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**DECEMBER 17, 2020 | 4:52 PM EST**

# 2021 Economic Outlook

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Public health authorities were alerted to the virus. Nevertheless, a pandemic developed. Social distancing measures were introduced. Authorities limited public transportation and banned mass gatherings. Schools, theatres, and places of worship were closed. Wearing face masks became common, although there were initial doubts about their effectiveness and organized protests against them. Public health directives varied across regions, with mixed results in containing the virus. The year was 1918…

**The Pandemic**

The COVID-19 pandemic had a significant impact on economic activity in 2020, and we should see a rebound from those effects in 2021. The major hit to the economy was in sectors where individuals come into close contact with others: consumer services, including tourism; air travel; sporting events; concerts; and brick-and-mortar retail shopping and restaurants. State and local restrictions on social distancing amplified these effects, but voluntary self-isolation (self-preservation) appears to have been a bigger factor. The November/December surge in COVID-19 cases is likely to dampen the pace of economic improvement into early 2021, but not lead to an overall contraction in economic activity. The arrival of vaccines should lead to more robust growth in the second half of the year.

Relatively speaking, there was some good news in 2020. Early on, the concern was that the pandemic would lead to a broad financial crisis and a snowballing of weakness across the economy. Thankfully, that didn't happen. The Federal Reserve cut rates to the effective zero lower bound in early March, re-launched liquidity facilities that it had employed during the 2008-09 financial crisis (and created a few new ones), and re-started large-scale asset purchases (what most people call quantitative easing or "QE"). Lawmakers in Washington passed a massive fiscal support package, which included healthcare expenditures, "recovery rebates" (checks and deposits), support for small business, extended unemployment benefits, and aid to state and local governments.

The economy lost 20 million jobs in March and April. Job losses were concentrated in low-wage service industries. As Fed Chair Powell noted, about 40% of those in the bottom 20% of income earners lost jobs in those two months, with more moderate job losses among higher-wage workers. However, low-wage, low-productivity jobs were shed within a wide range of industries. Absent these workers, average hourly earnings jumped and productivity growth surged, but that's simply an arithmetic artifact. The economy regained 12.3 million jobs from April to November, leaving us 9.8 million (6.4%) short of where we were in February.

Businesses and consumers adapted to living under the pandemic. White collar workers were more able to work from home. Telecommuting is expected to continue after the pandemic has passed. If you can work from home, you'll probably want a larger home in a better location. This shift strengthened the demand for housing. With a limited ability to spend on consumer services, mid- and upper-income households saw their savings rise, which helped boost spending on consumer durable goods. By October consumer spending on motor vehicles, home furnishings, and home improvement were substantially higher than before the pandemic, although strength appeared to fade into November. The increase in household savings is expected to help fuel the rebound in consumer services as vaccines are distributed, but many individuals may not accept a vaccine and others may be reluctant to resume pre-pandemic behaviors.

Some pandemic-related changes to the economy may be long-lasting. For many years, consumers have increasingly shopped online. That trend ramped sharply higher through the pandemic, leading to a surge in delivery and warehouse jobs. Bricks-and-mortar retailing had already been weakening in the years before the pandemic, and may be slow to recover. While residential housing is expected to remain strong, commercial real estate is likely to remain soft (except for warehousing). People may return to the office, but not fully, leading to reduced demand for office space.

**A New Administration**

The Biden/Harris administration will begin on January 20, but the transition team has already been active. The selection of former Fed Chair Janet Yellen as Treasury Secretary has given comfort to financial market participants. With her vast experience, she should provide a steady hand.

The amount of further fiscal support in 2021 will depend on the results of the Georgia run-off election on January 5. However, that support is expected to be substantially less than in 2020. By itself, the reduction in fiscal stimulus means economic growth will be slower than it would be

otherwise, but all else is not equal, as the recovery from the pandemic will add significantly to growth. In other words, the economic benefit of a retreating pandemic will be partly offset by reduced fiscal support

Fighting the pandemic will be the immediate focus, but the incoming administration will have a full agenda, including climate change, income inequality, and antitrust. Addressing climate change is expected to be a factor in most areas of the government and included in decision-making. Those in some industries may see this as a burden, others as an opportunity.

