Laidlaw & Company (UK), Ltd.

2021 Outlook – Five Forecasts

With 2020 drawing to a close, the Laidlaw Investment Policy Committee is updating the *"Laidlaw Five"* forecasts for 2021 to offer investors thoughts on five particular areas to take into account when considering how best to navigate the capital markets in the year ahead and which will be periodically revised as the year unfolds and significant events necessitate.

However, before hurling ourselves into the unknown, it is wise to review just how well our 2020 forecasts fared in providing useful guidance in considering the lay of the land investment-wise. Of course, we will readily acknowledge utter failure in anticipating the advent and subsequent devastation wrought by the COVID-19 coronavirus epidemic, but aside from that let us continue on to how else we may have gotten things right or wrong.

Here were the 2020 *"Laidlaw Five"* forecasts:

<u>2020 Assessment: Not Fully Capturing Volatility, But Did Anticipate Markets' Direction</u>

<u>Politics: Elections Prompt Markets To Pause</u>

With 2020 being a year of elections across the world culminating in the November 2020 U.S. general election, investors should consider that investment returns are likely to be muted until the electoral tea leaves are read. That said, Laidlaw expects positive investment returns will most likely be realized as a "relief rally" in the back half of 2020. Relative to the U.S. Presidential contest, while the expected candidates in the general election are Donald Trump (GOP) facing Michael Bloomberg (Democratic), it is important to note that there is high level of uncertainty as there are thoughts the Democratic Party at its July 2020 convention in Milwaukee, Wisconsin might have its first "brokered" convention in years. Meanwhile, impeachment, trade policy, technology sector regulation, health care reform, and Supreme Court vacancies are expected to result in a contentious campaign culminating in an election with high levels of voter turn-out. Interesting to note, 2020 will be the first U.S. election in which the "Baby Boomer" generation is no longer the majority of the electorate as "Millenials" move to the fore.

<u>Assessment:</u> *While we failed to call correctly the Democratic nominee, we did manage to anticipate the market's evolution during this election year fairly well as the S&P 500 on a total return basis was +9.74% through the end of August, then retraced -6.36% between then and the end of October as the general election kicked into high gear after Labor Day, and then surged +13.73% from the end of October until now.*

<u>Macro-economy: Tariff Wars, "Brexit", & Iran Are Wild Cards</u>

The global macro-economy is likely subdued as major events such as the U.S.-China trade tariff confrontation and the distinct possibility of a hard "Brexit" by the U.K. from the E.U. remain unresolved. Note that the inclination of the current U.S. Administration to withdraw from long-standing multilateral agreements in favor of more inefficient bilateral trade arrangements is likely to leave open the possibility of increased trade tensions with the E.U., something that may result in ECB monetary policy moving away from continued experimentation with negative interest rates. In terms of exogenous shock, Laidlaw believes an increase in oil prices to the $75/barrel level is possible depending on OPEC production cut-backs and the possibility of conflict with Iran limiting Persian

Gulf shipments through the Strait of Hormuz. With this as back-drop, GDP growth is expected as follows: U.S. +1.5%, E.U. +1.0%, and World +2.5%.

Assessment: *As we missed calling COVID-19 entirely, our economic forecasts were utterly useless as 2020 GDP growth is expected to end up as follows: U.S. -3.6% (according to The Conference Board), E.U. -7.8% (according to The European Commission), and World -4.4% (according to The IMF). Relative to our oil forecast, the price of a barrel of crude reached a high of $65.65 for a hot second on 1/8/20 as tensions flared between the U.S. and Iran, but then on the heels of COVID-19 it crashed along with the global economy to hit negative levels (-$40.32/barrel on 4/19/20) before stabilizing at its present $47.53/barrel, off –22.2% from its 2019 year-end price of $61.06. Meanwhile, on the trade front, relations between the U.S. and China have worsened and are likely to remain so under the incoming administration while relations with the E.U. are expected to be restored. The only call we appear to have right is the hard "Brexit" which may nevertheless be averted at the last minute. All in all, a rather mixed performance on our part*.

Markets: Equities +7% Due To Buybacks & "TINA", Interest Rates Edge Lower

The fixed income markets in 2018 called the tune as the shift in E.U. interest rates towards negative prompted the U.S. Federal Reserve to cut interest rates three times thereby supporting equities during a period when earnings contracted and capital investment spending stagnated under the uncertainty associated with the U.S.-China trade tariff confrontation. For 2020, Laidlaw has a 3,400 level target for the S&P 500, a +7% total return from current levels. Equities benefit from a return to corporate earnings growth supporting stock buy-back activity coupled with low interest rates leaving investors in the position of "there is no alternative" to equities. While no further Fed interest cuts are thought to be in the offing, the estimated -0.6% impact to U.S. GDP growth from Boeing halting 737 Max production may change that view. The U.S. Treasury 10-year rate now at 1.92% is expected to contract to 1.25-1.50% over the course of 2020 as the global macro-economy slows.

