FINANCIAL

THE POWER OF
INFORMATION
EXPERTISE
COLLABORATION

First Quarter Investment and Economic Outlook 2021

April, 2021

Steve Turi
Chief Investment Officer

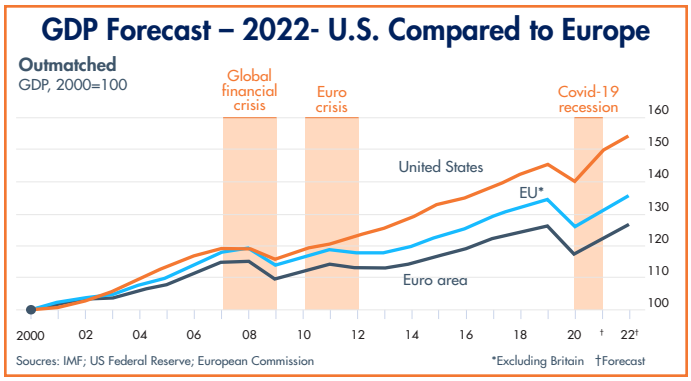
Andy Melnick
Chief Investment Strategist

New Government Spending Programs

The Administration's $2-3 trillion infrastructure plan underlines their seeming belief that big government, not private industry, can better lead big projects. That plan will shortly be followed by a roughly $1 trillion-dollar American Families Plan, which will focus more on what the administration sees as critical social needs in education and healthcare. The spending for both programs will total approximately $4 trillion over 8-10 years, financed in part with proposed higher tax rates as well as increased federal debt.

Bigger U.S. GDP in 2022 Than Pre-Pandemic

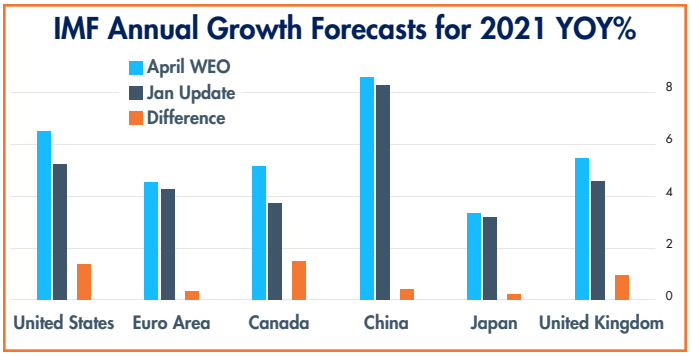
With the flood of spending this year from the most recent two rounds of Covid relief programs combined with vaccinations reaching over 3 million daily, economists seem to be trying to outdo each other in raising their economic forecasts. Using a conservative forecast from the IMF, the American economy in 2022 will reach a level 6% greater than that experienced in 2019. In comparison, Europe will likely be back to 2019 levels (see Figure 1.)



(FIGURE 1) Source: Economist

More Than U.S. – A Strong Global Recovery

Historically, South Korean exports provided a leading indicator of global growth. If that still holds, their recent March export numbers suggest a very strong global recovery seems likely. Korean exports in March jumped 16.6% from a year earlier. Supporting that conclusion, the IMF recently upgraded its forecasts for global growth (See Figure 2.) With growing supplies of vaccine, it would seem likely the U.S. will begin exporting vaccines to less developed countries, such as Mexico, to further support global economic growth.



(FIGURE 2) Source: Mizuho Securities, IMF, Daily Shot

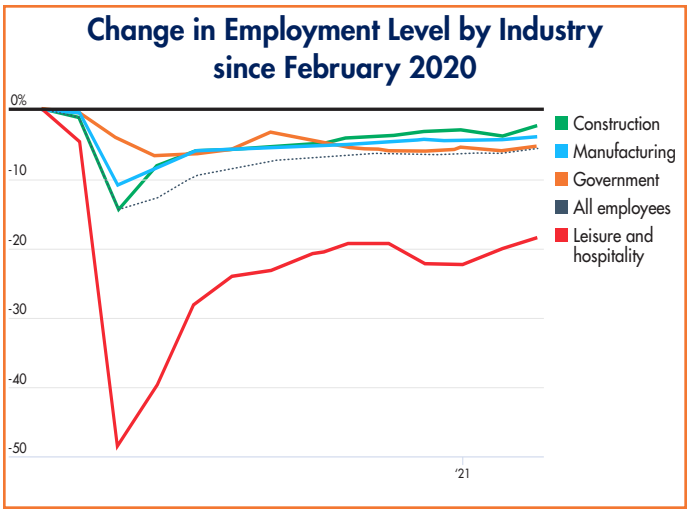
Service Industry Recovery Key to Employment Growth

Now Happening – Forecasts May Underestimate "BOOM"

Many economists now call the outlook for the remainder of the year a "boom." With vaccines now flowing, the service economy will particularly "boom" as consumers reduce their concerns about leaving their caves to mingle with other

consumers. ISM services index recently reached its highest level on record last month – beating economists' forecasts (see Figure 3.) With service industry employment decimated during the pandemic, its recovery will prove key to employment growth (See Figure 4.) As evidence, nearly half of the 1.4 million jobs created in February and March originated in leisure and hospitality services. With both the "unprecedented" pandemic followed by a "boom," not only will economists likely underestimate the recovery's strength so will analysts' earnings forecasts (consensus S&P 500 2021 earnings forecast +25%.) That shortfall will likely prove particularly beneficial for cyclical/value stocks.

