Cetera® Investment Management LLC

Outlook 2021

Cetera®

The Economy Goes Off to College

The past year has been one for the history books with both crashing economic output and a subsequent bounce-back, though with some sectors still not at pre-pandemic levels. While 2020 was a year to forget in many respects, it's important to remember that, from an economic perspective, it could have been a lot worse.

Like a student leaving home to go to college, the U.S. economy will have to make it on its own without much financial aid in 2021. And like parents saddled with a high debt burden and a mortgage to pay, the U.S. government may be limited in its stimulus support going forward.

Flip through our 2021 Outlook syllabus using the following links, or review the full course beginning on the next page.

SYLLABUS:

Global Economy
- Financial Aid: Fiscal and Monetary Stimulus
- Microbiology 101: The Virus
- Literature 101: The Alphabet Soup Recovery
- Studying Abroad: International Economies

Equity Markets
- Statistics 101: Valuations
- Finance 101: Earnings

Fixed Income
- Applied Mathematics 101: The Low Yields and Diminishing Returns of Bond Math
- Academic Probation: Zombie Companies

Abstract

The global economic downturn caused by COVID-19 was limited, as consumption and market liquidity were largely supported in 2020 by governments and central banks. The future of the economic recovery will largely depend on containing the virus and getting workers back to work and consumers back to spending. The shape of the recovery depends on the country or economic sector: we expect the path to be uneven, with distinct winners and losers.

The stimulus packages helped economies, but they really helped equity markets. Equity valuations are high, and some equity indexes even hit all-time highs during the pandemic. Price-to-earnings ratios for large cap equities haven't been at these levels since the dot-com bubble, and next year's earnings growth, while very good, doesn't seem to support these valuations.

These high equity valuations come at a time when government bond yields are bouncing off all-time lows. This creates a challenge for investors looking for a buffer against the possible equity volatility these valuations could cause. Other parts of the bond market appear overvalued as high-yield bond yields hit record lows, but the high-yield markets may not be as worrisome as some investors believe, and defaults, while expected to be elevated, may not be as high as investors' intuitions suggest.

This is no doubt a challenging environment for investors. There will be opportunities in this uneven recovery as capital flows in different directions. Working with your financial professional can help you stay on track and diversify against risks, and help you stay focused on your personalized goals and objectives.