Assessment: *In terms of our S&P 500 forecast for 2020, our 3,400 level call was surpassed during August at which time we raised our target to 3,800, still +2.4% over current levels. This hinges on the expectation that the corporate earnings cycle unfolding from the 2020 Q2 trough will drive earnings estimates higher over the course of 2021. While the current 2021 Street S&P 500 EPS forecast of $169/share indicates a market trading at 22x next year's earnings, an elevated multiple, it is our view that 2021 EPS will end up +9% higher at $184/shares as earnings outperformance relative to Street estimates continues. On the higher estimate, the adjusted market multiple is 20x, still high but supportable based on the earnings cycle dynamics. Our call on the U.S. Treasury 10-year rate to be lower over the course of 2020 was correct, but we failed to anticipate that it would end up at the current 0.95%. In sum, while correct on direction, we missed on magnitude yet gladly still made profitable calls on equities and fixed income*.

Sectors: Tech Sees Regulation Risk Limit Potential, Election May Benefit Healthcare Prospects

While investors have built wealth since the 2009 Recession by taking an overweight position in large-cap U.S. Tech, the increasing risk of greater regulation may serve to depress profit margins for names such as Alphabet and Facebook and in the process limit the sector's appreciation potential. While the yield curve has steepened off the August 2019 lows, a development that has favored Financial sector shares, Laidlaw expects the macro-economy's uncertainties to slow and eventually limit further curve steepening. Meanwhile, the possibility of "Amazonization" is rising in the Financial sector as Tech names are speculated to be considering potentially disruptive moves such Apple acquiring as asset manager. That said, Laidlaw views the Healthcare sector as offering an attractive combination of growth and valuation that has the potential to improve should the 2020 election better define its return potential.

Assessment: *In terms of our sector calls, the impact of COVID-19 in shifting activities to "Work From Home" (WFH) served to accelerate market share gains for the large-cap U.S. Tech companies to give them a banner year in 2020 with the sector (+41.3%) substantially outperforming the S&P 500 (+14.8%). The expectation that WFH will represent the "new normal" proved sufficient to allow the Tech companies to overcome the threat of increased regulation, a risk that became more apparent as the 2020 progressed. Overall, 2020 was another banner year for Growth companies (+30.3%) which substantially outpaced Value companies (-2.9%), although there has been a rotation towards Value unfolding over the course of 2020 Q4 after news of COVID-19 vaccine discoveries led to views of accelerating economic recovery in 2021. Our 2020 call for the Healthcare sector while netting positive results (+12.4%) did not outperform the broader market. We made money. Not bad*.

2021 *"Laidlaw Five"*: Now, The Hard Work Of Recovery Begins

So, with 2020 thankfully heading soon to exit stage left, we now set the stage for the entrance of 2021 which brings its own challenges very quickly soon after the turn of the year.

Here are the 2021 *"Laidlaw Five"* forecasts:

Politics: With Fiscal Stimulus Efforts Still Critical To Economy, Congress Remains In Spotlight

While it would be nice to consider the possibility that, after an election year, investors could just go back to focusing on things other than politics, it would be difficult, if not detrimental, to ignore fiscal policy as new, expanded programs are very likely to remain a critical element in supporting global economic recovery and thus financial markets.

The path for the incoming administration will be challenging as the first order of business is to get COVID-19 addressed with a well-executed federal-led plan. The pay-off is quite clear: beat COVID-19, win the hearts and minds of the nation; and in the process perhaps get some significant percentage of the 74mm voters (46.9% of turnout) who voted for the incumbent to accept the new administration as the nation yearns for competence and leadership in government.

While Congress is expected to pass an additional $900bn in fiscal stimulus, bringing the total provided since the onset of COVID-19 to $3.2tn, passage of the further larger stimulus effort sought by the new administration will take time and have to confront determined political resistance should the party leadership in the Senate not shift following the two Senate run-off elections in Georgia scheduled for early January. Away from the run-off outcome, we are open to the possibility that certain senators may opt to become independent in an effort to promote bipartisanship.

That said, Laidlaw expects positive investment returns will again be skewed towards the back half of 2021 as a better sense is gained as to how well the new Congress operates to support the nation's recovery. Particular areas such as trade policy, technology sector regulation, and health care reform will be important. The government will be looking for new sources of revenue, something that may lead to the legalization of controlled substances such as marijuana. Note that Prohibition was repealed in 1933 as a means to generate new tax revenues in the midst of the Great Depression. Other developments such as the ongoing population shift prompted by COVID-19 from densely populated cities to less densely populated suburbs along with a greater shift to online from traditional "in person" education and the likelihood of "Work From Home" as the "new normal" will have political impact as funds are needed to support new programs and restructure old ones as institutions such as universities and commercial properties are faced with crisis while COVID-19 remains uncontained.

