SMITH AFFILIATED CAPITAL

FIRST QUARTER 2021 INVESTMENT COMMENTARY

2021 Can't Come Soon Enough

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We've always said that the health crisis would determine the path of the economy, and the latest news on the pandemic is concerning. Cases of the virus, hospitalization and mortality rates have surged to unfathomable levels, and health officials expect a post-holiday surge in this distressing trend. While the encouraging prospect of widespread vaccinations over the next six months allows us to be more optimistic about 2021, the resurgence of the virus is poised to deal the economy a significant near-term blow. Indeed, growth in consumer spending and jobs is already slowing sharply from the vigorous rebound over the summer months.

As 2020 draws to a close, we reflect on a difficult year that couldn't end soon enough. Covid-19 infected more than 19 million individuals and led to 340 thousand lost lives in the US. The economy suffered its most severe contraction since the WWII demobilization, 22 million people lost their jobs, and tens of thousands of small businesses were shuttered. The initial recovery phase was extremely rapid with unprecedented fiscal and Fed stimulus helping the economy recoup roughly 80% of its output loss and 55% of its job losses in just eight months. But while some sectors like tech, retail and housing were outperformers, hard-hit households and businesses remain extremely vulnerable to the virus resurgence.

On the positive side, vaccine distribution should ensure we reach the critical herd immunity threshold around mid-summer. However, there will be hiccups along the way with virus mutations, logistical issues, and reduced public vigilance making the vaccine rollout phase a delicate one to navigate. With that in mind, dovish Fed policy and additional fiscal stimulus should provide much needed support to households and businesses. Despite President Trump's last minute objection, the Covid relief bill was signed just in time to prevent significant hardship for millions of vulnerable Americans. That said, the political drama that shrouded the $900 billion relief bill is far from over. With the upcoming Georgia elections on January 5th deciding who controls the Senate, the evolution of fiscal policy over the coming year is still to be settled.

Imperfect Fiscal Stimulus

The long-awaited $900 billion Covid relief bill is months late and will likely fall short of what is needed to prevent a rough winter, but it should help buffer the current economic slowdown and provide increased dynamism to the economy during the initial vaccine rollout phase.

The deal extends emergency unemployment benefits for 14 million Americans until mid-March while extending eviction protections for millions of renters through January 31. The package also includes $600 checks for most adults and children, a $300 weekly top-up to unemployment benefits for 11 weeks, $280 billion in aid to small businesses, along with funding for vaccines, education and transportation.

Last-minute political drama with President Trump striving to bump-up the $600 stimulus checks to $2,000 – an effort that is whole-heartedly supported by the Democrats – is symptomatic of 2020. While a larger check would no doubt support stronger consumer spending growth in the coming months the impact of doling out money to couples' earnings as much as $150 thousand a year is likely to be far smaller than generally expected. This was amply demonstrated with the more generous direct stimulus payments sent to households under the CARES Act passed in March. Simply put, the more financially secure households and workers who still held jobs stashed a significant portion into savings. A research study by the NBER revealed that 80% of recipients either saved the payout or used it to pay down debt. The personal savings rate surged to a record high of 33.7% in April, and still remains well above historical levels.

A more potent spending boost would come from targeting lower income households, particularly unemployed workers, who tend to spend every penny of incomes and are most vulnerable to the pandemic's effects. These individuals have little savings cushion to begin with and are not in a position to put aside a portion of their incomes for a future day. Hence, expanded unemployment benefits would provide a bigger bang for the buck than direct checks to more financially secure households. But while there is broad-based sentiment to enlarge direct stimulus payments, there has been no discussion in Congress to expand jobless benefits. Meanwhile, the economy is running out of fuel as it enters 2021, in good part due to the fading income support from the CARES Act that nurtured spending among lower-paid and, to a lesser extent, mid and upper-income households.