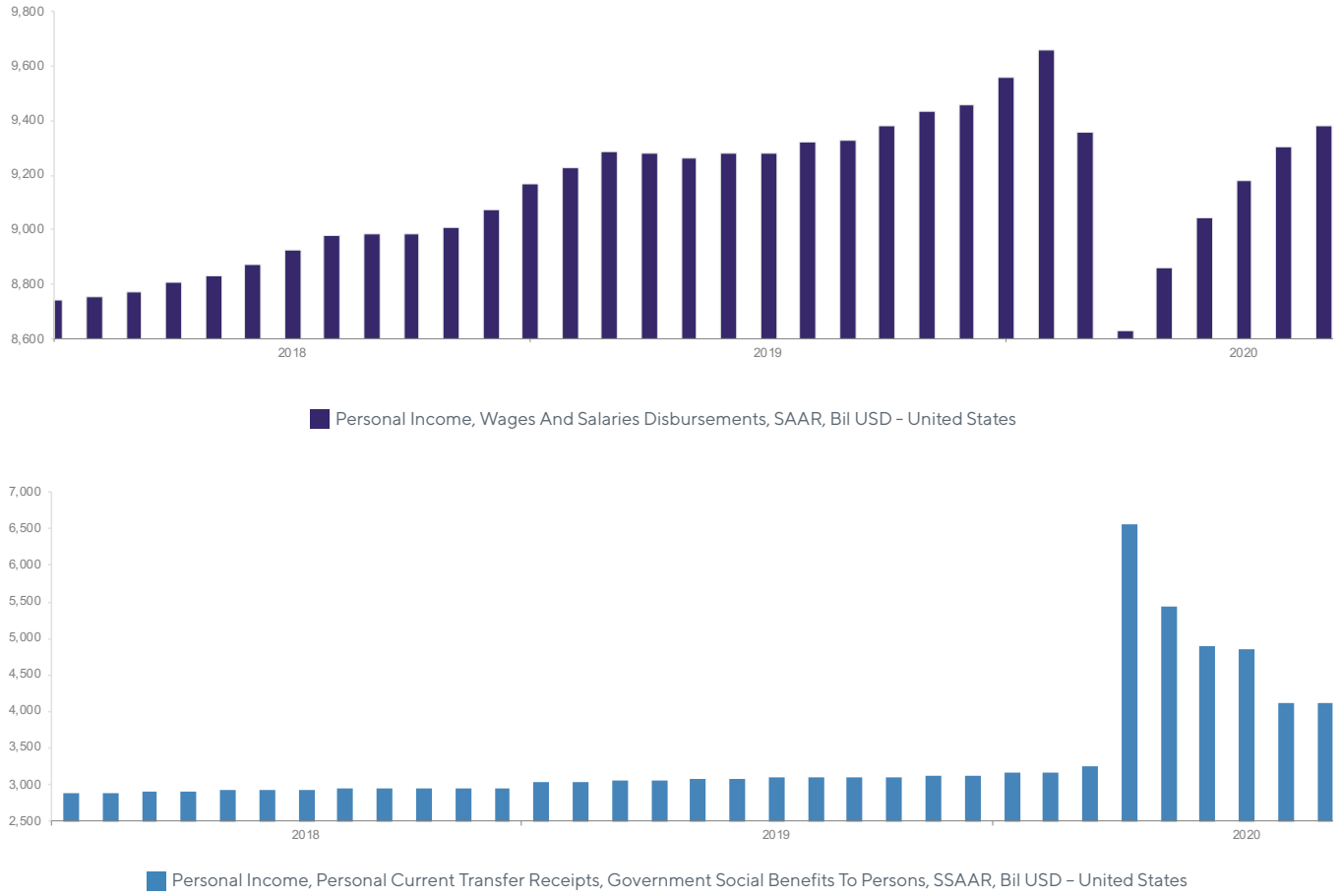
Global Economy

Financial Aid: Fiscal and Monetary Stimulus

As mentioned earlier, the economy will have to make it largely on its own in 2021. Fiscal and monetary support will be harder and harder to come by as we move deeper into the new year. As seen in **Figure 1**, the economy was largely supported in 2020 by monetary stimulus from the U.S. Federal Reserve (Fed) and fiscal stimulus from the U.S Congress. Personal income from wages and salaries declined rapidly in the spring because of the surge in pandemic-induced unemployment. However, total personal income actually rose above pre-pandemic levels because of a record rise in government transfers. This helped consumer spending recover quickly despite high unemployment.

Figure 1: Government Transfers

Personal Income: Wages & Salaries vs. Government Transfers
Billions ($)



Source: Cetera Investment Management, FactSet, and U.S. Bureau of Labor Statistics. Data as of 9/30/2020.

The future of the recovery in 2021 will rely less on government spending.

It will instead depend on the underlying economic fundamentals which will be impacted by containing the virus through a vaccine or social distancing measures.

Our base-case scenario is for a divided Congress, which will mean a smaller stimulus package, likely in the first quarter. The Federal Reserve already set the Federal Funds range to near zero and longer-term rates are at historically low levels, so the Fed's help could be limited going forward, too.

Microbiology 101: The Virus

We all need a crash course in microbiology because containing the spread of the virus will still be the most important aspect of the economic recovery. The sooner we can get back to work, go on vacation, and get on with our lives, the faster the economic recovery can pick up speed.

While there are hopes of a vaccine being available soon, administering it may still take time. Many vaccine companies received funding from Operation Warp Speed, so the U.S. government may own and distribute the initial supplies of the vaccine based on a Centers for Disease Control and Prevention (CDC) advisory committee's recommendations.

With a U.S. population of around 330 million people, it's tempting to do a back-of-the-napkin calculation and speculate that around 50 million doses would be enough to administer to the most at-risk individuals in the population, but the true number is much higher than this. This is how the prioritization may look:[1]

➤ **Healthcare Personnel (~17-20 million):**
Includes hospitals, long-term care facilities, outpatient clinics, home healthcare workers, pharmacies, EMS personnel, and public health workers

➤ **Essential Workers (~60-80 million):**
Includes food, agriculture, transportation, education, energy, water/wastewater, and law enforcement

➤ **Adults Over 65 Years Old (>53 million):**
Approximately three million people live in long-term care facilities

➤ **Those with High-Risk Medical Conditions (>100 million):**
Examples include individuals who are obese or those who have diabetes, chronic obstructive pulmonary disease (COPD), heart conditions, or chronic kidney disease

➤ **Everyone Else (~50% of the population)**

Keep in mind there will be overlap of these categories, but there is a need for a lot of vaccine doses before we can even get to people with high-risk medical conditions. Also, it's inevitable that some will be reluctant to get the vaccine for various reasons. While we are hopeful about the benefits of a vaccine, we are also realistic about how long it will take and must adjust economic expectations accordingly.

[1] *J.P. Morgan Eye on the Market, Michael Cembalest, 11/09/2020*

Literature 101: The Alphabet Soup Recovery

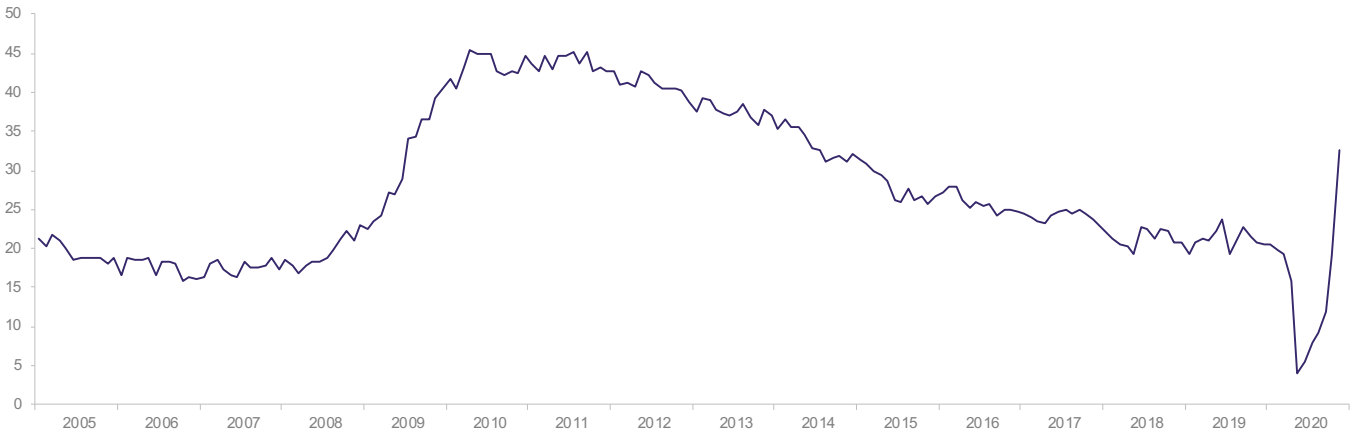
The potential shape of the recovery is hotly debated and described by shapes of letters. Will the recovery be V-shaped, with both a quick drop and recovery, or will it take longer, like a U shape? Or, will it look like a W, K, L, or something in between? The answer may be, "It depends." Like a literature class, much is up for interpretation. Let's look at different areas of the economy, because the recovery will not be uniform—think more like *A Tale of Two Cities*.

