2021 Outlook: Poised for takeoff

EXECUTIVE SUMMARY

- As the Covid-19 vaccine distribution widens, the recovery should accelerate as pent-up demand is unleashed among consumers, by far the largest segment of the economy. Growth may struggle a few months before reaching this inflection point.
- A gradual return to normalcy over the course of next year should feed animal spirits and lift equity markets to new highs. We've set respective S&P 500 price targets of 4,500 and 5,000 for 2021 and 2022.
- The recent tilt toward value stocks, which tend to perform best early in a recovery, is taking hold. Small caps should continue to benefit for similar reasons in 2021, and international stocks offer the potential for relative outperformance.
- Because rates likely will remain low, we believe the best fixed income opportunities should come from credit—investment-grade and high-yield corporate bonds, and emerging-market securities.

Catalysts line up for the year ahead

For investors whipsawed by events over the past 12 months, we believe 2021 promises a return to normalcy—and a potentially stellar year for risk assets.

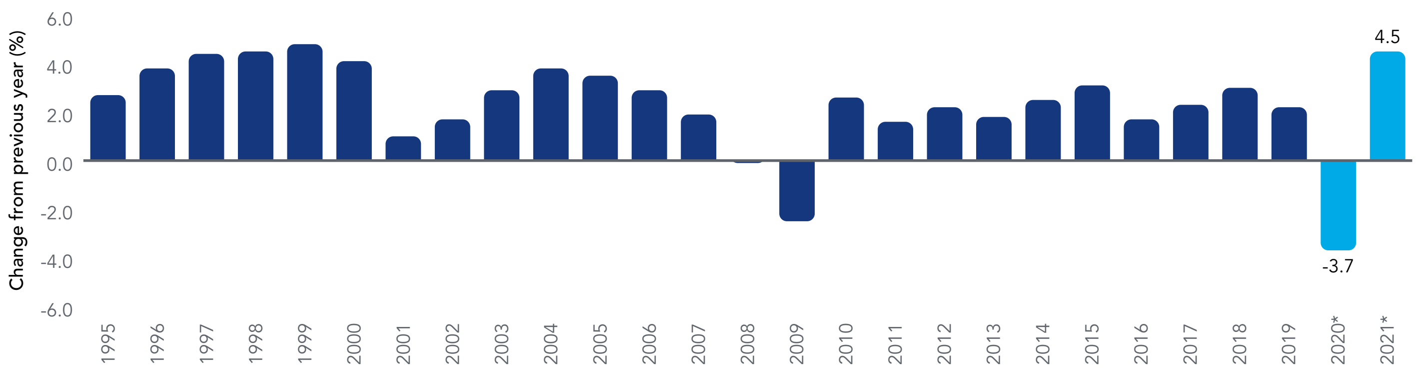
Federated Hermes forecasts real gross domestic product (GDP) to rebound to 4.5% in the new year, which would represent the best year for U.S. economic growth since 1999. Our equity team has targets of 4,500 on the S&P 500 Index for 2021 and 5,000 for 2022, with value and small caps leading on broadening market participation. We also like international stocks as GDP growth in emerging markets (EM) and Europe should outpace the U.S. In yield-challenged fixed income, improving economic and balance-sheet dynamics favor credit, specifically EM, investment-grade (IG) and high-yield corporate bonds. On the short end of the yield curve, we think low-duration strategies will offer income opportunities as yields drift higher despite a Federal Reserve that plans to keep its benchmark rate pinned near zero.

More broadly, 2021 should be calmer relative to the volatility that defined much of 2020, a year of once-in-a-lifetime extremes: the deadliest global pandemic in a century; the deepest quarterly decline in U.S. GDP in history, followed by the steepest quarterly increase on record; the quickest bear market and fastest market recovery ever; congressional approval of the largest-ever fiscal stimulus package ($2.2 trillion); and development, testing and distribution of efficacious vaccines in less than a year, a process that traditionally takes a decade or longer.

Amplified by a contentious election year, this constant wave of "unprecedented" occurrences weighed on investors. Despite the stock market's run to new highs off March's bear-market bottom, weekly equity fund flows were largely negative until the year's waning weeks, when a largely settled election and the approval of vaccines eased uncertainties.

Potentially dreary winter months lie ahead. Covid-19 cases are hitting new highs, with the labor market's recovery softening on renewed pandemic-driven restrictions. Still, Federated Hermes Portfolio Manager and Equity Strategist Steven Chiavarone believes the range of positives will overwhelm limited potential negatives in 2021, creating an "almost GI-returning-home moment" for the economy and risk markets in the year ahead.

