Macro

Lara Rhame's 10 for '21

Lara Rhame:

Hi. Thank you for joining us today. My name is Lara Rhame. I'm the chief U.S. economist at FS Investments, and I'm really pleased to be joined by Andrew Korz. He is an associate in our research department, and he and I together are going to be talking about our 10 for 21 Watch List on the economy, policy, and markets. I think it's always very hard as we begin these conversations to just launch into a void. Andrew, I'm going to pitch it back to you to summarize 2020 for us.

Andrew Korz:

Well, thank you, Lara. Happy to be here with you. So before jumping into next year, let's just take a brief look back at the year that was 2020. Boring year, huh? As we all know, a global pandemic, sharp global recession, an historic election, and record-setting fiscal and monetary policy. You know, Lara, this is the second year we're doing this annual outlook, and there's something slightly comical about the first one being for the year 2020. I don't know about you, but I think maybe we can give ourselves a pass on some of those 2020 predictions. I'm willing to forgive myself on some of those.

Andrew Korz:

At any rate, 2020 will soon be in the rear view mirror, to absolutely nobody's chagrin, and many of the same challenges faced by the economy and markets this year remain present going into 2021. So without further ado, let's jump into our 10 big things to look for next year, starting with the most important development of them all, and that is the vaccine. So Lara, we've had two vaccines show extremely impressive efficacy in phase three trials, Pfizer and Moderna, each of which could begin to be distributed before end of year. Obviously, this is all unequivocally good news, but a ton of work remains. What will you be watching as the calendar turns and the vaccines start to become a reality?

Lara Rhame:

Yeah, I think you could almost call 2021 the year of the vaccine. If 2020 was the year of the pandemic, the rollout and the efficacy, the production, and the distribution of these vaccines, I think it's going to really drive everything. The markets, the economy, even how reactive policy has to be to the continued health crisis, will really come down to the vaccine. And there is no way to overstate what good news we have gotten on the vaccine front. I really in many ways compare this to the moon landing, which was a multi-year effort where science coordinated to really drive an incredible scientific exploration forward.

Lara Rhame:

The problem is, I think when I look ahead to 2021, there's just still a lot of deep, dark space between where we are right now, and a man putting a foot on the moon, which is really what I think of as sort of this return to normal. So the news has been positive. I think happily it will be a year of optimism, but the news has been so good, it could swing in both directions. Markets will remain hypersensitive to any problem with rolling out vaccines, or as the trials continue, any

issues with safety and efficacy. So I think all good things, but this is really going to continue to be the focus for markets.

Andrew Korz:

Yeah, absolutely. And I think, like you said, the news so far has been just an extraordinary accomplishment for science as a whole, but like you said, there's still a huge herculean effort to try to distribute all of these doses to the public and really to convince the public that it's in their best interest to take the vaccine.

Andrew Korz:

I think, kind of segueing into our second topic, which is the economy and the resiliency of households and businesses, Lara, we've really sort of seen an extraordinary resiliency since the initial lockdowns in March and April, specifically from consumers and businesses. We've seen consumers really adapt to the environment. We've seen an extraordinary uptick in retail sales, and for businesses, we've seen the ISM data show extreme resiliency on both the manufacturing and services front. Can you sort of walk us through what you've seen, and sort of any pitfalls you see going into next year regarding the consumer and businesses?

Lara Rhame:

Absolutely. This is something that I think we really need to appreciate, and you hit on it, and I think it's our number two. The resilience is something that we just need. You cannot have a recovery without that optimism and without the positive momentum that has just been so extraordinary in the third quarter. When we frame out the decline in outcome and the economy in the second quarter, the bounce in the third quarter was so much more positive than I had expected. I guess that could be a rare instance where I'm happy to be wrong. I'm really glad that the economy just showed so much more momentum, and that to some degree has continued into the fourth quarter. So the optimism that is coming from households, the optimism that we're seeing in those big business sentiment surveys, is really critical.

Lara Rhame:

I think looking in the first half of the year, resilience will be tested for U.S. households, because we're starting to see job gains fade. We're starting to see some of the support of the CARES Act sort of recede. So while we experienced a historic employment shock, we didn't experience an income shock. The household balance sheet really stood up. So consumer confidence is at the top of my watch list. We're really teetering on a knife edge, because we have the job gains flowing and we still have a pretty solid buffer in the household savings rate. So that is kind of the big watch list.

