First Republic
Private Wealth Management

2021 OUTLOOK: A YEAR OF TWO BRIDGES

KEY TAKEAWAYS

Economy

After causing a tumultuous start to the new decade, the coronavirus pandemic will continue to heavily influence the trajectory of global economies and markets in the year ahead. Fortunately, green shoots of recovery are on the horizon, with the anticipated COVID-19 vaccine rollout (beginning in the first half of 2021) and further fiscal stimulus helping to bolster the economy and the case for an accelerated reopening.

Policy

Despite bipartisan gridlock in Washington, a new round of fiscal support measures is expected to be enacted as policymakers face increased pressure to provide a fiscal bridge to combat the risks of a double-dip recession. Nevertheless, the benefits resulting from this year's fiscal response are likely to diminish as 2021 evolves. As a result, economies around the globe will need to be able to stand on their own and rely less on policy support moving forward.

Financial Markets

We do not anticipate major shifts to the accommodative global monetary policy landscape in 2021. Therefore, interest rates and government bond yields are likely to remain at historically low levels. As economic recovery gains traction, the low interest rate environment combined with a rebound in corporate earnings should provide a favorable backdrop for equity markets. Despite this environment, we still see an appetite for seeking yield in select parts of the fixed income spectrum.

Investment Opportunities

The world emerging from the COVID-19 pandemic will present investors with new opportunities. Several disruptive forces and structural trends — such as those involved in the rollout of 5G technologies — were accelerated and are likely to play a transformational role over the next few years. Similarly, we anticipate that policy reforms stemming from the new administration will also give rise to an array of long-term opportunities, such as in the renewable energy and climate change space. The potential for innovation and other shifting dynamics will similarly illuminate potential opportunities for alternative investments and strategies.

SELECT 2021 FORECASTS

Forecast	Measure
4.5%	U.S. GDP growth
4.3%	Consumer spending
7.5%	Private investment
1.7%	U.S. inflation (Consumer Price Index)
6.9%	Unemployment rate
-10%	Budget % of GDP
0.00%–0.25%	Federal funds rate
1.00%–1.25%	10-year U.S. Treasury note yield
$175	S&P 500 EPS
3,900 / (3,600–4,000)	S&P 500 Target / Range

Source: First Republic Investment Management Research

GDP = Gross domestic product.
EPS = Earnings per share.

Forecasts and targets are based on certain assumptions and on our current views of market and economic conditions, which are subject to change.

ECONOMIC OUTLOOK: UNITED STATES

Looking at the year ahead, medical breakthroughs around the vaccine and other therapeutics will dictate the pace and timing of global economic recovery. Our base case for 2021 anticipates the rollout of a vaccine in the first half of the year, with momentum accelerating in the second half as the effects of a broader reopening set the stage for a more durable economic expansion. However, while vaccines represent a bridge to a post-pandemic world, health authorities estimate that mass inoculation programs remain months away. Given that the potential deployment of vaccines is likely to face logistical challenges around production and distribution, it will take some time before its impact on the economy becomes notably evident.

Therefore, while we remain optimistic on the prospects of a gradual recovery in the medium- to longer-term horizon, the next few months could continue to prove challenging for the global economy. With the weather getting colder in the U.S. and the Christmas holiday season approaching, an increased viral surge looks probable. The combination of intensifying outbreaks and the reimposition of restrictions leads us to believe that most sectors of the U.S. economy will not be able to return to their pre-pandemic levels of output and employment until health solutions are widely in place and members of society are confident that it is safe to reengage in a broad range of activities. Hence, while inflation may embark on a slight upward trend, we expect structural headwinds to keep a lid on consumer prices in 2021.

In the U.S., the impact of the pandemic is likely to continue reshaping the economic landscape in meaningful ways. Across labor markets, lockdowns and restrictions hit lower-income and semi-skilled workers the hardest, given that many high-contact occupations (such as food services, retail and hospitality) did not offer the flexibility of teleworking. With activity in labor-intensive sectors expected to remain constrained in the coming months, the threat of long-term unemployment across highly impacted industries could exacerbate some of the longstanding inequalities in the U.S. and spark social unrest. Like recent economic effects across households and businesses, we anticipate the recovery phase to be similarly uneven.

