FS INVESTMENTS®

Lara Rhame's

10 for '21

2021 will be a balancing act of long-run optimism and near-term challenges. We are here to help with our watchlist on the economy, policy and markets.

1 COVID-19
2 Resilience
3 Temporary vs. permanent
4 Deficits
5 Fed policy
6 Yield curve
7 Equities
8 Credit
9 Commercial real estate
10 The Giving Tree

1 The year of the vaccine

42	Number of states with rising COVID-19 cases over the past 14 days
-71ºC	Temperature at which the Pfizer vaccine currently needs to be stored
3 million pounds	Estimated amount of dry ice needed to distribute 100 million doses of mRNA vaccine in the U.S.
6	Vaccines currently in Phase 3 trials
50 million	Vaccine doses that Moderna and Pfizer expect to ship by year-end 2020
12.5 million	Americans this would vaccinate by year-end 2020. Approximately 50% of the doses have been promised overseas, and a full course of this vaccine requires two doses.
139%	Total number of inoculations pre-ordered by the U.S. as percentage of population. The government has ordered 810 million doses across six vaccines, most of which require two doses.

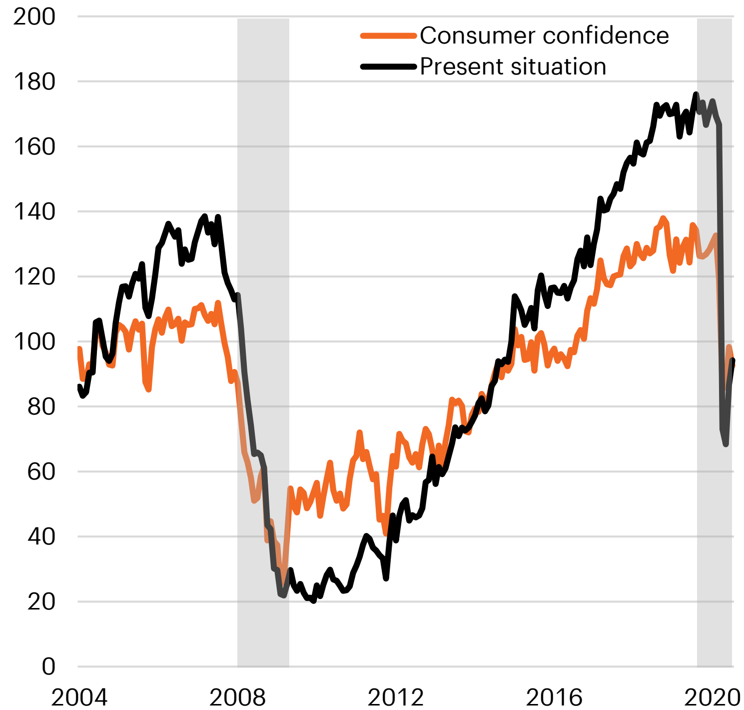
Source: All information presented are estimates based on data gathered from Bloomberg, The COVID Tracking Project, CDC and FS Investments as of December 8, 2020.

In 2021, the arc of the economy, markets and policy may very well come down to vaccines. While our economy has proven remarkably resilient in the face of an epic disruption in activity and employment, the reality is that the challenges posed by the pandemic remain formidable. Life-saving good news has come in the form of early successes with a vaccine. Several early trials have shown efficacy of over 90%, with some as high as 95%. These results are still preliminary, but the news is unambiguously positive. Some of these vaccines could ship before 2020 draws to a close.

Testing, producing, distributing and administering a vaccine to hundreds of millions of Americans, however, presents a host of challenges. We expect markets to remain hyper-sensitive to vaccine-related news, both good and bad. Hope for widespread inoculation by spring 2021, for example, may prove too optimistic. It is also important to note other scientific improvements could speed a "return to normal" – or as close as we may come in 2021. Testing is rapidly becoming better and more widely available. Treatment of patients with COVID-19 has improved. In the end, we remain mindful that we are still facing a health crisis that will be key to determining any outcome in 2021.

