Q1 2021 MARKET OUTLOOK

Executive Summary

We enter 2021 in the early stage of an economic cycle, yet asset prices are more reflective of a mid-to-late cycle economy, which may cause angst among market participants who are seeking a historical analog to navigate this unprecedented environment. Although we can empathize with such discomfort, we remain calm and continue to stick to our process, which is to allow our growth and inflation expectations to dictate our asset allocation. Despite elevated valuations that are arguably stretched, we believe the path of least resistance for equities and other risk assets remains upward, as growth and inflation appear poised to accelerate through the first half of 2021.

Fourth Quarter Review

Growth accelerated while vaccines and additional fiscal stimulus boosted optimism.

- Economic growth continued to accelerate despite another resurgence in COVID-19 cases in Q4.
- A global vaccination campaign was launched in December, increasing sentiment that the market risks associated with COVID-19 will dissipate in 2021.
- The US government also passed a $900 billion stimulus package aimed at providing aid to individuals and businesses most disrupted by the pandemic.

Equities

Equity rally continues as growth accelerates.

- Global equities returned **+14.7%** in Q4, led by cyclical sectors as prospects for the economy improved.
- We have favored (and continue to favor) using elevated volatility as an opportunity to increase exposure to equities, particularly those in more cyclical sectors.
- The Democratic sweep may result in more spending, which would likely provide an additional tailwind to equities in the near term.

Fixed Income

Credit leads and safe-haven bonds lag as market participants prepare for reflation.

- The US Aggregate Bond Index was up **+0.7%** in Q4.
- Investment-grade and high-yield corporate bonds led, gaining **+3.0%** and **+6.5%**, respectively. In contrast, safe-haven bonds like long-term treasuries declined **-3.0%** as expectations for higher growth and inflation (i.e., reflation) plus fiscal spending increased.
- We favor reducing exposure to fixed income given our expectation that interest rates will continue to rise in the coming quarters. Specifically, we have favored reducing exposure to long-term treasuries because they are most vulnerable to rising rates.

Commodities

Cyclical commodities rally; gold takes a pause.

- Broad commodities gained **+14.5%** in Q4 as market participants prepared for a pickup in economic activity.
- Gold was flat as market participants weigh the potential for higher real interest rates.
- We continue to favor holding gold as a hedge against inflation and US dollar debasement, although we have reduced exposure in case accelerating growth pushes real interest rates higher.

Looking Forward

Fundamental backdrop will likely be positive for risk assets through the first half of 2021 (1H21).

- Easy base effects, increased spending, and more relaxed social distancing measures should allow growth and inflation to accelerate through 1H21, which would likely be positive for risk assets during that time.
- A unified government could present an additional tailwind for equity prices in the near term as expectations for fiscal spending increase.
- We believe the probability of hyperinflation remains low for now, but are vigilant of the possibility that we could enter a higher inflation regime in the near-future.

POSITIONING HIGHLIGHTS

OVERWEIGHT

Gold. We favor remaining overweight gold as a hedge against lower real rates, increased volatility, and/or devaluation of the US dollar.

UNDERWEIGHT

Fixed Income. We favor shifting to an underweight posture in fixed income by locking in gains in treasuries as prospects for economic growth improve.

OVERWEIGHT

Equities. We favor increasing equity exposure to neutral while using elevated volatility as an opportunity to add further to this asset class.

***Note:** This document, including important disclosures on Page 8, is meant to be read in its entirety.*

Fourth Quarter Review

US economic growth continued to accelerate in the fourth quarter as economic activity increased despite a resurgence in COVID-19 cases. Meanwhile, the world began its vaccination campaign in December, fueling optimism that the worst of COVID-19 will soon be behind us. Sentiment was pushed even higher after the US government passed a $900 billion stimulus package that will enhance unemployment benefits and provide aid to small businesses to bridge the gap (financially) between pandemic-induced lockdowns and a return to normalcy.

