FREQUENTLY ASKED QUESTIONS REGARDING THE 2021 OUTLOOK

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Summary and Major Conclusions:

The yield curve portrays the interrelationship between the thrust of Fed policy and investor expectations regarding future economic growth and inflation. A flat yield curve is a signal that investors perceive monetary policy as too restrictive relative to underlying economic conditions. A steep upward sloping yield curve signals the opposite — that Fed policy is too expansionary relative to the expected path of economic growth and inflation. The yield curve has already steepened considerably in recent weeks in anticipation of faster growth and rising inflation.

- The Senate runoff election in Georgia will be a game changer for fiscal policy over the next two years. With Democratic control of both chambers of Congress, the Biden administration will have greater latitude in pushing through legislation to boost economic growth. Investors should expect another large fiscal spending package within a month or two.
- Democratic control of the Senate reinforces the key assumptions in my investment outlook for this year and in 2022: Rapid economic and profit growth; rising government bond yields; continued depreciation of the US dollar; and superior returns from both value stocks and non-US equities.
- There are far more differences than similarities between the 2020 and 2008 recessions. The Great Recession that began in 2008 was triggered by the most severe world debt crisis since the 1930s. The 2020 recession was self-induced, in an effort to reduce hospitalizations and deaths from COVID-19.
- The odds of a double-dip recession are low because of the $900 billion COVID-relief package passed by Congress just prior to yearend. As an approximation, government expenditures contained in this bill will add 2% to GDP in the first half of this year, just enough to forestall another recession.
- Without comparison, the most significant risk to economic growth pertains to the timing of distribution of vaccines to inoculate the US population against COVID-19. A continued delay in vaccinations could defer the reopening of the economy, thereby suppressing spending and raising unemployment.
- Other risks to the outlook include a slump in consumer spending triggered by a collapse in confidence; a nationwide lockdown of the economy resulting from a surge in hospitalizations; a spike in delinquencies on consumer and business loans; and a sharp slowdown in housing construction because of a weakening job market.
- As has occurred periodically in recent years, the housing market appears to be in a slowing trend. Once again, the slowdown appears to be primarily a supply-side phenomenon, as indicated by a record shortage of homes for sale.
- The inventory of existing homes for sale nationwide is currently 1.28 million units, the lowest on record, and the equivalent of only two months' supply, well below the long-term average of 5.8 months' supply. The sharp rise in house prices is another manifestation of the inadequate supply of homes for sale.
- An analysis of supply and demand conditions suggests that construction will remain strong for another two years, at a minimum. The only way for the strong underlying demand for homes to be met in coming years is for construction to increase from current levels until supply rises to the level of demand.

- Whereas the Federal Reserve has firm control over short-term rates, it has only partial control over long-term rates. The latter is determined primarily by investor expectations regarding future economic growth and inflation.

- Long-term interest rates are likely to rise over the next six to nine months, but not significantly, because of lingering weakness in spending, employment, and output. Continued very low inflation should suppress bond yields for much of this year.

- However, the Federal Reserve cannot suppress long-term interest rates indefinitely: Market expectations for future economic growth and inflation will trend higher along with more rapid distribution of a vaccine. Investors will become net sellers of bonds, forcing market yields higher and prices lower, triggering a sustained steepening of the Treasury yield curve.

Financial markets continue to be whipsawed by developments pertaining to the pandemic, distribution of vaccines, politics, and crosscurrents in economic data. This week's *Economic Perspective* addresses questions regarding the outlook for the economy and financial markets in 2021.

COULD YOU DISCUSS THE POSSIBLE REPERCUSSIONS OF THE SENATE RUNOFF ELECTION IN GEORGIA?