Lara Rhame:

And I think the second, I would follow that up closely and zero in on the labor market, because when we look at the recovery in jobs, again, the unemployment rate was at a high of 14.7%, so much higher than we experienced during the Great Recession. It's come down to 6.7%. That's a really impressive improvement. But when you peel back the layers of that, of the seven and a half million people who are still unemployed, over half of that is now permanent unemployment. These are permanent layoffs. That's risen by two and a half million people. I know I'm throwing a lot of numbers at people, but the point is, what started out as a huge dislocation were really only temporary layoffs. Now that has shifted to more permanent layoffs.

Lara Rhame:

And that is the kind of dislocation that becomes entrenched. And really to me, is something that could erode consumer confidence more significantly, if people start to feel like this

economic downturn is going to become more permanent. So looking very closely over the next immediate quarter at the temporary versus permanent layoff, and how that's impacting consumer confidence.

Andrew Korz:

Yeah. I think that's a great point. And I think people optimistically have always seen this crisis as hopefully somewhat fleeting, sharp, but fleeting, as compared to the global financial crisis when we saw, like you said, just these permanent scars for the economy, both in the labor market, for consumers, and for businesses. And the hope was that we would get a vaccine, and it looks like we are going to get a vaccine here. But I think the issue of policymakers really going into next year is to try to minimize the economic scarring and sort of bridge us to vaccine distribution.

Andrew Korz:

So that really takes us into our third pillar, which is the policy pillar. Let's first focus on the fiscal policy front. We got the CARES Act, which was a behemoth of a stimulus bill, $2.2 trillion, back in March, which provided for extended unemployment insurance, it provided for help for small and mid-size businesses. It provided for direct checks to Americans. That obviously helped us greatly survive through the first leg of the pandemic.

Andrew Korz:

Now going into next year, obviously, as we're speaking here, there appears to be hopefully some movement on a second stimulus bill out of Congress. Lara, what do you see going into next year, and how important is it that we get that second stimulus bill going into 2021?

Lara Rhame:

I think it's extremely important. And I think there are a couple of things to consider. You really calling the CARES Act a behemoth is exactly right. I think we all forget that trillions of dollars, the entire TARP fiscal action in the financial crisis was less than a trillion dollars. And at the time, it was considered to be abhorrently large. So the numbers that we're talking about when it comes to stimulus are meaningful. They really impact GDP. And I think if we learned one lesson from the financial crisis, we learned it again from the CARES Act, if you enact stimulus before there's a crisis, it doesn't need to be as large. It can be more targeted. You can roll it out in a way that is less wasteful and really hits the supports that are needed. And clearly that continues to be up for debate, but I think the debate, it can be more methodical, and that is what we hope for.

Lara Rhame:

So I know that's a lot to ask out of Washington, but when we think about stimulus at the beginning of the year, there's no doubt that we're going to need more. And I think this really relieved [inaudible 00:10:06] policy. One of my favorite graphs is point number five, which looks at said policy in the beginning of expansions. So we don't know when our recession is ending. We don't exactly know when this recession is going to end. It started in February. Usually recessions last about a year, but if you look at Fed policy at the start of an expansion, the Fed usually spends the first three years of an expansion cutting interest rates further, right? That was back in 2000, back in the prior recession, 1991. And these expansions, the Fed usually begins the expansion by cutting rates and holding them low for the first three years.

Lara Rhame:

We all know that in 2009, the Fed had taken rates down to zero. That wasn't an option. What did they do? We got quantitative easing. We actually got most of the quantitative easing after the

recession had ended, in the beginning of the expansion. So I think that's really a roadmap for Fed policy over the next several years. If we do get the economy renormalizing because of what could be a really extraordinary vaccine rollout, it still to me aligns with the Fed actually doing more to support the economy, and the fiscal side may need to do more, as well, simply because with the Fed fund rate at zero, there's just no room for the Fed to maneuver there. All of that, to me, speaks to continued stimulus throughout 2021.