The MSCI All World and Russell 3000 indexes were each up +14.7% in Q4 and finished the year up +16.3%, respectively. Cyclical sectors like energy, financials, industrials, and materials outperformed in Q4 as expectations for the pace of the economic recovery increased.

The Barclays US Aggregate Bond Index gained +0.7% during the quarter and finished the year up +7.5%. Consistent with rising risk appetite, investment-grade and high-yield corporate bonds gained in +3.0% and +6.5%, whereas safe-haven segments like long-term treasuries declined -3.0%. However, long-term treasuries remain one the best performing fixed income segments in recent history, up +18.1% in 2020 and +41.6% since the US economy began to slow in 4Q18.

Broad commodities climbed +14.5% in Q4 in anticipation of a pickup in economic activity while defensive commodities like gold were flat. That said, gold outperformed the broad commodity index by +48% in 2020 and has outperformed it by +90% since 4Q18. This performance gap narrowed a bit in Q4, and we expect that trend to continue in the coming quarters, as both the US and the global economy continue to accelerate.

MARKET REPORT CARD – December 31, 2020

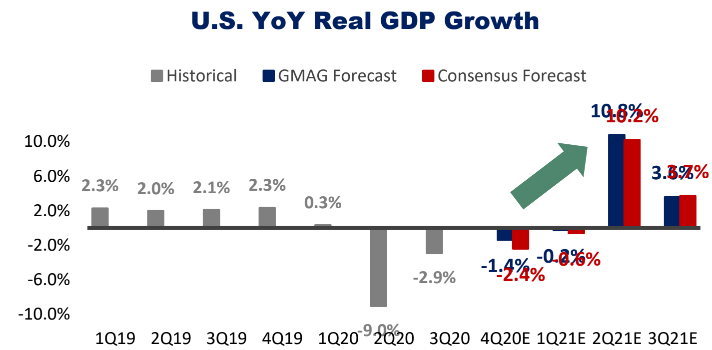
Performance Reported in US Dollars	4Q20	2020	Since 4Q18 (Start of Slowing Growth Regime)
Equities			
Global (MSCI All World Equity Index)	+14.7%	+16.3%	+28.4%
United States (Russell 3000 Index)	+14.7%	+20.9%	+35.7%
International Developed (MSCI EAFE Index)	+16.0%	+7.8%	+15.1%
Emerging Markets (MSCI EM Index)	+19.7%	+18.3%	+29.6%
Bloomberg Barclays US Aggregate Bond Index	+0.7%	+7.5%	+18.8%
Long-Term Treasuries (Barclays 20+ Year)	-3.0%	+18.1%	+41.6%
Investment-Grade Bonds (Barclays US Corp)	+3.0%	+9.9%	+25.6%
High-Yield Bonds (Barclays US HY Corp)	+6.5%	+7.1%	+16.9%
Commodities (S&P GSCI Index)	+14.5%	-23.7%	-30.9%
Crude Oil (S&P Crude Oil Index)	+18.4%	-60.3%	-67.0%
Gold (LBMA Gold PM Price Index)	+0.0%	+24.6%	+59.0%
Hedge Funds (HFRX Global Hedge Fund Index)	+5.1%	+6.8%	+9.6%

Source: Bloomberg, GMAG Research

Data Check: Green Shoots to Persist through the Second Quarter.

