INVESTMENTS®

Q1 2021 Economic outlook

Taxiing before takeoff

The outlook for 2021 is one of recovery, vaccine optimism and growth. But before takeoff, we need to navigate the loss of momentum in Q1.

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Lara is Chief U.S. Economist and Managing Director on the Investment Research team at FS Investments, where she analyzes developments in the global and U.S. economies and financial markets. Her fresh take on macroeconomic issues helps to inform and develop the firm's long-term views on the economy, investment trends and issues facing investors. Lara is committed to the Philadelphia community and serves on the boards of the Economy League of Greater Philadelphia, Hyperion Bank and Starr Garden Park.

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Dear Reader,

I love a good plane analogy, perhaps because I miss traveling so much. The idea of our economy on the tarmac, conducting preflight safety checks and getting ready to zoom forward, seems exactly right for what we are facing in Q1. We are taxiing before takeoff.

Like most households, I am confident about the future, but the timing of the takeoff remains uncertain. Businesses have been stockpiling cash, which will be badly needed for private investment and hiring to turn our takeoff into a long, smooth trip. Fiscal and monetary policy will be a tailwind, but that in and of itself will not be enough to sustain growth for the long run.

Until I can actually travel to your offices and see you in person, I am making the best of it. In the meantime, I remain eager for our new journey to get started.

My best,

Lara Rhame
Chief U.S. Economist
Managing Director

The outlook for 2021 is one of recovery, vaccine optimism and growth. But first, we have to get through Q1. There is good news: Despite stalled momentum, consumer and business confidence have been steadfast, private sector balance sheets are solid, and policy will continue to be a tailwind. For investors, 2021 will truly be new territory, with rising yields and reflation posing challenges not seen in over a decade.

Key takeaways

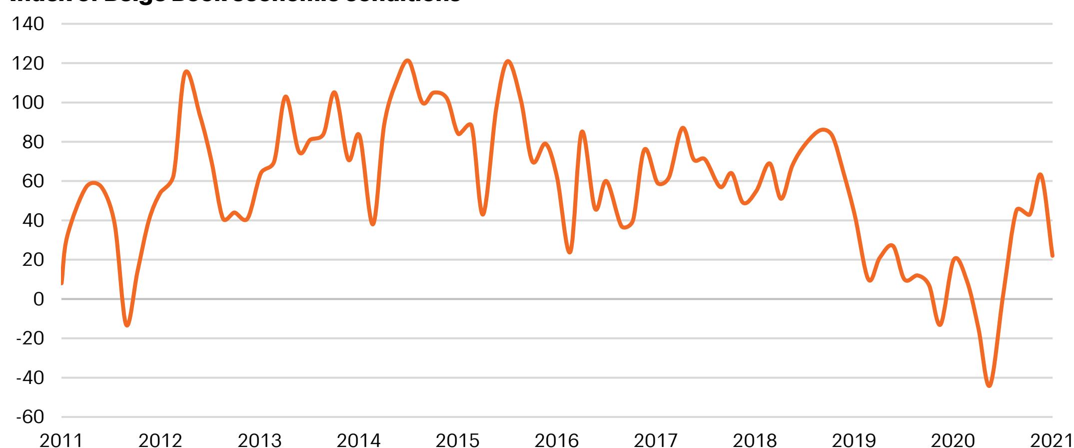
- We are at the dawn of a new expansion, and markets will rightly focus on inflation, reflation and inflation expectations.
- We expect dollar weakness to deepen in 2021, as low real yields and rising twin deficits erode support for the greenback.
- In 2020, equities became increasingly linked to interest rates, leaving investor portfolios even more exposed to rising yields.

Momentum has stalled, but sentiment is steadfast

Hopes for the economy in 2021 are high. The Fed estimates the economy will grow 4.2% in 2021,[1] the fastest rate since 1999, and some private forecasters are even more optimistic. But a snapshot of the economy at the start of 2021 is one of stalled momentum. First and foremost, the pandemic resurged in mid-October and has continued to worsen. In some states, this has caused fresh restrictions on school, dining and other mandated social distancing. In other states, rising community spread caused people to choose to stay home even if was not dictated by policy. For our early economic recovery, this caused a setback.

Several indicators have clearly shown a loss of momentum. Retail sales, which had surged from May to September, experienced three consecutive months of decline from October to December. At the start of 2021, initial jobless claims unexpectedly surged to over 900,000, a level not seen since August 2020. Anecdotally, the Fed's regional survey of business conditions

Index of Beige Book economic conditions



Source: Federal Reserve, FS Investments, as of January 13, 2021.
Note: Index reflects net word search of positive terms (strong, strength, expand, expansion, recover) and negative terms (weak, soft/soften/softer, tight/tightening).

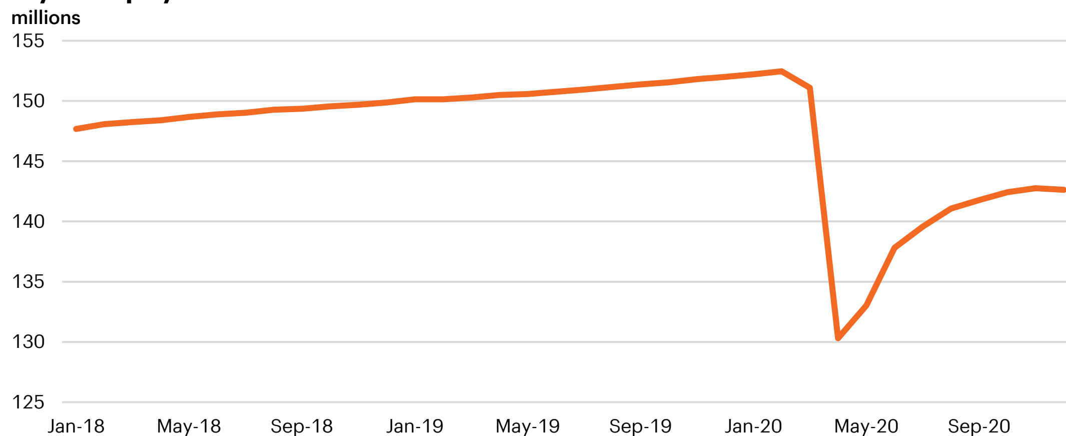
1 Median 2021 GDP forecast from the economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, December 16, 2020.

mirrored this as our index of economic conditions reversed course in the January 13, 2021, report.