Incomplete Recovery

The slowdown underway puts an exclamation point on a recovery that started strongly but has a long way to go to recoup the ground lost during the pandemic recession. The astonishing third-quarter rebound in GDP followed an even steeper decline in the second quarter. The continued, albeit more subdued, growth so far in the fourth quarter has not made up the difference. Hence, just under 10 million workers out of the 22 million that were laid off during the height of the pandemic in March and April are still out of a job and swelling the unemployment lines. Factories are operating well below normal capacity and tens of thousands of retail establishments have closed their doors, many permanently. The pandemic took the biggest toll on service establishments that rely on in-person sales, such as bars and restaurants, whose revenues are still down nearly 20% from earlier in the year.

The carnage inflicted on service-providing firms distinguishes this pandemic-induced downturn from most past recessions. Typically, cutbacks in the demand for goods – particularly big-ticket items such as cars and other discretionary durable goods purchases – would lead the way in downturns, as rising unemployment and interest rates prompt households to curtail nonessential spending. This time the catalyst was a supply shock, as the social-distancing mandates and government lockdown restrictions forced service providing firms to close down or severely scale back operations. Since the service sector is far larger than the goods-producing sector, the economy suffered a much larger contraction in GDP during the second quarter than in previous recessions.

The steep cutback in the supply of services is another reason why stimulus checks are not an efficient way to jump-start the economy. Putting money in people's hands may boost demand, but the constraints on purchasing outlets will just funnel the funds into savings or further inflate asset prices, thus amplifying the inequitable division of wealth in this K-shaped recovery. It also highlights the fact that the economy is still being held hostage by the path of the coronavirus. Until the health crisis ends and the service sector reopens, supply constraints will impede the recovery process.

Economy's Engine Running Out of Fuel

The resurgence of the virus is further pushing back the recovery process, which was already sagging. Importantly, the economy's main growth driver, consumer spending, is running out of fuel. A rapidly worsening health situation, weakening income, depleted savings for lower income families and cooler weather led consumers to slam their wallets shut in November. Personal spending fell for the first time in this recovery cycle, and real time data points to ongoing weakness in December. Not surprisingly, the major weakness was in spending categories most exposed to the resurgence of the virus.

It is not hard to see why households are reining in spending. Not only are supply restraints from renewed lockdown restrictions having an impact but thanks to the fading support from the CARES Act, personal incomes fell for the second consecutive month, slipping 1.1% in November. The main drag came from the fall-off in government transfer payments, reflecting lower unemployment benefits from the expiration of the FEMA Lost Wages Supplemental Payments program. To be sure, with payrolls still rising through November, labor compensation did increase. Wages and salaries rose 0.4% and are 2.0% above year-earlier levels.

But the 0.4% increase was the slimmest in seven months and half the average increases over the previous two months. The weakening wage gains align with the slowing pace of job growth and points to a continued softening trend in coming months.

Indeed, we may well have seen the end of the jobs recovery, as layoffs keep mounting and job openings are sliding. There is a good chance that the December jobs report, due out on January 8th, will show little if any increase in payrolls and may even reveal a decline. Ironically, that might add an upward bias to the wage data, as the loss of jobs would be concentrated among lower-wage workers in the services sector, which again is being hobbled by renewed restrictions due to the resurgence of the virus. As low-wage workers drop out of the calculations, the heavier concentration of higher-wage workers on payrolls gives a boost to the average for all wage earners.

This is just another reflection of the K-shaped recovery that has defined this recovery. White-collar workers who retained jobs that can be carried out remotely are doing just fine. They represent the upper right arm in the K, and not only because of the paychecks that keep coming in. They also are in the group that holds the majority of stocks, and hence, benefited from the robust market rally in 2020, which was not stifled by the pandemic. But the pandemic has taken the biggest toll on workers that occupy the lower right leg of the K – the ones that have borne the brunt of the layoffs and have little in the way of stock holdings.