Macro-economy: COVID-19 Containment, Trade Policy & Inflation Are Wild Cards

Assuming vaccines prove effective in containing the COVID-19 pandemic and no significant mutations develop, the global macro-economy should be poised to recover as customer-facing economic sectors that can represent approximately 20% of employment may fully resume operation. Meanwhile, U.S.-China confrontation on a range of fronts including trade policy and the possibility of a hard "Brexit" by the U.K. from the E.U. will serve to depress recovery on the margin. What will be interesting to see over the course of 2021 is whether inflation strengthens as supply chains have been strained during the pandemic. Recent changes in monetary policy by The Federal Reserve Bank have eased guidelines to allow inflation to run on average over a 2% rate. How other central banks known for anti-inflationary policies such as the European Central Bank and the fixed income market are comfortable with this possible development will be a central question in 2021 as Laidlaw expects inflation break-evens to increase from 1.8% currently to 2.3% over the course of the year. In terms of exogenous shock, Laidlaw does not expect oil prices to spike as they trade towards the $60/barrel level seen before the pandemic, an expected +26% gain which will add to the inflation outlook. With this as back-drop, GDP growth is expected as follows: U.S. +3.6% (vs. -3.6% in 2020), E.U. +4.2% (-7.8%), and World +5.2% (-4.4%). Off the back of easy monetary policy and slower relative economic growth, Laidlaw expects to U.S. Dollar (DXY, 90.016) to weaken -10% over the course of 2021.

Markets: Equities +8% Due To Recovery Trade, Interest Rates Edge Higher

The pace of monetary policy easing and fiscal stimulus drove the markets in 2020 as greater liquidity served to support financial markets as the global economy contracted. At present, there are strong indications that both of these factors will extend forward for the foreseeable future until COVID-19 is contained fully. For 2021, Laidlaw has a 4,000 level target for the S&P 500, an +8% total return from current levels, with an upside possibility of a +15% return to the 4,265 level. As outlined earlier, equities benefit from the corporate earnings cycle outperforming expectations which along with a resumption of buy-back activity coupled with low interest rates will continue to leave investors in the position of "there is no alternative" to equities. The U.S. Treasury 10-year rate now at 0.95% is expected to rise to 1.50% over the course of 2021 as central banks allow negative real interest rate policy to support the global economic recovery. Meanwhile, with inflation expected to rise in 2021, this should support alternative assets such as gold (now $1,909/oz, target $2,100/oz) and Bitcoin (now $22,931, target $25,000).

Sectors: Tech Continues To Disrupt, But Value and International Stocks Outperform

COVID-19 has clearly transitioned a greater share of the economy over to the companies who dominate the Tech sector. In 2021, while Laidlaw fully expects the disruption-led growth Tech has produced will continue, we forecast the economic recovery trade will favor Value stocks from sectors where high fixed costs will lead to high profit margins on the incremental revenues realized from the recovery and thereby produce better than expected EPS growth. Sectors that fall into this category include Energy (XLE, $39.40, -30.9% in 2020, -45.7% vs. S&P 500) and Industrials (XLI, $88.84, +10.8% in 2020, -4.0% vs. S&P 500). A steepening yield curve should favor the Financials (XLF, $28.49, -5.5% in 2020, -20.4% vs. S&P 500). A weaker U.S. Dollar serves to lower the prices of commodities such as oil and industrial metals in foreign currency terms. For 2021, Laidlaw expects that non-U.S. equities will outperform the S&P 500 until such time as market expectations begin to factor in a monetary tightening shift by The Fed. In 2020, the broader Emerging Markets (EEM, $50.99, +15.5% in 2020, +0.7% vs. S&P 500) paced the U.S. market with substantial gains by South Korea (EWY, $81.22, +31.6% in 2020, +16.8% vs. S&P 500) and Taiwan (EWT, $51.57, +27.8% in 2020, +13.0% vs. S&P 500). For 2021, along with the broader Emerging Market and leaders South Korea and Taiwan, we suggest investors consider India (INDA, $39.33, +12.3% in 2020, -2.5% vs. S&P 500) for its growth potential and the U.K. (EWU, $29.38, -11.5% in 2020, -26.3% vs. S&P 500) for a recovery trade as "Brexit" is resolved hopefully for good and COVID-19 is beaten.

Odds & Ends: Random Thoughts To Consider

As we are not "all markets, all the time," we would like to take a moment to offer up random thoughts to consider. One that intrigues us is contemplating how Amazon founder and CEO Jeff Bezos will reallocate the capital he has generated. While it is fascinating to consider how he is developing his own space exploration venture, Blue Origin, and as such has designs perhaps on leaving the planet, we think more terrestrial concerns may occupy his mind. Namely, as Amazon evolves its business model around media offerings, it is possible that Mr. Bezos may consider acquiring multiple professional sports franchises to expand the company's content offerings. The cross-marketing and sell-through opportunities would be out of this world.