Income inequality has been a growing concern over the last few decades. As a rule, Americans do not begrudge someone's success, but most people feel that one should earn that success and pay a fair share of taxes. Rescinding the Trump tax breaks for upper income households and increasing the capital gains tax rate are expected to be on the agenda, but that will be difficult to get through congress even if the Democrats gain narrow control of the Senate. The bigger concern for the incoming administration is the whittling away of the middle class and the removal of paths for economic advancement. The pandemic has had a disproportional impact on lower-income households, worsening income inequality. College costs rose in the recovery from the 2008-09 financial crisis, making it more difficult to move up the ladder. The pandemic disrupted education, as poor households generally did not have the resources for remote learning. College enrollment is down. The pandemic also generated childcare issues, leading to reduced female labor force participation, especially at the lower end of the income spectrum.

The regulation of large tech firms has been a growing issue on both sides of the Atlantic. The new administration is expected to follow on the Trump administration's efforts, but monopoly/antitrust regulation is often a complex, lengthy, and difficult process. The new administration is concerned about the concentration of market power in general and is likely that to be more active in mergers and acquisitions.

**Federal Deficits, the National Debt, and State and Local Government**

The Treasury posted a $3.1 trillion budget deficit in FY20 (ending September), about 16% of Gross Domestic Product. The annual deficit had been tracking at around $1 trillion before the pandemic (in comparison, it was $439 billion in FY15).

Is the deficit a problem, a burden for future generations? Not really. The government has no problem borrowing. Interest rates are low. In fact, the government's interest payments over the next 10 years are projected to be lower than they were before the pandemic. The government is not like a household. The debt doesn't have to be paid off. The government need only pay interest and be able to roll over existing debt. The federal debt is over 100% of GDP, but that doesn't mean much. Japan's national debt is about 223% of GDP. Debt is a stock (or level), measured in dollars. GDP is a flow, dollars per time. The proper comparison would be debt to the future total of GDP, which is estimated in quadrillions (thousands of trillions) of dollars.

The broad consensus of economists has shifted over time. There is less concern about debts and deficits. There is little evidence that government debt crowds out private debt. However, the prevailing view is that at some point, lawmakers should work toward a more sustainable deficit, with the federal debt growing no faster than GDP. That could involve higher tax revenues, from both increased tax rates and increased compliance. It could involve spending cuts. However, outside of interest, entitlements (Social Security and Medicare), and defense, there's not that much left to cut. We could see entitlement reform, such as raising the retirement age or means testing. In the current recovery, the danger is not doing enough to support the economy in the near term and acting to reduce the deficit too soon.

Unlike the federal government, state and local governments generally have balanced budget requirements. With tax revenues down, spending cuts follow. Prior to the pandemic, state and local government accounted for 13% of nonfarm payrolls. These include teachers, police, and fire personnel, who in turn, spend their paychecks. A contraction in state and local government was a significant problem following the 2008-09 financial crisis, subtracting about 0.6 percentage points from GDP growth in the first few years of the recovery. Only in the last couple of years did state and local government employment reach its pre-recession peak.

State and local government lost 995,000 jobs in March and April, and another 351,000 were shed from April to November. Federal aid to the states has been a sticking point in fiscal support negotiations. More support will be needed and we can expect the Biden administration to make a focus of this in the months ahead.

**Trade and the Dollar**

Trade policy in the last few years has run counter to economic thinking. Economists disagree about a lot of things, but there is a strong consensus that focusing on bilateral trade deficits is misguided. Trade negotiations should be multinational. The Trump tariffs did little to reduce the trade deficit. Tariffs are paid by U.S. consumers and businesses, not China. They raise costs, invite retaliation, disrupt supply chains, and undermine business investment. The trade agreement reached a year ago had unrealistic goals for Chinese imports from the U.S. Trade policy under the Biden administration is expected to be less combative, but we may not see much change, at least right away. As we saw during the presidential

campaign, bashing China plays well politically. The tariffs were a drag on economic growth, but not enough to matter much.