We saw a sharp decline in the labor market with the loss of over 20 million jobs. Its rebound was also sharp as 10 million jobs were recovered quickly, but that's only around half the number of jobs originally lost. While the initial recovery looks like a V, recovering the remainder of these jobs may look like a long-bottomed, upward-sloping U. Breaking down the labor market, the recovery will not be even and instead look more like a K.

The hospitality and tourism sectors were hit particularly hard and will take longer to recover, while online retail has largely benefited from social distancing orders. **Figure 2** shows a third of unemployed individuals have been unemployed for more than six months—a figure that's rising each week.

Figure 2: Unemployed More than 27 Weeks

Unemployed 27 Weeks or More as a % of Total Unemployment



Of Unemployment, Percent Unemployment, 27 Weeks & Over, SA, Percent – United States

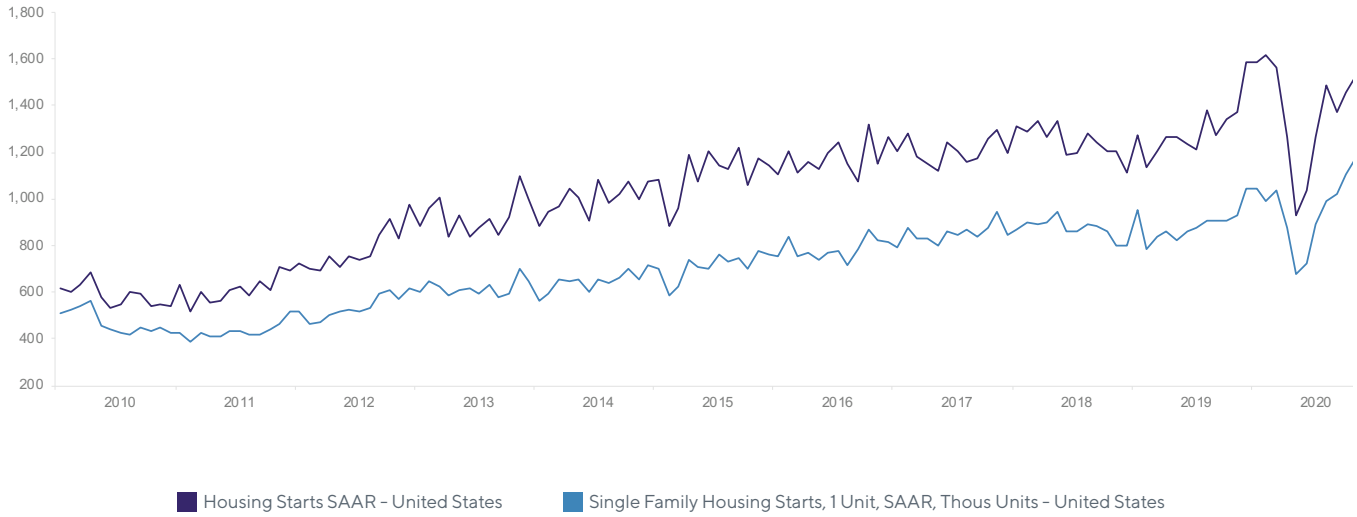
Source: Cetera Investment Management, FactSet, and U.S. Department of Labor. Data as of 10/31/2020.

In real estate, the housing market benefited from very low long-term yields, which pushed 30-year mortgage rates to record lows.

COVID-19 accelerated the work-from-home trend, making it easier for those in the city to move to the suburbs without having to worry about a commute. Additionally, there was some pent-up demand from millennials to buy homes. Low rates, combined with the ability to turn many homes into offices, propelled single-family housing starts to a post-housing bubble high **(Figure 3)**. While we see that nice V shape in housing, the commercial real estate sector may look more like an L over the longer term, due to the excess supply of office space caused by the pandemic.

Figure 3: V-Shaped Housing Market Recovery

U.S. Housing Starts
Monthly Level ('000), Seasonally Adjusted and Annualized



Source: Cetera Investment Management, FactSet, U.S. Department of Labor. Data as of 10/31/2020.

The shape of the overall recovery will largely depend on the consumer, as consumer spending makes up approximately 70% of the U.S. gross domestic product (GDP).

Retail spending has fully recovered from the start of the pandemic, but the way forward could be more challenging as fiscal stimulus funds start to dry up.

We did see a jump in one-time big-ticket items like cars and trucks, exercise bikes, and home furnishings. U.S. GDP is forecasted to fall around 3.5% in 2020, which equates to around $750 billion of lost revenue from 2019. The estimated $4 trillion in stimulus still couldn't save the economy from contraction.

The economy may be mostly on its own in 2021 though: GDP growth in 2021 is currently expected to be 4.5%, so expectations are high, but coming off low levels. With a divided Congress, passing more stimulus and adding to the debt will be increasingly challenging. The Federal Reserve will remain accommodative but may have to get creative as it's running out of tools. We expect a Biden administration to keep Jerome Powell as chair of the Federal Reserve, reducing potential uncertainty. A Trump administration was expected to appoint a new chair in 2022.

Studying Abroad: International Economies

In Europe, we see similar issues to those in the United States. Europe was hit even harder by the virus and GDP is expected to contract 7.5% in 2020 and only rebound 3.5% in 2021, according to Capital Economics, an economic research firm based in London. The Eurozone, under the European Union (EU), has additional challenges because the EU is an economic and monetary union, not a fiscal one that also issues debt. The pandemic may be changing this, though: for the first time, the EU issued close to $1 trillion in debt and created fiscal stimulus packages for countries hit hardest by the virus.

