Outlook 2021

Setting the Stage for 2021

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KEY POINTS

- Reflecting on market action during the first month of the new year is a method used by MCF Capital Management to develop an outlook for the entire year. January witnessed several interesting market events forming our cautious yet optimistic view of 2021.

EQUITY MARKET

Equity markets got off to a good start in early 2021, but by the end of January they were in retreat from new all-time highs. With signs of excess speculation across most indices, certain market sectors and most notably within a small number of individual stocks, investors took to the sidelines as volatility spiked. This combined with the early days of the new Biden administration, stalled stimulus talks and unclear policy initiatives; most market indices saw early gains evaporate and move to negative starts for the year. The Dow Jones Industrial declined 2.04% to start the year, the S&P 500 fell 1.11% while the NASDAQ composite gained 1.42% on the back of strong earnings in the technology sector for the 4th quarter. We would like to take note that most of the declines occurred in the final week of January.

While early earnings reports provided continued evidence of the economic recovery in the final quarter of 2020, sharply rising volatility at the end of the month due to excess speculation was cause for concern for most institutional investors. This led them to reduce portfolio risk. At the time of this outlook, we at MCF hold our highest percentage level of cash in portfolios since early 2018 and remain concerned in the noticeably short term.

FIXED INCOME

Economic data remains mixed as the economy continues to contend with partial or full lockdowns in various states across the country. While manufacturing gauges per the ISM Purchasing Managers' Index surveys (PMI's) continue to exceed expectations, the job market continues to struggle after losing 140,000 jobs in December and expectations are for limited gains in January. Even the housing market which has been strong since last spring, due to historically low interest rates, is showing some signs of slowing. GDP came in at 4.00% for the 4th quarter 2020, slightly below expectations, growth nevertheless building of the record growth in the 3rd quarter of last year post national lockdown.

Most expect 2021 to be a better year than 2020. Optimism for the new year is centered on increased vaccine approvals, a growing percentage of the population being vaccinated, and an eventual re-opening of the economy both at home and abroad. Most economists at major financial institutions remain quite optimistic as their expectations for growth estimates range from 3% to as high as 8% in some cases. The Federal Reserve continues to maintain an extremely accommodative monetary policy as it did this past week. The central bank held the key Fed Funds interest rate at 0-.25% and signaled plans to do so until 2023. All of this sent yields on 10-Year Treasuries to an almost one year high of 1.185%, a clear sign of continued expectations for an economic recovery in 2021.

2021 MARKET OUTLOOK

Before providing a market outlook for the upcoming year, we at MCF Capital Management like to see how the previous year ends and how the new one begins, even more so when a new President and administration are inaugurated. The reason for this is that trading data collected at the turn of the year has proven to be insightful as to the direction of equity markets for the year. The start of 2021 has proven to be very insightful as we observe the new Biden Administration and some remarkably interesting developments in market action. For example, we expected market volatility to continue declining throughout the year, yet with the advent of very speculative trading in several stocks, we now expect volatility to remain higher than the historic norm—much as it did in 2020.

Our clients know that Marco always says that over his 36-plus years in the investment management business, he has never seen anyone consistently be right when it comes to forecasting the US economy or financial markets. We prefer to focus on looking at what the consensus is in the areas of economic growth, unemployment rates, inflation, and corporate earnings while looking at the potential risks to these forecasts. This provides us with a guideline in helping us determine if our asset allocation needs any adjustments versus our longer-term data driven analysis. As for sector selection, we remain committed to being invested in the leading long-term investment trends or potential emerging trends especially with a new administration in Washington having significantly different long-term priorities. We remain fully committed to only owning the absolute best companies in the best sectors in our portfolios.

General market consensus forecasts for major economic statistics center around the following estimates in 2021:

- US GDP Growth of 4.7%
- US Un-employment Rate of 6.0%
- Core Inflation Rate of 2.20%
- Federal Fund Rate of 0.00 to .25%
- S&P Earnings Forecasts $175
- WTI Crude Oil Forecasts $50 to $60

COVID-19 remains a wild card in any forecast. We remain optimistic that 2021 will see a better year economically than 2020. In recent days, the question has re-emerged as to how strong the economic recovery will be given a number of issues that have arisen. While several vaccines have been approved or are about to be approved, we continue to see constrains on supply and distribution with the potential of slowing down a stronger recovery pushing it further into the future. We have also witnessed, despite Democrat control of all branches of government, additional fiscal stimulus seems in doubt, if not dramatically reduced. These are all elements that have transpired in the last thirty days and could have a profound impact on economic forecasts.

