PERFORMA

2021 OUTLOOK

MARKET PERSPECTIVE

INSIGHTS & REVIEW FROM PERFORMA'S INVESTMENT TEAM

2021 OUTLOOK

A year ago, we finished our 2020 Market Outlook piece by saying: "Buckle up – it's going to be an interesting year." While some may call 2020 "interesting" – in reality, that proved to be a dramatic understatement. The onset of the COVID-19 virus, now having taken over 1.8 million lives worldwide, ushered in global social distancing and lockdown measures. With the economic light switches moved to the "off" position during the Spring, we saw violent swings in asset prices, historic gyrations in economic activity and an unmatched policy response from both fiscal and monetary authorities in the U.S. and abroad. Akin to the credit crisis of 2008, 2020 will go down as a year everyone wants to forget, but the economic and sociological scars will unfortunately be long-lasting.

As we ring in the New Year, the battle with COVID-19 remains far from over and the virus will endure as a defining factor in 2021; thankfully, so too will its vaccines. In the U.S., we see a unique juxtaposition entering 2021 as the pandemic's outlook has never been darker nor brighter. The near-term prospects are alarming as there are now more infections, hospitalizations and deaths than at any other time since the onset of the virus. Yet, with two vaccines in play and more on the way, there is light at the end of the coronavirus tunnel. Financial markets have been decidedly more optimistic about the future even as numerous challenges remain. Whether those are known (logistics, manufacturing constraints, public adoption, etc.) or unknown, the data thus far indicate that the scientific community has successfully developed multiple effective vaccines that mark the beginning-of-the-end of the COVID-19 pandemic. There will likely be bumps and bruises along the way, but with a successful vaccine rollout we should find ourselves in a much more normal world by this time next year, or perhaps even sooner.

MONETARY POLICY

After effectively one-upping the 2008 Federal Reserve's policy extravaganza, current monetary policy will be highly accommodative in 2021 as the Fed remains committed to the economic recovery. Asset purchases will continue until the recovery is on more stable footing and the Fed sees substantial progress on both its employment and inflation goals. Meanwhile, in an effort to convince markets that they are serious about achieving higher rates of inflation, the Fed is currently forecasting three full years with no rate hikes. Yes, that's right, no interest rate hikes until at least 2024 according to current Fed projections.

Moreover, since September 2020, the Fed has been operating in a new monetary policy framework that closely ties interest rate hikes to realized inflation. Historically, the Fed has been preemptive by hiking interest rates early to keep future inflation in check. This time around, the Fed has promised to be patient and will hike interest rates only after the recovery is more established, the labor market has recovered and inflation is running consistently north of 2%. This shift in policy is significant and has been an explicitly dovish signal to the market. Down the road, the time will come for the Fed to tighten monetary policy; the intention today is to first wind down asset purchases then turn toward interest rate hikes.

Of course, things rarely go as planned. What if inflation trends become untenable in the years ahead, forcing the Fed into rate hikes prior to a full labor market recovery? It is hard for us to see run-away inflation as a likely outcome in the medium-term given broader demographic trends, massive debt loads and subdued rates of inflation in other developed markets. However, unlikely does not equal impossible. In fact, the recent trend higher in market-based measures of inflation (which use market pricing to derive expectations about future inflation) suggest that the inflation outlook might already be heating up and any upside surprise in economic activity would only add fuel to the fire.

Another risk more germane to 2021 arises if the market and the Fed disagree on the definition of temporary inflation. During his final press conference of 2020, Chair Powell made it clear that the Fed will not tighten monetary policy in response to what they deem to be temporary increases in inflation. The question remains, what happens if the Fed believes an increase in inflation is temporary while the market believes it to be more permanent or vice versa? This situation could arise in the year ahead and would likely produce some unwanted market volatility.

A NEW, BUT WELL KNOWN, SHERIFF IN TOWN

After much concern and apprehension, the 2020 election has come and gone without much in the way of disruption. Yes, markets had to endure delayed vote counts and unprecedented legal action, but the process was not the worst-case scenario and Joe Biden will be sworn in as the 46th President of the United States of America on January 20th.

WORKING TOGETHER AGAIN: CURRENT FEDERAL RESERVE CHAIR JEROME POWELL (RIGHT) JANET YELLEN, JOE BIDEN'S NOMINATION FOR TREASURY SECRETARY AND FORMER FED CHAIR.