The virus seems to have brought Europe closer together, possibly reversing any more exit talk like in the case of the United Kingdom, which may see a contraction north of 10% in 2020 and a projected recovery of about 4% in 2021. The U.K. will continue paying into the EU budget in 2021 as it works out the details of its Brexit plan and tries to minimize the impacts from its departure.

Looking to Asia, Japan took an economic hit similar to other developed counties. China is claiming GDP growth will be positive in 2020, although many economists estimate growth will be relatively flat. Regardless, China was able to weather the virus better due to the stringent social distancing policies they enacted. China's economy could also benefit from a Biden administration, which may reduce tariffs (although probably not immediately).

WHAT TO KNOW FOR THE FINAL EXAM

With World War II-era debt levels and a likely divided Congress, the economy needs to support itself more in 2021 without financial aid from the federal government and with less help from the Federal Reserve. The shape, or speed, of the recovery will be largely dependent on containing the virus. The sooner workers can get back to work, make money, and spend money, the sooner the economy can recover. Looking overseas, Europe was hit harder by the virus and will take longer to recover than Asia.

Equity Markets

Statistics 101: Valuations

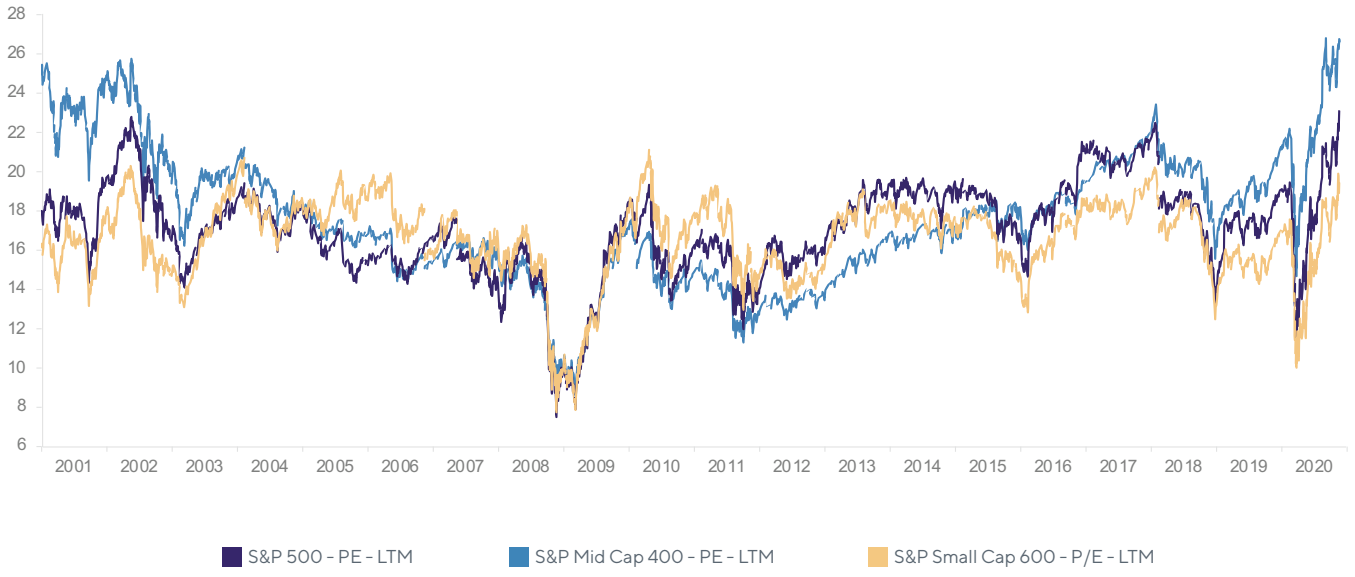
Stock markets' high valuations are currently giving investors a lesson in statistics. Currently the S&P 500 price-to-earnings ratio is 2.6 standard deviations above its 15-year mean. Said another way, investors are paying a lot for stocks relative to their earnings (both future earnings and historical earnings). Since 2.5 standard deviations equate to roughly the 99.5th percentile, that means the price-to-earnings (P/E) ratio has only been higher around 0.5% of the time.

The S&P 500 represents large cap stocks and is concentrated with high-growth companies at the very top: 10 stocks make up roughly 30% of the S&P 500 index right now. We speak a lot about diversification, but you can see the importance. Diversification comes in many forms and owning a lot of stocks in different percentages, like an index, doesn't always give the diversification that may be expected. Concentration isn't necessarily bad either, but it's important to do your homework and understand the risks.

The good news is that if we look at smaller companies, the statistics start to change. The S&P Mid Cap 400 is 0.9 standard deviations above its 15-year mean (only higher 16% of the time) and the S&P Small Cap 600 is 0.2 below its 15-year mean (higher 66% of the time). **Figure 4** shows the trailing P/E ratios of these indexes over the past 20 years. Worth highlighting: large cap hasn't been this highly valued since the tech bubble in the early 2000s.

Figure 4: High Valuations

Valuations: Trailing 12-Month P/E



Source: Cetera Investment Management, FactSet, S&P Global. Data as of 11/17/2020.

Smaller companies aren't the only ones with better valuations.

Value stocks, which normally trade at lower P/E ratios, are a lot cheaper compared to growth stocks even on a relative basis. Growth has outperformed value significantly over the past few years.

Growth stocks have also outperformed in international markets. Investors around the world have been bidding up growth stocks relative to their value-stock counterparts. We think when the economic recovery strengthens and the broader economy starts to rebound, value stocks will be a beneficiary.

One should interpret these results with some caution, as high P/E ratios shouldn't be viewed in a vacuum. Earnings growth expectations can improve as the economy recovers, lowering P/E ratios. In addition, momentum can be strong and high valuations can persist for long periods of time. Valuations are not a good determinant of short-term performance and tend to be a better forecast for longer-term performance. In general, you never want to pay too much for an asset.