However, as vaccination programs take place through the course of the year, we are likely to see a gradual and more durable normalization in the service sector. We expect that dislocated areas of the economy will strengthen in the second half of 2021, as fading restrictions allow the service industry to become a larger contributor to gross domestic product. In addition, pent-up demand and an improving labor market will boost consumer spending. Some risks to our base outlook include a delayed arrival of a vaccine and a premature tapering of fiscal and monetary support. On the other hand, a swifter distribution of the vaccine and a more multilateral approach to trade policy could lead to a pickup in international commerce and lift global growth.

Looking further out, the pandemic accelerated trends that were in place, but it also started new trends that will transform the ways we live and work, including the adoption of new technologies and the shift toward a greener future. The impact of this next wave of revolutionary trends will generate new opportunities for societies and help create new businesses and jobs. Artificial intelligence, automation, robotics, fintech and e-commerce are among the elements that have been pulled forward and could fuel a further shift toward a digital economy. Similarly, the adoption of green economic recovery policies by several major goverments to address climate change will also have significant implications for financial markets and investors. We believe that this heightened focus on enviromental, social and governance (ESG) concerns will underpin the transition toward a greener and more resilient global economy.

ECONOMIC OUTLOOK: INTERNATIONAL

Just like in the U.S., we believe that the international economic expansion next year will be uneven, with a country's success or failure in containing the virus likely determining its performance trajectory. Further, the recovery will also be driven by the availability of resources to combat the virus. While some wealthy countries may be able to provide vaccines to large portions of their populations in 2021, some of the least developed countries around the world may face supply limitations on their vaccination efforts. Consequently, equitable global distribution of vaccines will be one of the biggest challenges in the year ahead.

Geographically, China is likely to experience a broader economic acceleration than most nations. So far, that growth has come mainly from more traditional industries such as manufacturing, rather than consumer purchases. However, while the U.S. and Europe grapple with a resurgence in infections and lockdowns, China's early containment of the virus and reopening are expected to help unwind excess savings and lift consumer spending across the service sector. Exports are also forecasted to remain elevated, given the sustained demand for medical equipment and other goods. However, Beijing is likely to normalize credit growth and ease some pandemic-related measures that helped the nation weather the initial downturn. This will in turn elevate interest-rate differentials, driving a further appreciation of the yuan and stronger foreign exchange inflows into China. The challenge for Chinese policymakers in 2021 will be the delicate balancing act of tapering stimulus measures while avoiding halting growth momentum.

China's early exit from lockdowns and stimulus measures will likely also help boost emerging markets' export-driven economies more broadly. However, prospects for recovery across emerging markets are increasingly more vulnerable to setbacks. Emerging market nations have been among the worst hit by the health crisis, raising the probability that they will also be some of the slowest to recover. A material deterioration in labor market conditions, policy uncertainty, low public and foreign investment, and in some cases, economic softness that preceded the pandemic, are some of the headwinds that plague these nations. On a positive note, stronger demand for commodities and the likelihood of a softer U.S. dollar could act as tailwinds. U.S. interest rate differentials versus its trading partners, resurging global growth, a widening U.S. trade deficit and risk-on sentiment across financial markets support our slightly bearish view for the greenback.

Looking at Europe, we believe that the United Kingdom and the European Union are still likely to secure a free trade agreement, averting a disorderly Brexit. However, if a "hard Brexit" were to materialize, the imposition of tariffs and customs checks at the borders could cause some economic disruption, as trade moves more slowly across borders. Despite the cloudy political landscape, we believe that unprecedented measures of both fiscal and monetary support by policymakers are likely to provide European economies with a stopgap until the arrival of a vaccine. Support from governments has included cheap loans, furlough support for unemployed workers, tax breaks and direct subsidies. In addition, a €750 billion recovery fund was enacted to pay for new environmental and digital projects, almost doubling the EU's proposed budget for the next seven years. The EU's response has not only set the foundations for a post-vaccine recovery, but also strengthened public trust in the world's largest trading bloc.