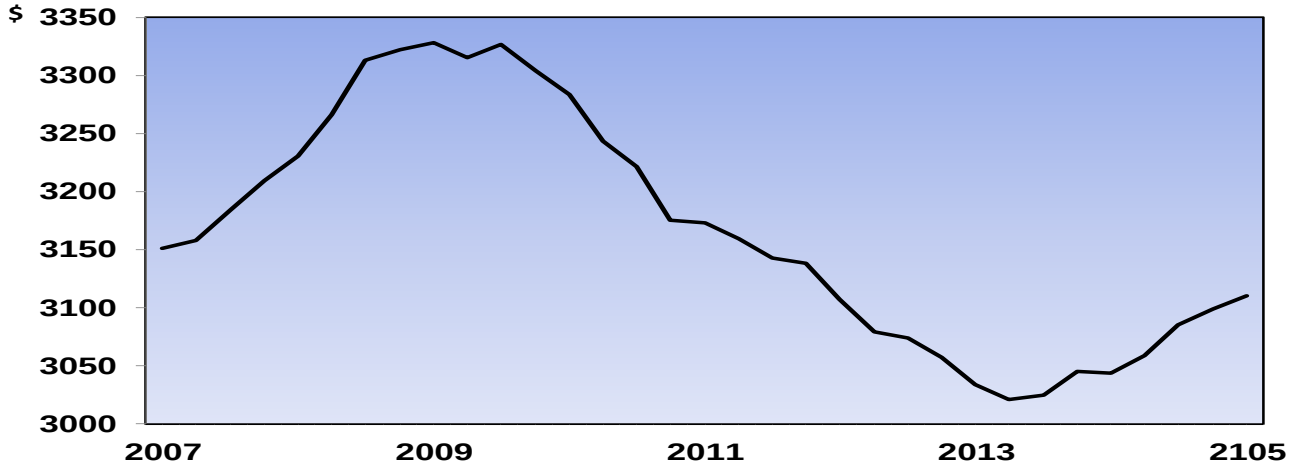
The Senate runoff election in Georgia will be a ***game changer*** for fiscal policy over the next two years. With Democratic party control of both chambers of Congress, President Biden will have far greater latitude in pushing through spending programs to boost economic growth. Whereas another COVID-relief package seemed unlikely under Republican control of the Senate, passage of further stimulus following the inauguration — on the order of $1 trillion — appears virtually assured. Tax increases are likely to be deferred until later this year or in 2022, when the economy should be on a firmer footing.

Democratic control of the Senate reinforces the key assumptions in my investment outlook: Economic growth and company earnings will surprise on the upside; the rise in government bond yields this year will exceed market expectations; the US dollar will remain in a downtrend; and both value stocks and non-US markets will outperform the S&P 500.

WHY DID FINANCIAL MARKETS SEEMINGLY IGNORE THE ASSUALT ON THE US CAPITOL ON JANUARY 6?

Stock prices and bond yields rose — both signals of economic confidence and risk-on investing — in the immediate aftermath of the riots in Washington, while measures of volatility rose only briefly. Financial markets largely disregarded the seditious assault on the Capitol on January 6 because of a widespread belief that the transfer of power on January 20 was not at risk. The certification of the election on December 14 by members of the electoral college had already ensured the legal outcome of the 2020 election.

Chart 1: Fiscal Policy Restraint Undermined the 2010 Recovery
Government Expenditures, GDP Account
$ Billions, Adjusted For Inflation
Source: Bureau of Economic Analysis



Market history is clear regarding sudden shocks. *In principle, the market impact of sudden political and geopolitical events tends to be transitory, assuming no lasting adverse implications for the economy or government policy*. Financial markets do react negatively to sudden shocks when it is clear that such events will bring about durable negative consequences for economic conditions and/or economic policy.

COULD YOU COMPARE THE 2020 RECESSION WITH THAT OF 2008?

There are far more differences than similarities between these two recessions. Most importantly, the Great Recession that began in 2008 was triggered by the most severe world debt crisis since the 1930s. Conversely, the 2020 recession was self-induced: The economy went into lockdown early last year in an effort to reduce hospitalizations and deaths.

The US economy entered the 2008 recession with very large imbalances and excesses that required many years of private sector rehabilitation. These excesses included a massive overbuilding of homes, an undercapitalized banking sector, and record household debt. In sharp contrast, the US economy was actually strengthening in late 2019 and early 2020 prior to the onset of the pandemic.