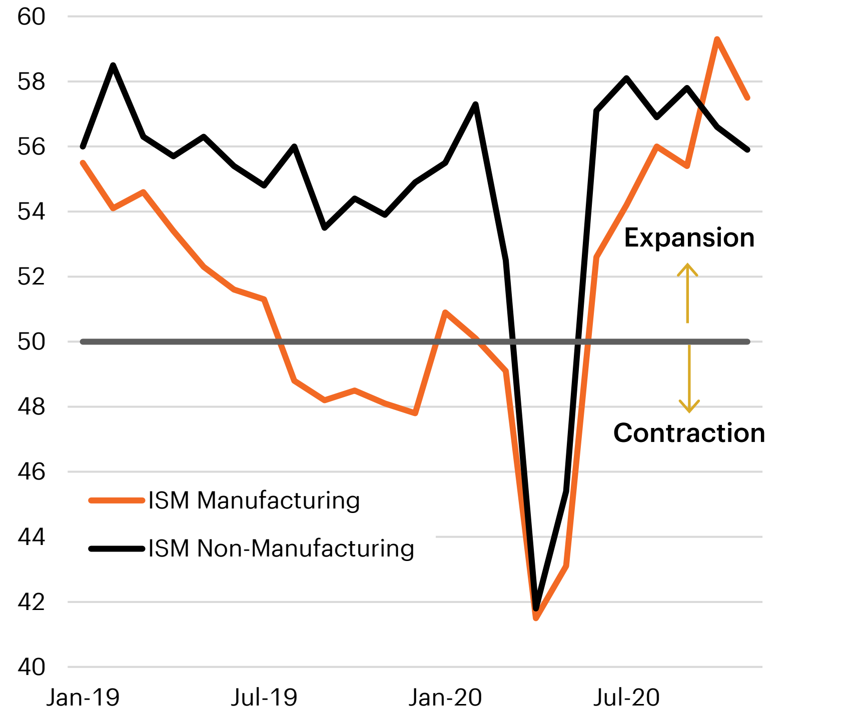
2 Resilient households and businesses

Consumer confidence index



Source: The Conference Board, NBER. Shaded areas represent NBER-dated recessions.

Business confidence index



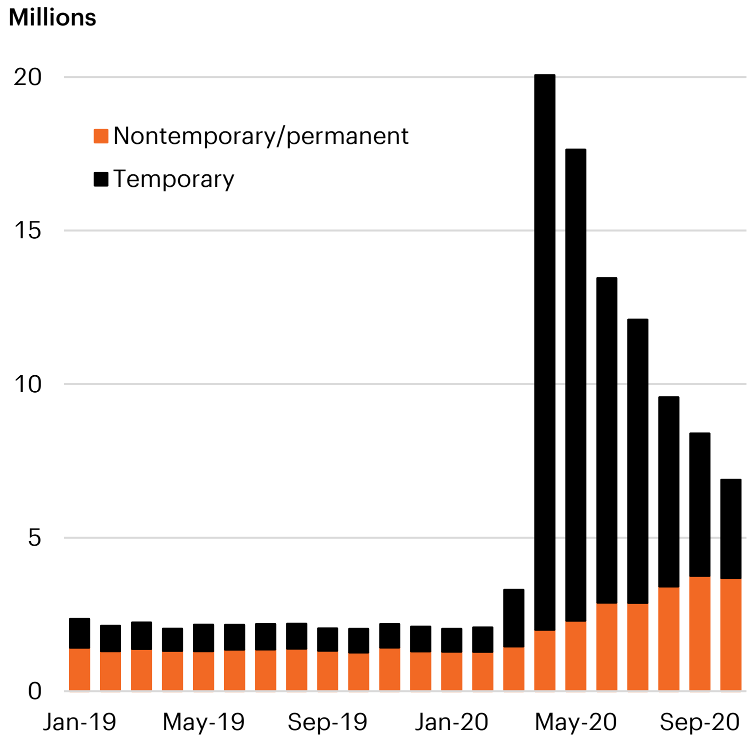
Source: Institute of Supply Management, as of December 3, 2020.

The U.S. economy recovered faster than expected from the epic decline in Q2, due largely to the resilience of U.S. households and businesses—resilience that will be more critical than ever in the first half of 2021. Consumer confidence was knocked lower in March and April as 22 million people lost their jobs. But confidence stabilized quickly, has improved and remains well above levels of the prior recession. Fiscal support from the CARES Act helped support the household balance sheet, and the savings rate remains elevated at 13.6%.

Business confidence has staged a truly remarkable recovery. Manufacturing received a powerful boost as pent-up demand for goods surged after shutdowns lifted in the spring. Even more remarkable has been the recovery in the sentiment of service-oriented businesses. Sentiment does not always translate into dollars and cents of consumption and investment, but it is a necessary element of recovery, and positive sentiment is our first and best defense against a double dip in 2021. It will also be the first warning sign that more fiscal or monetary support may be necessary to sustain our economy's positive momentum.

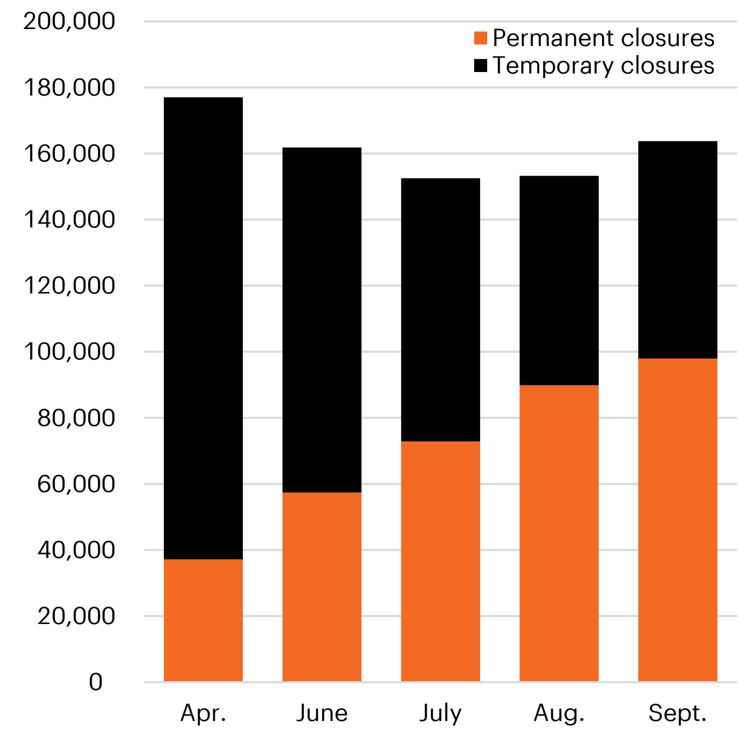
3 Temporary vs. permanent: Disruption could linger

Job losses



Source: Bureau of Labor Statistics, as of December 4, 2020.