(FIGURE 3) Data: FactSet; Chart: Danielle Alberti/Axios

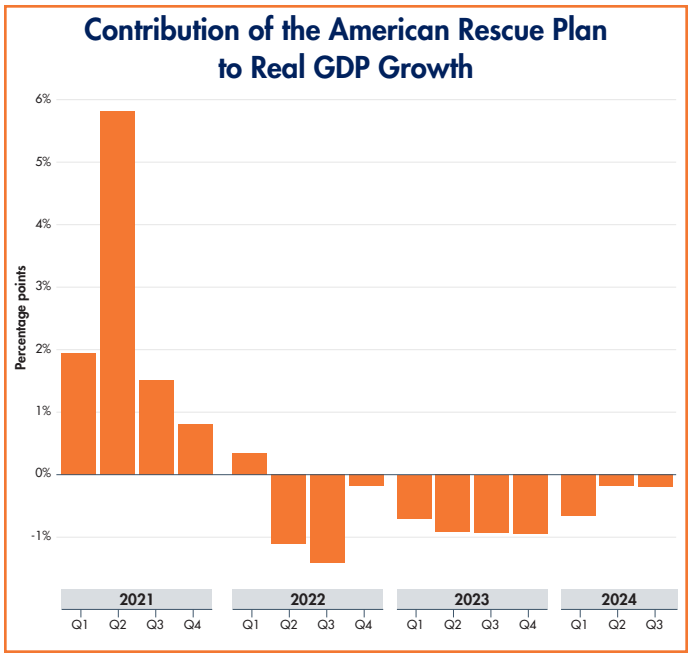


(FIGURE 4) Note: Seasonally adjusted. Source: Wall Street Journal, Daily Shot

How Far Economic Momentum Carries into 2022

Key to Market Outlook – Greater Market Volatility May Result

As we move into late summer months, investors will try to judge how far the momentum from this year will carry into 2022. Figure 5 shows estimates for the most recent Covid relief spending package's impact on quarterly GDP growth. Those estimates show the economic impact will ebb early next year. At the same time, the Fed will still keep its highly accommodative monetary policies in place to maintain economic momentum. The uncertainty as to how far the momentum will carry into next year will likely lead to broader dispersion of 2022 economic and earnings estimates. Therefore, greater market volatility will likely result this fall.



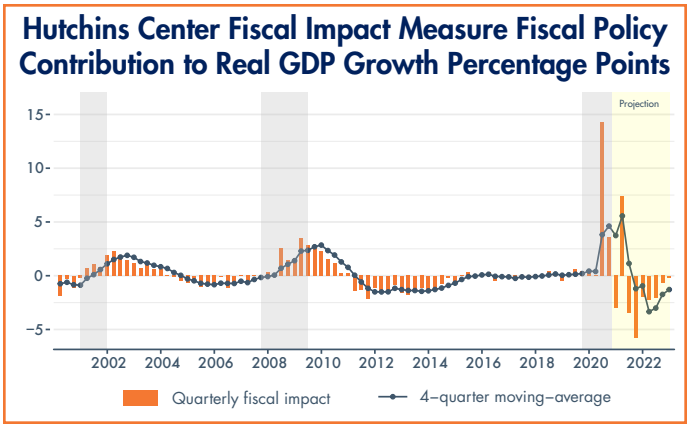
(FIGURE 5) Hutchins Center calculations from Bureau of Economic Analysis and Congressional Budget Office data

Fed's New Framework will Attempt to "Fully" Maximize Employment Levels

Markets May Underestimate This Focus

In 2022, the economic momentum will likely reflect reduced new fiscal spending support as well as higher taxes (See Figure 6.) As the economy transitions to a more normal recovery, the Fed will more clearly show its new framework which focuses on a broad-based and inclusive

concept of maximum employment. Fed Governor Lael Brainard said the new framework "seeks to eliminate *shortfalls* of employment from its maximum level; in contrast, the previous approach called for policy to minimize *deviations* when employment is too high or too low." With this new framework, the Fed will use a broad range of employment measures to determine maximum employment levels. Until and unless inflation forces the Fed to pullback, the Fed will strongly support an economy that can bring broad-based unemployment measures below levels previously experienced. In our view, investors underestimate the importance of this framework change on the economic outlook.