This question has relevance for the future direction of economic growth. *The 2008 recession is an inappropriate model for the outlook in 2021 and 2022*. US GDP increased at a painfully slow 1.9% annual rate in the first three years following the 2008 recession, the slowest economic recovery in American history. There were two primary contributors to this dismal economic performance: (1) A prolonged *deleveraging cycle* by households and banks that constrained spending; and (2) An extended period of *fiscal policy austerity*, as Congress cut spending to reduce the budget deficit, creating a large drag on growth
(see chart 1).

Neither of these two factors is likely to recur during the next several years. Because private sector balance sheets are in generally good health, there is little need for a protracted deleveraging cycle. And because of profound weakness in numerous key sectors of the economy, fiscal policy should remain expansionary. *Compared with **1.9%** annual growth from 2009 to 2012, real GDP should expand by an estimated **4% to 5%** during the three years ending in 2023*.

HOW VULNERABLE IS THE US ECONOMY TO A DOUBLE-DIP RECESSION?

The economic recovery that began in May of last year is extremely fragile, with many segments of the service sector depressed. The labor market is also very soft and remains in a weakening trend. That said, the odds of a double-dip recession are low, in my judgment, within an estimated probability range of only 20% to 25%.

A critical factor in reducing the likelihood of a recession during the first half of this year is the $900 billion COVID-relief package passed by Congress just prior to yearend. I estimate that this fiscal stimulus will add 2% to GDP in the first half of this year, just enough to forestall a recession.

In addition, with Democrats in control of Congress and the White House, the odds of additional fiscal stimulus have risen significantly. My revised forecast assumes GDP growth of 5.5% for all of this year, followed by 6% growth in 2022, the fastest pace of economic growth since the 1990s.

WHAT ARE THE PRIMARY RISKS TO YOUR ECONOMIC FORECAST?

Without comparison, the single most significant risk pertains to the rollout of vaccines to inoculate the US population against COVID-19. Public health officials expect to vaccinate more than 100 million Americans by May 1 and 200 million by the end of September, which is far from certain. Simply put, ***the pace of GDP growth during the year is a function of the speed at which vaccines are distributed***. A significant deviation from these ambitious targets could defer the recovery until later in the year, culminating in higher unemployment, greater credit losses, higher budget deficits, and an increased number of COVID-19 deaths.

There are other secondary risks to the economic outlook. These include the following:

- A slump in consumer spending triggered by a collapse in confidence
- A nationwide lockdown of the economy resulting from a surge in hospitalizations
- A spike in delinquencies on consumer and business loans
- A sharp slowdown in housing construction because of a weakening job market

Chart 2: Inventory of Unsold Homes at an All-Time Low
Existing Single-Family Homes For Sale, Millions of Units
Source: National Association of Realtors

Bottom Line: The US economy is currently at a critical juncture, and is likely to weaken further over the next several months until the newly legislated fiscal stimulus contributes to a resumption in growth. However, an actual contraction in GDP appears unlikely in the interim, and the economy should strengthen during the second half of the year and all of 2022.