In the early part of the pandemic, exports fell more than imports, widening the trade deficit, and in the initial recovery, imports rebounded more than exports, widening the deficit further. The trade deficit is likely to remain elevated in 2021.

The global outlook for 2021 is mixed. Advanced economies will benefit from vaccines, but they are expected to arrive later in poorer countries. Responses to the pandemic varied widely across countries. Experienced following previous epidemics, the major economies of East Asia did better. In China, Japan, and South Korea, the total number of cases is lower than the current daily average of new cases in the U.S. The U.S., with 4% of the world's population, has had 22% of the global cases of COVID-19.

The dollar can be thought of as a price, dependent on supply and demand. The dollar adjusts to balance trade and capital flows. In the short term, it's largely about central bank policies. The Federal Reserve is expected to keep short-term interest rates low, but so are other central banks. In the intermediate term, it's about growth differentials. The U.S. economy is expected to outpace the European economy. Chinese growth should be strong and its currency reserves are likely to expand, leaving the exchange rate in a narrow band. Over the longer term, the trade deficit should be the most significant factor. Global investors may become more enamored with countries outside the U.S., especially emerging economies, and U.S. investors may look to diversify following strong domestic stock market gains in 2020. Any pandemic-related flight to safety in the dollar should reverse. On balance, we may see some softening in the dollar in 2021, but probably not a lot.

The dollar is not the Fed's responsibility. That falls to the Treasury. Janet Yellen, the incoming Treasury Secretary, may signal support for a strong dollar, but we're unlikely to see any intervention in the currency markets (and intervention would not be enough to offset market forces). With the Fed purchasing Treasury securities, government borrowing should not be a factor.

**Inflation and the Fed**

The pandemic led to a drop in some prices, which rebounded as the economy began to re-open. However, there doesn't appear to be a broad-based pickup in inflation. While home prices have risen, that doesn't factor into inflation. The Bureau of Labor Statistics measures the cost of the service that housing provides and rents have been relatively soft. Homeowners' equivalent rent, which accounts for 24% of the overall CPI and 30% of the core CPI, rose 2.3% over 12 months ending November 2020, vs. 3.3% in the 12 months ending November 2019. Inflation expectations remain well anchored. The labor market is the widest channel for inflation pressures. With slack in the job market, there should be limited upward pressure in labor costs in 2021. Government borrowing does not lead to higher inflation.

Prices of raw materials should pick up as the global economy improves, but pressures ought to be mixed. In recent years, there has been little evidence that U.S. firms are able to pass higher costs along. Inflation in imported finished goods remains low. Increased household savings could fuel stronger demand, possibly putting some upward pressure on prices, but this would likely be limited to services that experienced price declines in the pandemic.

The Federal Reserve adjusted its statement on long-term monetary goals and strategies in August. The 2% inflation goal (as measured by the PCE Price Index) remains, but following a period of inflation below 2%, the central bank will shoot for a period above 2%. There is no mathematical formula involved – the Fed will continue to use its judgement. The Fed also broadened its employment goal and made it more inclusive. One of the key lessons of the last several years is that the reported unemployment rate may not be a good gauge of the amount of slack in the labor market. Moreover, in its 2019 town hall sessions, Fed officials learned that low unemployment was especially beneficial for low-income communities. The bottom line is that the Fed will be more tolerant of higher inflation, more tolerant of low unemployment, and less likely to raise short-term interest rates.

Most Fed officials expected the federal funds target rate to remain near 0% through 2023. The Fed is currently buying $120 billion in securities per month ($80 billion in Treasuries, $40 billion in mortgage-backed securities). On December 16, the Federal Open Market Committee indicated that it would maintain this pace "until substantial further progress has been made toward the Committee's maximum employment and price stability goals." The Fed may begin to taper the monthly pace of asset purchases at some point in 2021.