With the benefit of observing the last few weeks, we are now reducing our expectations for economic growth below consensus forecasts and continue to expect employment gains to remain muted over the next six months. This will prove to be a drag on the consumer sector especially with no clarity on additional government stimulus. We now expect inflation to rise to much higher levels as supply constraints in various areas such as semiconductors, materials, and other key areas to become more severe in a continued economic recovery. This will force long term interest rates to move higher and quicker than markets anticipate while at the same time, debt financed government further exerts upward pressure putting the Federal Reserve in a difficult position. Ultimately the Fed will keep short term rates at current levels. They may be forced to use extraordinary measures such as yield curve control to suppress the yield curve, rather than risk slowing down the housing market which has proved to be one of the economy's best performing sectors over the last year.

Commodity markets will also prove difficult to forecast due to increased volatility. As the Biden Administration's policies in areas such as climate change and increased regulations on business may cause unintended consequences on supply and demand in various sectors. For example, there could be possible supply shortages in both the electricity markets and oil and gas. Increased taxes may also push prices higher for consumers thus further raising inflation.

The earnings forecast for S&P 500 companies are higher, but are these expectations too high? We believe they are indeed too high, especially when we consider how well major U.S. companies adapted during the pandemic and how the technology sector delivered record earnings due to the stay-at-home work orders. While earnings overall will not be an issue for markets, they may not prove to be the catalyst for much higher stock prices in the near term.

Based on our reduced economic growth expectations and market data analysis, we remain positive on equity markets, yet the type of returns we saw in portfolios in 2020 will prove difficult to match over the coming year. We expect market returns to be in the higher single digits to low double digits range with most gains coming in the second half of the year. The first half may well be marked by elevated volatility and an equity market correction driven in large part by uneven re-openings of the US economy across numerous states along with continued uncertainty as the Biden Administration unveils its economic policy going forward.

The risks to our expectations for 2021 are a continued poor roll-out of vaccines or their effectiveness in combating new variants of COVID-19. Setbacks in these areas could lead to longer or new lockdowns, a much slower economic recovery than forecasted by markets, and higher long-term interest rates caused by larger than expected government spending requiring more debt to be issued than anticipated. Finally, government policies that are implemented far too fast to achieve ideological goals, perceived or otherwise, to solve society's inequalities could cause unintended economic consequences.

In the fixed income markets, we enter 2021 once again with potential negative outcomes for investors. While longer term rates have already moved higher in the first weeks of 2021, the rise may well continue for a period before leveling off for an extended period or the Federal Reserve stepping-in to control the yield curve on the long end to not derail the economy, especially in the housing markets. Fixed income investors will have to be agile to avoid negative returns or deliver positive ones. We believe that traditional fixed income investors would be best seeking alternatives to US Treasuries for income in the near term and may want to consult with us in this area.

CONCLUSION

As we reflect on the first month of 2021, we continue to rely on our data driven approach to adapt to evolving trends over the course of this year. The month of January finishing in negative territory has compelled us to reduce our expectations for the year, yet still maintaining an overall positive outlook for equity markets. In the short term, we remain cautious as excess speculation and the achievement of all-time market highs warrant such action and reevaluation.

Policy on all fronts, whether monetary or political, remain a core focus for determining market trajectory for the year. The advent of the Biden Administration and a Democrat controlled Congress also offer us new considerations on the policy front and remains a key variable in determining how policy will affect investor actions in financial markets. In addition, the COVID-19 pandemic will continue to cast its shadow over such policies and will affect overall market sentiment. With this in mind, our long-term general optimism for the US economy remains in sight, but not without assessing potential headwinds in the short-term. We will continue to monitor the situation at hand over the course of this year and will act accordingly when managing our portfolios.

Please feel free to contact us with any questions or concerns regarding our 2021 outlook. We would like to take this opportunity to wish our clients and readers a happy and prosperous new year.

If you have any questions, please contact us directly at 949.472.4579.
Feel free to forward this article to anyone who might be interested in our insight.

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