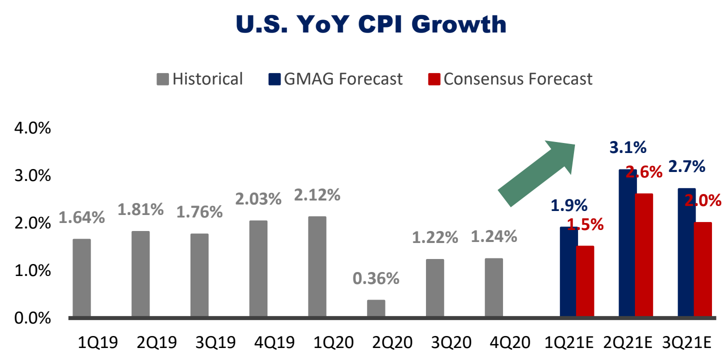
We expect that both US growth (**Figure 1**) and inflation (**Figure 2**) will accelerate through the second quarter, which should provide a positive backdrop for equity and commodity prices, particularly those more sensitive to changes in economic activity. Primary tailwinds to growth and inflation include (1) easy base effects, (2) increased economic stimulus, and (3) pent-up demand that should be deployed as social distancing restrictions are eased:

Figure 1: Growth likely to accelerate through the second quarter.



Source: Bloomberg, Hedgeye Risk Management, GMAG Research

Figure 2: Inflation likely to accelerate to 3% for the first time since 2011.



Source: Bloomberg, Hedgeye Risk Management, GMAG Research

1. Extremely easy base effects in Q2 will likely facilitate the largest year-over-year acceleration in US growth and inflation since 1950 and 2011, respectively. We also expect quarter-over-quarter (QoQ) growth to remain positive through 2021, and we believe the QoQ growth outlook is more relevant during this recovery than it is normally.
2. The $900 billion stimulus package passed in December, plus any additional spending from the new administration—an additional $1.9 trillion stimulus proposal was made yesterday—will likely boost economic activity even further.
3. We believe the distribution of effective vaccines should allow the U.S. and other countries to reduce lockdown restrictions in the coming months. Total household savings in the US increased by $1.5 trillion relative to the March–November period in 2019. The deployment of that savings as economic activity renormalizes should serve as a meaningful amplifier to spending growth.

We believe the biggest risk to this view would be a scenario where inflation rises higher and faster than expected, forcing the Fed to tighten interest rates. However, we believe this risk is relatively low in 2021 because (1) there are still several disinflationary forces at play despite the aggressive monetary expansion being implemented in the U.S. and globally, and (2) the Fed's tolerance for higher inflation has increased. Nonetheless this is a risk we are vigilant of and will be monitoring closely.

For now, we favor positioning for a period of global synchronized quad 2s (**Figure 3**). The last time we experienced a setup similar to this one was in 2017—a year when global equities gained **+24.0%**.

Figure 3: We are entering a period of synchronized global growth.

1/12/2021	Global Quad Outlook												
	Actuals									Estimates			
	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20E	1Q21E	2Q21E	3Q21E
Australia	3	4	4	4	1	1	3	4	2	2	2	2	4
Brazil	2	4	4	2	4	2	3	4	2	2	2	2	3
Canada	2	4	4	2	4	3	4	4	2	2	2	2	4
China	3	4	4	2	3	2	3	1	1	1	2	3	3
Eurozone	3	4	1	4	1	3	3	4	1	4	2	2	3
France	3	4	1	1	4	3	3	4	2	4	2	2	3
Germany	3	4	1	3	1	3	3	4	1	1	2	2	3
India	4	4	1	3	3	3	3	4	2	2	2	2	4
Italy	3	4	1	1	1	4	4	4	1	1	2	2	3
Japan	3	1	1	2	1	3	4	4	2	1	2	2	3
Russia	3	2	3	1	1	1	4	3	2	3	2	2	3
South Korea	3	2	4	2	4	2	3	4	2	1	2	2	4
United Kingdom	2	4	1	3	4	4	3	4	1	2	2	2	3
United States	4	4	4	3	1	2	3	4	2	2	2	2	4
MODE/MEDIAN	3	4	4	2	1	3	3	4	2	1	2	2	3

Source: Hedgeye Risk Management

Investment Outlook

Global Equities

Increase risk to overweight.

Since the economy bottomed in April, we have favored incrementally increasing risk exposure as opportunities have presented themselves.