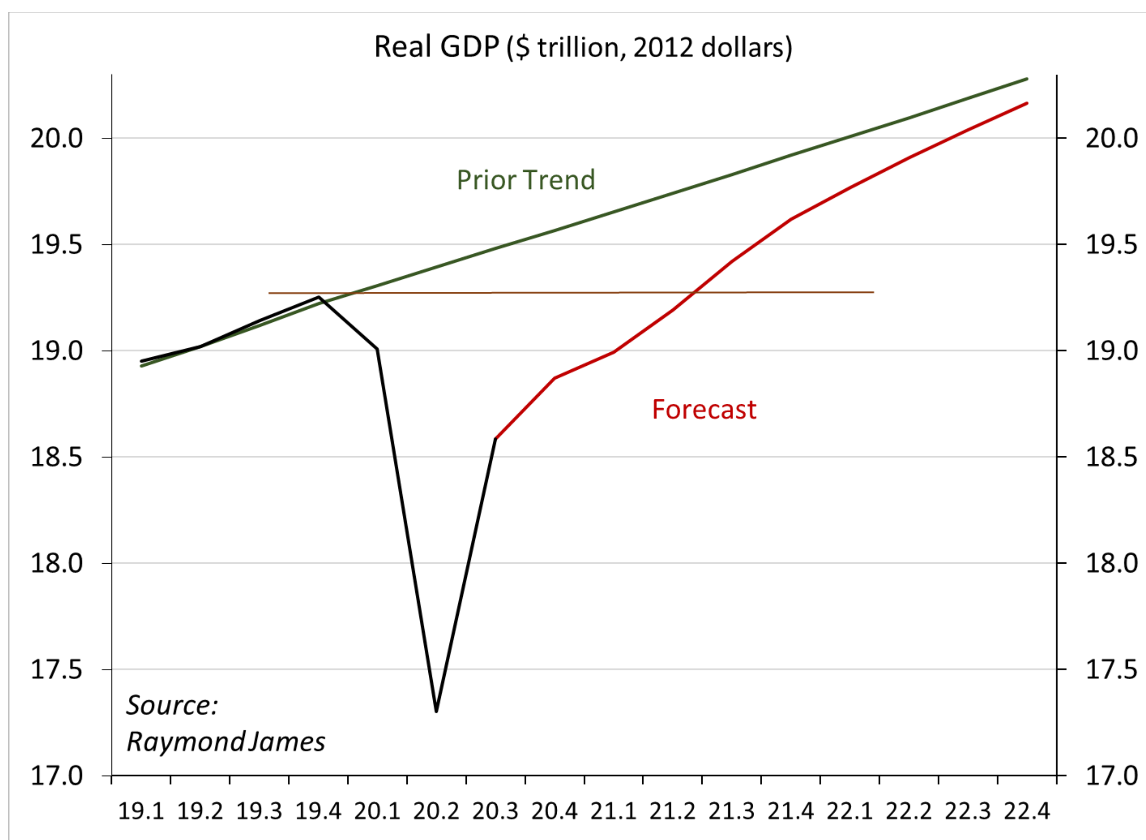
Spending on consumer services should begin to expand more rapidly as vaccines are distributed, leading to a strong pace of recovery in the second half of 2021. Long-term interest rates can be expected to rise as that happens, but not too rapidly.

