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2021 Schwab Market Outlook: On the Path to Recovery

By Schwab Center for Financial Research

As we move into 2021, we may see another dip in economic activity in the near term, but the longer-term outlook appears brighter. Easy monetary and fiscal policy, combined with an anticipated COVID-19 vaccine rollout beginning in the first half of 2021, may lead to a strong rise in economic and earnings growth.

A rotation away from the "big five" U.S. stocks that dominated performance during the early part of the pandemic already has begun. New market leadership often comes with a new cycle, so we may see a continued shift toward areas that have lagged recently, including small-cap and international stocks. We expect the Treasury yield curve to steepen, creating an opportunity for investors to capture more income from interest payments, without necessarily taking more risk.

U.S. stocks and economy: Better days

Throughout 2020, central bank monetary policy was the stock market's heavy lifter. That, along with the market's forward-looking tendencies, have allowed stocks to quickly span the chasm created by the COVID-19 pandemic. Meanwhile, government fiscal relief, and the human ingenuity associated with the high-efficacy vaccines coming soon, have provided support for consumers and the broader economy.

As we close out the year, it's a bit of a push-and-pull: The vaccine news has pulled forward the post-pandemic improvement to economic growth, while the surge in virus cases nationally is pushing down near-term growth projections. Looking ahead to 2021, we believe we will see another dip in economic activity in the near term, but courtesy of the coming COVID-19 vaccines, the longer-term outlook appears brighter.

Aside from the vaccine, other tailwinds include the prospects of a divided Congress and its relatively benign implications for major changes to tax policy, and stronger-than-expected corporate earnings. In addition, although it appears there is limited chance of another fiscal relief package being passed during the lame duck session of Congress, there is bipartisan support for a package post-inauguration. Meanwhile, corporations' cash hoard and consumers' savings are both ample relative to history.

Rotation shifts into gear

Investors often ask us about the perceived disconnect between the stock market and the economy. To a large extent, the unique nature of the gap reflects an economy that had a small handful of "thrivers" during the pandemic, while the majority of companies and industries were in a very beleaguered state. For a large part of the year, the top five largest stocks in the S&P 500® by market capitalization—Apple, Microsoft, Amazon, Facebook and Alphabet/Google—massively outperformed the other 495 stocks. At their early September peak, these five stocks represented nearly 25% of the S&P 500, so their hefty outperformance lifted the overall index.

However, since early September there has been a series of rotations into other areas of the market—not just the thrivers. We've seen shifts from growth stocks to value stocks, from large-cap to small-cap, from defensives to cyclicals, from stay-at-home stocks to get-out-and-about stocks, and from leaders to

laggards. Looking ahead, we expect rotations will continue to come in fits and starts, largely driven by virus-related news about economic activity.

Stock valuations do represent a risk in 2021, especially if earnings do not live up to expectations; although multiples will continue to receive implicit support from extremely low interest rates. Valuation is as much an indicator of sentiment as it is a fundamental indicator—and frothy sentiment is also a risk heading into 2021. As the stock market recently reached new peaks and investor optimism has become more widespread, the risk grows that bad news could cause a near-term reversal.

Investor takeaways: Whenever the market is trading at or near all-time highs, it's important to assess the risks. We are optimistic about getting to the other side of the COVID-19 chasm, but there are likely to remain some broken planks on the bridge to get there.

Investors should remain disciplined, diversified, and opportunistic with regard to rebalancing portfolios. Diversification will remain key heading into 2021, both across and within asset classes. Don't try to time these rotational shifts, but make sure you remain appropriately diversified and not overly exposed to one particular theme or group of stocks.

Global stocks and economy: New cycle, new leadership

As 2020 draws to a close, economic momentum is fading, with infection rates on the rise, governments responding with more lockdowns, and few prospects for any major near-term fiscal stimulus.

However, the global economy has the potential to make a full recovery in 2021, rebounding from the 4.4% decline in 2020 to growth of 5.2% in 2021, according to current estimates from the International Monetary Fund. Next year, we expect very easy monetary and fiscal policy, combined with a vaccine rollout beginning in the first half of 2021, to lead to a strong rise in economic and earnings growth. This backdrop may see the U.S. pass the baton of global growth leadership to Europe, favoring international stocks and a broader overall market advance compared to 2020.

New economic cycles typically come with new leadership. Market leadership tends to last for many years, even a decade, before reversing at the start of a new cycle. For example, after international stocks outperformed in the 1980s, the 1990 recession saw a shift to U.S. stock outperformance. The 2001 recession saw a switch back to international outperformance, before the 2008 recession flipped the switch again to U.S. outperformance. And now, the start of a new cycle may once again signal a switch to international stocks.

These changes in leadership result from both behavioral as well as fundamental factors. After a full cycle of outperformance, relative valuations and earnings expectations often get stretched and begin to reverse with the catalyst of a new cycle. These factors have aligned once again, favoring international stocks. History shows that valuation extremes alone are rarely the trigger for changes in market direction or leadership, but they do help to support a shift during new market cycles.

Investor takeaways: Consider rebalancing your portfolio, paying attention to your exposure to international stocks vs. U.S. market-capitalization-weighted indexes, such as the S&P 500®. International gross domestic product and earnings-per-share growth are likely to exceed those in the U.S. for the first time in years, supporting potential relative outperformance by international stocks.

Fixed income: Calmer Waters

Federal Reserve officials will no doubt be among the happiest to say good-bye to 2020. It was a year in which the Fed led the response to the COVID-19 crisis, pushing interest rates lower and rolling out a variety of programs to help support the economy. There was federal government fiscal aid at the beginning of the COVID-19 crisis, but for much of the year, the Fed has been the major force pushing the economy forward, throwing lifelines to corporations, foreign central banks and municipalities through its special facilities and programs.

As we look into 2021, we see a different outlook. With the likelihood that vaccines for the coronavirus will become widely available by mid-year, the economy should get a boost as sectors that have been held back by the health crisis recover. There is also the possibility of more fiscal relief for the economy.

Consequently, we see the potential for the 10-year Treasury bond yield to trade in a range of 1% to as high as 1.6% in 2021, reflecting the prospects for real economic growth to recover at a faster pace. Meanwhile, short-term interest rates are likely to remain pinned near zero throughout the year as the Fed waits to “normalize” interest rates until inflation rises. Consequently, the yield curve should steepen as the difference between short and long-term yields expands.

The prospect of rising interest rates tends to make bond investors wary, as higher rates mean lower bond prices, all else being equal. However, we view higher bond yields as an opportunity. When bond yields move up, it offers the chance for investors to capture more income from interest payments without necessarily taking more risk.

Investor takeaways: Keep your average portfolio duration low for now, but be ready to increase it if yields move higher. A bond ladder can help you do this, because it lends itself to averaging into higher yields over time.

In a world with low and rising interest rates, it makes sense to hold bonds with higher coupons, as most of the return is likely to come from the interest income generated. However, we would be cautious about reaching into the lowest credit ratings in search of yield. The risk/reward in the lower tiers of high-yield or municipal bonds looks unattractive to us based on current valuations.

Consider inflation-linked bonds, like Treasury Inflation Protected Securities (TIPS). While we don’t expect a big rise, having some inflation protection can help offset a gradual rise over time.