Economic and Market Outlook: Fourth Quarter 2020

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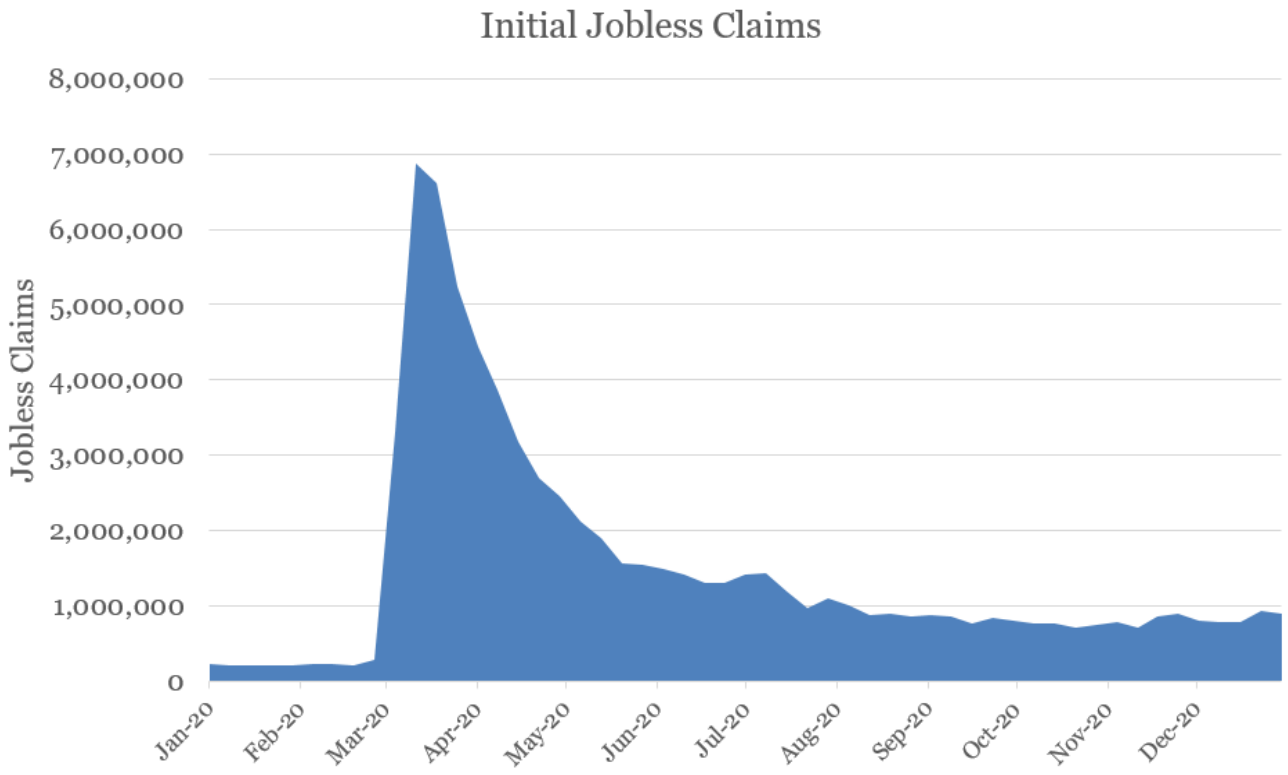
The year 2021 will be one of economic and political transition. The global pandemic that emerged in 2020 is, unfortunately, still with us, but there is optimism in the market that despite rising cases. The approved COVID-19 vaccines will be effective against the virus and distributed to healthcare workers and others most at risk in the first half of the year. This will be a game changer as the global economy reopens, employees return to work and students get back to school. Until then, governments around the world must continue to provide financial support to state and local governments, businesses and households that are currently unable to operate due to the pandemic.

A New Administration with a Focus on Pandemic Relief

The incoming Biden/Harris administration has prioritized COVID-19 relief needed to support the U.S. economy. The proposed $1.9 trillion American Rescue Plan continues the programs passed in early 2020 at the start of the pandemic and those approved by Congress in the last weeks of the year. The latest plan includes resources for a national vaccine program and expanded testing capabilities, more access to emergency paid leave and increased school funding. The Plan also calls for an increase in direct payments to eligible households, continued eviction protection for renters and additional unemployment benefits. Finally, financial support for small businesses and local governments will continue via the programs already in place. While the proposed legislation faces challenges in Congress, there is general consensus in both political parties that more fiscal stimulus is required and a version of the proposed Bill is likely to pass.

