GALLIARD
Capital Management, Inc.
ARCHITECTS OF INVESTMENT SOLUTIONS

ECONOMIC UPDATE

FOURTH QUARTER 2020

Quarterly Key Points

- By mid-December, two COVID-19 vaccines received emergency approval in the U. S. after proving ~95% effective in clinical trials. While the news of successful vaccines provided a much needed light at the end of the tunnel, it offered little immediate relief from ballooning infection rates.
- The November elections came and went, with Joe Biden emerging as the president-elect. The House remains Democrat controlled, albeit by a smaller margin than previously held, while the Senate tipped in favor of the Democrats. Former Federal Reserve Chair Janet Yellen has been announced as the first female treasury secretary in history (subject to Senate approval).
- Following a historic drop of -31.4% q/q annualized in 2Q, GDP expanded by an equally historic 33.4% q/q annualized in 3Q. Current forecasts are calling for more normalized economic growth of 3% - 4% q/q annualized in 4Q, such that 2020 GDP would be down ~3.5% for the year.
- In December, Congress finally passed a new $900 billion stimulus package primarily aimed at helping consumers and businesses, and the Fed reiterated its commitment to purchasing $80 billion of Treasury securities and $40 billion of Agency MBS per month for the foreseeable future. With increased Government spending on the horizon and the Fed's strong commitment to reaching its average inflation target, there may be upside potential to inflation forecasts.
- Retail sales contracted in October and November - the trend likely got worse in December. Unemployment continues improve albeit at a much slower pace over the last several months. On the flipside, record low mortgage rates, coupled with pandemic related shifts in housing demand, have powered housing market activity to red hot levels, and measures of business activity highlight a manufacturing sector that is busy playing catch-up to consumer demand.

Our View

- The economy has shown remarkable resilience, aided by unprecedented support from the Government and the Fed. We remain hopeful that vaccines will prove effective and that there are brighter days ahead; however, we expect the recent slowness in economic activity to continue into the early part of 2021 as infection rates will likely remain elevated following the holiday season.
- Liquidity is abundant and markets remain well supported; however, valuations are stretched and everything seems priced to perfection. Therefore, a heightened focus on downside risk is paramount.

FOURTH QUARTER 2020 – ALWAYS DARKEST BEFORE THE DAWN

As warned by epidemiologists, elevated cases of new COVID-19 infections coinciding with increased indoor social activity in the fall eventually ballooned into a massive wave of new infections, leading to renewed lockdowns and restrictions on activity and travel. To say that the current wave dwarfs the earlier spring and summer waves is not an overstatement. During the initial outbreak last spring, daily new infections in the U.S. peaked at around 30k per day. After the economy re-opened and lockdown restrictions were lifted, a second wave with peak daily infections of ~75k happened in July. Since late November, new COVID cases have been running at ~200k per day and, unfortunately, things could get worse before they get better. Health care professionals are expecting a considerable uptick in infections within a few weeks following the holiday season.

December brought with it a light at the end of the tunnel, however, as two vaccines produced by Moderna and Pfizer were granted emergency, fast-track approval for distribution in the U.S. after proving 95% effective in clinical trials. So far, the harsh logistical reality of inoculating 330 million people in the U.S. and 7+ billion people globally is proving to be a challenge, exacerbated by the handling requirements of the vaccines. Nevertheless, the system will get more efficient as it did earlier in the year with testing. In the meantime, debates continue regarding public willingness to accept fast-tracked vaccines, the long-term effects of mRNA vaccines in humans, and what populations should get treated first.

On the political front, Joe Biden emerged from the November election as the president-elect, winning narrow victories in the key swing states of Wisconsin, Michigan, Pennsylvania, Arizona, and Georgia. As predicted, this has not been without dispute and underlying political polarization will likely persist, posing an ongoing risk that markets have thus far shrugged off. Regarding Congress, the House remains Democrat controlled, albeit by a smaller margin than previously held, while the Senate tipped in favor of the Democrats via dramatic January runoff elections in Georgia. This gives a green light for a Biden-led, Democrat agenda that will most certainly include increased deficit spending, perhaps along the order of $2-$4 trillion over the 10-year budget window.

