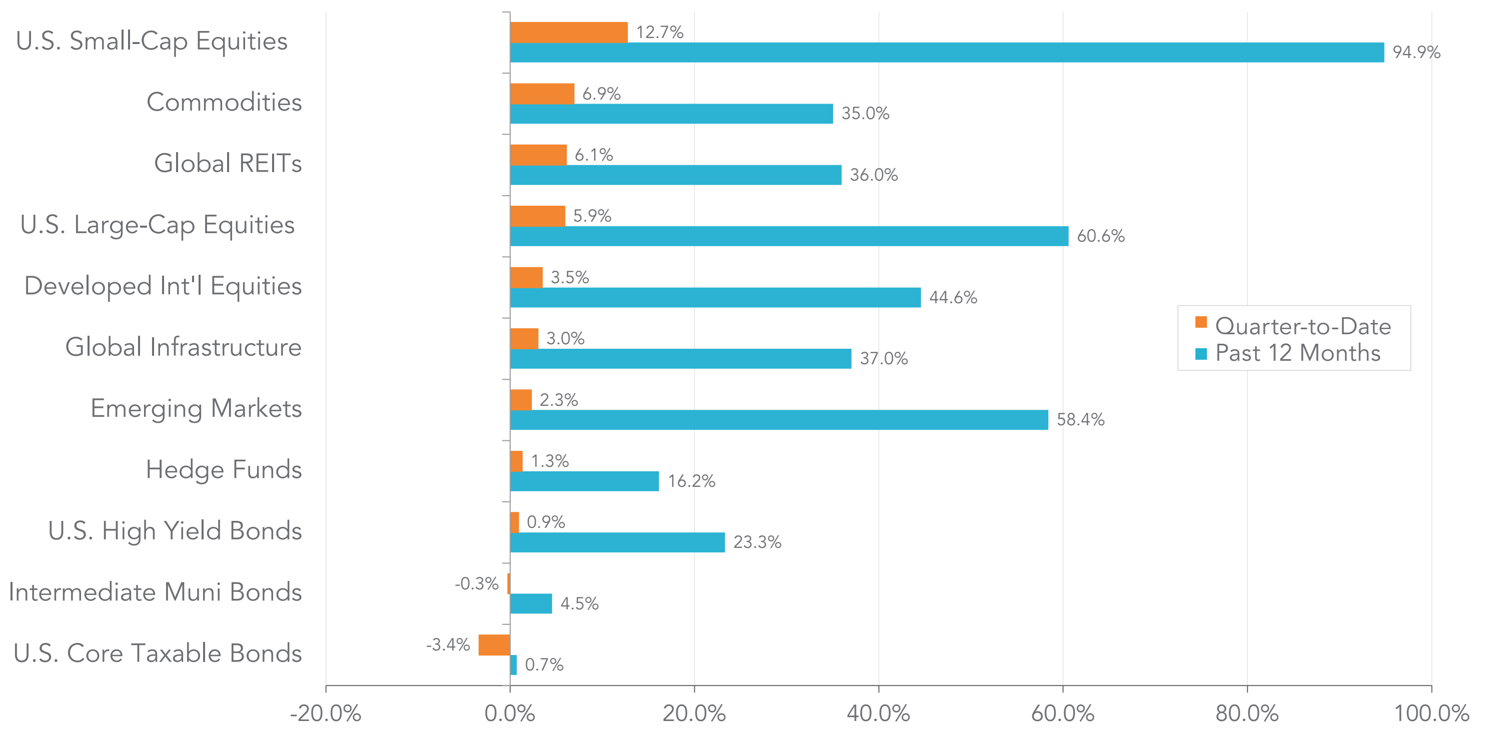
Underpinning all this: signs we may be seeing the beginning of the end of the worst pandemic in over a century, thanks to the record-breaking development of multiple vaccines now being broadly administered. We are certainly on a favorable pace toward herd immunity here in the US, although progress is not equal across the globe.

Can the boom last? Our short answer to this is yes, for the time being. But we are long-term investors, and we see significant risks associated with the extraordinary measures taken to make the economic rebound possible. Let's take a look at how we arrived at this point and the specific risks associated with the current progress.

HOW WE GOT HERE

Along with the vaccines, both the Trump and Biden administrations administered fiscal stimulus that is many multiples higher than what was applied during the 2008 financial crisis. In past Outlooks, we have acknowledged the necessity of debt-fueled spending during a pandemic, while also expressing concern over the level of stimulus being applied and subsequent levels of new US debt.

We are not alone in our concern. Larry Summers, a top economic adviser in the past two Democratic administrations, recently said: “These are the least responsible fiscal macroeconomic policies we've had for the last 40 years.” He went on to describe current policy as having a high probability of driving inflationary risks, which could lead the Federal Reserve to tighten monetary policy.



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

In March, the checks for the Biden administration's $1.9 trillion stimulus plan had yet to be sent when discussions began on a $1.9 trillion infrastructure bill to be paid for mostly by higher corporate taxes over the next 15 years. Details are scarce so far, but this certainly demonstrates the appetite of government officials to increase spending on priority areas — from climate change to social equity/justice — even though the federal deficit has already ballooned due to the pandemic and the 2017 tax cuts.