Exhibit 1: The U.S. Job Market Recovery Stalls As Virus Cases Accelerate Again



Source: U.S. Employment and Training Administration, Initial Claims [ICSA], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/ICSA, January 22, 2021.

The job market recovery that began in the summer of last year has stalled, making more direct relief critical to sustaining the recovery. Jobless claims, a measure of how many people are out of work and applying for unemployment benefits, remain near one million a week as illustrated in Exhibit 1, due to the spike in new virus cases over the winter. While many of these job losses are temporary, the longer the pandemic lasts, the more likely they will become permanent.

In addition to significant fiscal stimulus, the Federal Reserve reiterated their commitment to easy monetary policies by keeping borrowing rates low, even if inflation picks up. While inflation is a long-term risk to growth, it is not a near-term

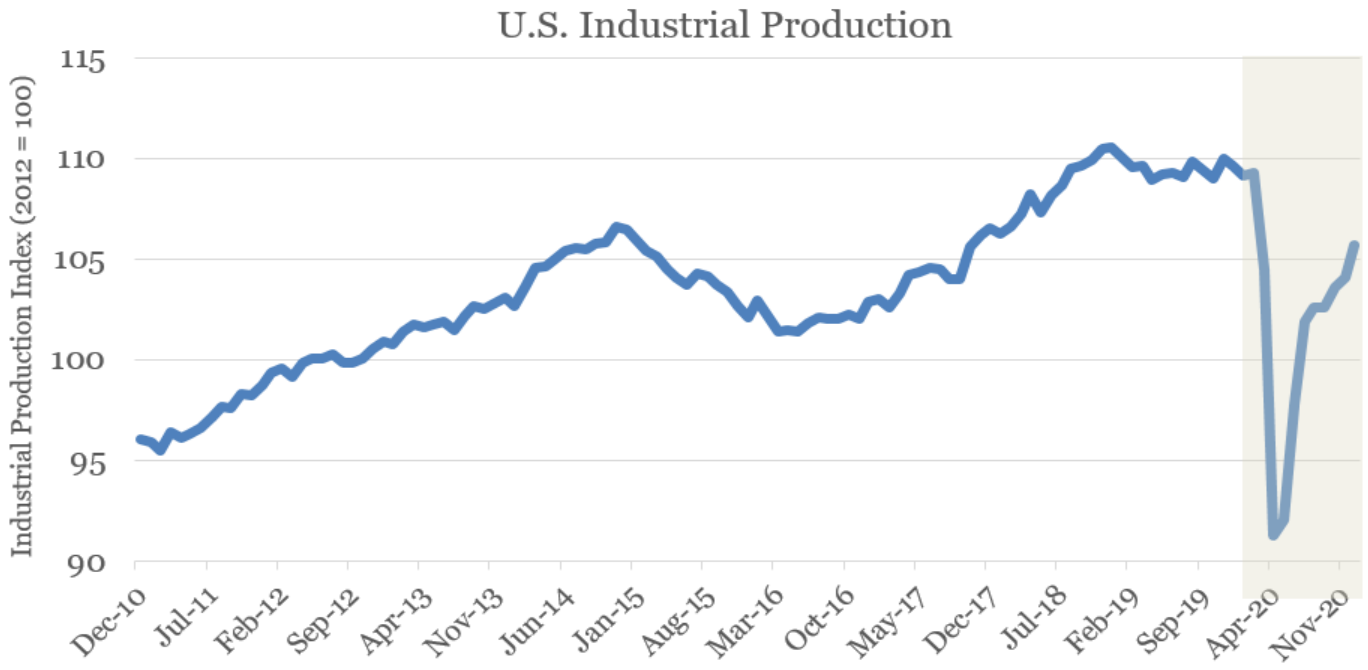
concern for the market because there is so much slack left in the labor market. Inflation won't become a risk until the U.S. approaches full employment again. Investors have come to rely on the support from the Fed in periods of economic uncertainty and their policies have contributed to the strong stock market over the last several years.

The Light at the End of the Tunnel

Despite rising cases and the emergence of a new strain of the virus that slowed recovery in the U.K. and Europe, there are signs that many parts of the global economy are healing. Unlike previous recessions, this one was caused by an external shock and has put more pressure on service industries such as travel and leisure, than on manufacturing industries. The sharp recovery in U.S. Industrial production Index, a measure of manufacturing, mining, gas and electric utility output, is a good sign that the economy is bouncing back.

As we look to 2021, there is evidence that even the hardest hit service industries are beginning to expand again. The most recent reading of the IHS Markit US Services Purchasing Managers Index (PMI) of 57 was higher than many expected (a reading above 50 indicates expansion). The survey suggested that business owners were optimistic about the months ahead and were hoping for a quick vaccine-roll out and a reduction in restrictions on movement. This bodes well for an economic recovery and a return to growth in 2021 that we expect will have broader participation.