Finance 101: Earnings

The dividend discount model taught in finance classes will explain that high valuations or asset prices can be supported by low interest rates. The Federal Reserve dropped the Fed Funds rate close to zero and long-term bond yields are also very low. This explains why housing values and stocks have risen, as homeowners and corporations can afford to borrow more money.

However, we did have low rates for many years coming out of the Great Financial Crisis of 2008, so there is a recent comparison. Worth highlighting: valuations are still high compared to this period.

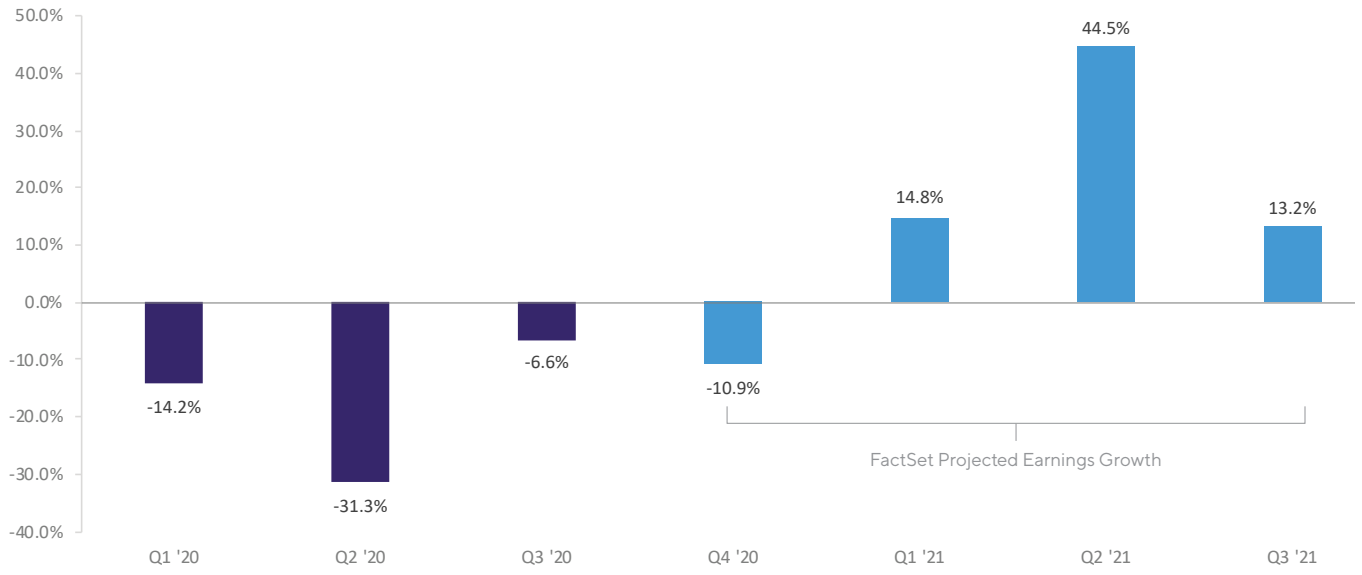
A rising denominator in the P/E equation will lower the ratio, so let's look at projected earnings. The trillions in stimulus dollars are supporting earnings and could act as a tailwind next year. In **Figure 5**, we look at the S&P 500's year-over-year projected earnings growth by quarter. Earnings growth is expected to become positive the first quarter of 2021 with a big bounce in the second quarter, but the way the math works can be a little deceiving.

The series of returns makes it necessary to understand how these percentages work. Losing 31% in the second quarter of 2020 and then gaining 45% in the second quarter of 2021 only puts earnings back to first-quarter 2020 levels. Regardless, you can see earnings could recover to 2019 levels by late 2021.

At this point, we do not think projected earnings justify high valuations. Equity markets, especially larger growth companies, could be priced to perfection, and may therefore be riskier.

Figure 5: Earnings Growth

S&P 500 Earnings Growth (YoY)



Source: Cetera Investment Management, FactSet, Standard & Poor's. Data as of 11/18/2020.

Since mid-March, the U.S. dollar has weakened dramatically against major currencies.

Internationally, a weaker dollar could hurt businesses selling to the United States because their goods would become more expensive to U.S. consumers. But this would also benefit people in the U.S. investing internationally because currency gains would occur when translating profits back to dollars.

This has been a headwind for U.S. investors the past few years. International companies are facing many of the same challenges as U.S. companies while economies recover from social distancing measures.

We mentioned growth outperforming value is a worldwide phenomenon, but we should note a lot of this is also driven by investors bidding up technology companies. U.S. indexes have performed better than international ones in large part because technology stocks make up a large portion of the U.S. stock market. This is less true in Europe than in Asia and is one factor in why Asian markets have outperformed European ones. As economies recover, value stocks and Europe may start to catch up.

WHAT TO KNOW FOR THE FINAL EXAM

Putting this crash course of statistics and finance together, we end up with high valuations and a modest corporate earnings outlook. This could mean more volatility in 2021. Investors may have to adjust their expectations, especially in growth stocks. As mentioned earlier though, these trends can last a long time. Trying to time the market is difficult, so being diversified in smaller companies, value companies, and international companies is prudent. Paying attention to concentration in portfolios is also important to ensure there are no unintended risks.