For now, the prospect of the US economy digging itself out of the hole the pandemic created outweighs inflation fears. Another positive: direct infrastructure investment has one of the highest multiplier effects on the economy, although the estimated range of impact is wide, per the Congressional Budget Office. Because the proposed infrastructure program seems to include spending that is not historically considered infrastructure, these figures could be off. However, most types of government spending have significant multiplier effects and the range of impact is not all that different for each. This isn't to say that government spending is the perfect cure for an ailing economy. Economists generally agree that government spending is effective only on a short-term basis and not sustainable since it will require higher interest payments that will create a headwind for future budgets.

INTEREST RATES ARE KEY

In our view, the greatest risk to the current economy and the markets is rising interest rates, be it from inflationary pressures, a loss of confidence in US government-backed debt, or a domestic crisis. For the

Source of Data: Congressional Budget Office, February 2015; J.P. Morgan.

last 40 years, rates have declined steadily, providing fuel to the fire of increasing asset prices – the recent housing market data is certainly an example.

Since the onset of the pandemic, the Federal Reserve has been resolute in their determination to keep US interest rates low by keeping the Fed funds rate near zero and buying $120 billion worth of fixed-income securities each month. Despite this, US bond yields have been rising: The yield on the US 10-year Treasury was recently 1.67%, up from 0.92% at year-end and 0.52% last August.

Fed Chair Powell has said he is not concerned about the increase in bond yields or inflation, seeing this as temporary and contained. However, the US could approach full employment in the coming year and an inflation level above 2% (vs. 1.7% recently). When one combines these developments with a growing US deficit and subsequent Treasury bond issuance, it's difficult to take a forward-looking view that bond yields will fall from here.

While we do not take a short-term position on the direction of rates (or markets), we do generally assess risks associated with the various asset classes. A key concern is that at some point the Federal Reserve 'takes the umbrella back' driving yields higher and putting current asset price levels at risk. Asset prices, including equities, are somewhat dependent on bond yield levels. Because yields are still very low, the additional return investors require to invest in stocks vs. bonds (the "equity risk premium") is about average now. This implies that equities might not be too overvalued despite the price-earnings ratio for the S&P 500 being historically high at 22 vs. a 10-year average of 16. However, low interest rates are unlikely to last forever and this implies lower expected returns going forward.

Asset prices, including equities, can climb when bond prices are falling and yields are rising, as economic growth and prospects for higher corporate earnings boost stock prices and offset the rise in yields. The question now is how much growth is already priced in at current levels, with the financial markets already having rebounded and looking beyond Covid. As I've already said, we don't attempt to time markets and it is impossible to know when bond yields will move higher. However, we are definitely cognizant of the risks associated with higher yields as we make allocation decisions.

WHAT WE'VE DONE/ARE DOING

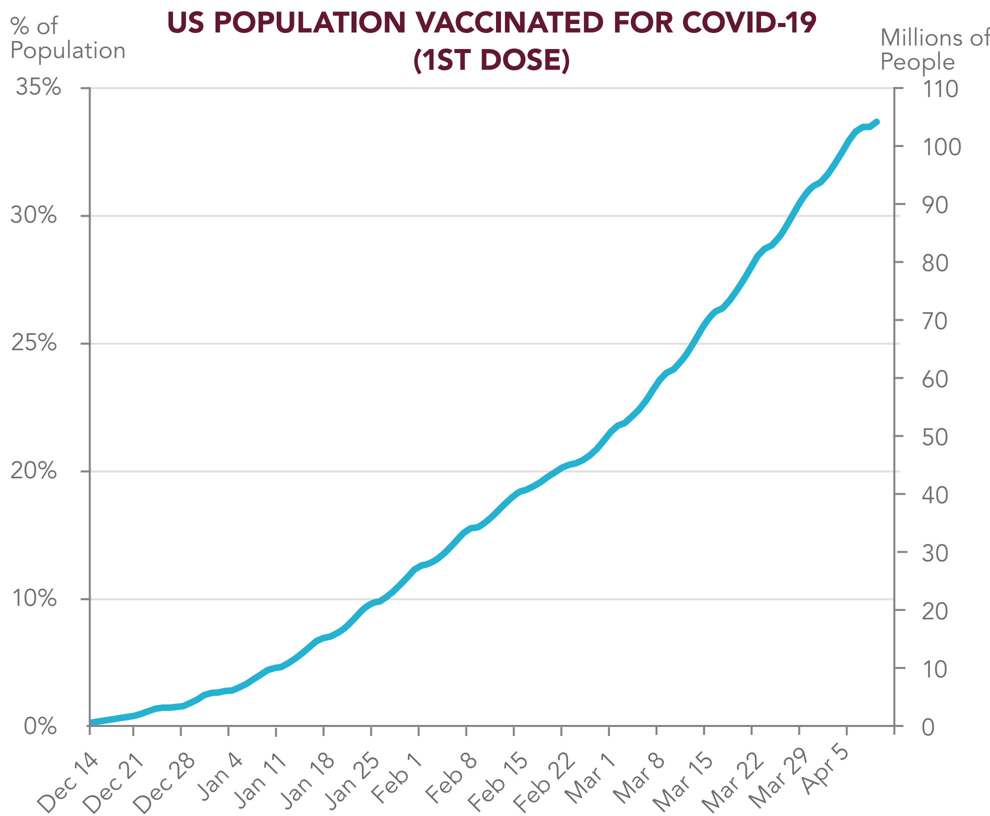
Coming out of 2020, we made several asset allocation changes that have proven beneficial to client portfolios. Since then, our focus has been on several new private market opportunities given our outlook that stock market returns are likely less strong from here on out. We have also been expanding our sustainable investing offerings, an area that is becoming increasingly important for our clients.