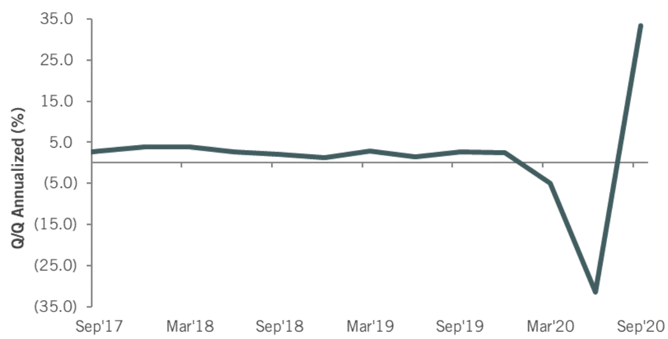
Former Federal Reserve Chair Janet Yellen has been announced as the first female treasury secretary in history (subject to Senate approval). In addition to a lengthy career at the Federal Reserve that included six years as president of the Federal Reserve Bank of San Francisco and culminated in her becoming the first woman to chair the Federal Reserve, Yellen also worked as the chair of the Council of Economic Advisors during the Clinton administration. Suffice it to say, she is no stranger to the interconnectedness of monetary, economic, and political policy. In theory, a former Federal Reserve chair will more likely align with the current Fed leadership regarding the need for increased fiscal stimulus. The market has taken notice of this with 10-year inflation break-evens 30 bps wider since her appointment announcement on November 23rd.

Following a historic drop of -31.4% q/q annualized in 2Q, GDP expanded by an equally historic 33.4% q/q annualized in 3Q (Figure 1). Current forecasts are calling for more normalized economic growth of 3% - 4% q/q annualized in 4Q, leaving 2020 GDP down ~3.5% for the year. Economic activity has slowed since earlier in the fall, commensurate with the aforementioned virus surge, renewed lockdown restrictions, and fading tailwinds from

800 LaSalle Avenue, Suite 1400
Minneapolis, MN 55402-2054
www.galliard.com 800-717-1617

stimulus spending. While a new $900 billion relief package has been signed by Congress, it will take several weeks for the stimulus to begin to take hold. As a result, continued economic weakness is expected heading into 2021. Economic momentum should pick up steam beyond the first quarter as vaccinations become more widely available, infection rates abate, lockdown restrictions slowly get removed, and fiscal stimulus funnels through the economy. Early estimates for 2021 GDP growth are in the 4%-5% range.

FIGURE 1 REAL GDP GROWTH[1]



CONTINUED GOVERNMENT & CENTRAL BANK RESPONSE

After six months of unsuccessful wrangling over the $3 trillion HEROES Act (Democrat) and the $1 trillion HEALS Act (Republican), Congress finally agreed to a new $900 billion fiscal stimulus bill. Signed in late December, days before unemployment extensions were set to expire, the new spending package is primarily aimed at consumers and businesses, with additional funds allocated for schools, vaccine distribution and testing, rental assistance, transportation, and SNAP food assistance programs. For the consumer, the bill provides $286 billion of direct aid via another round of stimulus checks in the amount of $600 per qualifying person and extended emergency unemployment benefits of $300 per week for up to another 11 weeks. For perspective, these support payments are half of what was provided for in the CARES Act. On the business side, the new bill provides $325 billion primarily through another round of forgivable Paycheck Protection Plan loans to small businesses. Notably absent from the stimulus package is direct support for state and local governments.