GDP growth



Source (1995 to 2019): FRED (Federal Reserve Bank Of St. Louis). Real gross domestic product, percent change from preceding period, annual, not seasonally adjusted.

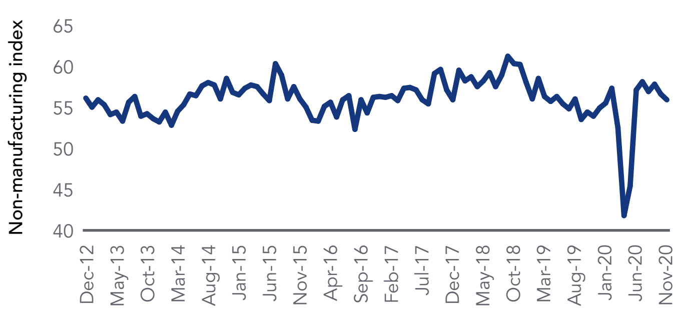
*Federated Hermes forecasts as of 12/11/20.

Here comes the consumer

While early months may prove challenging, we believe increasing vaccinations should begin to unleash massive pent-up demand among consumers by March. Consumer spending accounts for roughly 70% of domestic economic activity. Stuck at home due to Covid-19 constraints, households have built an estimated $1.5 trillion of "excess savings"—money beyond typical savings that's available to spend. What better way to celebrate Covid's end than to go out and splurge?

Manufacturing and services activity as measured by separate Institute of Supply Management and IHS Markit surveys already have rebounded to post-pandemic highs. Drivers of this surge include an inventory rebuild after a Covid-crisis collapse, a resurgence in productivity-enhancing capital expenditures, and a restructuring in the way many companies do business in response to pandemic-related disruptions to supply chains.

ISM Services PMI



As of 11/30/20. Monthly data. Axis label interval is five months.

Sources: Institute for Supply Management Non-Manufacturing (or Services) Purchasing Managers' Index, Bloomberg.

ISM Manufacturing PMI

As of 11/30/20. Monthly data. Axis label interval is five months.

Sources: Institute for Supply Management Purchasing Managers' Index, Bloomberg.

Housing is on a tear, lifted by fundamental and structural forces. Record-low mortgage rates and a pandemic-fed shift in demand for less-crowded suburban and exurban developments have pushed single-family home sales and construction to multidecade highs and sent homebuilder confidence to an all-time high. Indeed, the biggest deterrent to sales appears to be a lack of available homes.

More stimulus is on the way, too. At this writing, Congress is tussling over nearly $1 trillion of aid that proponents hope to pass before Christmas; if that fails, a Covid-related fiscal package seems likely in early 2021. Combined with a zero-bound Fed that, since February, has expanded its balance sheet by nearly 75% to $7.2 trillion, that's a lot of money to grease the wheels of commerce.

Homebuilder confidence

As of 11/30/20. Monthly data. Axis label interval is seven months.

Source: NAHB/Wells Fargo National Housing Market Index (HMI) (seasonally adjusted) from 1/31/08 to 11/30/20. The HMI is based on a monthly survey of NAHB members designed to take the pulse of the single-family housing market. The HMI can range between 0 and 100.

2021 equities: Goldilocks

We expect the best domestic economic growth in 22 years will boost earnings per share (EPS) of the S&P 500 Index components to $180 in 2021, up 20% from where we think 2020 will end up. Our early EPS target for 2022 is $200.