Looking forward, we are concentrating on how best to mitigate risks brought on by inflation and subsequent rising interest rates, should those trends materialize. To be clear, LNWM portfolios already include assets we expect to perform well in an inflationary environment, and we want to be ready to adjust these positions based on market developments.

Our investment philosophy has remained consistent during a year that is likely to have long-term consequences for how we live and work. Investing is still about meeting long-term risk and return targets despite market trends that are often murky or unclear. We continue to believe that the key to success is objective, independent decision-making and well-diversified portfolios, especially during periods of major economic transition, such as now.

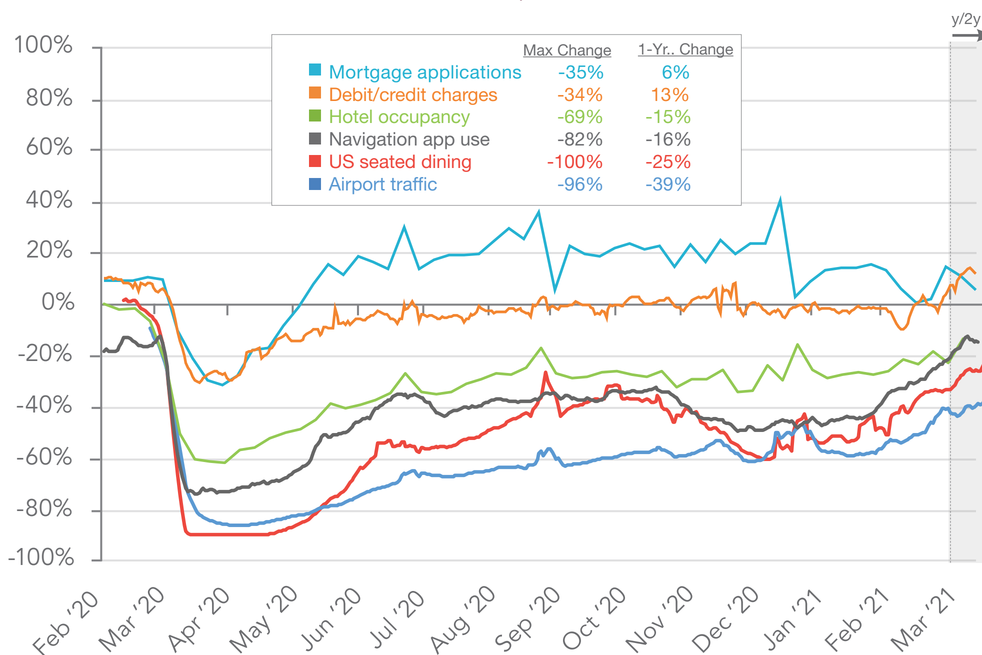
Q2 2021 KEY ECONOMIC DRIVERS

- **Inflation/Interest Rates –** We view higher US interest rates as the greatest risk to the current economic trend. Higher rates can be driven by multiple factors, one of which is inflation. Thus far, central banks have not expressed any fears regarding forward-looking inflation risks but that could change quickly. Alternatively, the current increase in inflation could prove to be transitory as government spending slows and supply bottlenecks get resolved. Regardless of reason or tenure, inflation and thereby interest rates will be a key focus in 2021.
- **Covid-19 –** We hope this is the last quarter we have to list this as a major US economic driver and that the efficacy of the vaccines proves reliable enough to begin the reopening of economies globally. While US unemployment is falling as the number of vaccinated people increases, the current economic trend is dependent on an eventual defeat of Covid-19 here and abroad.
- **US Tax Policy –** President Biden has clearly indicated a desire to increase taxes to partially pay for his administration's infrastructure plan. About two-thirds of the new tax revenue would come from corporations and one-third from individual taxpayers in the upper tax brackets. The Biden proposals would effectively reverse the 2017 corporate tax cuts. Current analysis suggests this would reduce S&P 500 earnings 8% to 9% but details are yet to be worked out so this could change significantly.