Looking ahead to 2021, there are powerful supports that could keep our economy moving until vaccines and herd immunity allow for growth to truly take off. **Business and household sentiment** have been solid in the face of the worsening pandemic. In and of itself, this doesn't add to GDP. But consumer and business sentiment are necessary requirements for household spending and business investment, without which the economy cannot sustain growth. Strong **private sector balance sheets** are also a critical near-term support. While households and businesses may have taken a respite from spending as 2020 wound down, high levels of stockpiled cash mean that there is plenty of room for pent-up demand to kick in further once pandemic conditions lift.

The labor market will continue to play an enormous role in the economy in 2021. December 2020 saw 140,000 jobs lost, the first interruption in the impressive jobs recovery that began in May, stalling the unemployment rate at just under 7%. Some 9.6 million people remain unemployed compared with January 2020, and about half of these job losses are permanent. But this tells only part of the story. Nearly 4 million workers have vanished from the workforce, as the lack of in-person school and heightened health risks have combined to shrink the **participation rate.** How many of these potential workers can be coaxed back into the workforce later in 2021 will be a critical ingredient if growth is truly to accelerate.

Payroll employment
millions



Source: Bureau of Labor Statistics, as of January 13, 2021.

Twin tailwinds of fiscal and monetary policy

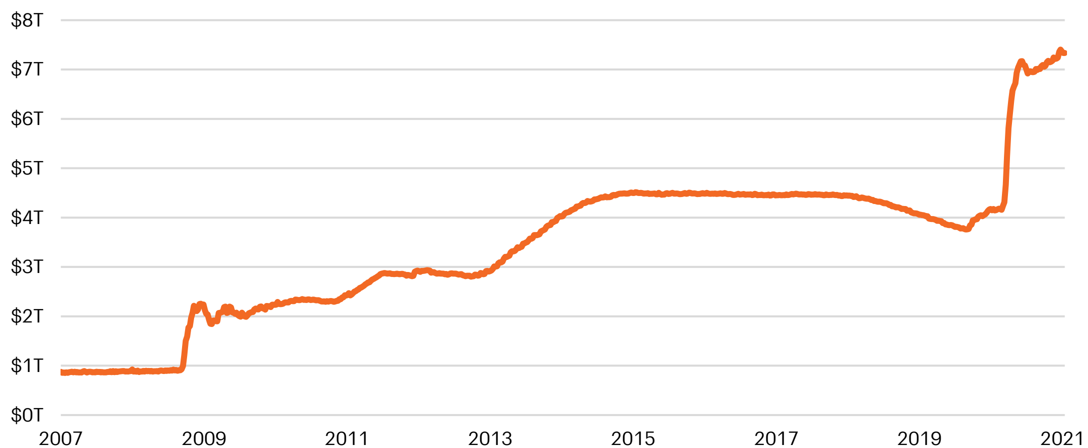
Fiscal and monetary policy will continue to be powerful tailwinds in 2021, but the nature of support could change later in the year. The Democrats' control of the House, Senate and White House has caused markets to price in more aggressive fiscal stimulus. President Biden's early announcement of a $1.9 trillion COVID relief package includes a third round of checks to households—$1,400 this time—as well as $400 billion to directly fight the pandemic.

Direct payments to households have carried demand through an epic dislocation in labor, and the hope is this will happen again in Q1. There is bipartisan support for another round of payments because a) it is a popular policy, and b) it is a fast pathway to push dollars into the economy. However, with each new round of direct stimulus checks, the pass-through to immediate impact on the economy may be fading. Put another way, consumption is being "smoothed" by households who are still unclear when the pandemic will end and jobs and wage income will fully return. Households are saving part of these checks and using some of the funds to pay down debt. Yes, this is good for the economy in the long run, but for every dollar of stimulus payments, far less than that will show up as GDP in the current quarter.

Expectations of substantial fiscal spending are already causing GDP forecasts to be revised up in 2021, despite mounting evidence of Q1 weakness. At some point, however, growth in the private sector will need to take over for government largesse, and fiscal stimulus will need to shift to supporting long-run growth initiatives; a prime example would be infrastructure spending. This could help improve U.S. productivity and standard of living and create sustained growth to truly buoy our economy after the post-pandemic rush of activity.

Monetary policy will also continue to actively support the economy in 2021. A look at the early years of prior expansions shows that the Fed typically cuts rates in the first year and a half of an expansion and holds off on raising rates until several years of growth and hiring have materialized. In 2009, with interest rates at zero, the Fed was unable to cut rates further, a situation the Fed finds itself in yet again. Indeed, the Fed deployed quantitative easing to support the economy in 2011 and 2013, well into the last expansion. QE is a tool we expect the Fed to continue to lean on as the Fed funds rate is back at the zero lower bound. For now, the Fed has shown little interest in easing up on the pace of bond market purchases—much less raising policy rates—and rhetoric is still leaning on the side of caution that more may be needed.

Federal Reserve balance sheet



Source: Federal Reserve, as of January 13, 2021.

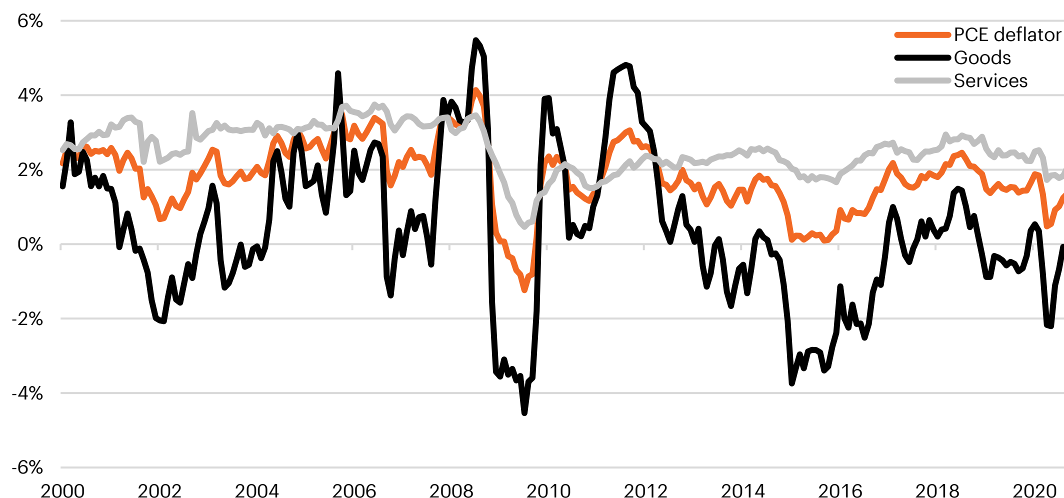
Unlike the Great Recession, during this cycle monetary policy is being supported by a strong fiscal response which looks set to continue for the next two years (until the midterm elections). Janet Yellen, the former Fed Chair, has been confirmed as the next Treasury Secretary, ensuring greater policy coordination and truly creating twin policy tailwinds. How this evolves practically will bear close watching in the coming year.