Post-Covid Uncertainty

With virus cases still accelerating and the distribution of vaccines proceeding slower than expected, the health crisis will get worse before it gets better. A similar pattern will unfold in the economy. Most key measures of activity, highlighted by consumer spending and job growth, downshifted over the final quarter of the year and forward-looking indicators point to a continuation of this sagging trend. The Covid-relief bill will likely prevent an outright contraction in GDP during the first quarter, but the period will barely register a positive reading. The economy should hit an air pocket in January before slowly recovering and regaining some momentum heading into the second half of the year.

The question then is, what happens in the post-Covid economy, when Americans feel confident about dining, going to theaters and concerts, and resume long-delayed travel aspirations. Some believe that when the establishments providing these and other services fully reopen, the economy will achieve a V-shaped rebound and set the stage for a sustained period of above-trend growth fueled by pent-up demand. For proof, they refer to the third quarter's record-setting 33.1% surge in GDP following the lifting of nationwide restrictions that locked down the economy in February and March.

But that would be a misguided expectation. The summer rebound was indeed driven by pent-up demand that was mostly funneled into goods purchases and supported by the massive income support provided under the CARES Act. Hence, retail sales surged as households were finally able to get their hands on goods they were deprived of during the lockdown. Sales of autos, appliances, furnishings, building materials and many discretionary items took off, although online purchases continued to replace in-store shopping as the preferred method of transaction. At the same time, the ebbing of the virus over the summer months encouraged governments to ease lockdown restrictions on service providers, which brought consumers back to restaurants, bars and other services dependent on in-person sales.

When the health crisis ends, a similar burst of activity is likely to occur. However, it's important to note that pent-up demand lacks staying power and is limited mainly to goods purchases. One distinguishing aspect of the pandemic recession was that it caught both households and businesses by surprise, and neither was prepared for the supply shortages that soon beset the nation. Toilet paper disappeared from shelves, businesses couldn't restock merchandise acquired from overseas, factories saw their supply lines cut off and auto dealers were forced to shut down. Hence, when lockdown restrictions eased over the summer, the rebound in activity was amplified by two catalysts – the huge volume of pent-up demand and the push by businesses to rebuild inventories.

That inventory boost should be missing this time. Businesses have restocked shelves and are keeping up with demand. Earlier trade tensions with China have prompted more firms to turn to domestic sources for resource inputs or to onshore production themselves, and the pandemic has accelerated that trend. With shortages of goods not as acute as was the case last February and March, pent-up demands – either by households for goods or businesses to replenish inventories – should not be as powerful in driving demand when pandemic restrictions are eased this time. What's more, pent-up demand for services is much less potent than for goods. People will return to restaurants and bars but they won't double up on meals or drinks to compensate for what they could not purchase during lockdowns. Nor will they get two haircuts or visit Disneyland multiple times.

The Disconnect between Wall Street and Main Street

Despite the resurgence of the virus and dire warnings from health officials that things will get worse before they get better, the financial markets entered the new year priced for a goldilocks economy. The stock market shook off the initial shock from the pandemic and, after its harsh but brief 30% correction in March, raced to new highs by year's end. Not even the downshifting in activity in the fourth quarter and the weak forecast for the first quarter deterred the rally. No doubt, the Federal Reserve's turbocharged easy policy has been a key driver behind market behavior. In a zero-rate environment and the Fed's "put" firmly underpinning stock prices, investors have had a strong incentive to take on risky assets.

But the disconnect between Main Street and Wall Street has widened to a chasm rarely seen in modern history. True, the Fed is committed to keeping rates at rock bottom levels until employment returns to maximum levels and inflation rises to 2% or above for some time. Its own forecast is that the federal funds rate will be kept at near zero for three more years, an outlook that coincides with ours. Inflation will likely pierce the 2% target for a brief time in the spring because it will be compared with the pandemic-depressed inflation readings of a year earlier. But once the base effect is passed, ingrained deflationary forces that the pandemic has amplified will once again tamp inflation down and keep it below 2% for years to come.