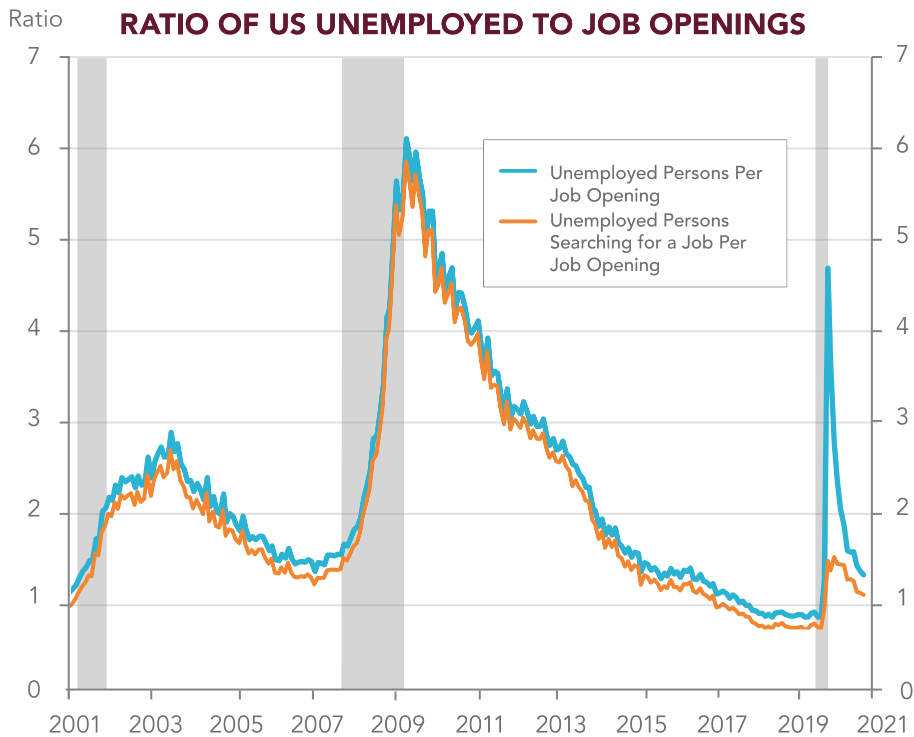
Source of Data: Our World in Data, Department of Health and Human Services, Goldman Sachs Global Investment Research.

Rapid progress in administrering Covid-19 vaccines to the US population continues, with more than 3 million doses now being given daily. With roughly a third of the population having received their first dose by early April, the US is on pace to achieve herd immunity sometime this summer, assuming more virulent Covid-19 variants do not emerge.



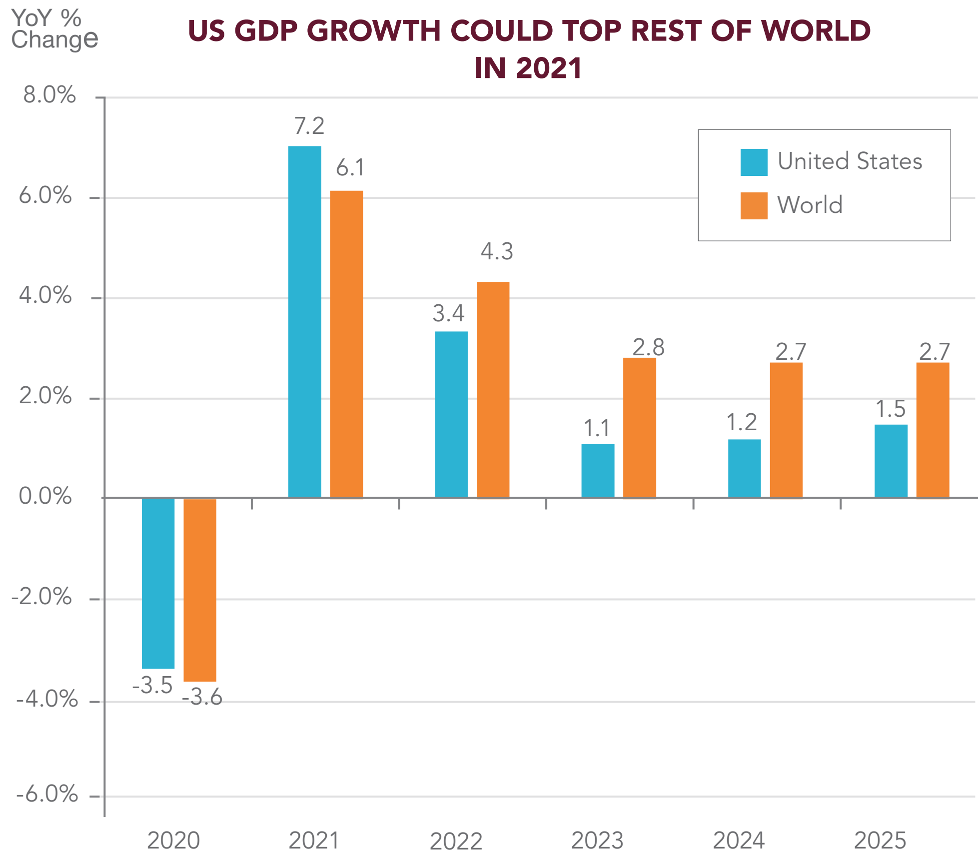
Source of Data: App Annie, Chase, Mortgage Bankers Association (MBA), OpenTable, STR, Transportation Security Administration (TSA), J.P. Morgan Asset Management.

The chart at left shows the impact of the COVID crisis on "high-frequency" economic data, showing change for one year to March 15, 2021 and two-year change after that to smooth out any base effects. The Federal Reserve's lowering of interest rates increased demand for mortgages and consumer credit, both of which have recovered fully. More heavily impacted travel and dining statistics show recent improvement but remain far below pre-COVID levels.