Inflation in focus in 2021

Strong 2021 growth projections have rightly brought **inflation** dynamics to the top of the discussion. Given the rising deficit, easy monetary policy has caused a surge in the monetary aggregates, which has some expecting inflation to surge. We see other dynamics at play. First, the outbreak of the COVID-19 pandemic delivered a shock to inflation. While there were offsetting shocks—some important subindexes like food and auto prices rose during the pandemic—the main result was deep deflation. The Consumer Price Index fell from 2.5% y/y at the start of 2020 to 0.1% y/y in May.

Over the next 4–6 months, we expect these "base effects" to work themselves out of the inflation data, which will cause an offsetting rise in inflation in May. A jump in inflation to as high as 3% would not be unexpected, given even trend-like increases in monthly inflation. Markets should resist the impulse to interpolate this climb forward, as it will likely normalize into year-end. But the increase may cause some volatility in inflation expectations and interest rates.

PCE deflator



Source: Bureau of Economic Analysis, as of January 14, 2021.
Note: PCE deflator represents **personal consumption expenditures** prices excluding food and energy prices.

The dynamic that we expect to get more attention, particularly in the second half of the year, is **reflation**, which refers to the broader system of economic recovery, inflation, inflation expectations and interest rates, all of which can change rapidly in the early stages of an expansion. We divide the discussion between two often confused outcomes. One of these is healthy reflation, where inflation expectations move higher, thereby implying strong enough growth to promote inflation close to the Fed's 2% average target.

The more problematic outcome could be runaway inflation that would risk a premature end to the business cycle by causing the Fed to raise rates. This is not our base case, by any stretch. Indeed, the greater concern is that inflation has been on a structural decline. Of even greater concern is that decades of low interest rates and falling income have created complacency among investors who have piled into duration risk in search of better yields. Even healthy, modest reflation could cause a big headache for investors who must manage to shorten duration or quickly pivot from equity exposure. Interest rates that trend higher would be a challenge not faced for decades.

Finally, we expect **dollar weakness** to deepen in 2021. The dollar fell versus most of the major currencies in 2021 as Fed policy intervention caused real interest rates in the U.S. to swing from +100 bps to -100 bps. While U.S. interest rates had been historically low for the past decade, they were still higher than interest rates in Europe and Japan, offering a carry to those holding greenbacks. Another feature of the pandemic has been the explosion of both the current account deficit and the government deficit; in the 1980s, these were known as the "twin deficits." The current account deficit, which is driven largely by trade, widened sharply in Q3 and early data for Q4 points to an even further deterioration.

Finally, the new administration will not continue the Trump administration's rhetoric to specifically weaken the dollar. And yet Treasury Secretary Yellen does not seem inclined to return to the strong-dollar policy of the Clinton/Bush/Obama eras. This "hands off" approach to the dollar may be read as a tacit endorsement of further dollar weakness, which, all else equal, acts to support the economy and boost inflation.

Markets face old challenges with new vulnerabilities

The economic outlook is one of robust growth in 2021 (even if momentum may not return until well into the second quarter). All the foundations of solid private sector sentiment and balance sheets point to a clear runway for a swift takeoff. Fiscal and monetary policy support an

optimistic growth outlook. Moreover, this dual policy tailwind, which includes issuing ever-greater amounts of government debt, could lead to shifting inflation dynamics. After years of decelerating inflation, we may have turned a corner. Investors may need to contend with rising long-term interest rates, pushed higher by rising growth and inflation expectations.

For many investors, this could come as a rude awakening. Our expectations for interest rates are that they could move between 1% and 2% in 2021. This is hardly a brave outlook—the 10-year Treasury was 1.87% at the start of 2020, before the entire world learned where Wuhan was on a map. And yet even a move of this magnitude would pressure **fixed income.** Duration-sensitive assets like Treasuries and investment grade corporate bonds would see prices fall, with too little income to make up the shortfall. Therefore, we believe that core fixed income has little room left to run. Those looking for yield may need to turn elsewhere. We see further opportunities in credits that have not yet fully recovered, such as lower-rated assets and those in sectors hardest hit by the pandemic.

Equity markets appear frothy from almost any angle at the start of 2021. A look at the 12-month forward P/E estimate shows valuations that have surpassed even the dot-com bubble. In our view, fundamentals will take center stage in 2021. After giving some companies a pass in 2020, investors will want to see a robust recovery in results that confirms their expectation that the COVID crisis had a sharp but fleeting impact on earnings.

S&P 500 valuations are looking overstretched

12-month forward P/E ratios

Source: Bloomberg Finance, L.P., as of January 26, 2021.

Under the surface of the surreal steady gains in the S&P 500 in 2020 has been a quick and sometimes violent change in market leadership. This could continue going forward, as growth, defensives and cyclicals take turns in pole position given shifts in the macro and rates outlook. Indeed, we break down how equities have become increasingly tethered to interest rates, with large-cap growth pushing a 15-year high in correlation to the 10-year Treasury. Should interest rates break meaningfully higher, it will do more than upset fixed income portfolios; it will require a broad reevaluation of all traditional asset classes.

Confidence and balance sheets sustain economy in Q1

Key takeaways

- The severe COVID-19 outbreak at the end of 2020 sapped momentum from our nascent recovery.
- Until vaccines clear our economy for takeoff, consumer and business sentiment are critical supports.
- Strong private sector balance sheets mean growth can ramp up rapidly.

The extraordinary economic momentum seen in Q3 and early Q4 2020 stalled at the start of 2021. To some degree, this was predictable. The pandemic still dominates much of the economic landscape, and surging new cases caused renewed hurdles to economic activity. In December, the economy lost 140,000 jobs, the first interruption in the labor market's strong recovery. This was almost entirely borne by leisure and hospitality workers as other sectors of the economy added workers. This shows that our economy has broad-based economic strength but is still highly vulnerable to COVID.

Until the reprieve of widespread vaccination, expected later in 2021, the economy could remain in somewhat of a holding pattern. There are critical supports that need to be maintained to ensure growth is robust once we are cleared for takeoff.