Andrew Korz:

Yeah. I think that's a key point there. I mean, I think Fed chair Powell has consistently and pretty forcefully advocated for fiscal policy, sort of implying that the Fed has sort of fired a lot of their shots. They've done what they can do. They've added three plus trillion dollars to the balance sheet. They've cut rates to zero. They've promised to let inflation run hot if necessary. I think their goal now is to really keep financial conditions as easy as possible and make sure nothing on the financial or monetary side of things throws any wrenches into any possible recovery. But I think Powell has been pretty explicit in that it's going to have to be Congress that acts here, because fiscal policy is really going to be what is able to reach the real economy in the most efficient manner.

Andrew Korz:

And I think this segues well, in terms of the yield curve, I know we're going to speak about the yield curve in our outlook. I think the yield curve really speaks to both fiscal and monetary policy here. Certainly one thing we'll be closely watching is the shape of the yield curve. I think we all know where the short end will be, with the Fed keeping rates at zero for the foreseeable future. But on the long end, the vaccine news has really pushed the 10 year up roughly 10 basis points as of yesterday. I think now I'm looking and at it's somewhere close to one percent now. So we're up like 15 or 20 basis points.

Andrew Korz:

Now, if we get a stimulus bill, which is obviously the hope, and a successful vaccine rollout and a return to normalcy sometime in the range of Q2, maybe early Q3, you can certainly see growth and inflation expectations pick up. So Lara, do you see the yield curve steepening somewhat next year? And how do you think the Fed would react to such a situation?

Lara Rhame:

Yeah, so I think this is a really, first of all, I think we all tend to look at where equity markets are. And when I think about volatility or a curve ball coming in 2021, I really think it could come from yield curve dynamics and from the treasury market, because what you talked about is really critical. We often, you know, old school, you think about yield curve steepening and flattening, it's because both the long and short-term rates are moving, but now with the Fed really anchoring short-term rates at zero, it's all of the signals sent by the yield curve are going to come from long-term interest rates.

Lara Rhame:

And you don't want to say there's nowhere to go but up, but the reality is, with long-term interest rates so low, as we look to growth and financial conditions to renormalize, you would expect some modest deepening in long-term interest rates. I want to be clear. There's a lot of talk, especially right now, about a big reflation trade. I still think that structurally low potential growth and structurally low inflation will be dynamics that drive our economy over the next one to five years, but there's certainly room for U.S. interest rates to move between where they are right now and something more like one and three quarters or even two percent. That's where

long-term inflation expectations are, which is kind of where long-term interest rates usually align.

Lara Rhame:

So that actually would imply a pretty significantly steeper yield curve than we have right now, and I think it would also be enough to really bash up the fixed income portion of an investor's portfolio. I mean, everybody is so long duration right now. A 100 basis point increase in long-term interest rates, which is not at all an outlandish call, that's a pretty basic renormalization, that would cause a severe price decline that would take three years of that very low level of income to recover from. So it's enough to do some damage.

Andrew Korz:

Yeah, I think at some point fixed income investors have to pay the piper here. They've reaped the benefits from an over 200 basis point decline in rates since 2018, and with rates as low as they are, I think at some point there's just nowhere else to go, really. And I think, Lara, that segues as well into our final topic, which is markets. And we sort of just went over the fixed income portion of things and the risks that lie in 2021 with a potentially steeper yield curve.

Andrew Korz:

So looking at equity markets, I think a really interesting point is on fundamentals, specifically on earnings. If we look back and compare this crisis to the 2008 crisis, the global financial crisis, I think one really interesting point is that markets in 2008 were really seeing that crisis as a long-term scarring recession that would have lasting impacts on earnings. So if we go back and we look in 2008, markets were expecting not only a really deep earnings recession in that year, but they were expecting it to sort of sustain all the way into 2010.

Andrew Korz:

Fast forward to this crisis, we're having a very similar earnings recession, down about 20 or 25% on S&P 500 earnings. The difference is, markets and analysts are seeing a short-term nature in this crisis. So if we look forward to 2022 expectations, there's been a pretty high bar set. Markets really only expect earnings to be 5% or so lower than they expected back in January.

Lara Rhame:

I love that graph. We show that on point number seven, this idea of markets being inherently forward-looking. And some of that is fueled by this idea of liquid courage, that really important technical drivers that help, 175 basis points of rate cuts, three trillion dollars of additional quantitative easing from the Fed, facilities to support investment grade bonds, facilities to support municipal markets and financial markets, and then obviously all of the facilities the Fed put in place, plus the fiscal stimulus, right? I mean, all of these are incredibly powerful technical drivers that support the markets.