POLICY OUTLOOK

In addition to a healthcare bridge, the path to economic stability will also require a timely, targeted and temporary fiscal bridge to ensure that households and businesses have the support they need to keep the recovery in pace between now and the widespread availability of a vaccine. Amid signs of slowing economic momentum in the U.S., we expect policymakers to pass another round of stimulus that will focus on aiding distressed sectors, small businesses, and workers who have been laid off or furloughed due to business disruptions caused by lockdowns and social distancing mandates. Yet, the economic benefits stemming from the fiscal bridge will begin to decay through the course of the year, even if Congress passes a larger-than-expected relief package.

We also expect a number of policy changes to emerge from Washington as President-elect Biden takes control of the White House. However, expectations of a split Senate will likely limit overhauls in areas such as taxes and regulation. A Democrat sweep in the Georgia runoffs in January would give each party 50 Senate seats, but Democrats would effectively gain control because Vice President-elect Kamala Harris would be the deciding vote in any tie. Even in this scenario, Democrats would only have a slim Senate margin, raising the possibility of gridlock since any legislation would need support from more moderate party members.

With regards to foreign policy, we anticipate the incoming president to take a more diplomatic and less confrontational approach to China, preferring to build pressure in a multilateral way and avoiding tariff measures if possible. Nevertheless, we believe that tensions will persist around an array of issues, such as Taiwanese independence and China's access to American technology and financial markets. An escalation in tensions would have an adverse effect on cross-border investment, supply chains and access to intellectual property and markets, thereby increasing the risk of business disruption and loss of investor confidence.

While the upside for improvement in relations between the world's two largest economies is likely to be limited, we do see an opportunity for Euro-Atlantic relations to be rebuilt. Under Biden, the U.S. and the European Union will likely seek negotiated solutions on lingering issues around trade, defense, human rights and China, but additional cooperation and dialogue will be needed to halt their current tit-for-tat policy of tariffs. Lastly, the U.S. is expected to rejoin its global peers in the effort to combat climate change, with the President-elect intending to reenter the Paris Climate Accord on the first day of his presidency. We anticipate this to help spur green finance and investment, and shape the policies for global economic recovery in 2021.

FINANCIAL MARKETS OUTLOOK

We believe that as we head into 2021, the broader reopening of the global economy driven by the distribution of vaccines and policy support will provide a favorable backdrop for equities over a 12-month horizon, given that equities have historically outperformed other asset classes amid moderate economic growth. Furthermore, an extended period of low inflation and low interest rates will leave investors searching for higher returns with fewer alternatives to equities, driving increased appetite for risk assets broadly. Given that equity markets are forward looking and discount months into the future, we anticipate that any short-term downward pressures will be short-lived and will give way to higher equity returns by year-end.

In turn, we see potential for corporate profits to stage a meaningful rebound in 2021, as a pickup in economic activity is likely to boost companies' top-line growth, while the benefits of this year's cost cuts will help drive operating leverage and net profit margins higher. Meanwhile, valuations also offer a constructive view of equities, given that the global equity risk premium — the rate by which stocks are expected to outperform risk-free investments — is likely to remain elevated. In our view, companies focused on strengthening their balance sheets and free cash flow generation appear best positioned to outperform over the medium term, whether they belong to the growth or value sectors.

On the fixed income front, we do not anticipate any Fed rate hikes through year-end 2021, with the federal funds target rate expected to remain unchanged from its current levels. Therefore, short-term interest rates are likely to remain pinned near zero throughout the year as the Fed waits for the economy to evidence a durable recovery and inflation to materially rise before embarking on rate normalization. While we anticipate some longer-dated maturities to gradually drift higher as a result of higher inflation expectations, the Fed's backstops and bond-buying programs will likely keep those moves contained. Consequently, it is probable that yield curves may steepen only slightly in 2021.