We now enter 2021 favoring a posture that is overweight risk, which is a stark contrast to the highly defensive stance that we favored for the better part of the past two years when the US economy was slowing (**Figure 4**).

Figure 4: The US economy had been slowing since the fourth quarter of 2018 and bottomed in April 2020.

Source: Bloomberg, GMAG Research

Although it is possible that the recovery stalls and we enter a double dip recession, we believe this risk is relatively low at this time, given the current fundamental tailwinds referenced on page 3.

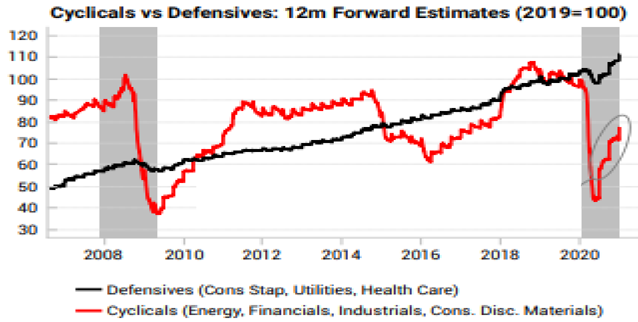
As a result, we have favored (and continue to favor) using corrections as an opportunity to increase portfolio risk.

Continue to favor cyclical equity sectors.

We have favored adding to cyclical stocks since April, as these companies are positioned to benefit most from an economic recovery. Cyclical stocks have performed particularly well in recent months as expectations that the recovery will continue have firmed.

Earnings of cyclical companies were among those hit hardest by the pandemic, and although earnings estimates have started to recover, they still have room to be revised higher (**Figure 5**). In contrast, earnings for companies in defensive equity sectors were hardly affected and estimates already exceed pre-pandemic levels. We believe there remains room for market participants to rotate back into cyclical companies as earnings estimates continue to be revised upward. We furthermore expect that cyclicals will benefit from an increase in fiscal spending, an event that appears increasingly probable following the Democratic victory in the Georgia Senate races.

Figure 5: Earnings of cyclical companies have been revised upward but there is still room for them to move higher.



Source: Variant Perception

Continue to favor tech stocks.

We continue to favor maintaining an overweight to secular growers like US tech stocks, as we expect them to perform well, even if they underperform cyclicals during this recovery. We believe the biggest risks to the sector is a slowdown in economic activity or a material increase in interest rates driven by higher than expected inflation. However, we believe the probability of either of these events remains low for now.

Continue to favor emerging markets.

Accelerating global growth, plus aggressive fiscal spending in the U.S.—which eases global liquidity conditions and puts downward pressure on the US dollar—should be positive for emerging market stocks. We have favored increasing exposure to emerging markets since the summer, and emerging market equities have outperformed the Russell 3000 by **+10.7%** in the second half of 2020.

Liquidity and positioning are neutral to supportive.

- Excess liquidity remains high. **(positive)**
- Cash balances remain elevated, suggesting that there is dry powder ready to be deployed into other asset classes like equities. **(positive)**
- Hedge fund exposure to equity markets (as measured by beta) and speculative positioning in equity futures is not indicative of crowded long positioning. **(neutral)**

But valuations are stretched…

Despite a positive fundamental and technical backdrop from a macro perspective, valuations are near all-time-highs, which reduces the margin of safety and could lead to higher levels of volatility.

Our Thoughts on a Few Hot Investment Topics Entering 2021.

What to expect under a unified government? ▲Fiscal Spending, ▲Corporate Taxes, ▲Regulation

Following the Democratic Party's victory in both Georgia Senate races, it now has control over a unified government. This should increase President Biden's ability to execute his agenda, including higher spending, taxes, and regulation, among other items.