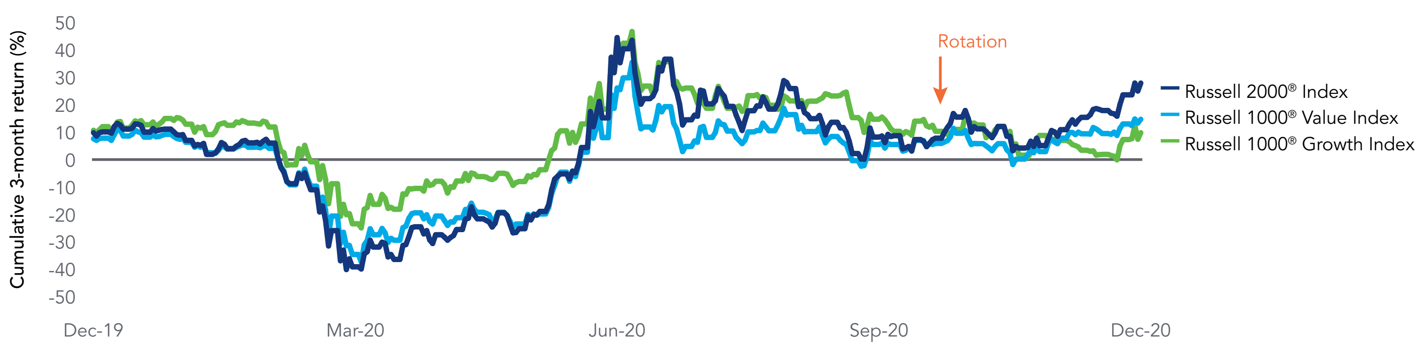
Relative to big tech and defensive stocks, cyclical value and small-cap stocks should benefit most in this environment. Hammered during the Covid crisis, these asset classes have a lot more room to make up than tech, which ran hard throughout the crisis, with five mega-names at one point accounting for nearly a quarter of the entire S&P 500's market cap.

Year-over-year comparisons to 2020's beaten-down metrics should be very favorable for cyclicals, which like small caps, tend to perform their best early in a recovery. The market has been pricing in the shift since September, with a rotation from growth/tech stocks to cyclical value and small caps after years of these two segments trailing the market. President-elect Biden's plans for massive infrastructure investment, including in green technologies, could provide an added punch to cyclicals.

Meanwhile, international stocks, like domestic stocks, should get a lift from the arrival of Covid vaccines and from more rounds of central bank support and fiscal stimulus, including the European Union's landmark $2.21 trillion long-term budget and Covid recovery package. The Federated Hermes team projects the EM economies as a group to grow 6%, with China's expansion elevating neighboring Asian economies, and for Europe's economy to expand 5%. After years of handwringing, Brexit worries appear to be receding regardless of the outcome.

Also fueling the U.S. investor's appetite for stocks: near record-low bond yields and an estimated $4.2 trillion available to invest. Even if bond yields inch higher as expected next year, the benchmark 10-year Treasury is likely to continue to run below the breakeven inflation rate. Indeed, the real 10-year yield has been negative for most of the year, making stocks attractive by comparison and justifying an S&P 500 price/earnings multiple above historical norms.

Growth, value and small-cap equities — three-month rolling returns



As of 12/10/20. Three-month rolling returns. Daily rollback. Daily data 9/26/19 to 12/10/20 (253 time periods). Axis label interval is three months.

Sources: Russell, Morningstar, Inc., Federated Hermes.

2021 fixed income: It's mostly about credit

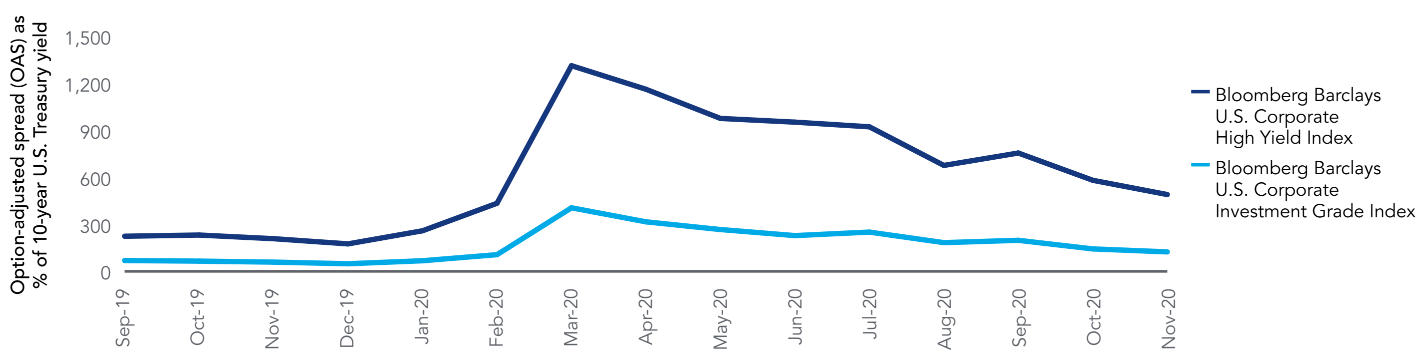
With the Fed expected to be on hold through 2022 and inflation stuck below the central bank's 2% target, it's difficult to see Treasury yields making a big upside move, particularly as Fed policymakers appear ready to shift purchases to longer-dated securities. But yields are likely to drift higher as growth picks up. Federated Hermes strategists think the 10-year Treasury could reach 1.25% in 2021. At these levels, it's hard to get bullish on Treasuries.