Total business closures



Source: Yelp, as of November 9, 2020.

Despite our economy's resiliency, there are risks. As our recovery drags on, the most glaring risk is that temporary disruptions in employment and business closures become permanent. Employment has recovered faster than we expected so far, with the unemployment rate falling to 6.9% in November from a high of 14.7% in April. But almost all of this recovery has come from temporary workers. Of the 7.7 million people who are still unemployed, more than half are now permanent layoffs, which have grown by 2.4 million people during the recession.

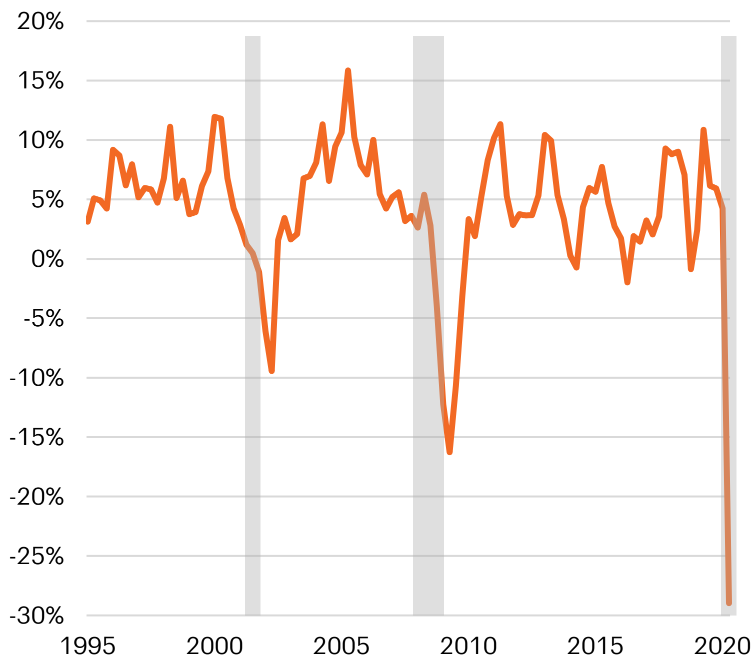
Business closures have also tipped from temporary to permanent. At the start of the pandemic, only 21% of closures were permanent, but in just five months, that has risen to 60%. New businesses are being created, a nod to the entrepreneurial spirit. But permanent business closures raise the risk of a troubling cycle that could cause lending standards to tighten and lead to more permanent employment. These trends will need to be closely watched, particularly in the first half of 2021.

4

Deficits will start to matter again

State and local budgets have been gutted

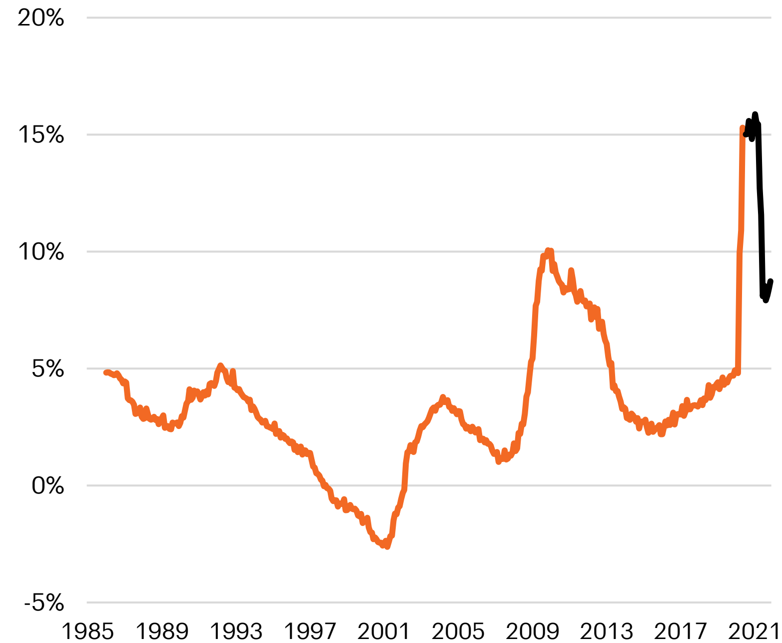
State tax revenue, % y/y



Source: U.S. Census Bureau. Shaded areas represent NBER-dated recessions.