Fixed Income

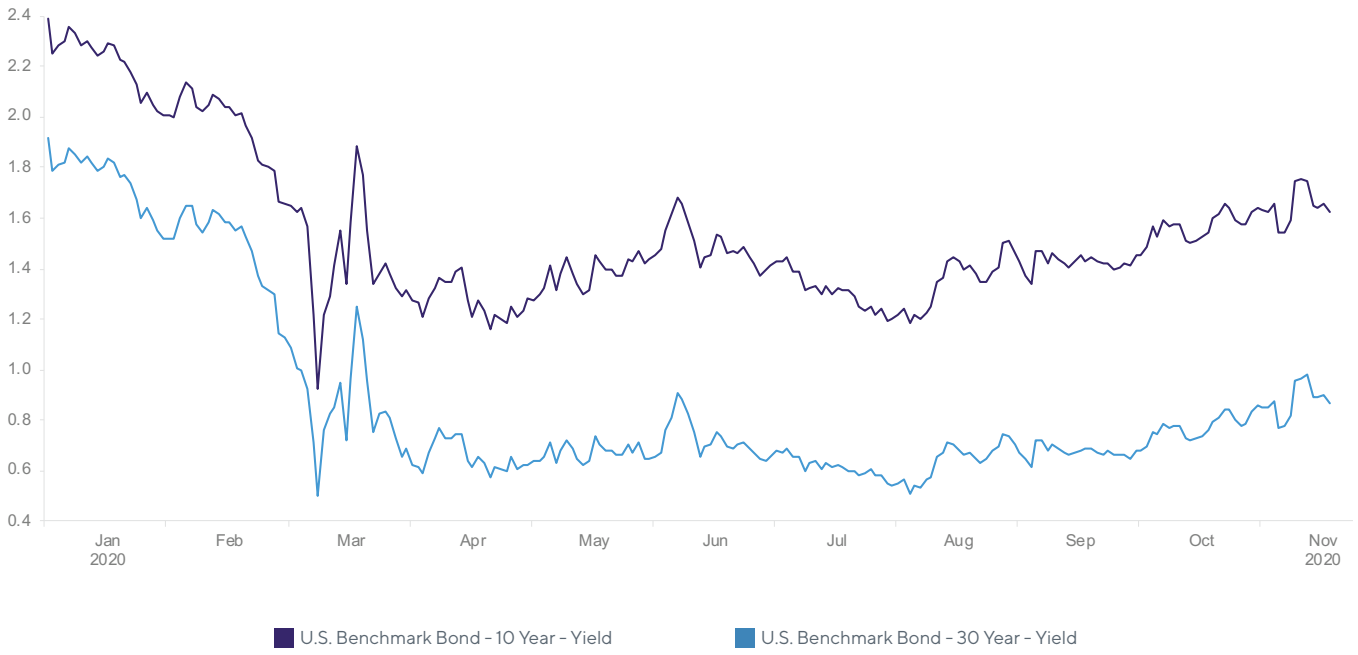
Applied Mathematics 101: Low Yields and Diminishing Returns of Bond Math

On a fundamental level, bond math is actually pretty simple: bond prices move inversely to bond yields. For 40 years bond yields have been falling, so bond prices have been rising. Returns in bonds have been pretty good—so good that at one point in the Great Recession, bonds actually outperformed stocks over a 30-year period. But now bond yields may have hit a floor.

This year, 10-year Treasury bonds, which tend to correlate to mortgage rates, hit an all-time intraday low of 0.32% in March (mortgage rates will be higher because of credit risk). It's theoretically possible that yields could go negative (and they are in other parts of the world), but the reality is yields probably aren't going much lower and the 40-year bull market in bonds may be over. You can see in **Figure 6** after hitting bottom, longer-term Treasuries yields are starting to rise off very low levels.

Figure 6: Low Bond Yields

Treasury Yields: 10-Year vs. 30-Year



Source: Cetera Investment Management, FactSet, U.S. Treasury Department. Data as of 11/17/2020.

So where do bonds go from here? A lot will depend on inflation expectations.

As expectations for growth rise, so do expectations for inflation. Looking at Treasury Inflation Protection Securities (TIPS) 10-year break-even rates—or, the rate at which investors think inflation will be in 10 years—can hold some clues to what investors are thinking. If one thinks inflation will be above this rate, TIPS are more attractive than Treasury bonds with the same maturity.

When the economy fell in the spring of 2020, the break-even rate fell with inflation and growth expectations to 0.50%. With all the subsequent stimulus pumped into the economy, this break-even is now over 1.7%.

For inflation to rise meaningfully higher one would expect wage inflation to pick up and that is unlikely with current unemployment levels. It's something we are watching though as the economy starts to pick up in 2021.

The yield curve is also steepening.

Meaning, longer-term yields are rising faster than shorter-term yields.

Very short-term yields are essentially pegged to the Fed Funds rate, which is currently near zero. Looking at the spread between the 2-year Treasury bond and the 10-year Treasury bond, it went from negative for a brief period in 2019 to currently over 0.70%. This tells us there are expectations for more inflation in the future. If yields rise too quickly before the economic recovery can fully take hold, the Fed may be forced to intervene and start buying longer maturity bonds to push yields down, which would keep mortgage rates and corporate borrowing costs low.