However, there is a wrinkle. Although the "Blue Wave" eventually came through, the swell was considerably smaller than originally anticipated. With only a small majority in the Senate and the House, this will be one of the narrowest majorities ever, which may limit the Democrats' ability to execute their full agenda unless they eliminate the filibuster rule. It remains to be seen whether they will choose to do that, as both parties have utilized the filibuster heavily in recent history. Michael Cembalest, JP Morgan's chairman of market and investment strategy, believes it is likely that the filibuster will stay, and, if that is the case, that only one-third to one-half of Biden's agenda will be implemented. We will be monitoring developments on this front, but below are some changes that may be on the agenda in the coming years, and the likely impact that they might have on markets:

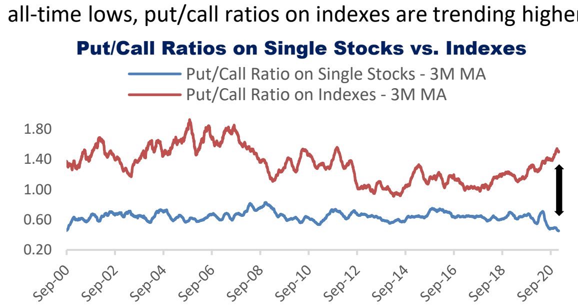
- **Increased Fiscal Spending.** Although Biden may not be able to spend the $5.4 trillion laid out in his election campaign, we do believe it is probable that there will be considerable spending across areas like pandemic relief, infrastructure, and education.
  - **Market Implication:** This would likely provide a material boost to economic activity, which should provide a tailwind to equity markets in the near term, particularly for stocks in cyclical sectors like financials, materials, industrials, and energy.
- **Corporate Tax Increase.** Biden proposed raising the corporate tax rate from 21% to 28%, which would undo roughly half of the cuts made via the Tax Cuts and Jobs Act in 2017. We expect at least a modest increase in the corporate tax rate under the new administration.
  - **Market Implication:** A corporate tax hike would likely create a drag on corporate earnings, which is not inconsequential given that its decline has been a key driver of profit margin expansion in recent years. By itself, this would likely adversely affect equity prices.
- **Renewable Energy.** We believe that promotion of renewable energy sources is likely, but we are less confident that the new administration will focus on punishing the fossil fuel sector.
  - **Market Implication:** This would likely provide opportunities for renewable energy companies.
- **Regulation on Legal Monopolies.** We could see more stringent regulation on companies like FB, AMZN, AAPL, and GOOGL.
  - **Market Implication:** Depending on the magnitude of scrutiny, this could adversely impact the earnings and prices of these companies in the years ahead. However, how stringent regulations will be and the implications of such action are unclear at this time.
- **Pressure on Large Cap Pharma.** Price pressure on US drug companies could increase.
  - **Market Implication:** This could potentially provide a headwind to the earnings and price of companies within large cap pharma.

To summarize, it's too early to know what will or won't get through Congress, but we believe it is likely that a significant portion of President Biden's agenda will be executed. We believe that higher corporate taxes and increased fiscal spending are very likely, and although we acknowledge that a higher corporate tax rate by itself is a negative for equity prices, we believe the net impact of these polices would be positive for risk assets in the near term.

Is sentiment too bullish? Although sentiment is high, this alone does not warrant a defensive posture.

- The trailing 3-month average of the AAII Investor Bullish Sentiment Index is in the 77th percentile, suggesting that sentiment has room to increase from here. Furthermore, history shows that although elevated bullish sentiment has, in some cases, preceded large equity market drawdowns, it doesn't have to. It is normal for high levels sentiment to persist coming out of a recession.
- Although put/call ratios on single stocks are near all-time-lows—extremely low put/call ratios have historically preceded large drawdowns in the broader stock market—put/call ratios on indexes have been trending in the opposite direction (**Figure 6**), potentially compromising the validity of this signal.
- Lastly, the consensus is right about half the time. Therefore, we do not believe it is prudent to be a contrarian for contrarians' sake. Rather, there is greater opportunity to fade the consensus when we believe the fundamental outlook does not support its view. However, we believe there are valid reasons to be optimistic at this time.