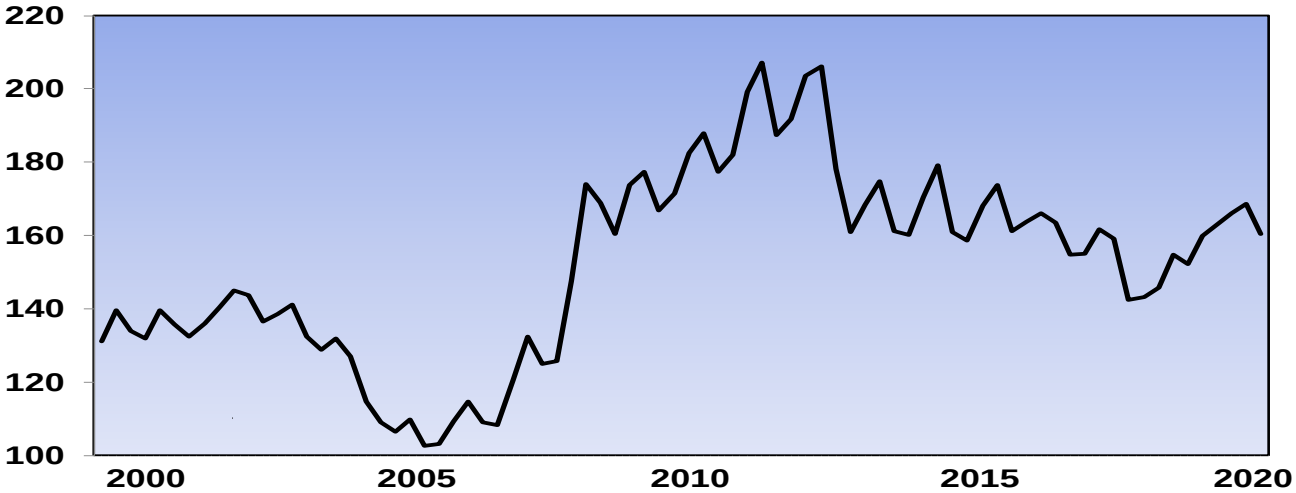
HAS THE US HOUSING BOOM ENDED?

The most recent monthly data depict a plateauing in the housing market. Building permits have flattened and home sales have declined for three consecutive months. The home building stock index has declined by nearly 15% since mid-October, which compares with a 10% ***gain*** in the S&P 500. However, it is important to drill down in order to determine the root cause of the slowdown.

As has occurred periodically in recent years, the housing market appears to be in a slowing trend. Once again, *the slowdown appears to be primarily a supply-side phenomenon, as indicated by a record shortage of homes for sale*. The demand for housing remains strong. The inventory of existing homes for sale is currently 1.28 million units, the lowest on record, and the equivalent of only two months supply. The long-term average is 5.8 months' supply. Hypothetically, the implication is that the number of unsold homes would decline to zero in only two months in the absence of any new construction (see chart 2).

There is additional evidence of an inadequate number of homes for sale. The quarterly homeowner vacancy rate was 0.9% in September, the lowest in the history of the data. The sharp rise in house prices is another indication of the inadequate supply of homes for sale. Prices of single-family homes rose at an annual rate of 8% in the third quarter, and further gains lie ahead.

Chart 3: Rapidly Rising House Prices Raise Affordability Concerns
The Affordability Index: Less Favorable But Still Above Historical Average
Source: National Association of Realtors



Rising property prices are a double-edged sword because of the effect on affordability. The affordability index measures the ability of the average homeowner to afford the average house, considering three variables: Home prices, mortgage rates, and household income. The affordability index has declined in recent months because of price increases and weakness in household income. *However, with mortgage rates at all-time lows, affordability is currently comfortably above the average of the past 25 years* (see chart 3).

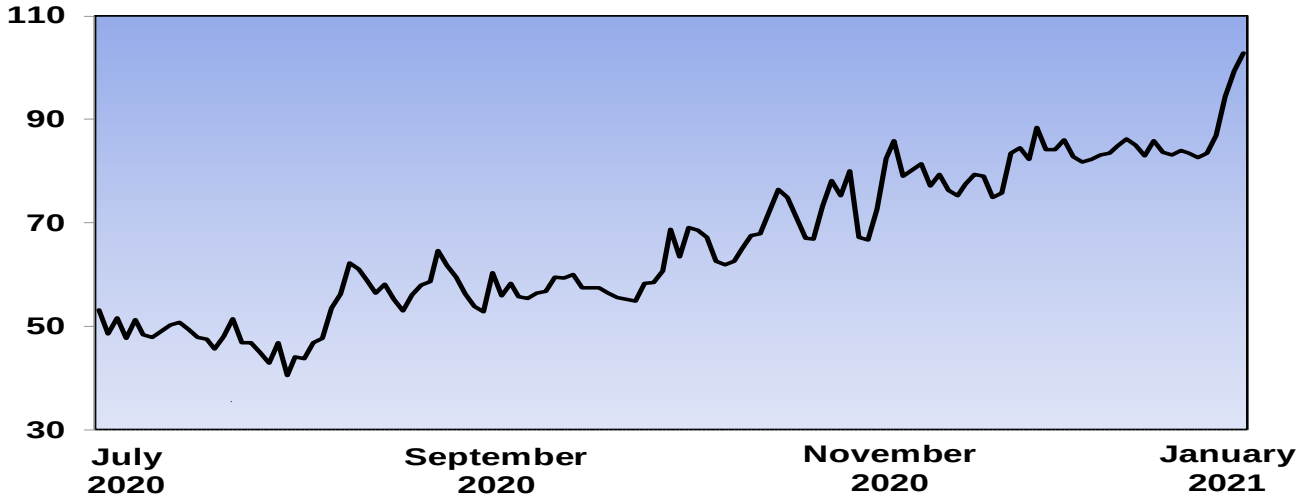
The bottom line is that construction of single-family homes might pause in coming months, but should proceed at a rapid clip over the next two years. The only way for the strong underlying demand for single-family homes to be effectively met in coming years is for construction to increase from current levels until supply rises to a level equal to underlying demand.