Academic Probation: Zombie Companies

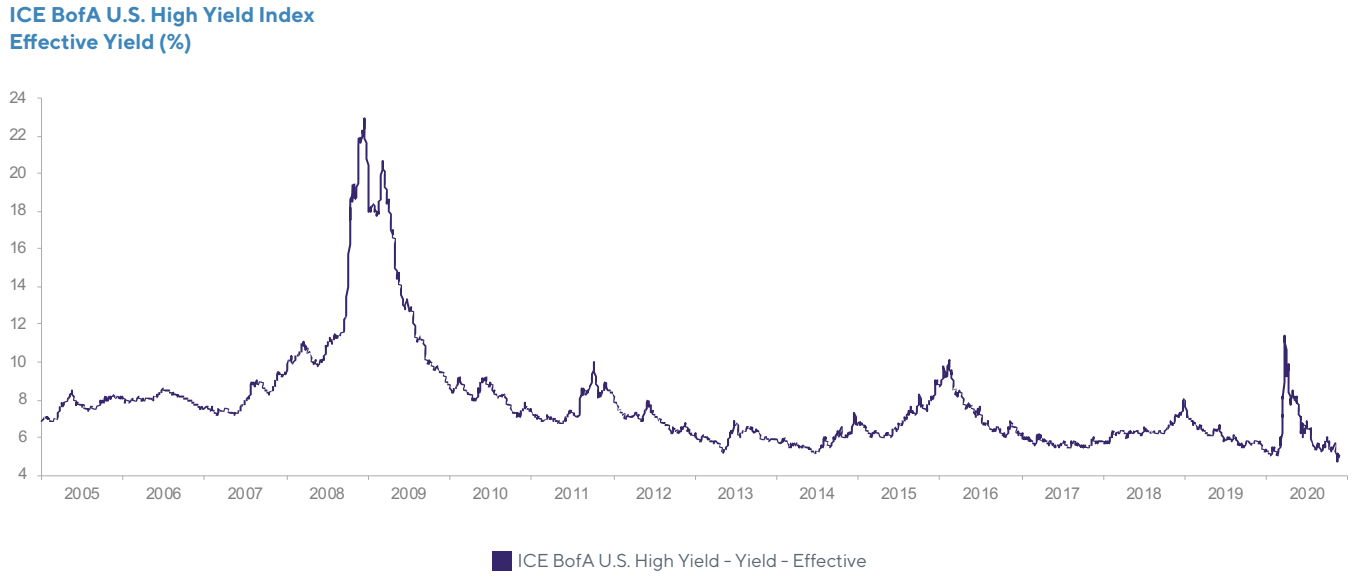
Like a student who didn't go to class and will likely have to go home after the semester, but still has money to remain "in school" a little longer, there are companies out there that might be hanging around on probation, or what we sometimes call zombie companies.

A zombie company is one that's relying on bailouts from their creditors, parent company, or government to continue to operate. Some fear there are a lot of these companies out there and defaults will rise dramatically in the future. The good news is that default rates aren't expected to rise as much as some may be anecdotally thinking. Yes, there will be many small businesses that go bankrupt, but keep in mind most do not issue high-yield bonds in the debt market. They are small mom-and-pop shops that don't have access to capital markets. Larger companies with access to credit are more likely to weather this crisis.

Many high-yield managers believe default rates will be elevated this year, but over the next few years, defaults may not be as bad as many would expect. Credit rating agency Fitch confirms this thesis. They expect defaults in the high-yield market to be 15% to 18% cumulatively over the three-year period of 2020 to 2022. Again, these are cumulative numbers and not annualized numbers. For comparison purposes, the default rate was 22% from 2008 to 2010 during the financial crisis. Leveraged loan defaults, which were 15% from 2008 to 2010, are anticipated to jump to 17% to 20%, exceeding those during the financial crisis.

The next question an investor may ask is whether these expected defaults are currently priced into markets. Are they already expected and discounted in the price of bonds? The effective yield for the ICE BofA U.S. High Yield Index, as seen in **Figure 7**, is at an all-time low, suggesting high-yield bonds may be overpriced. But if we dig deeper there's another explanation. The yield spread over treasuries is not an all-time low—Treasury bond yields are just very low. It does look like markets may be underestimating defaults, but they could still be in the range of expectations. So high-yield bonds may be a little overpriced, but possibly not by that much. There are a lot of students in college spending too much time socializing, but they will probably be back next semester.

Figure 7: All-Time Lows in High Yield



Source: Cetera Investment Management, FactSet, ICE BofA. Data as of 11/17/2020.

We recommend holding some high-yield as part of a diversified portfolio but are more constructive on investment grade credit.

Yields are relatively low, but if we see equity volatility, they would see fewer drawdowns than high yield bonds and offer better yields than government bonds.

Another sector that could buffer equity volatility could be municipal bonds. This sector's high-quality bonds can act like government bonds during equity drawdowns. Municipals tend to have more duration, so rising yields may be problematic. Relative to government bonds, they can be attractive to high-income earners especially in states with high tax rates. The highest-grade municipal bonds, rated AAA, have a yield that's close to government-backed Treasuries, yet municipal bonds can offer more tax benefits.

A blue wave, or Democrat sweep, may cause more money to flow into municipal bond markets and drive up prices as investors anticipate higher tax rates, but our base case of a divided Congress makes municipals slightly less attractive.

We think cities and states could face budget challenges due to COVID-19 and be downgraded, but defaults should be rare. However, there's headline risk in this supply-and-demand-driven market that's dominated by retail investors. If there were downgrades, municipals may sell off and present a possible buying opportunity, but one needs to do their homework. That's why we prefer active managers in this space.

WHAT TO KNOW FOR THE FINAL EXAM

Bond yields are low, creating risks to bond investors, but bonds can be an important hedge to equity volatility in a portfolio. Government debt levels seem unprecedented and so do these low bond yields, but there's a notable historical reference point. After World War II, debt-to-GDP levels and bond yields were close to today's levels.

Inflation gradually rose during this period and government bond returns did not see large losses or even many annual losses. It's important to note, however, that on an inflation-adjusted basis bond returns were negative. Also, the good news with higher yields is that bond investors can reinvest their money in higher-yielding bonds going forward.