Since enacting unlimited QE in March, the Federal Reserve has purchased ~$2.5 trillion in Treasury securities and ~$1.4 trillion in Agency MBS (gross of paydowns). Unsurprisingly, the Fed kept the policy rate unchanged at both its November and December meetings, while published forecasts indicate that Fed members almost unanimously agree that policy rates will remain near zero for at least the next several years. More immediately important, the December FOMC policy statement reiterated the Fed's commitment to purchasing $80 billion of Treasury securities and $40 billion of Agency MBS per month for the foreseeable future until "substantial further progress has been made toward the Committee's maximum employment and price stability goals." Meanwhile, several of the Federal Reserve's emergency liquidity facilities were allowed to expire at the end of the year, including the Primary Market Corporate Credit Facility (PMCCF), the Secondary Market Corporate Credit Facility (SMCCF), and the Term Asset Backed Securities Loan Facility (TALF). Notably, the programs that expired were largely unused, with only $25 billion of funding provided out of $1.95 trillion total lending capacity.

Regarding the recent FOMC policy statement language addressing its commitment to asset purchases, it is worth highlighting the importance of such qualitative statements in the context of the policy framework shift to Flexible Average Inflation Targeting (FAIT) announced late last summer. Recall that in his Congressional testimony in September, Chairman Jerome Powell reiterated that central bank support will continue "for as long as it takes, to ensure the recovery will be as strong as possible, and to limit lasting damage to the economy." More recently, Charles Evans, Chair of the Federal Reserve Bank of Chicago and FOMC voting member, stated that, "I'm not worried about inflation going up substantially beyond 2.5%. I don't even fear 3%. The more we get inflation up above 2% then the markets are going to understand that, yes, we are in it to win it." After a decade of undershooting stated inflation targets, even after multiple rounds of QE and holding policy rates at the zero lower bound, these statements represent another piece of the changing monetary policy puzzle.

Still, after healthy gains during the summer and early fall, headline and core CPI have stalled out, with both measures coming in at 0.0% m/m in October followed by a paltry 0.2% m/m in November. Measured year-over-year, headline and core inflation are currently running at only 1.6% and 1.2% respectively, well below pre-pandemic levels and the Fed target. Most forecasts,

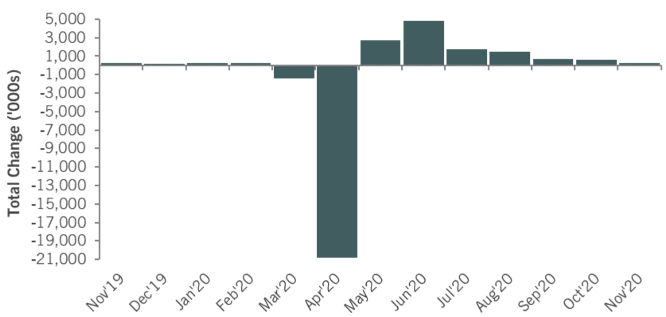
[1]Source: Bloomberg

including the Fed's, suggest that core inflation won't break through 2% for several years; however, with Democrat control of the budget, Janet Yellen at the helm of the Treasury, and a growing belief in the Fed's commitment to reaching its average inflation target, there may be some upside to inflation breaking out sooner than expected. Indeed, 5-year and 10-year break-even inflation rates ended the year at 1.97% and 1.98% respectively, the highest levels in several years.

CONSUMER SPENDING FALTERS, BUSINESS ACTIVITY CATCHING UP

Consumer spending slipped during the fourth quarter amid surging infection rates and renewed lockdowns. Personal consumption expenditures slipped to 0.3% m/m and -0.4% m/m in October and November respectively, while retail sales contracted by -0.1% m/m and -1.1% m/m over the same time period. Unfortunately, the trend likely got worse in December. The aforementioned stimulus package will offset some of this; however, the expectation is that lackluster consumer spending will continue into early 2021 until the virus abates and restrictions are lifted. Measures of consumer confidence have more or less drifted sideways. Since rebounding to 80.4 in September, the University of Michigan Consumer Sentiment Index ended the year at 80.7 in December. Lingering unemployment coupled with constant reminders of the surging virus are obviously still weighing on consumers.