It is hard to understate the importance of steadfast consumer and business confidence. Consumer confidence stabilized in the second half of 2020 after falling at the start of the pandemic. Yet even as the economy slowed in late 2020 and stimulus hopes faded, consumer confidence remained well above levels seen in the prior recession.

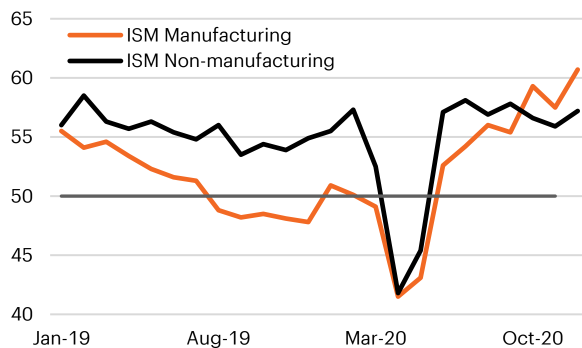
Business confidence has surged. ISM manufacturing sentiment hit 60.7 in December, the highest level since mid-2018, with optimism reflected across major manufacturing industries. Services sector confidence has also staged a full recovery to pre-pandemic levels.

Another vital support which could propel growth later in the year is strong household and private sector balance sheets. The household savings rate remained elevated at 12.9% in November as stimulus payments, augmented unemployment benefits and strong market performance have offset the income losses of the jobs market. And more stimulus is clearly being discussed, which should help consumers weather the near-term uptick in pandemic-induced unemployment.

The corporate sector has also been stockpiling cash, as nonfinancial business cash holdings have risen almost $1.5 trillion since the pandemic began. The best hope for a healthy, sustained economic recovery later this year is for businesses to ramp up investment and hiring as economic uncertainty lifts. A strong cash position is not a guarantee, but it is a necessary condition for private-sector growth.

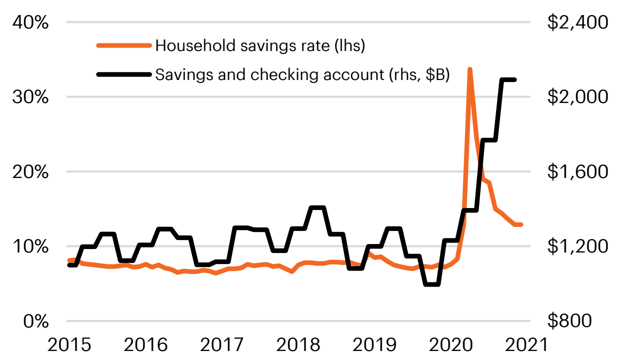
A looming question is how much of these savings will be spent. The next round of household stimulus checks could be plunked into savings or used to pay down debt, factors which don't directly add to GDP in the current quarter. But the foundations of solid confidence and healthy balance sheets put our economy in a much better position for a robust trajectory once we are cleared for takeoff.

Business confidence measures



Source: Institute of Supply Management, as of January 14, 2021.

Household savings and cash holdings



Source: BEA, Federal Reserve, as of December 14, 2020.

Employment: Participation rate in focus

Key takeaways
- While initially faster than expected, the labor market recovery is far from complete.
- The participation rate has plunged post-pandemic, which could restrain the economic recovery later in 2021.
- Permanent layoffs now account for more than 50% of total unemployed.

The labor market staged an outstanding recovery in 2020 but faces both near-term and long-term challenges. Initial claims jumped to 965,000 in the week ending January 9, the highest since August, as fresh lockdowns caused unemployment to rise again. It is a powerful reminder that the pandemic still poses a clear and present danger to the economy and the labor market recovery.

While initially faster than expected, the labor market recovery is far from complete. Unlike measures of consumer spending, which have come close to pre-pandemic levels, 9.6 million people remain unemployed versus January 2020. Half of these are permanently unemployed, a number which has risen to 3.4 million from just 1.3 million pre-COVID. The recovery in temporary employment has been more notable but also remains elevated.

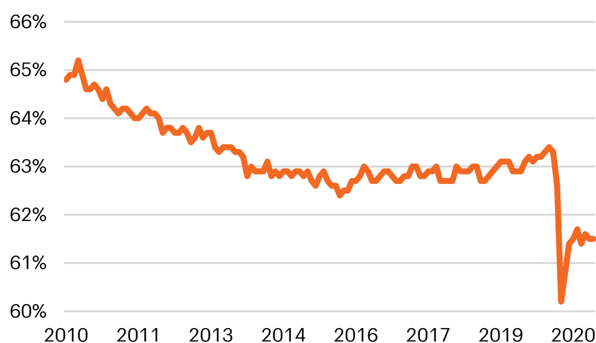
But this paints only part of the picture of the impact the pandemic has had on employment. Since the pandemic began, 3.9 million workers have entirely dropped out of the labor market.[2] This is expressed by the participation rate, which initially plunged as low as 60.2% in April and has since only recovered to 61.5%, almost 2 percentage points below the start of 2020.

This is almost certainly due to the unique nature of this downturn, which was driven by the pandemic. In much of the country, about half of schoolchildren are still schooling at home. In addition, working has suddenly become more dangerous for older workers. The great hope of 2021 is that vaccinations will bring back full-time in-person school across the nation, and that herd immunity combined with a fuller economic recovery will coax workers back into the workforce.

In the long run, the participation rate will remain a challenge to economic growth. Even well before the pandemic, the participation rate had been on a multidecade decline. Caused partly by demographics and partly by economic shifts and the Great Recession, the participation rate bottomed in 2015 at 62.4%, the lowest since the late 1970s. A depressed participation rate imposes a structural constraint on GDP, because growth, in its simplest form, is a combination of growth in our workforce and growth in productivity.

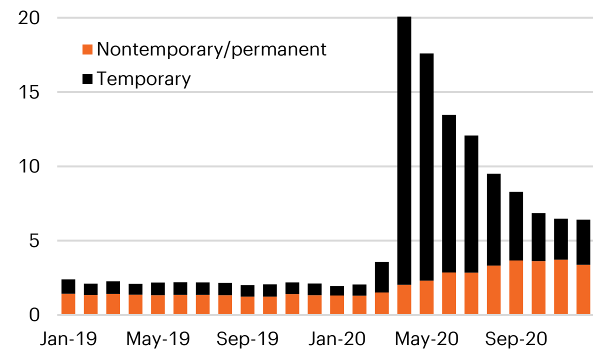
The rapid aging of our labor force is set to continue for years. The Census Bureau expects labor force growth to drop from its paltry 0.2% per year to 0.1% and to not accelerate until 2027. All of this means that even a strong post-COVID recovery in 2021 could hit a wall of an aging workforce and little room for the participation rate to recover.