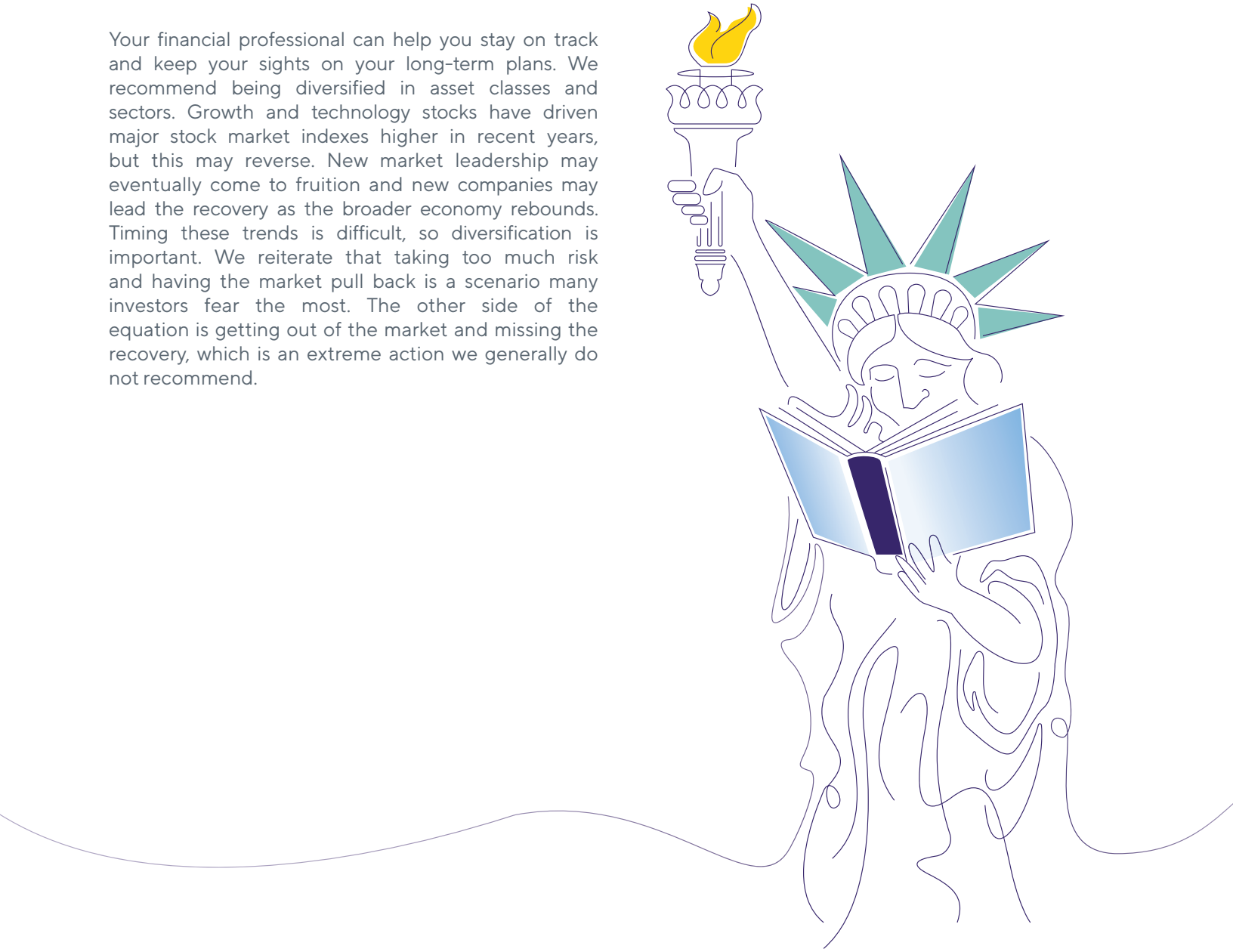
We recommend being underweight duration to mitigate some of this interest rate risk. High-yield bonds can have a place in a diversified portfolio, but we prefer investment-grade corporate credit in this environment of high equity valuations. For high-income earners, municipal bonds may be more attractive than government bonds, but having an active manager who can do the credit analysis is important.

Also, investors in this space should be aware of interest-rate risk and try to balance this risk with shorter duration municipals or other bonds that fit their investment objectives.

Final Exam

As we look back at 2020, 2021 may be defined by less fiscal and monetary support. Economies around the world will increasingly have to rely on underlying fundamentals. The recovery will be an uneven one and depend on containing the virus. There will be winners and losers in the economy, stock market, and bond market. The shape of the recovery will vary by country, sector, and company. Stock valuations are at high levels that don't seem to be entirely supported by future earnings growth, which should add to market volatility. Bonds offer a buffer to this volatility, but with low yields, the buffer could be limited. There's no doubt this creates challenges for investors in 2021.

Your financial professional can help you stay on track and keep your sights on your long-term plans. We recommend being diversified in asset classes and sectors. Growth and technology stocks have driven major stock market indexes higher in recent years, but this may reverse. New market leadership may eventually come to fruition and new companies may lead the recovery as the broader economy rebounds. Timing these trends is difficult, so diversification is important. We reiterate that taking too much risk and having the market pull back is a scenario many investors fear the most. The other side of the equation is getting out of the market and missing the recovery, which is an extreme action we generally do not recommend.



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All economic and performance information is historical and not indicative of future results. The market indices discussed are not actively managed. Investors cannot directly invest in unmanaged indices. Please consult your financial advisor for more information.

Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards.

A diversified portfolio does not assure a profit or protect against loss in a declining market.

Glossary
The **S&P 500** is an index of 500 stocks chosen for market size, liquidity and industry grouping (among other factors) designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

The **ICE BofA US High Yield Index** tracks the performance of U.S. dollar-denominated below-investment-grade-rated corporate debt publicly issued in the U.S. domestic market. To qualify for inclusion in the index, securities must have a below-investment-grade rating (based on an average of Moody's, S&P, and Fitch) and an investment-grade-rated country of risk (based on an average of Moody's, S&P, and Fitch foreign currency long term sovereign debt ratings).

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