But the same factors that are good for stocks—accelerating growth, improving earnings, the arrival of vaccines, the end of election uncertainty and the likelihood of more stimulus—are good for credit sectors, too. While investment-grade, high-yield and EM yields are near historical lows, so are government yields, causing credit spreads—the yield differential between credit bonds and comparable maturity government bonds—to trade near their long-term medians. This offers room for spread tightening. EM bonds also are benefitting from the weaker U.S. dollar, China's expanding economy and rebounding commodity prices, trends that should carry over to the new year as the Covid slump fades.

In a yield-starved world, credit yields still offer value, as well. They're the highest in this low-yield environment. The same holds for municipal bonds, which continue to experience demand despite stressed state and local government finances and Covid-challenged sectors such as hospitals and airports. Additional fiscal stimulus and widespread vaccine distribution could help counter these negatives.

Even with overnight rates and yields at the shortest end of the curve likely to hold near all-time lows on the Fed's pledge to keep its target funds rate at a range of 0-0.25% through 2022, we see possibilities for income-oriented, risk-averse investors in low-duration strategies. Such strategies can capitalize on a steepening yield curve without adding much of the risk that comes with investing in the intermediate and longer ends of the curve.

U.S. corporate credit spreads



As of 11/30/20. Monthly data.
Sources: Bloomberg Barclays, Federated Hermes.

Animal spirits awaken

In our 2020 Outlook, we thought stocks would climb modestly and that credit may take a breather after both had strong years. What we didn't foresee—nor did anyone else—was a pandemic that would cause global devastation and the sharpest one-quarter U.S. GDP contraction in our history. So, we'll eat our humble pie, mindful that predicting the future is always an exercise fraught with unknowns.

Still, we enter 2021 in recovery mode and supported by unprecedented global central bank accommodation, massive fiscal stimulus and most importantly, vaccines. Amid little sign that either inflation or interest rates are about to break out, there are Covid-fatigued consumers about to let loose and an America that is chomping to get back to work. This is bullish. Let the animal spirits rise.

Past performance is no guarantee of future results.

Views are as of 12/11/20 and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Value stocks may lag growth stocks in performance, particularly in late stages of a market advance.

Yield Curve: Graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

The yield spread is the difference between the yield of a security versus the yield of a U.S. Treasury security with a comparable average.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

Duration is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.

Credit ratings of A or better are considered to be high credit quality; credit ratings of BBB are good credit quality, and the lowest category of investment grade. High-yield, lower-rated securities generally entail greater market, credit/default and liquidity risks, and may be more volatile than investment grade securities.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

The Russell 1000® Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000® Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment. The Index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics. The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000® Index companieswith lower price-to-book ratios and lower expected growth values. The index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The Russell 1000® Value Index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics. Indexes are unmanaged and cannot be invested in directly. The Russell 2000® Index measures the performance of the small-cap segment of the US equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000® is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

The Bloomberg Barclays U.S. Corporate Investment Grade Index is the Corporate component of the Bloomberg Barclays U.S. Credit Index. The Bloomberg Barclays U.S. Corporate High Yield Index is the Corporate component of the Bloomberg Barclays U.S. High Yield Index.

The NAHB/Wells Fargo HMI is a weighted average of three separate component indices: Present Single-Family Sales, Single-Family Sales for the Next Six Months, and Traffic of Prospective Buyers. Each month, a panel of builders rates the first two on a scale of "good," "fair" or "poor" and the last on a scale of "high to very high," "average" or "low to very low". An index is calculated for each series by applying the formula "(good – poor + 100)/2" or, for Traffic, "(high/very high – low/very low + 100)/2".

International investing involves special risks including currency risk, increased volatility, political risks, and differences in auditing and other financial standards. Prices of emerging markets securities can be significantly more volatile than the prices of securities in developed countries and currency risk and political risks are accentuated in emerging markets.

The value of equity securities will rise and fall. These fluctuations could be a sustained trend or a drastic movement.

Small company stocks may be less liquid and subject to greater price volatility than large capitalization stocks.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices.

Diversification does not assure a profit nor protect against loss.

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Federated Global Investment Management Corp.