Participation rate



Source: Bureau of Labor Statistics, as of January 14, 2021.

Temporary vs. permanent job losses



Source: Bureau of Labor Statistics, as of January 14, 2021.

2 The unemployment rate reflects people who are unemployed but are to some degree seeking employment. Eligible, working-age people who drop out of the labor force entirely are neither employed nor unemployed.

Fiscal and monetary policy: Twin tailwinds

Key takeaways
- Market expectations for fiscal spending have risen as Democrats take majority in Congress.
- Fiscal spending should pivot away from direct payments to households and toward more productivity-enhancing policies.
- Treasury Secretary Yellen will likely coordinate closely with the Fed, which should remain accommodative.

The policy response to COVID in 2020 was aggressive and is far from over. In 2021, we expect both monetary policy and fiscal policy to remain tailwinds, although the nature of support could shift.

An initial adjustment in expectations came at the start of 2021 as Democrats gained a (slim) majority in the Senate, opening the door to more aggressive fiscal spending. Markets internalized this by sending long-term interest rates 24 bps higher in the week following the runoff election in Georgia. Since then, President Biden has proposed a $1.9 trillion COVID relief bill that includes another payment to households of $1,400, plus $400 billion to marshal a coordinated federal response to the virus.

Looking ahead, fiscal spending should move from direct transfers to households to policies which improve long-run growth prospects. Stimulus checks have helped close the income gap and keep consumption solid. But there is increasing evidence that each new wave of stimulus checks is being saved and does not directly filter through to spending. It is akin to pouring gas on a fire: There is a flare, but it is short-lived.

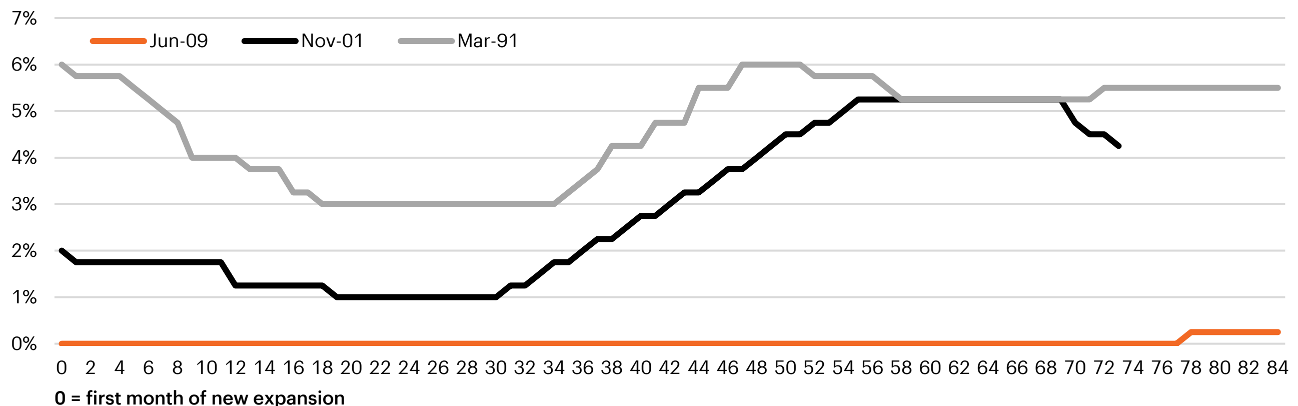
Spending that more rapidly tames the pandemic would be an enormous economic benefit. Infrastructure spending, which the past several administrations have proposed but been unable to deliver, would help create jobs, lift long-term income prospects, and hopefully improve the productivity of our economy.

Against the backdrop of these fiscal spending plans is a clear sea change in how the federal government thinks about debt. Neither political party can claim fiscal austerity as its orthodoxy. President Trump added almost $3 trillion to the debt before COVID hit. COVID relief spending has added on another $3 trillion spread across two packages in 2020 and early 2021. All of this dwarfs the rescue spending on TARP, which totaled less than $1 trillion.

Clearly, low interest rates are helping to justify deficit spending. The Fed is an important player in facilitating government spending. Historically, the Fed actively supports growth at the start of a new expansion. In the past, this has been done by cutting rates well into a new growth cycle. Now—as with the 2009 expansion—rates are already at zero, and the Fed is increasingly relying on quantitative easing. We expect the Fed to continue monthly purchases of $120 billion per month, with the ability to do more should markets or the economy require it. Talk of raising rates is several years premature, at least.

With Yellen confirmed as the next Treasury Secretary, we expect greater coordination between the Treasury and the Fed, all of which adds up to powerful policy tailwinds in 2021.

Fed rate changes after recessions end



Source: Federal Reserve, NBER, FS Investments, as of January 14, 2021.

Inflation dynamics in focus

Key takeaways

- The pandemic delivered offsetting shocks to inflation.
- Look for inflation to rise in Q2 2021 as base effects work their way out of the data.
- Whether inflation shocks are temporary or become permanent is one of the overarching questions for forecasters this year.

Despite stalled momentum in the first quarter, 2021 is expected to be a year of solid growth and the first year of a new expansion. Inevitably, this thrusts inflation dynamics to the top of the discussion. COVID-19 has had a big impact on inflation, delivering both positive and negative shocks. This has muddied the near-term picture compared to long-term dynamics.

The consumer price index decelerated from 2.5% y/y at the start of 2020 to as low as 0.1% in May. While a broad deflationary pulse was underway, several smaller parts of the price index spectacularly plunged. In May, accommodation away from home (i.e., hotels) fell -17.3% y/y, energy was down -18.3% and airline tickets plunged -28.8%.[3] As these base effects unwind in the year-over-year calculation, we can expect inflation to bounce in 2021, particularly from April to June. A simple projection that assumes monthly increases will return to a long-run trend would push CPI up to 3.1% y/y in May 2021, but thereafter it would revert and end the year at 1.9%.

Drilling into the pandemic's impact on inflation reflects to a large degree shifts in our lives during this historic time. COVID-19 and related shutdowns caused offsetting shocks in major subindexes.