Quite possibly, the temporary inflation spike combined with the growth rebound expected in the spring and summer could send bond yields higher for a while. Such a scenario might generate fears the Fed would tighten sooner rather than later – akin to the "taper tantrum" that led to a brief spike in bond yields in 2013. Such a development would also set the stage for another severe stock market correction. But it's unlikely that the inflation blip would be sustained or derail the Fed's commitment to a sustained easy monetary policy. We don't expect the job market to fully recover all of the pandemic-related layoffs for at least three more years nor eliminate the copious excess capacity in the product markets.

Contrary to persistent beliefs in some quarters that inflation is a monetary phenomenon the Fed's commitment to keep credit flowing and rates at rock bottom levels is actually exacerbating deflationary forces. A recent New York Fed research study amply documents this observation –which is also supported by at least three decades of evidence both in the U.S. and overseas. The authors of the study note that excessively easy monetary policy keeps distressed or "zombie" firms alive and creates excess production capacity that drives product prices down. From our lens, it also creates asset bubbles and mispricing in the financial markets that sooner or later will wreak havoc with investor portfolios. The risk-free and liquid Treasury market proved to be a rewarding asset in 2020 and those attributes should be just as appealing to investors in the highly uncertain economic and financial environment that lies ahead in 2021.

Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market (Barclays TSY Bellwethers)	Yields (%)			Total Return (%)	
	12/31/2019	9/30/2020	12/31/2020	Last Quarter	Last Year
6-Mo. Bill	1.57	0.11	0.09	0.04	1.04
2-Yr. Note	1.56	0.12	0.12	0.04	3.07
5-Yr. Note	1.68	0.27	0.36	-0.22	7.26
10-Yr. Note	1.91	0.68	0.91	-1.91	10.61
30-Yr. Note	2.38	1.45	1.64	-4.18	18.72

Municipal Bonds	Yields (%)			Total Return (%)	
	12/31/2019	9/30/2020	12/31/2020	Last Quarter	Last Year
Barclays GO Bond Index	1.64	1.07	0.87	1.51	5.49
Barclays State GO Bond Index	1.54	0.98	0.77	1.43	5.12
Barclays Local GO Bond Index	1.73	1.16	0.97	1.59	5.86
Barclays Revenue Bond Index	1.89	1.51	1.22	2.11	5.31

Equities	Levels			US $ Terms (%)	
	12/31/2019	9/30/2020	12/31/2020	Last Quarter	Last Year
S&P 500	3230.78	3363	3756.07	12.14	18.40
DJIA	28538.44	27781.7	30606.48	10.73	9.73
NIKKEI (Tokyo)	23656.62	23185.12	27444.17	21.11	24.70

Commodities	US $			Percent Change (%)	
	12/31/2019	9/30/2020	12/31/2020	Last Quarter	Last Year
COMEX Gold Active Monthly	1523.1	1887.5	1895.1	0.40	24.42
CRB Future Com. Pr. Index*	185.787	148.5066	167.79	12.98	-9.69
West Texas Intermediate Crude ($ per bbl.)	61.06	40.22	48.62	20.89	-20.37

Currencies	Levels			Percent Change (%)	
	12/31/2019	9/30/2020	12/31/2020	Last Quarter	Last Year
Yen	108.61	105.48	103.25	2.11%	4.94%
Sterling	1.3257	1.292	1.3672	5.82%	3.13%
Euro	1.1213	1.1721	1.2216	4.22%	8.94%

Global Bond Markets**	Levels			US Dollar Terms (%)	
	12/31/2019	9/30/2020	12/31/2020	Last Quarter	Last Year
German 10-Yr.Bond	-0.28	-0.61	-0.66	4.77	11.98
Japanese 10-Yr.+ Bond	-0.08	-0.04	-0.04	2.22	5.25
UK 10-Yr.+ Bond	0.71	0.10	0.14	6.07	8.71
Emerging Market (USD)	4.89	4.09	3.50	4.5	6.52

Source: Bloomberg Financial Data

*Thomson Reuters/Jefferies CRB Commodity Excess Return Index

** Global Bonds Represented by Bloomberg Barclays Indices