Federal deficits have skyrocketed

Annual federal deficit, % GDP



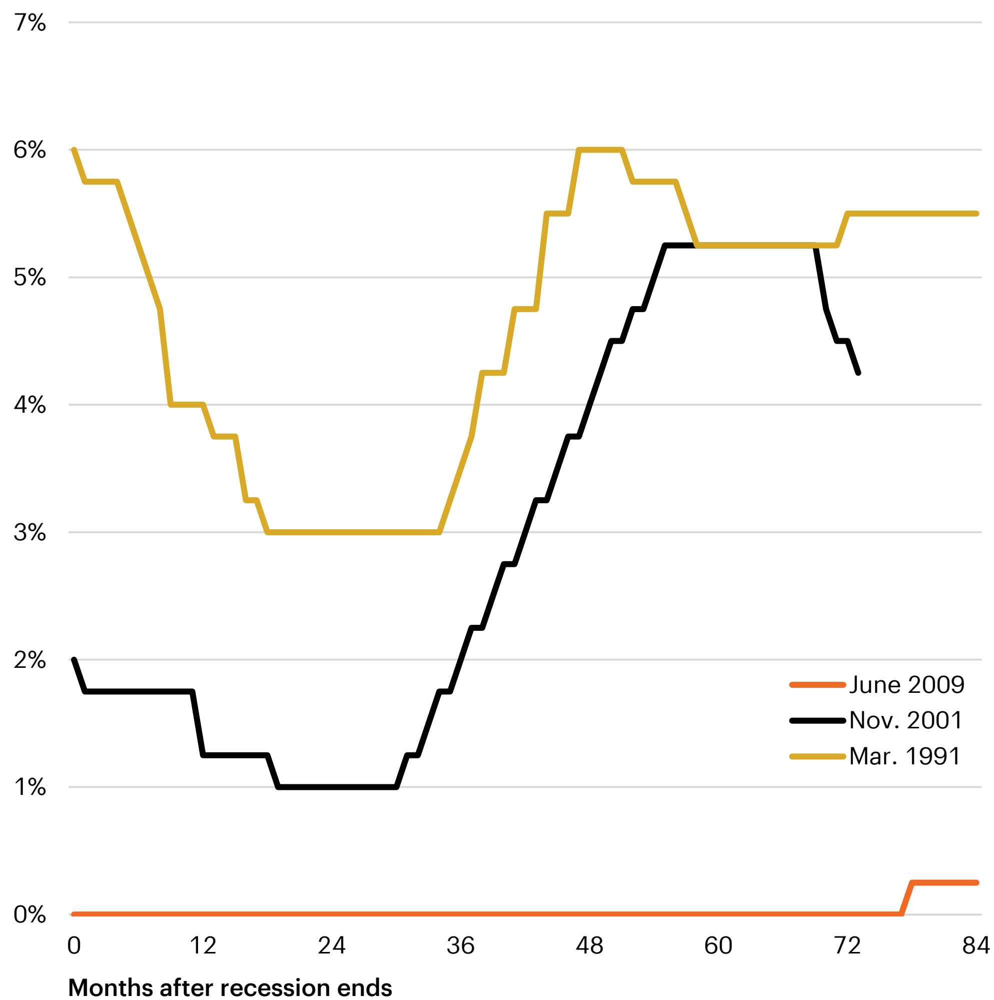
Source: Macrobond, BEA, CBO, as of November 15, 2020. Projections are based upon CBO estimates for 2020 and 2021 and CBO projections for GDP.

For both the economy and policy, deficits will be a major fixture of 2021. The federal deficit gets most of the attention—the CBO projects a whopping shortfall of 8.6% of GDP in 2021—and federal debt outstanding is now $22.5 trillion, crossing a grim threshold of more than 100% of GDP. While neither party can legitimately claim orthodoxy as responsible budget managers, the size of the deficit is a clear justification to restrain fiscal stimulus, particularly in a divided government. Given historically low interest rates, however, servicing this debt is manageable over the foreseeable horizon.

Other deficits will likely have more immediate impact. State and local budgets have been gutted and could be a significant drag on our economic recovery. Local governments can't run a deficit indefinitely, and deep spending cuts are expected next year. This is directly linked to unemployment: As the jobless rate stays high, the tax base erodes and the need to pay unemployment benefits will continue. This is a bipartisan issue, however, as governors across the political spectrum are contending with painful budget choices. This may spur federal action to offer state and local governments some badly needed relief.

5 Fed policy will remain accommodative

Fed funds rate remains low long after a recession ends



Source: Federal Reserve, NBER, FS Investments.