Figure 6: Although put/call ratios on single stocks are near all-time lows, put/call ratios on indexes are trending higher.



Source: Bloomberg, GMAG Research

Are valuations too high? Valuations are stretched, but valuation is not a catalyst.

There is no doubt that current equity prices are more consistent with what is generally experienced in a late-cycle economic environment than in an early cycle environment because the Fed allowed market participants to front-run the post-recession earnings recovery more quickly than they ever have historically. Although valuation should not be ignored, we acknowledge that cheap becomes cheaper and expensive becomes more expensive, depending on market conditions (i.e., growth and inflation).

We believe it is plausible for earnings to recover at a fast enough pace so that equity prices rise while valuation multiples contract, and that this scenario is likely as long as growth is accelerating.

COVID Vaccines Spur Optimism that the Worst Will Soon Be behind Us.

Severity remains low relative to where it was in the early part of 2020…

Globally, cases and mortalities have reached new highs, and restrictions of varying degrees have been implemented to impede further stress on hospital systems. Encouragingly, the severity of the outbreak measured by the ratio of mortalities to cases remains stable and lower than at the onset of the pandemic because both treatment and our understanding of the virus have improved. Although select hospital systems are stressed, the situation is mostly manageable in the U.S.—hospital capacity usage is below the country's historical average of 68% in 80% of US cities (**Figure 7**).

…and the focus now shifts to the vaccination campaign.

The first COVID-19 vaccinations were administered in December as the global economy initiated the next phase required to return the economy and society to normalcy. So far, 11.2 million people in the U.S. and 35.3 million globally have been vaccinated. Two vaccines have been authorized for use in the U.S. and the federal government has secured 300 million doses with the option to purchase up to a total of 1.5bn. Additionally, it is likely that more vaccines will be approved.

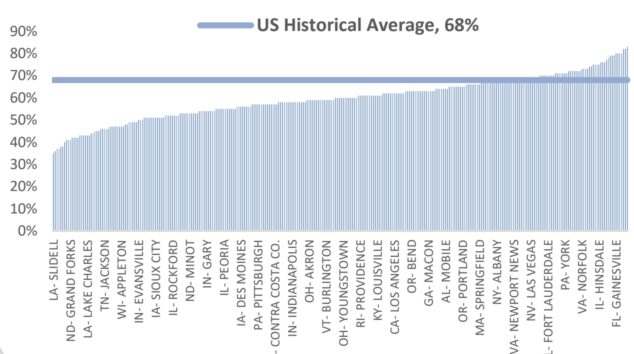
Now that distribution is underway, many are wondering how long it will take until a meaningful portion of the population is inoculated and if, or when, herd immunity can be reached. Our most trusted third-party relationship specializing in the health-care sector believes we are trending toward 45% of the population being vaccinated by Q2/Q3, and that this, coupled with existing immunity, may be enough to achieve herd immunity by the July/August timeframe, give or take one to two months.

Tracking the percentage of populations vaccinated is key to understanding which countries and regions can remove restrictions on mobility and the economy. So far, the U.S. and the U.K. lead the Western world, with 3.4% and 4.9% of their populations vaccinated, although Israel (an outlier) has already inoculated over 25.0% of its population. We believe vaccinations could suppress cases, hospitalizations, and deaths in the coming months, causing policymakers to ease restrictions, which remain elevated across the world's largest economies (**Figure 8**). We'll be monitoring Israel closely to (1) gauge the speed of improvement and (2) understand how mass inoculations may affect policy decisions, because more policymakers will likely be in a similar situation as distribution progresses.

Distribution logistics have been a challenge in the U.S., but we expect market participants to remain optimistic unless the vaccination timeline shifts significantly.