**General Outlook:**

| | 20.1 | 20.2 | 20.3 | **20.4** | **21.1** | **21.2** | **21.3** | **21.4** | **22.1** | **22.2** |
|---|---|---|---|---|---|---|---|---|---|---|
| GDP q/q % | -1.3 | -9.0 | 7.4 | **1.5** | **0.6** | **1.1** | **1.2** | **1.0** | **0.8** | **0.7** |
| **GDP q/q, annual rate** | -5.0 | -31.4 | 33.1 | **6.3** | **2.6** | **4.3** | **4.8** | **4.2** | **3.1** | **2.9** |
| GDP y/y | 0.3 | -9.0 | -2.9 | **-2.0** | **-0.1** | **10.9** | **4.5** | **4.0** | **4.1** | **3.7** |
| Unemployment Rate, % | 3.8 | 13.0 | 8.8 | **6.6** | **6.1** | **5.7** | **5.3** | **5.0** | **4.8** | **4.7** |
| CPI, y/y | 2.1 | 0.4 | 1.3 | **1.1** | **1.3** | **2.7** | **1.9** | **1.9** | **2.0** | **2.1** |
| ex-f&e | 2.2 | 1.3 | 1.7 | **1.6** | **1.6** | **2.4** | **1.8** | **1.9** | **2.0** | **2.1** |
| PCE Price Index, y/y | 1.7 | 0.6 | 1.2 | **1.2** | **1.3** | **2.2** | **1.7** | **1.8** | **1.8** | **1.9** |
| exf&e | 1.8 | 1.0 | 1.4 | **1.4** | **1.4** | **2.0** | **1.5** | **1.6** | **1.7** | **1.8** |
| federal funds rate | 0-.25 | 0-.25 | 0-.25 | **0-.25** | **0-.25** | **0-.25** | **0-.25** | **0-.25** | **0-.25** | **0-.25** |
| 2-yr Treasury note | 0.45 | 0.19 | 0.13 | **0.17** | **0.20** | **0.23** | **0.27** | **0.31** | **0.39** | **0.47** |
| 10-yr Treasury note | 0.87 | 0.73 | 0.68 | **0.94** | **1.02** | **1.10** | **1.21** | **1.32** | **1.40** | **1.46** |

Source: Raymond James

Unemployment rate is the quarterly average, interest rates are the average for the final month of the quarter




M20-3375745

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**Index Definitions**

The **S&P 500** is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market.

The **Dow Jones Industrial Average (DJIA)** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The **NASDAQ Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market.

The **MSCI World All Cap Index** captures large, mid, small and micro-cap representation across 23 Developed Markets (DM) countries. With 11,732 constituents, the index is comprehensive, covering approximately 99% of the free float-adjusted market capitalization in each country.

The **MSCI EAFE (Europe, Australasia, and Far East)** is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the United States & Canada. The EAFE consists of the country indices of 21 developed nations.

The **MSCI Emerging Markets Index** is designed to measure equity market performance in 23 emerging market countries. The index's three largest industries are materials, energy, and banks.

The **Russell 2000** index is an index measuring the performance of approximately 2,000 smallest-cap American companies in the Russell 3000 Index, which is made up of 3,000 of the largest U.S. stocks.

The **NYSE Alerian MLP** is the leading gauge of energy infrastructure Master Limited Partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents earn the majority of their cash flow from midstream activities involving energy commodities, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX).

The **Barclays Intermediate Government/Credit Bond** index measures the performance of U.S. Dollar denominated U.S. Treasuries, government-related and investment grade U.S. corporate securities that have a remaining maturity of greater than one year and less than ten years.

The **Euro Stoxx 50 Index** is a market capitalization weighted stock index of 50 large, blue-chip European companies operating within Eurozone nations. Components are selected from the Euro STOXX Index which includes large-, mid- and small-cap stocks in the Eurozone.

The **China CSI 300** is a capitalization-weighted stock market index designed to replicate the performance of top 300 stocks traded in the Shanghai and Shenzhen stock exchanges. It had a sub-indexes CSI 100 Index and CSI 200 Index.

The **S&P 500 Futures** is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The **DJIA Futures** is a stock market index futures contract traded on the Chicago Mercantile Exchange`s Globex electronic trading platform. Dow

Futures is based off the Dow 30 stock index.

The **Nasdaq 100 Futures** is a modified capitalization-weighted index of the 100 largest and most active non-financial domestic and international companies listed on the NASDAQ.

**Europe: DAX** (Deutscher Aktienindex (German stock index)) is a blue chip stock market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

**Asia: Nikkei** is short for Japan's Nikkei 225 Stock Average, the leading and most-respected index of Japanese stocks. It is a price-weighted index composed of Japan's top 225 blue-chip companies traded on the Tokyo Stock Exchange.

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