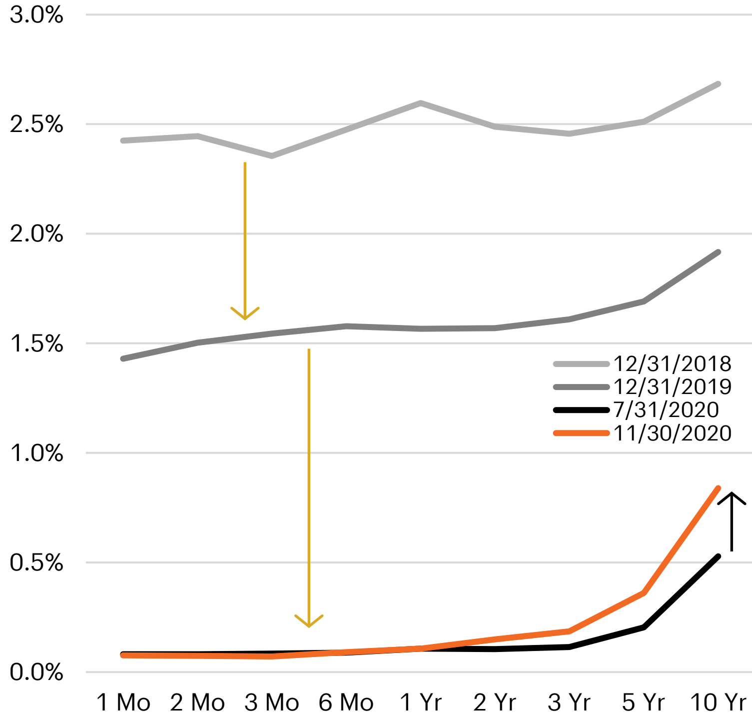
2020 was a busy year at the Fed, which responded to the pandemic with 175 bps of rate cuts, aggressive quantitative easing, and multiple new facilities to support markets. Looking ahead to 2021, market optimism that the economy will rapidly renormalize will invariably lead to talk of when and how Fed policy will renormalize as well.

Yet this is premature. A look at the last three growth cycles shows that when a new expansion begins, the Fed still actively adds support for the economy for the first several years. In 2001 and 1991, the Fed cut rates well into the early years of the new expansion. In 2009, the Fed funds rate was zero, limiting the Fed's options to support our nascent expansion. Thus, in 2011 and 2013, the Fed found itself ramping up QE. In 2021, the Fed will most likely push the policy envelope once again. Look for closer coordination with the Treasury should Janet Yellen be confirmed as the new Treasury Secretary, and settle in for the Fed funds rate to be locked in at zero for years to come.

In a new expansion, the Fed still actively adds support for the economy and markets.

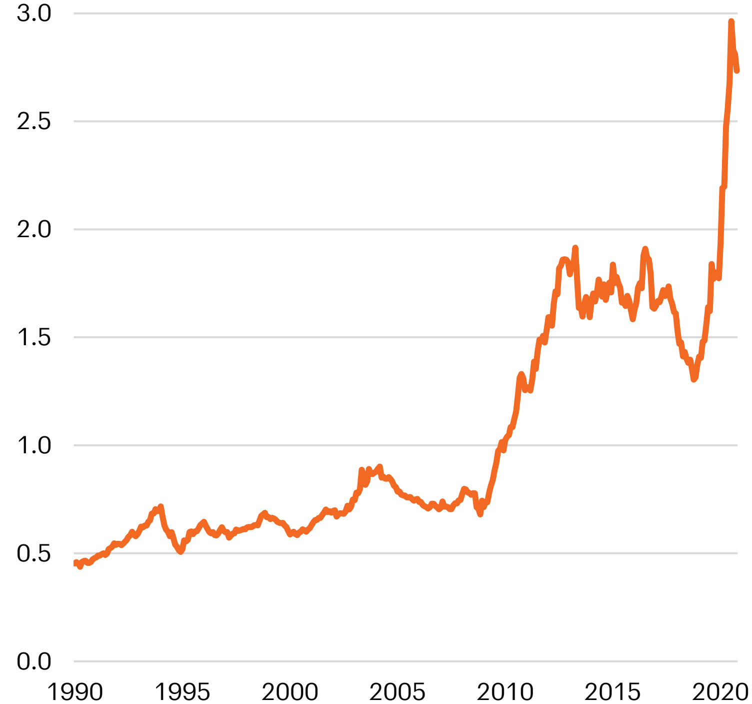
6 Yield curve dynamics could spark volatility

Yield curves across time



Source: Bloomberg Finance, L.P.

Years to recover price loss using income from Barclays Agg if yield rises 100 bps



Source: Bloomberg Finance, L.P., FS Investments. Calculated using modified duration of Bloomberg Barclays U.S. Aggregate Bond Index and hypothetical yield-to-worst of the index given a 1% increase in yields.