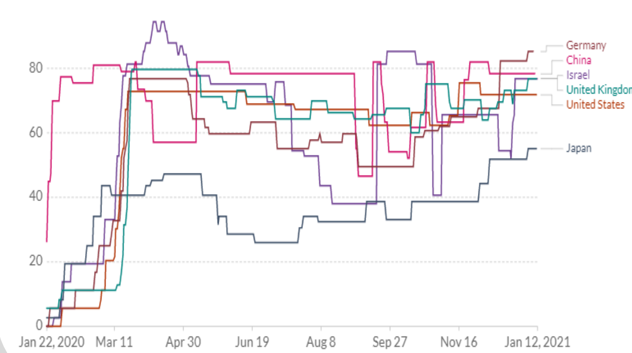
Although the distribution of the COVID-19 vaccines provides cause for confidence, the rollout in the U.S. has fallen short of its objective to have 20 million people vaccinated by the end of December. However, we still expect that the majority of the population who are most vulnerable to the virus will be vaccinated in Q1, which should reduce mortalities and alleviate pressure on stressed hospital systems, which, in turn, should facilitate a reduction in government restrictions and an increase in mobility.

Figure 7. 80% of US cities currently have hospital bed capacity usage below the national historical average.



Source: Covidcaremap.org

Figure 8. COVID-19 Government Response Stringency Index shows that restrictions remain elevated across most major economies.



Source: Oxford COVID-19 Government Response Tracker

Fixed Income

Maintain underweight to fixed income as economic conditions improve.

We have favored reducing fixed income exposure to an underweight posture given that bonds have historically underperformed equities and commodities when both growth and inflation are accelerating. This is because interest rates are positively correlated with these two factors, therefore, when growth and inflation expectations increase, interest rates generally rise, which provides a headwind to most bonds.

Continue to reduce exposure to long-term US treasuries.

Although long-term US treasuries performed very well when the US economy was slowing—they returned +55.3% from October 1, 2018, through March 9, 2020—they are likely to retrace a significant portion of those gains if the economy continues to recover and interest rates grind higher. We have favored gradually reducing exposure to long-term bonds since June—recall that when we released our 3Q20 Market Outlook, we communicated our belief that the next big move in US treasuries was likely to be lower. Since August, long-term treasuries have returned **-10.1%**.

Expect credit spreads to continue to tighten.

We expect corporate bonds to perform well as fixed income allocators migrate from higher quality bonds to lower quality bonds while the economy recovers. However, we generally prefer equities relative to credit because equities have historically outperformed credit in quad 2. Since the start of the fourth quarter, the Russell 3000 is up +17.1%, whereas US investment-grade and high-yield credit are up +1.9% and +6.6%, respectively.

Commodities

Maintain overweight to gold, but reduce exposure in case real yields rise.

Like treasuries, gold performed very well when the US economy was slowing, as slowing growth and moderate inflation pushed real interest rates lower—gold has had a **-0.92** correlation to real yields during the past 20 years (**Figure 9**).

Figure 9. Gold has a strong inverse relationship with real interest rates.

Source: Bloomberg, GMAG Research

We continue to favor maintaining exposure to gold as a hedge against (1) inflation rising faster than we expect, and (2) potential dollar debasement caused by incessant money printing. However, we also acknowledge that an acceleration in growth may place upward pressure on both nominal and real interest rates—the latter depends on how strong inflation is—and in an environment where real yields are flat to up, gold will likely underperform most other asset classes.

Conclusion

In summary, we are cautiously optimistic in our outlook regarding the economy and risk assets in the coming quarters. Although we manage each portfolio individually, we favor being overweight risk as economic growth accelerates from these depressed levels. We furthermore believe that cyclical equity sectors stand to benefit more from a continuation of this recovery than other sectors, and that any additional fiscal spending—which we believe is likely under the new administration—should provide an additional tailwind to these stocks.

Please call us at any time to discuss our market views and how they are affecting your individual asset allocation. We will keep you apprised of any important developments.

Sincerely,

gmag

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