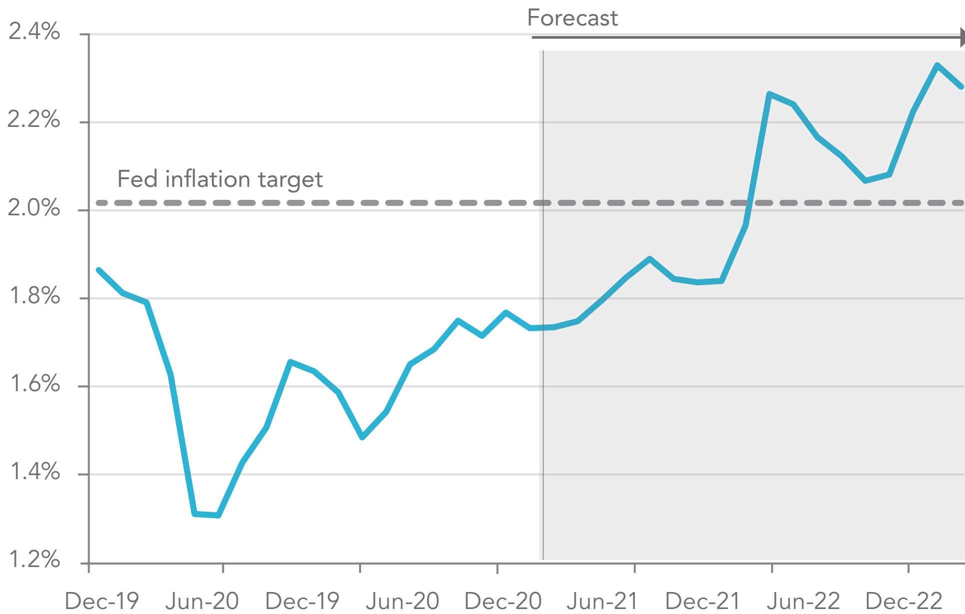
Source of Data: Department of Labor, Goldman Sachs Global Investment Research.

Headline unemployment continues to drop and was recently at 6%, while broader jobless measures that include underemployed and discouraged workers were close to 11%. Compared to past economic recovery periods, there are now many more job openings relative to people unemployed, indicating there are potentially more opportunities for jobseekers and further labor market repair ahead.



Source of Data: Oxford Economics.

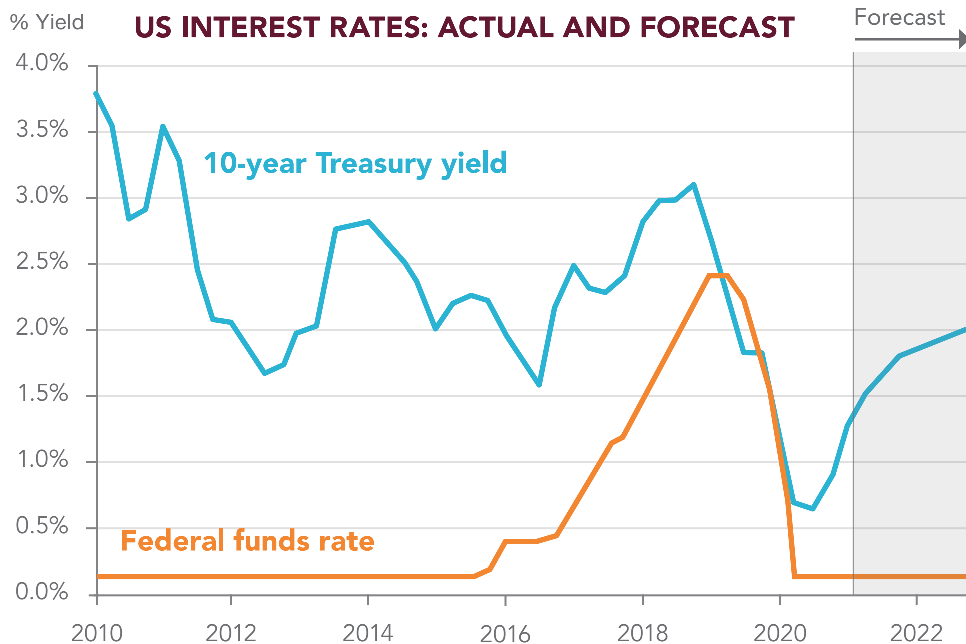
GDP declined sharply in both the US and the rest of the world last year. But 2021 is expected to show a rapid recovery that continues into 2022 before returning to longer-term trends, including stronger growth overseas, especially in emerging markets.



Source of Data: BEA, BLS, Haver Analytics, Morgan Stanley Research.

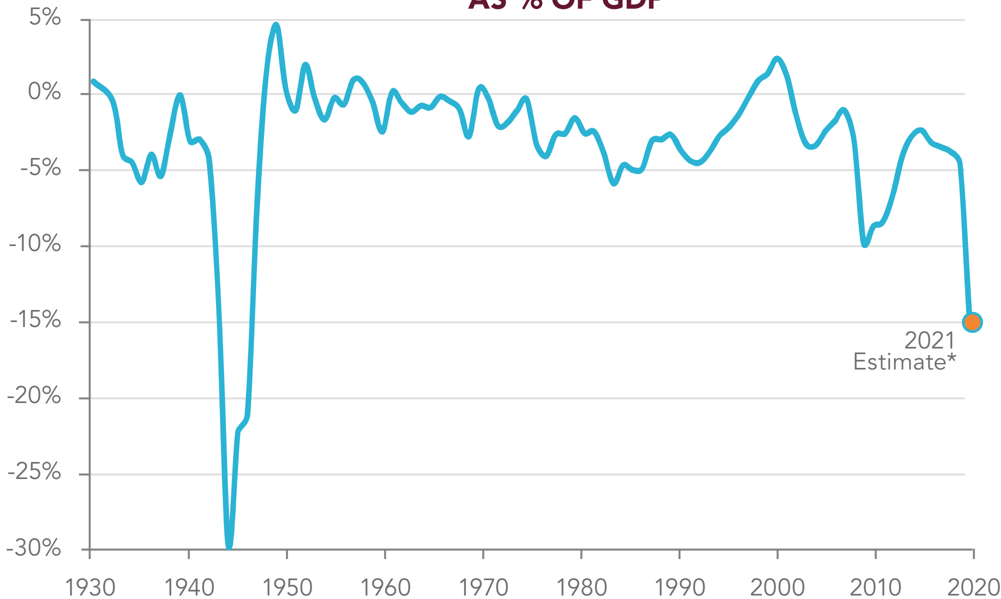
How high US inflation might go longer term is uncertain. But it is very likely to accelerate in the near term, relative to the low levels during the start of the pandemic.