Similarly, target rates from the European Central Bank and other developed-market policymakers are also expected to hover near zero, or even in negative territory in some parts of the world. Across credit markets, while defaults may increase going into 2021, we believe that additional fiscal aid and central bank interventions should help alleviate some credit concerns. In an economic environment where monetary policy remains accommodative and growth is rebounding, corporate default rates should remain contained, keeping borrowing costs range bound. We also do not anticipate a wave of municipal bankruptcies at the state level amid extensive policy support.

INVESTMENT OPPORTUNIES & PORTFOLIO RECOMMENDATIONS

Turning the page to 2021, we believe that as the global economy emerges from the health crisis, the arc of recovery is likely to be bumpy along the way. Investors should avoid portfolio overconcentration as this can limit their investment opportunities and performance. Therefore, diversification both across and within asset classes will remain a bulwark in the year ahead. Given that several uncertainties cloud the near-term outlook, market participants should avoid trying to time the market and making impulsive emotional decisions in the face of turbulence. Instead, we recommend investors to take the opportunity at year-end to revisit their investment plans and work with their investment advisors to rebalance their portfolios according to their financial goals, risk appetite and time horizon.

While there is still much uncertainty around the outcome of the U.S. Senate elections, we are not currently recommending any significant repositioning for tax purposes at this time. Further, despite a more positive outlook for the year ahead, we maintain our bias for high-quality investments. Given the uneven performance trajectory across asset classes next year, an active approach to portfolio management anchored in selectivity will play a key role in driving performance. With historically low bond yields and increasing optimism about a brighter outlook for the second half of 2021, we continue to favor equities over bonds and cash from an asset allocation perspective. Yet, it is worth noting that markets don't always travel in a straight line indefinitely, and while we think 2021 will be a constructive year for equities, investors should be prepared to face bouts of volatility moving forward.

During 2020, we recommended investors to move up in quality within their equity exposure, favoring companies with robust balance sheets that benefited from the "stay at home" strategy. We believe that many of these high-quality companies still offer compelling investment opportunities given that they are well-positioned to capitalize on long-term secular trends. Furthermore, for investors with higher risk tolerance, we are beginning to see some opportunities to increase the cyclicality of portfolios by rebalancing growth-focused U.S. equities toward small-cap and value stocks. In turn, for investors looking to increase their portfolio's international exposure, we favor developed markets over emerging markets, and see attractive valuations across quality companies, particularly in Europe. We also recommend a modest allocation to cash to take advantage of any short-term dips in equity prices.

In fixed-income portfolios, investors should be conscious of their maturity profile, but be ready to take advantage of opportunities should yields move higher. A ladder maturity structure composed of staggered maturities could help generate a steady stream of income, smooth out interest rate risk and offer risk-averse investors some degree of stability. Further improvement in the municipal bond space will depend on the extent of additional fiscal stimulus and the speed of economies reopening. However, given that a wave of municipal bankruptcies is not likely amid ongoing support from policymakers, we remain constructive on municipal markets. Despite the risk-on sentiment across markets, we believe quality still matters across fixed income securities. Therefore, we recommend that investors exercise caution navigating riskier parts of the credit market in the search for yield. Given the ongoing near-term uncertainties, investors tilting out of government bonds into credit may benefit from favoring the highest-quality corners of the market.

Finally, we believe investors should also consider allocations across alternative investments that go beyond broad asset classes and can provide an additional layer of diversification. Some of these non-traditional investments, including private credit and venture capital, have the potential to generate value while helping investors reduce volatility. Late-stage venture capital fund raising reached a new high in 2020, and this flood of capital to the largest startups is expected to continue and set new records in 2021 amid elevated levels of dry powder on the sidelines. As a result, we expect tech-unicorns to emerge across innovative industries including 5G technology, fintech, health technologies and green technologies. As the next six months are likely to represent an initial transition to the post-pandemic investing environment, we also believe that some of the hardest-impacted areas of the economy will offer private equity firms dislocation opportunities such as secondary investments, distressed debt and special situations.

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