(FIGURE 6) Source: Hutchins Center calculations from Bureau of Economic Analysis and Congressional Budget Office data; grey shaded areas indicate recessions and yellow shaded areas indicate projection

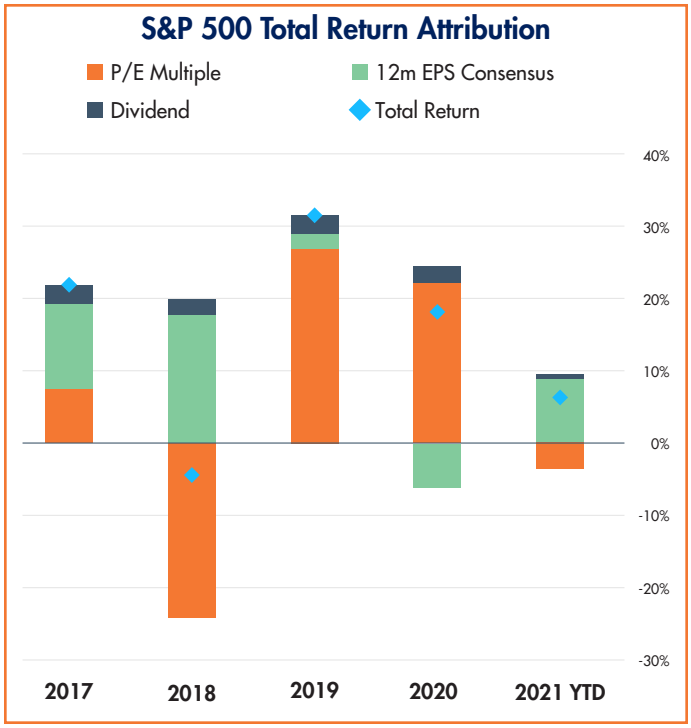
A New Fed Chair?

Chair Powell's term ends February 2022. At this point, it seems likely he will be renominated for that position. At the same time, with the Fed gradually moving somewhat past its dual full employment and stable price mandates, perhaps a progressive administration will look for a chair more fully committed to its agenda.

Investment Conclusions

Earnings – Market Key

Last year stocks benefitted primarily from multiple expansion rather than earnings growth. In 2021, equity market performance will likely depend more on EPS growth rather than multiple expansion (see Figure 7.) If forecasts calling for 25% EPS growth for the S&P 500 Index hold up or, in our opinion, the "boom" drives those numbers even higher, equity markets will respond very positively.



(FIGURE 7) Source: Bloomberg, The Daily Shot

Volatility

As we move through the summer, investors will attempt to make judgements about 2022. It seems likely that there will be a broader dispersion of economic forecasts as to how far into 2022 the current economic momentum will carry. This will likely lead to greater market volatility.

Inflation

The second question will surround how temporary the "boom" inflation will prove to be. Financial markets will not wait to see. Rising interest rates will likely result until inflation proves to be transitory – or not. The equity market response will depend on whether higher inflation accompanies a continued strong economic recovery.

Growth, Pricing, and Labor Costs

If the economic outlook for the second half of 2022 projects slower economic growth, then investors may return to faster growing companies. At the same time, if inflation also raises its ugly head, then investors will likely seek out companies with pricing power as well as those with lower labor costs – among others, growth companies also fit that outline.

Fixed Income

Having federalized fixed income markets, the Fed may still hold off attempting to moderate the yield curve's upward tilt unless unexpected pressures result. With that and an uncertain inflation outlook, investors should stick with shorter-duration fixed income investments. This will avoid price risks longer duration debt normally faces from potentially rising interest rates.

An index is a portfolio of specific securities, the performance of which is often used as a benchmark in judging the relative performance to certain asset classes. Indexes are unmanaged portfolios and investors cannot invest directly in an index. An index does not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown. Past performance is not a guarantee of future results/

The S&P 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies by market value, the index is widely regarded as the best single gauge of large-cap U.S. equities.

The Russell 1000 Value Index measures the performance of those companies in the Russell 1000 Index with lower price-to-book ratios and lower forecasted growth values. The Index is calculated on a total return basis with dividends reinvested and is not assessed a management fee. It is not possible to invest directly in an index.

The Russell 2000 index is an index measuring the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

The Russell 2500 Index is a broad index, featuring 2,500 stocks that cover the small- and mid-cap market capitalizations. The Russell 2500 is a market cap-weighted index that includes the smallest 2,500 companies covered in the Russell 3000 universe of United States-based listed equities.

The MSCI World Index captures large and mid-cap representation across 23 Developed Markets (D.M.) countries. With 1,633 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI EAFE Index is an equity index which captures large and mid-cap representation across 21 Developed Markets countries around the world, excluding the U.S. and Canada. With 920 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (E.M.) countries. With 1,125 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. An index is a portfolio of specific securities, the performance of which is often used as a benchmark in judging the relative performance to certain asset classes. Indexes are unmanaged portfolios and investors cannot invest directly in an index. An index does not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown. Past performance is not a guarantee of future results.

An index is a portfolio of specific securities, the performance of which is often used as a benchmark in judging the relative performance to certain asset classes. Indexes are unmanaged portfolios and investors cannot invest directly in an index. An index does not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown. Past performance is not a guarantee of future results.