With unemployment falling, consumer activity recovering, and the Fed committed to allowing inflation above its target of 2%, most forecasts are predicting inflation above 2.5% for 2021 (due to low comparisons in 2020) and decidedly above 2% for the next few years.

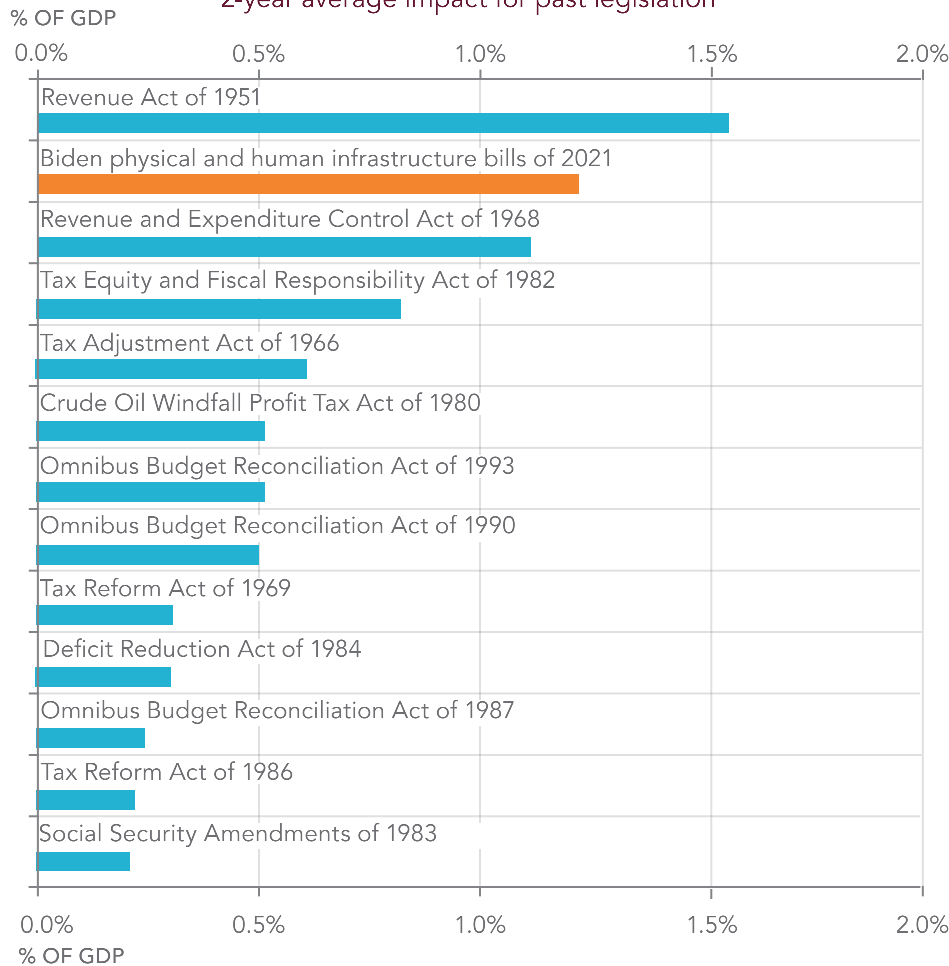


Source of Data: Oxford Economics.

Forecasts for rising US interest rates are based on anticipated increases in inflation due to the surge in government debt issuance to combat Covid-19 and to fund ambitious new programs. Still, with the Fed on hold in the near term, the 10-year US Treasury yield (nearly 1.7% today) isn't generally expected to exceed 2% before the end of 2021.



*As of March 2021; includes March 2021 Covid-19 relief; excludes new infrastructure proposal.
Source of Data: OMB, CBO, CRFB.