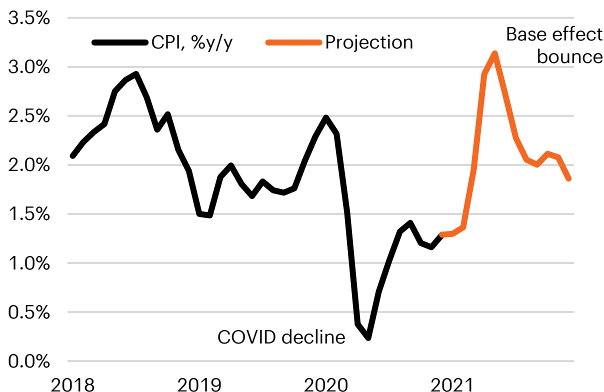
Comparing inflation data during the pandemic[4] with averages of the prior five years reveals that some sectors have experienced sharp deflation. Energy prices plunged as demand was severely interrupted. Nondurables excluding food prices (i.e., apparel and other consumer goods) dropped sharply.

One of the largest drivers of COVID disinflation has been the deceleration in owner's equivalent rent (i.e., the cost of shelter), which makes up almost a quarter of the entire CPI. This decline stems from people moving out of cities, which has caused rents to fall in some of the most populated (and historically most expensive) cities. In addition, low interest rates have encouraged people to move out of rentals and purchase homes.

Other large categories have shown a sharp increase in prices due to COVID. Food prices, which account for 14% of consumer spending, have surged both at home and in restaurants. Durable goods inflation, including new and used car prices, is sharply higher.

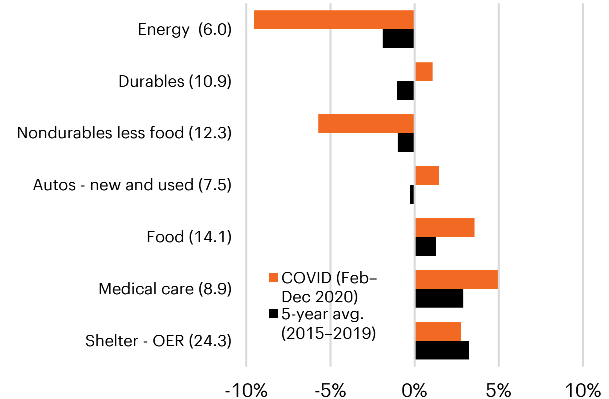
Whether changes imposed by the pandemic will be temporary or become permanent is one of the overarching questions for forecasters. Beyond the expected bounce in inflation in Q2, consumer price inflation will likely return to a more trend-like 2% later in the year.

CPI may rise mid-2021 due to base effects



Source: BLS, FS Investments, as of January 13, 2021.
Note: Projection uses the 5-year average monthly increase in CPI and projects % y/y growth using that increase.

Offsetting inflation shocks from COVID-19



Source: BLS, FS Investments, as of January 15, 2021.
Note: Subindexes include overlapping components. Number in parentheses represents category weight in total CPI index.

3 These subindexes have relatively small weightings, and together make up only 7.6% of total CPI.

4 Data from February to December 2020.

Dollar depreciation likely to deepen

Key takeaways
- Negative real interest rates drove dollar weakness in 2020.
- Twin deficits have skyrocketed, further eroding support for the greenback.
- The new administration seems to be taking a "hands off" approach to the currency, a tacit approval of recent dollar weakness.

The dollar weakened significantly in the second half of 2020, and our expectation is that this trend will continue in 2021. Dollar weakness has been broad-based, with the U.S. Dollar Index[5] falling -6.7% and the dollar down -6.6% vs. the Chinese yuan. Indeed, the dollar ended down versus virtually every major currency in 2020.

There are several factors contributing to dollar weakness that are likely to continue. First and foremost is the policy response to the pandemic, which delivered the most aggressive monetary policy intervention and fiscal stimulus in living memory. Quantitative easing pushed U.S. real rates into sharply negative territory, as nominal yields plunged on the back of Fed asset purchases, while inflation expectations bounced fairly quickly.

In other words, while negative real interest rates have been a feature of the European financial market landscape for some time, and Japan's real rates have hovered near zero, real U.S. interest rates swung from +100 bps to -100 bps within the course of nine months. This undercut one of the dollar's main supports: While the U.S. has previously faced historically low interest rates, they were still significantly higher than the rest of the developed world.

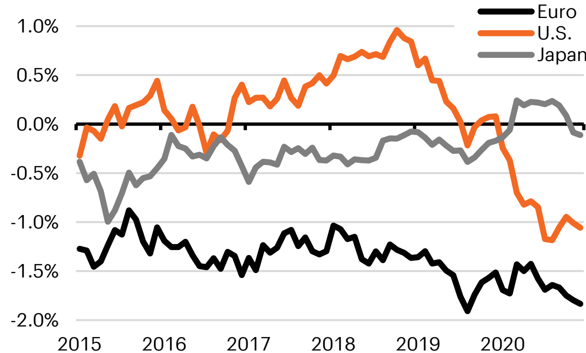
Going forward, the U.S. could maintain negative real rates well into 2021. Given the pause in growth, interest rates (which move higher with growth expectations) have also come to rest just above 1%. We expect they may move higher later in 2021, but for now, this dynamic could continue to weigh on the greenback.

Another factor is the surging U.S. trade and government deficits. Normally, in a recession, the U.S. trade and current accounts deficits narrow. This time, however, the current account deficit has widened by $94 billion and was -2.6% of GDP in Q3. This is not a record deficit, but the rapid deepening of the deficit is a huge vulnerability to the dollar, and given trade data in October and November, the current account deficit likely deteriorated more in the fourth quarter.

The dollar will remain a political topic. The Biden administration has not indicated that it will openly call for a weaker dollar, as the Trump administration had. On the other hand, it has stopped short of calling for a resumption of the "strong dollar" policy of the Clinton/Bush/Obama eras, either. More likely, the administration will take a hands-off approach to the currency. From the Fed's perspective, a weaker dollar helps stimulate our economy and keep U.S. manufacturing competitive, all else equal.

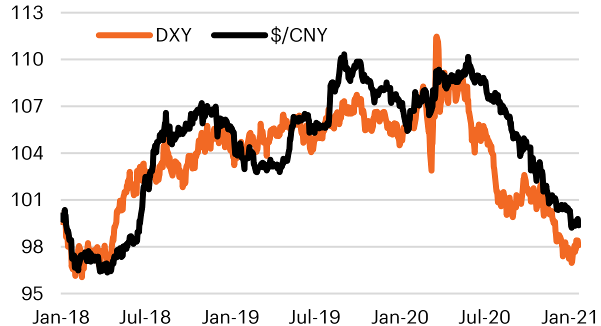
At the end of the day, with the U.S. deficit rising, the Fed holding down real rates, and our trade deficit eroding support for the greenback, we expect dollar weakness to deepen in 2021.