Lara Rhame:

And zero interest rates really changes the equation. That is why this deeper yield curve is such a big risk to upsetting the apple cart that's going, that seems to be really stable right now. To your point about the incredibly rapid nature of this financial market recovery, zero interest rates really pushes everybody out on the risk spectrum. It changes the discount, it changes the valuation models that we use for equities. The difference of that denominator being zero short-term interest rates, 0.5 long-term interest rates, this is where we were for most of the summer, is very different when you're starting to talk about long-term interest rates that are just not even high, they're just sort of accounting for normalized inflation of 1.8% or 2%. That really changes the denominator.

Lara Rhame:

So all of this is the dynamic that I think investors are going to have to navigate in 2021. We've had this one way trade, super fueled by fiscal stimulus. And I think as the economy starts to recover, and markets, being forward-looking, can bite both ways. Right now, when you're just focused on supercharged liquidity, forward-looking is a very positive picture. But as you look to a renormalized economy and start to think about how the Fed possibly unwinds some of that support, that won't happen in 2021, but markets will start worrying about it in 2021. That, to me, is what could create some volatility and some return of uncertainty.

Andrew Korz:

Yeah. And I think we have to acknowledge just the incredible concentration of equity markets right now. I haven't looked, but I assume with the introduction of Tesla into the S&P 500, the top 10 names, probably, I don't know the exact number, but they probably make up upwards of one third of the market cap of the S&P 500.

Lara Rhame:

It's a totally different index now than it was 10 years ago, five years ago. It's a totally different index.

Andrew Korz:

Yeah. I mean, Exxon is not the number one holding anymore, suffice to say. Anyway, I think that sort of wraps up our discussion, Lara. Do you want to say a few parting words?

Lara Rhame:

Yeah. I think, looking ahead to 2021, after such an extraordinary, challenging, difficult 2020, I am counting down the minutes until we can pop the champagne and roll into a new year. That's not going to make all the problems go away, but I think all of us are really...

Andrew Korz:

I think we can pretend that it will, though, right?

Lara Rhame:

I think we can, too. I plan on it. 2021, I think, the pandemic is still going to be center stage, but at least I think we can hope that that shifts towards the more optimistic lens of vaccinations. That doesn't mean that we aren't still going to face challenges. So our watch list for the economy really starts with the positive of the resilience of U.S. consumers and businesses. But we, in the first half of the year, are really going to contend with this issue of whether growth and employment dislocations have been temporary or permanent.

Lara Rhame:

And when we think about policy, we're going to be thinking about continued support from the Fed. That's what we usually get as recessions end, and as expansions start again, and that's going to have really powerful implications for the yield curve. We're going to have this tug and pull of renormalization wanting to cause the yield curve to steepen, but continued Fed intervention that is going to keep long-term yields lower. So this potential volatility and mixed signals from the yield curve, I think will keep markets a little bit on edge, and I think will be something that we're really going to have to navigate in a way we haven't before.

Lara Rhame:

And finally, just looking at drawing it back to investors. We're going to, I think, continue to see some of the dynamics in play, where we have hyper concentration of equities that are at top

decile valuations. So I think that markets are going to be hypersensitive to news on vaccinations, and we could really struggle in the beginning of the year, as I think rollouts and deployments of vaccinations may not go as smoothly as the most optimistic news it's priced in right now, and for fixed income investors, those yield curve dynamics could really, I think, cause us to realize, I think it's exactly as you put it Andrew, that fixed income investors have gotten a lot of gifts. And this last year has really, I think, just been the final gift, with really strong returns, because price gains have been so dramatic. That is probably what they will have to give back in 2021.

Lara Rhame:

So a lot to think about as we look ahead for next year, but I hope that you will take some time, flip through our 10 for 21. Thank you for tuning in today. And as always, we hope that you'll look to fsinvestments.com, continue to read our research, and as always, reach out to us with any comments or questions. We just want to keep this conversation going.

Andrew Korz:

And Lara, just before we go, I'd like to wish everybody a happy and safe holiday. And I know none of us are going to be tearing up at the sight of 2020 in the rear view mirror, and we all, I think, look forward to a better 2021. So thanks for the discussion, Lara. I look forward to having more of these.

Lara Rhame:

Absolutely. Stay safe, everyone.