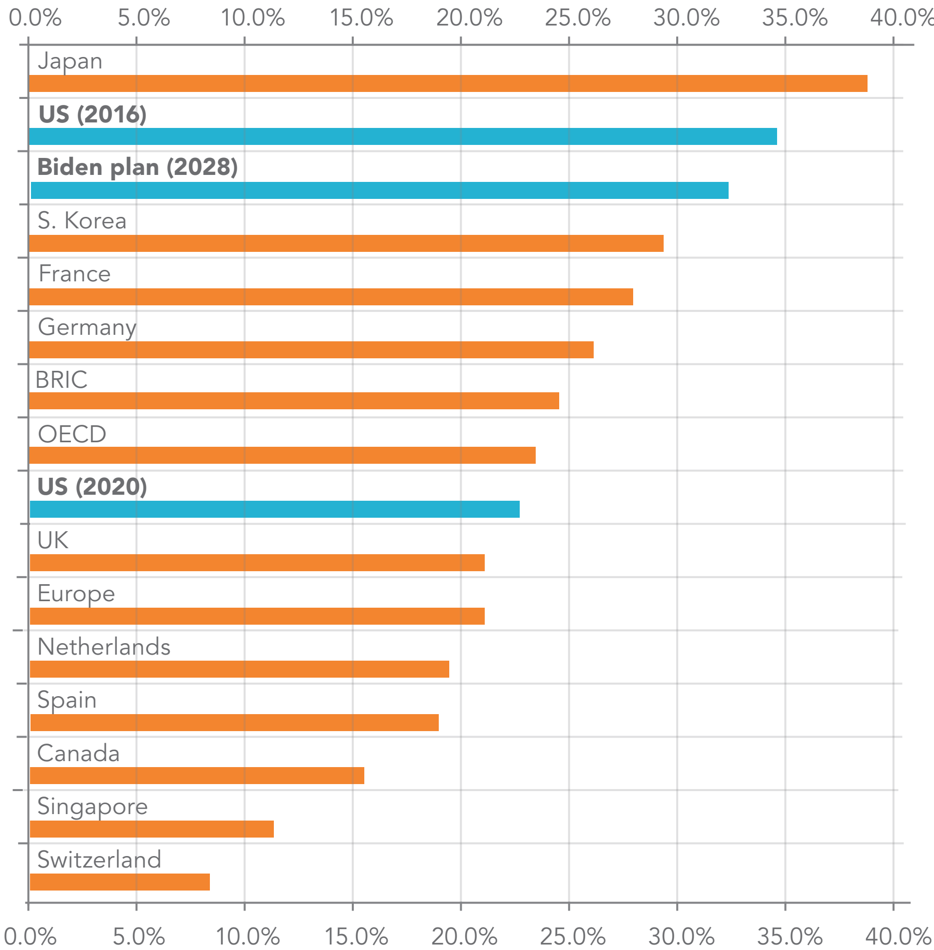


Source of Data: US Treasury, CBO, Cornerstone, J.P. Morgan.

We continue to be concerned with the level of debt the US government is adding and the ultimate implications of this debt. At present, the US government is running its 2nd highest deficit since WWII and has increased the gross federal debt as a % of GDP to historic levels (above 100%). Impacts from this level of debt could include significantly higher corporate and individual income taxes, slower growth in the future, and increased interest rates if purchasers of government debt become concerned about the ability of the US to repay its obligations.

While the infrastructure investments proposed by the Biden administration are likely to contribute to US economic growth, the tax increases necessary to fund the addititonal $1.9 trillion in new spending could be some of the most significant in history. Proposed new tax revenue would come mostly from corporate tax hikes (67%), and 33% from high-income individual taxpayers.

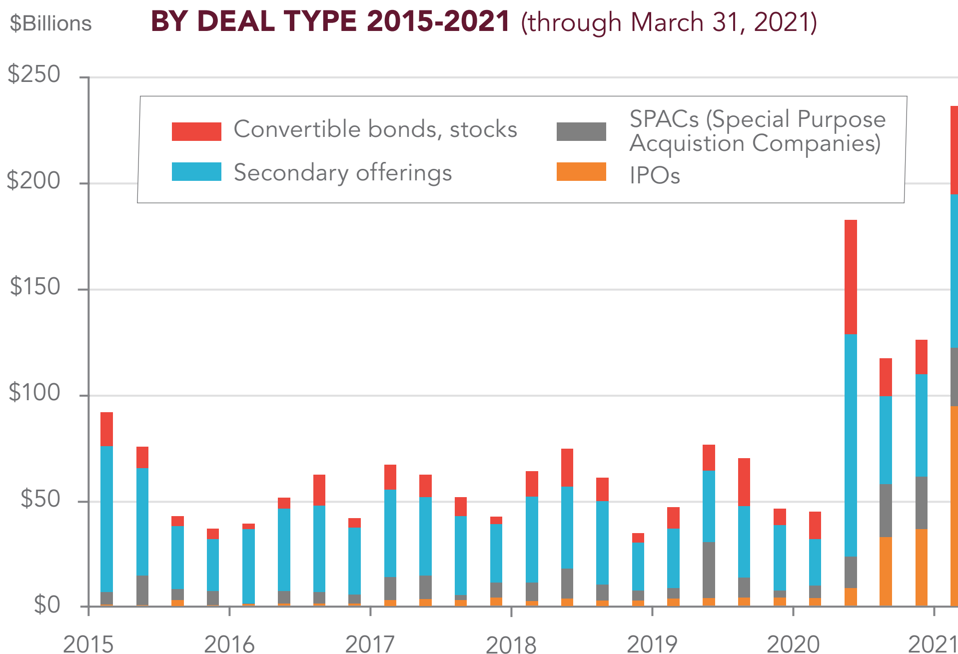
EFFECTIVE CORPORATE TAX RATE ON NEW INVESTMENT



March 2021. Source of Data: Mintz and Bazel (University of Calgary), J.P. Morgan.