Real interest rates



Source: Bloomberg Finance, L.P., FS Investments, as of January 14, 2021.

Dollar weakness has been broad-based
Indexed to 1/1/2018 = 100



Source: Bloomberg Finance, L.P., FS Investments, as of January 20, 2021.

5 DXY index, with over 50% weighting to EUR and the rest includes JPY, GBP, CAD, SEK and CHF.

Reflation could be healthy or a headache

Key takeaways

- Reflation—the arc of inflation and inflation expectations—will heavily influence interest rates.
- There is an important difference between healthy reflation and runaway inflation.
- For investors, even modestly higher interest rates and trend inflation would be a significant challenge not seen in decades.

The topic of reflation has surfaced as a dominant theme for 2021. This is not a surprise. We are at the dawn of a new expansion, and the arc of inflation—and inflation expectations—will heavily influence interest rates. Let me reframe that: After decades of investors pivoting to accommodate falling yields and lower inflation, any reversal of these trends could wreak havoc on portfolios that are long duration and have become complacent.

A critical issue when considering the outlook for (and risk of) reflation is deciding on a definition for it. Often, reflation is used as an umbrella term for recovery and a return to "normal" inflation. Note that recessions typically deliver a deflationary pulse—this cycle is no different—and with expected economic recovery comes a reversal and recovery in inflation and interest rates.

That process is already in play. Yields were crushed by a devastating economic downturn, and Fed policies of quantitative easing pushed long-term Treasury yields down even further, below the 0.50% mark. But a robust economic bounce, an aggressive fiscal policy response and vaccine optimism have caused the 10-year Treasury to double from its low and rise back above 1%. Long-run inflation expectations have also bounced from their lows and are back around 2%. This is below levels seen when the economy was firing on all cylinders (2017–2018 as a recent example). There is upside room for yields should optimistic growth scenarios play out.

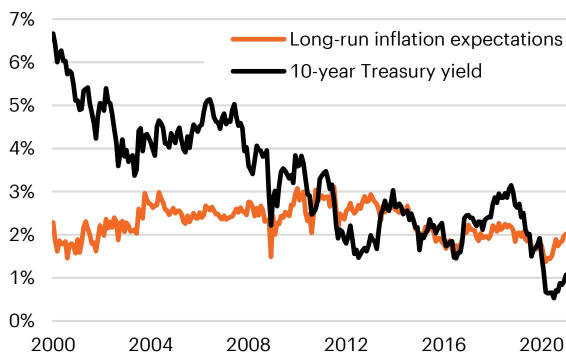
This is what we would consider healthy reflation: Inflation expectations sustained between 2.5%–3%, and long-term yields back toward 2% (or more) on the back of strong growth. In this scenario, the Fed would comfortably allow inflation to remain at or above 2%, giving time and room for the labor market to fully recover to pre-COVID levels.

This is different from reflation that includes a surge in inflation to 3% with an upward trajectory, which could cause the Fed to prematurely raise rates and shorten the business cycle. This view can become muddled within a discussion of reflation.

This is not our base case by any stretch. Indeed, the greater concern is that inflation has been on a long-run decline. Over the past 20 years, inflation has averaged below the Fed's target of 2%. This worsened in the 2010s, causing the Fed to give back rate hikes in 2018 and undertake a broad framework review to try to fix the policy prescription against the backdrop of chronically low inflation.

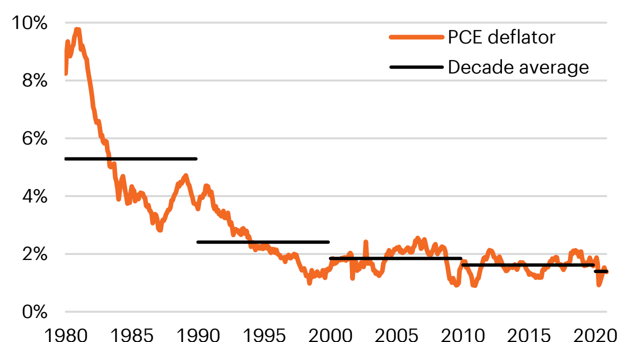
This low-inflation, low-yield environment has created an Achilles' heel for investors. Decades of falling yields have pushed investors to increase duration risk. Liquidity from QE policies and low yields have created equity markets that are now highly correlated to interest rates. Even healthy reflation could cause big headaches for investors, who will have to manage to shorten duration or quickly pivot equity exposure. Higher rates and inflation would be a challenge not faced for decades.

Yields, inflation expectations on the rise



Source: Bloomberg Finance, L.P., as of January 15, 2021.

Inflation in the face of structural disinflation



Source: Bureau of Economic Analysis, FS Investments, as of January 14, 2021.

Fixed income: Further room to run?

Key takeaways

- Core fixed income had a strong first half of 2020 but faces headwinds going forward.
- A solid backdrop for credit should continue to create opportunities in 2021.

Against the odds, or at least in contradiction to what many forecast entering 2020, core fixed income posted yet another strong annual return. The Barclays Agg returned 7.51% and, for the most part, hedged equities in their times of weakness. But did fixed income have a great year, or just a great six months? The dichotomy between the first half of 2020 and the second is stark. The Barclays Agg returned over 6% through June 30, most of which was driven by price appreciation as long-term interest rates collapsed around the globe. Since then, the Agg has returned only 1.3%, driven almost in equal parts by price and income returns.

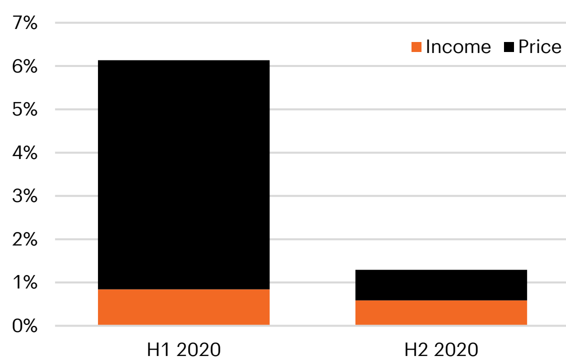
Long-term rates have nearly doubled from their all-time lows. We expect rates to continue to edge up through 2021, with a target range of 1%–2%, which will pressure duration-sensitive assets like Treasuries and investment grade corporate bonds. Given still-very-low yields and headwinds in the form of higher rates, we believe that core fixed income has little room left to run. Those looking for yield may need to turn elsewhere.