HOW CAN LONG-TERM BOND YIELDS RISE THIS YEAR AND IN 2022 WITH POLICY RATES PINNED AT ZERO?

It is critical for investors to understand the unique forces that determine short-term versus long-term interest rates. *Whereas the Federal Reserve has firm control over short-term rates, it has only partial control over long-term rates*. *The latter is determined by investor expectations regarding future economic growth and inflation*.

The yield curve portrays the interrelationship between the thrust of Fed policy and investor expectations for future economic growth and inflation. A flat yield curve is a signal that investors perceive the thrust of monetary policy as too restrictive relative to underlying economic conditions. A steep yield curve signals the opposite — that Fed policy is too expansionary relative to the expected path of economic growth and inflation. The yield curve has already steepened considerably in recent weeks in anticipation of faster growth and rising inflation (see chart 4).

Chart 4: The Yield Curve Continues to Steepen at a Steady Pace
Ten-Year US Treasury Yield Less Three-Month US Treasury Bill Rate (Basis Points)
Source: Federal Reserve



Long-term interest rates are unlikely to rise significantly over the next six to nine months because of lingering weakness in spending, employment, and output. Continued very low inflation should also keep a lid on bond yields for much of this year. In addition, very low odds of a new Fed rate-tightening cycle this year and in 2022 also support a forecast of relative stability in long-term rates in the immediate future.

However, the Federal Reserve cannot suppress long-term interest rates indefinitely, as market expectations for future economic growth and inflation should move higher consistent with faster distribution of a vaccine. Investors will become net sellers of bonds, forcing market yields higher and prices lower. Currently priced at a yield-to-maturity of 1.1%, the ten-year US Treasury bond could climb to 2.5% by the end of 2022 before the Fed begins a hike in short-term rates. The result would be the steepest yield curve in more than five years.

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Bloomberg Barclays US Aggregate Bond Index: is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. Investors frequently use the index as a stand-in for measuring the performance of the US bond market.

Dow Jones Industrial Average: is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States.

MSCI World Excluding US Equity Index: is a stock market index comprising of non-U.S. stocks from 23 developed markets and 26 emerging markets. The index is calculated with a methodology that focuses on liquidity, investability, and replicability.

NASDAQ: is an American stock exchange at One Liberty Plaza in New York City. It is ranked second on the list of stock exchanges by market capitalization of shares traded, behind the New York Stock.

Russell 2000 Index: is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

Russell 3000 Growth Index: is a market capitalization-weighted index based on the Russell 3000 index. The Russell 3000 Growth Index includes companies that display signs of above-average growth. The index is used to provide a gauge of the performance of growth stocks in the United States.

Russell 3000 Value Index: : is a market-capitalization weighted equity index maintained by the Russell Investment Group and based on the Russell 3000 Index, which measures how U.S. stocks in the equity value segment perform by including only value stocks.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

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