Should the Biden administration's proposed increase in corporate tax rates be enacted, it would almost reverse the 2017 corporate tax cuts, which significantly boosted US corporate earnings while increasing the federal budget deficit. Unwinding of the 2017 tax cuts could create headwinds for some parts of the US equity market in the form of reduced profit growth and lower competitive returns on new investment.

RECORD LEVELS: QUARTERLY US EQUITY ISSUANCE BY DEAL TYPE 2015-2021 (through March 31, 2021)



Source of Data: Oxford Economics.

Incentivized by record-high US stock prices, the first three months of 2021 saw the highest equity issuance on record at almost $225 billion, less than half of which was in traditional Initial Public Offerings (IPOs). SPACs raised $90 billion, with secondary offerings and convertible bonds/stocks making up the rest. While we believe this level of issuance produces new opportunities, especially in the US small stock arena, we remain cautious given the valuation levels of many of these newly public companies.

THE BENEFITS OF DIVERSIFICATION

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

Best Performance

2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	YTD 2021	15-Year Annualized Return	15-Year Annualized Volatility#
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 Small Cap 12.70%	US Large Cap 10.17%	MSCI EM 21.60%
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%	COMM. 6.92%	US Small Cap 8.83%	US Small Cap 20.28%
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%	Global REITs 6.11%	Diversified 6.36%	Global REITs 19.83%
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 12.53%	Illiquid HF 6.08%	MSCI EM 5.95%	MSCI EAFE 17.41%
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 11.83%	US Large Cap 5.91%	Illiquid HF 4.76%	COMM. 16.50%
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%	Diversified 3.75%	Global REITs 4.66%	US Large Cap 15.48%
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%	MSCI EAFE 3.48%	10yr Treas 4.43%	Diversified 11.72%
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%	MSCI EM 2.29%	US Bonds 4.29%	10yr Treas 7.04%
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%	Liquid HF 1.30%	MSCI EAFE 4.10%	Illiquid HF 6.62%
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 -0.26%	Muni Bonds 3.69%	Liquid HF 5.65%
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%	US Bonds -3.37%	Liquid HF 0.96%	US Bonds 3.24%
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%	10yr Treas -7.10%	COMM. -3.42%	Muni Bonds 2.86%

2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 YTD 2021 15-Year Annualized 15-Year Annualized

Worst Performance

*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; Global Infrastructure 4%; Commodities 2%

Past performance is no guarantee of future results. Data as of 3/31/2021. 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 2006 to 2021 (as of March 31, 2021). The last two columns show 15-year annualized returns and price volatility for the diversified portfolio as well as for the asset classes. Implementation of a vaccine program more broadly across the US and other parts of the world boosted stocks in cyclical industries (which had lagged most of last year), allowing them to outperform the growth 'work-from-home' segment. Additional increases in longer-term interest rates caused fixed-income securities to underperform significantly in 1st quarter 2021, with high-quality bonds posting a loss.

INDEX DEFINITIONS

US BONDS: Barclays Capital US Aggregate Bond Index – Covers the US Dollar-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities.
The index includes bonds from the Treasury, Government-Related, Corporate, MBS, ABS, and CMBS sectors.

COMMODITIES: Bloomberg Commodity Index - A broadly diversified index of futures contracts intended to be representative of the commodities market. It currently includes 19 commodity futures in seven sectors.

MUNICIPAL BONDS: Barclays Capital Municipal 1-10 Year Index - Tracks the broad market performance of tax-exempt bonds with 1 to 12 years remaining to maturity.

10-YEAR US TREASURY BONDS: BofAML US Treasury Current 10 Year Index – The market value weighted index of public obligations of the US Treasury with maturities of 10 years.

INT'L DEVELOPED EQUITIES: MSCI EAFE Index - A free float-adjusted market-capitalization index that is designed to measure developed market equity performance, excluding the US and Canada. Consists of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands,
New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

EMERGING MARKETS EQUITIES: MSCI Emerging Markets Index - A free float-adjusted market-capitalization index that is designed to measure equity market performance in the global emerging markets. Consists of the following 25 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

US LARGE CAP EQUITIES: Russell 1000 Index - Measures the performance of the large-cap segment of the US equity universe and represents approximately 92% of the US market.

US SMALL CAP EQUITIES: Russell 2000 Index - Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, representative of the US small-capitalization securities market.

LIQUID HEDGE FUNDS: HFRX Global Hedge Fund Index – A daily-valued index designed to be representative of the overall liquid hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry.

ILLIQUID HEDGE FUNDS: HFRI Fund Weighted Composite Index – A global, monthly-valued, equal-weighted index of over 2,000 single-manager funds that is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies. Constituent funds report monthly net of all fees performance in US dollar and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

GLOBAL REITS: FTSE EPRA/NAREIT Developed Real Estate Index - A measure that tracks the performance of listed real estate companies and REITs worldwide.

DIVERSIFIED PORTFOLIO: 10% US Municipal Bonds; 10% US Core Bonds; 25% US Large Cap Equities; 5% US Small-Cap Equities; 22% Int'l Developed Equities; 9% Emerging Markets Equities;
4% Global Infrastructure; 13% Illuquid Hedge Funds; 2% Commodities.

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ABOUT THE AUTHOR

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