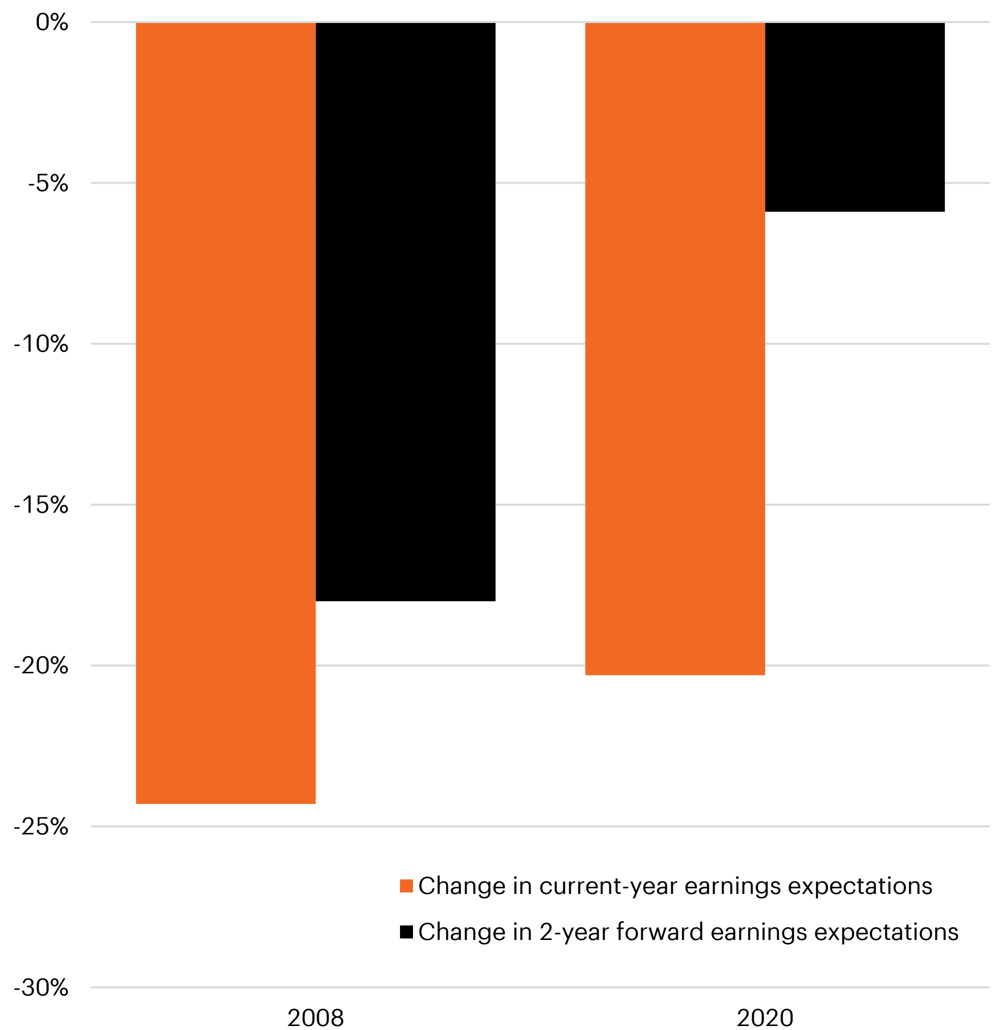
Yield curve dynamics will be critical in 2021. QE kept the yield curve flat at the start of 2020. Now, with short-term rates pegged near zero, the yield curve slope will be guided by long-term rates. A renormalization in the economy could cause long-term rates to rise from current levels. Already, after news of vaccine development and strong growth momentum, the 10-year Treasury hovers under 1%, up almost 50 bps from its summer low. Over time, long-term rates align with inflation expectations. It would not be a stretch to imagine the 10-year Treasury testing 2% in the second half of 2021.

Here is where investors are vulnerable. Years of historically low rates have caused the duration of traditional indexes to rise. The duration of the Bloomberg Barclays U.S. Aggregate Bond Index (Barclays Agg) is 6.3 years. If the yield on the Barclays Agg rises 100 bps, it would take almost three years for income to offset the price decline. On the other hand, QE and speculation about the Fed imposing yield curve control could keep long-term interest rates crisscrossing a range of 1%–2% for much of 2021. This could spark unwelcome volatility in a part of the portfolio meant to be the steadying ballast.

7

Equity markets: Helped by liquid courage

Technicals could remain supportive, while fundamentals may be vulnerable



Source: Bloomberg Finance, L.P., FS Investments, as of November 17, 2020.
Note: Chart shows percent change in Bloomberg consensus S&P 500 EPS expectations from January 1–November 17 of 2008 and 2020, respectively.