More importantly, all eyes have turned to the two Georgia senate runoff elections on January 5th; races that will determine the balance of power in that chamber. Duel Democratic wins would change control of the Senate, leaving Democrats with unbridled control of both chambers and the presidency. Should that scenario come to fruition, financial markets will have to weigh the prospects of potentially higher taxes and increased government spending. One or more Republican wins in Georgia leaves President-elect Biden negotiating with a split Congress, making it harder for him to achieve his agenda; an outcome with which the market currently seems comfortable.

ECONOMIC OUTLOOK

We expect to see solid improvement in the economic backdrop during 2021, aided by highly effective vaccines and continued policy support. There are obvious difficulties in the short run, but as we move through the year economic activity should gain momentum.

The surge in new COVID-19 infections has produced meaningful near-term economic headwinds. Already elevated filings for unemployment benefits continue to tick higher, restaurant reservations and hotel occupancy numbers have declined significantly from their summer peaks and consumer confidence is once again falling. With approximately 10 million people still out of work since the start of the pandemic, mounting business closures and record new COVID-19 cases, hospitalizations and deaths, the short run outlook remains bleak. Conversely, the medium and longer-term outlooks are fairly constructive. First off, the new $900 billion COVID-19 relief bill will provide some much-needed support. Secondly, the Federal Reserve has been unwavering in its commitment to the current recovery and, as such, monetary policy will remain highly accommodative. Lastly, but certainly not least, we now have two highly effective vaccines being administered and more up for approval in the not-too-distant future. It will not be a straight line from the dark, virus-ridden winter months to a more enthusiastic period of economic growth but armed with effective vaccines we do expect to get there.

Once the economic recovery is more self-sustaining and policymakers begin to remove emergency levels of support, the markets' attention will shift from the pandemic to broader macro themes. Prior to COVID-19, the financial landscape was defined by low interest rates, accommodative monetary policy, subdued rates of inflation and economic growth, aging demographics and elevated corporate and government debt loads. When we emerge from the pandemic many of these same factors will come back into focus and, in some cases, will have been amplified.

MARKETS

In the year ahead, we expect the economic backdrop to be constructive for risk markets and modestly bearish for fixed income assets. A strengthening economic recovery and continued central bank support should ultimately put upward pressure on interest rates while encouraging additional risk-taking, despite the near-term economic headwinds. Given historically low yields and tight credit spreads, any upward drift in interest rates will prove problematic for fixed income markets in 2021. Meanwhile, a disorderly spike higher in interest rates akin to the 2013 taper tantrum would all but guarantee meaningful negative returns for the asset class and could prove disruptive to equity markets.

In 2021, we expect to remain positioned defensively with respect to interest rate risk in fixed income portfolios. We are comfortable sacrificing upside should the economic recovery fall apart causing interest rates to head lower but will be able to protect capital if further progress is made and the recovery becomes self-sustaining. Risk markets will also benefit from more robust economic activity, but it will be important to become increasingly selective. In the second half of 2020, we saw a convergence between large cap tech and other previously unfavored sectors of the equity market. This momentum should continue into 2021 and laggard sectors such as banking and REITs, as well as small and mid-cap value, should continue to find increased sponsorship. Making sure to add exposure in segments of the markets that are best positioned for the next leg of the recovery will be critical. In short, we expect to maintain our risk allocations where appropriate, looking to selectively add on market pullbacks while taking a defensive stance with respect to investment grade bonds through a short duration position and/or an outright underweight to the asset class.

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ABOUT PERFORMA

Combining our extensive knowledge of the insurance industry with the institutional expertise of our investment team, Performa has been managing assets on behalf of captive and other insurance clients for more than 25 years. Our capabilities include asset allocation, active fixed income and equity management through diversified mutual funds and separate account portfolios. With offices in the world's largest captive domiciles, including Bermuda, Vermont and South Carolina, we are focused on delivering customized solutions to meet the unique investment objectives and liquidity requirements of our clients. We are 100% employee-owned and have $4.80 billion in captive assets under management and advisement as of November 30, 2020. Our investment philosophy is value driven and long-term in nature. Whether approaching asset allocation, fixed income or equities, our ability to be nimble, contrarian and decisive sets us apart from our peers and promotes capital preservation.

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