Exhibit 2: Improvement in Manufacturing Activity is Evidence of Economic Recovery



Source: Board of Governors of the Federal Reserve System (US), Industrial Production: Total Index [INDPRO], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/INDPRO, January 20, 2021.

Non-U.S. and Emerging Markets

The Chinese economy is also showing signs of life and benefited from government stimulus programs initiated in early 2020 shortly after the start of the pandemic. Chinese exports were up 21.1% for the 12-months ended November 30, 2020 and manufacturing surveys indicate continued expansion. Because China was the first economy to be impacted by COVID-19, the rebound they have experienced since the middle of 2020 suggests Western economies, such as the U.S. and Europe, will follow.

As growth accelerated again in China, we began to see increased capital flows into emerging markets and strong stock market returns as a result. Emerging markets returned 19.8% in the fourth quarter and they were among the highest returning asset classes in 2020 with a full year return of 18.7% according to the MSCI Emerging Market Index.

European economies have more exposure to China and the stock markets tend to be more cyclical in their sector make-up. A pick up in Chinese growth is a positive for a Europe which is beginning to recover from a deep recession. Like the Federal Reserve Bank in the U.S., the European Central Bank has provided accommodative monetary policy to support European economies and businesses in the face of rising virus cases, but anticipates an eventual end to the Pandemic as vaccines become widely available later in 2021.

Market Outlook

With a global economic recovery as our base case expectation, global stock markets should continue to rise in 2021 while U.S. bond markets may face headwinds. While last year's stock markets were driven mainly by companies providing essential mobile communications and online shopping services, we expect economically sensitive sectors such as financials, industrials and energy should lead markets higher this year. Not only are these sectors more leveraged to a recovery given their business models, but they are trading at attractive valuations when compared to the rest of the market, and growth stocks in particular.

We highlighted the catalysts that we thought would drive a shift in market leadership in our ***Third Quarter 2020 Economic and Market Commentary.*** *The first and most important was the announcement of a safe and effective COVID-19 vaccine and this indeed has been the case. Smaller companies, value stocks and emerging markets outpaced U.S. growth stocks in the fourth quarter of 2020 and this will likely continue into 2021 as the global economy gradually reopens.*

The other catalysts we identified included rising bond yields, a falling U.S. Dollar and a pick-up in inflation. We have seen modest but meaningful moves in each one of these indicators since October of last year. As an example, the yield on the U.S. 10-Year Treasury is now above 1.0% today, rising from just under 0.6% in September of last year. While the yield remains quite low on an absolute basis, the market is clearly signaling increased growth expectations. We remain positioned defensively in our bond strategies relative to rising bond yields by maintaining a short duration stance.

Exhibit 3: Bond Market Strength Eases as Growth Outlook Brightens

Source: Board of Governors of the Federal Reserve System (US), 10-Year Treasury Constant Maturity Rate [DGS10], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DGS10, January 22, 2021.

As is typical in global recovery scenarios, the U.S. Dollar has weakened relative to other major currencies as capital flows to economies that show promising growth. The weaker U.S. currency is something that the incoming U.S. Treasury Secretary, Janet Yellen, will accept as a natural result of economic theory and interest rate policies. A weaker Dollar results in higher non-U.S. market returns for U.S. investors given the translation effect.

Interestingly, as the U.S. currency began to weaken against other currencies, the price of both Gold and Bitcoin rose. Both are now seen as alternatives to the Dollar, although Bitcoin's volatility makes it less of a currency alternative and more of a speculative asset. The price of gold tends to rise when inflation expectations rise. While inflation remains low today, the conditions for higher inflation are developing.

Throughout 2020, we focused on the impact of the virus on the real economy and the seeming disconnect relative to the strength of the stock market. The leading stocks in the market indexes were well positioned to pivot and provide essential services during the Pandemic, at the expense of the older economy such as traditional retail, real estate, energy, travel and leisure. The COVID-19 Vaccines, which were developed in record time, promise an end to the Pandemic later this year and this bodes well for economic recovery in 2021.

While there will be set-backs and delays in vaccine distribution, markets are forward looking and have already started to price in a post-pandemic world. *We are all looking forward to the day when we can return to our lives as we knew them, but the impact of the Pandemic in many aspects will remain. As a result, Wescott continues to manage portfolios with discipline and balance for resiliency over the long term.*

2021 Wescott Disclosure Information

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