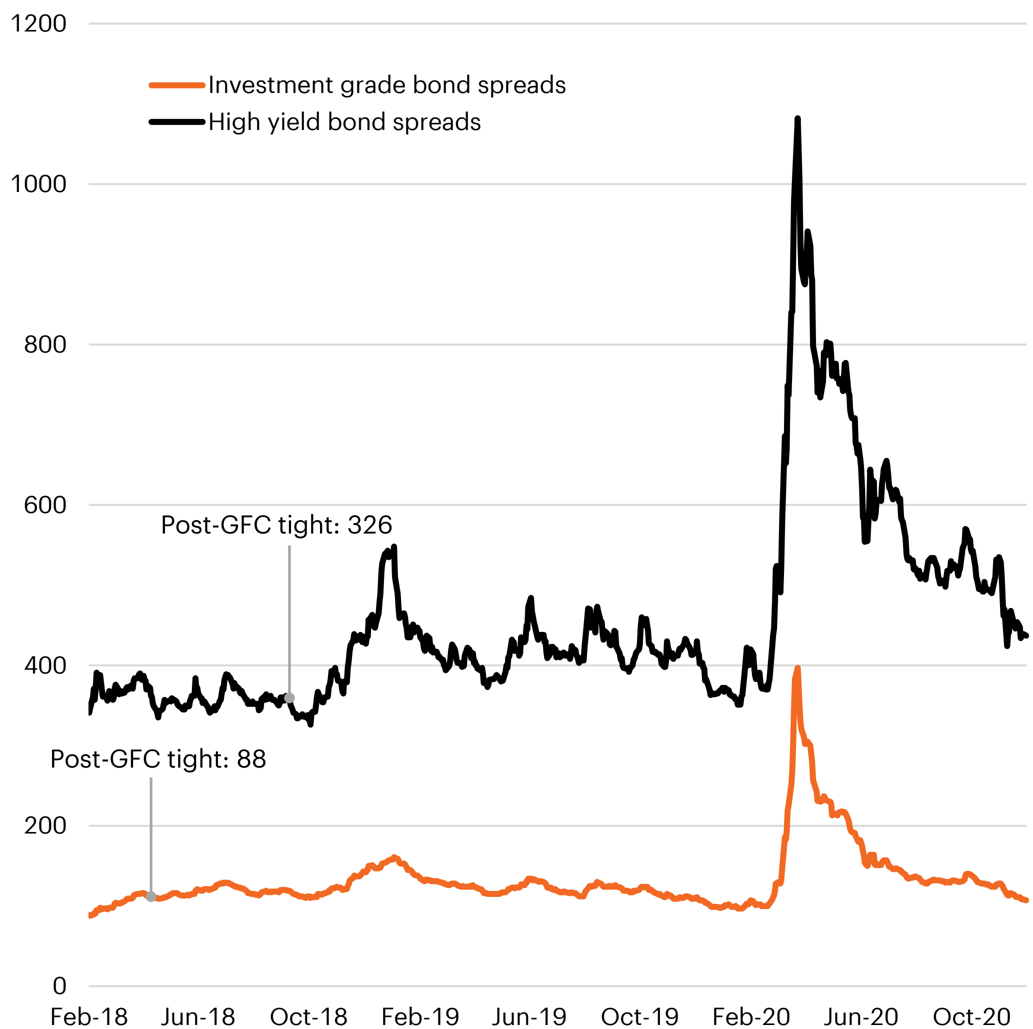
A remarkable feature of 2020 has been the fastest bear (-34% in 5 weeks) and bull market cycles (22 weeks to recover) in living memory. This is due in part to market confidence that the current economic—and earnings—disruption is only temporary. Compared with 2008 estimates looking ahead two years, current expectations are that earnings will be back near pre-COVID levels by 2022.

Yet it is important to appreciate the amount of "liquid courage" markets have received to bolster their confidence. 175 bps of rate cuts, $3 trillion of QE, $2.5 trillion in fiscal stimulus and other facilities to support financial markets amounted to technical support that dwarfs the policy response during the 2007–2009 crisis.

The opening bell of 2021 approaches with many equity indexes at or near all-time highs. Investors should understand the technical drivers of market confidence. Yet in Q4 2021, fundamentals may well come back into focus. Until then, we expect equity markets to remain hyper-sensitive to vaccine-related news.

In Q4 2021, fundamentals may come back into focus.

8 Credit spreads will retest pre-COVID lows



Source: Bloomberg. ICE BofAML U.S. Corporate Index, ICE BofAML U.S. High Yield Index.

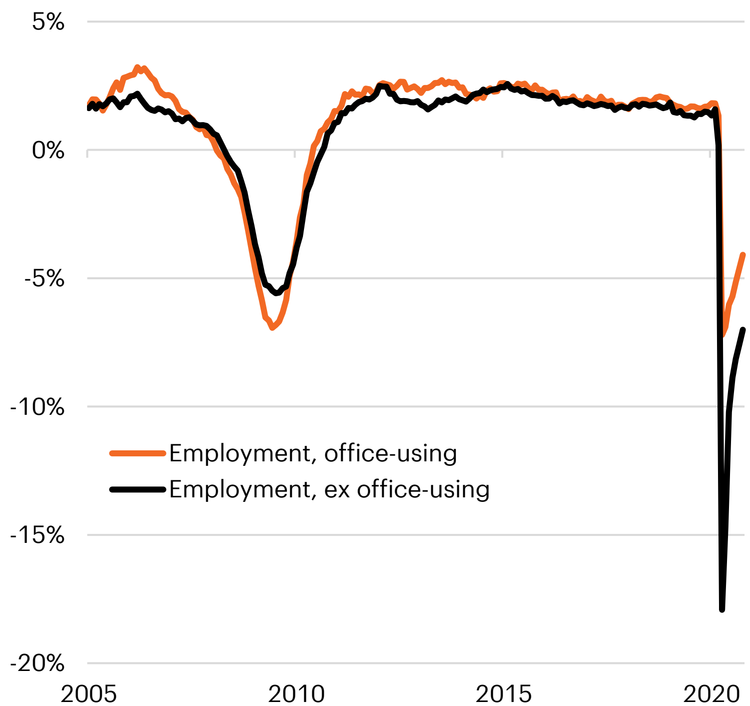
Both investment grade and high yield credit markets entered 2020 with spreads nearing post-Global Financial Crisis (GFC) lows. Even after the rout in March, the remarkable market recovery has left spreads looking relatively tight once again. This begs the question: How much more room does credit have to run? We think spreads will continue to compress during 2021 and are likely to test or surpass those post-GFC lows last seen in 2018.

In addition to a broadly positive macro backdrop, technical conditions should remain supportive. We expect issuance will remain steady with yield-seeking investors at the ready to buy in both markets. High yield seems to have avoided a tidal wave of defaults, and we expect the default rate to continue declining throughout 2021. Plus, the record number of fallen angels this year has made the high yield market higher quality, as a larger percentage of the high yield index is now BB rated. Lastly, the relatively low level of global interest rates will likely continue to create demand for fixed income asset classes that provide high absolute yields, like high yield bonds and loans.