Credit markets proved their resiliency once again last year, recovering in remarkable fashion. High yield bonds and senior secured loans ended the year up 6.1% and 3.2%, respectively. However, unlike most segments of core fixed income, we still believe credit has more room to run. Optimism is apparent throughout financial markets as investors now see the vaccine-lit end of the tunnel. A solid economic backdrop, downward-trending default rates, the likelihood of widespread vaccine distribution and continued implicit Federal Reserve support should all create a conducive environment for credit for much of 2021.

At the broad index level, spreads have retraced nearly to pre-pandemic tights, although given the favorable backdrop, we believe spreads may retest or possibly surpass their post-GFC lows. Even the highest-rated portion of the high yield market could stand to gain. The spread gap between BBB and BB rated bonds—the lowest-rated investment grade bonds and highest-rated high yield bonds—remains slightly elevated, especially considering many of these BB bonds are recently fallen angels, meaning they were investment grade rated just prior to the onset of the pandemic. While we do expect a spread premium for any bond trading in the high yield market, we would not be surprised if this gap closes slightly.

We see further opportunities in credits that have not fully recovered, such as lower-rated assets and those in sectors hardest hit by the pandemic. Technicals should also remain supportive, with fewer fallen angels forecast and reignited demand for loans, given their floating rate and attractive duration. However, with current spread levels and lingering pandemic-related risk, we continue to stress the need for active management in this end of credit markets—those with the ability to discern which companies are best positioned to navigate the remainder of the COVID crisis and, eventually, a post-pandemic world.

Traditional fixed income runs out of room



Source: Bloomberg Finance, L.P., FS Investments, as of December 31, 2020.

BBB–BB spread gap

Source: ICE BofAML U.S. BBB Corporate Index, ICE BofAML U.S. BB Corporate Index, Bloomberg Finance, L.P., as of January 5, 2021.

Equities: A change in leadership

Key takeaways

- Markets appear frothy from almost any angle at the start of 2021.
- Market leadership can change violently, as we experienced in 2020.
- Investors should consider the impact this may have on their equity book, which has become more tethered to interest rates.

Equity markets put a bow on their incredible 2020 recovery in Q4 as positive news around COVID vaccines gave investors confidence to drive a robust rebound in cyclical parts of the market. The energy, financial and industrial sectors powered the S&P 500 to a 12.14% return in Q4, while the Russell 2000 recorded the best quarterly return in its history and outperformed the S&P 500 on a full-year basis. Markets appear frothy from almost any angle heading into 2021, leaving investors to ask where returns might come from in the 12 months ahead.

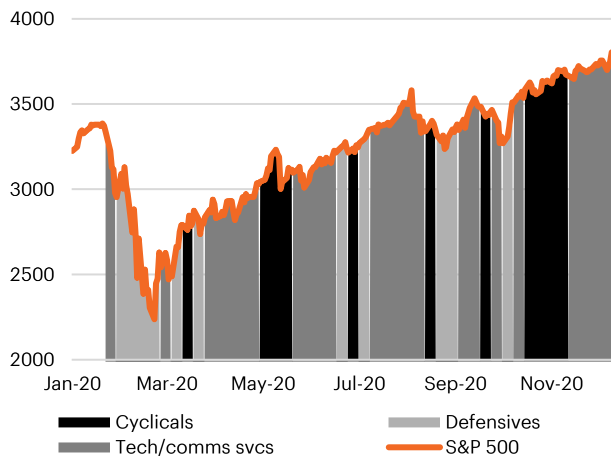
The trailing P/E (price-to-earnings) ratio of the S&P 500 closed 2020 nearing 30x and has since eclipsed it, the first time that level has been breached since the peak of the dot-com bubble. Backward-looking valuation metrics tend to rise around recessions because the denominator (earnings, sales or free cash flow) tends to decline. Even so, the S&P 500 is trading at more than 19x consensus EPS for 2022, during which most expect (and hope) the pandemic will be in the rearview mirror. This represents a significant uptick from pre-COVID levels.

Of course, it is difficult to estimate future earnings levels. In our view, fundamentals will take center stage in 2021. After giving some companies a pass in 2020, investors will want to see a robust recovery in results that confirms their thesis of the COVID crisis as having a sharp but fleeting impact on earnings. Currently, consensus estimates expect S&P 500 EPS to surpass 2019 levels in Q4 2021. This is certainly possible, given continued government aid and progress toward widespread vaccination, but it is a lofty target.

As we experienced in 2020, market leadership can change quickly and violently. Shares in technology and tech-enabled firms led for much of the rebound, but there were two impressive shifts toward cyclicals: in May and June as the U.S. economy reopened from springtime lockdowns, and in early November following the election and vaccine news. In our view, the macro and rates backdrop will continue to be a key driver of relative returns.

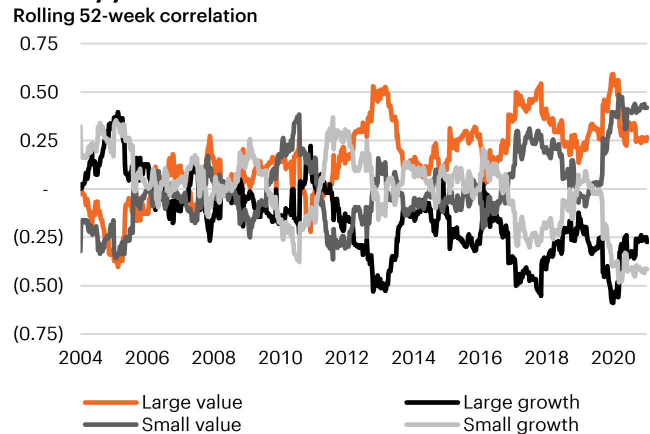
Certain growth-oriented areas of the market benefited greatly from pandemic trends. This has stemmed in part from extremely low rates, which changed the calculus on valuations, making future earnings more valuable. As a more robust economic recovery begins to take hold, all eyes will be on the potential for higher inflation, higher GDP growth and higher interest rates. Investors must consider the impact this will have not only on their fixed income allocation, but also on their equity book, which has become more tethered to rates.

Shifting S&P 500 leadership



Source: Bloomberg Finance, L.P., FS Investments, as of January 8, 2021.

Underrated risk: Stock correlation to 10-year Treasury yield
Rolling 52-week correlation



Source: Bloomberg Finance, L.P., FS Investments, as of January 8, 2021.