FIGURE 2 NONFARM PAYROLLS[2]



Unemployment continues improve, albeit at a much slower pace over the last several months due to the virus surge and ensuing lockdown restrictions. November's unemployment rate was 6.7%, down only 0.2% from the previous month. Furthermore, nonfarm payroll growth slowed to only 245k jobs in November, marking the fifth month in a row of slower job gains (Figure 2). Although the December unemployment report from the Bureau of Labor Statistics was not yet available at the time of writing, the ADP National Employment Report showed a job loss of 123k in December. While not a perfect predictor, the ADP report is a harbinger of a subdued nonfarm payroll number to end the year. The unemployment rate is expected to remain largely unchanged for December as well. Unemployment claims remain elevated, with progress stalling out over the last several weeks. Five million people continue to file unemployment claims and initial claims remain stuck at ~800k per week.

Meanwhile, measures of business activity charged ahead during the quarter. The ISM Manufacturing Index and the ISM Manufacturing Report on New Business Orders Index ended the year at 60.7 and 67.9 respectively, topping a seven-month run in expansionary territory following the spring shutdown. Inventory measures like the Adjusted Retail Inventories Index also ended the year on a strong note, growing at 1.6% m/m, 0.9% m/m, and 0.7% m/m in September, October, and November respectively. These figures highlight a manufacturing sector that is busy playing catch-up to consumer demand. Meanwhile, the Federal Reserve's most recent report on industrial production and capacity utilization, published in December (November numbers), highlights a similar trend of consistent monthly gains. Specifically, the report indicates that industrial production has rebounded to 104.1% of base year 2012 and now sits only 5.0% below the pre-pandemic level. This is remarkable considering that between February and April industrial production fell 16.5%. Meanwhile, capacity utilization has climbed back to 73.3% compared to a pandemic low of 64.2% in April, and a pre-pandemic measure of 76.9% in February. As we have argued in the past, these figures indicate a solid runway for continued gains in 2021.

As expected, 30-year mortgage rates as measured by the Freddie Mac Weekly Survey Rate continued to grind lower, winding up at an all-time low of 2.67% by the end of the year. Mortgage origination capacity has expanded, leading to a 50 bps contraction between the 30-year mortgage rate and the 10-year Treasury rate since September. Coupled with pandemic related shifts in housing demand, record low mortgage rates have powered housing market activity to red hot levels. Measures of annualized unit

[2]Source: Bloomberg

sales for existing homes and new homes are at the highest levels since before the GFC, and housing supply of both new homes and existing homes are at record low levels. With all of this as a backdrop, the S&P CoreLogic Case-Shiller 20-City Composite City Home Price Index catapulted 7.9% higher year-over-year in October.

LOOKING AHEAD

The economy has shown remarkable resilience, aided by unprecedented support from the Government and the Federal Reserve. We remain hopeful that vaccines will prove effective and that there are brighter days ahead; however, we expect the recent slowness in economic activity to continue into the early part of 2021 as infection rates will likely remain elevated following the holiday season. Lingering unemployment will be problematic, particularly in those sectors of the economy related to travel, leisure, and retail. While a new Government administration is transitioning in, separating political policy shifts from economic triage could be difficult until the virus is more under control, at least in the early months. Liquidity is abundant and markets remain well supported; however, valuations are stretched and everything seems priced to perfection. The underlying assumptions of continued Government and central bank support will likely receive increased attention in 2021. Any signal of a pull-back of resources vis-á-vis a tapering of QE or underwhelming fiscal policy could trigger a sell-off in risk assets. Furthermore, the path of the virus, the speed of vaccine distribution, and public acceptance of the vaccine are all potential sources of volatility. As a result, heightened focus on downside risk is paramount.