Credit spreads will retest post-financial crisis lows

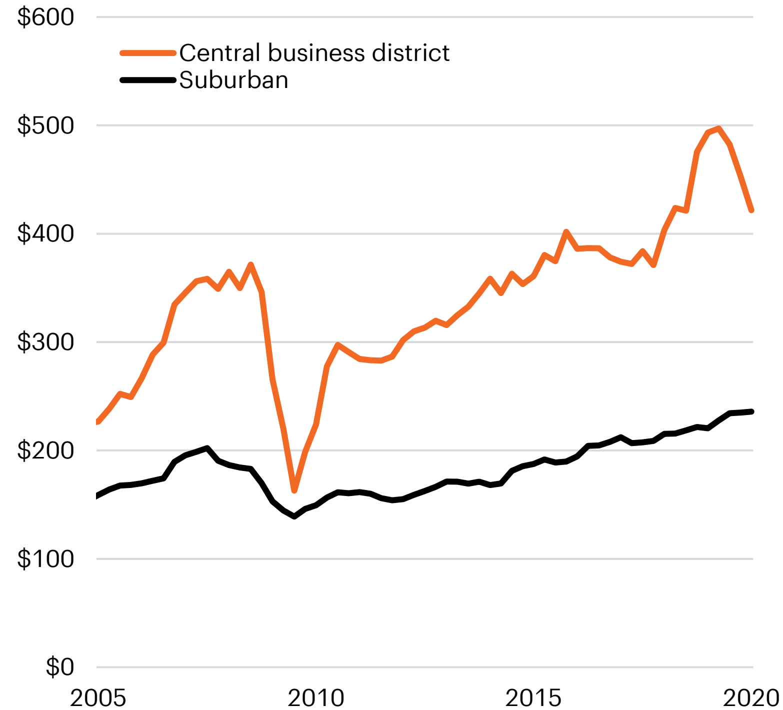
9 Commercial real estate: Out-of-office messages may prove premature

Change in employment, % y/y



Source: Bureau of Labor Statistics, FS Investments, as of October 31, 2020. Office-using industries include Professional & Business Services, Financial Activities and Information.

Office space: Average price/square foot



Source: Real Capital Analytics, as of September 30, 2020. Reflects 12-month average of transactions valued at $2.5 million and above.

The commercial real estate space has seen a tsunami of negative headlines since the onset of the pandemic, many of which have dealt with the future of office work. Importantly, the uncertainty has not necessarily stemmed from traditional employment fundamentals—office-using employment has held up much better than many other parts of the labor market. Instead, questions have arisen around how and where those workers perform their duties. Since March, many industries that have traditionally been the primary office tenants (e.g., technology, finance, law firms) have transitioned to a work-from-home model with success.

This does not mean office is dead as a core real estate sector. First, the office sector is not a monolith. While most think of big city-center skyscrapers, suburban office buildings accounted for 62% of sector deal volume in 2019 and figure to be attractive for employees as a convenient, lower-density option. Second, the long-term nature of office leases has helped the sector avoid more significant immediate pressure. Delinquencies on CMBS office loans were just 1.9% in November, far lower than the 7.8% overall number. Ultimately, while firms' relationship with physical space may change and become more flexible, we believe offices will continue to play a vital role in driving firms' culture and innovation.

10 Fixed income: There was no more left to give

Shel Silverstein's *The Giving Tree* is a classic children's book about giving and, yes, love. I can't help but think of the arc of this story when I think of the fixed income market in 2021. The story traces the life of a child—think of an investor—across the decades from youth to retirement. The tree gives him apples to eat, shade to enjoy, and wood to build and travel.

This has been our experience with fixed income. Like the tree, over the decades it has provided growth while also delivering income and diversification—virtually everything an investor could ask for. In the 1990s, high interest rates fueled Barclays Agg total annualized returns of nearly 8.0%. But interest rates have been on a structural decline since, and by the 2010s this had faded to only 3.75%. In the past two years, fixed income delivered its final gift: outsize returns as monetary policy and economic crisis caused long-term interest rates to plunge to less than 1.0%. As of November 30, 2020, the Barclays Agg has returned 7.3%, with 6.0% of coming from price appreciation and only 1.3% from income.

Looking to 2021, interest rates are near historic lows. Traditional income will almost certainly be insufficient. A modest rise in interest rates would imply a significant decline in price that would likely offset income gains. The story has a nostalgic end. After decades of giving, the tree has nothing left to offer; it is only a stump.

Lara Rhame

Chief U.S. Economist, Managing Director

Lara is Chief U.S. Economist and Managing Director on the Investment Research team at FS Investments, where she analyzes developments in the global and U.S. economies and financial markets. Her fresh take on macroeconomic issues helps to inform and develop the firm's long-term views on the economy, investment trends and issues facing investors. Lara is committed to the Philadelphia community and serves on the boards of the Economy League of Greater Philadelphia, Hyperion Bank and Starr Garden Park.

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All data as of November 30, 2020, unless otherwise noted.

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REPORT-10FOR21-MACRO

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