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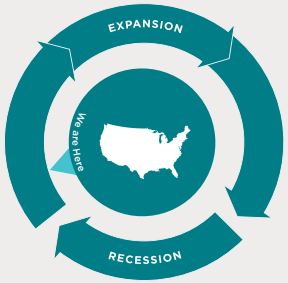
Cycle Watch | Through the soft patch

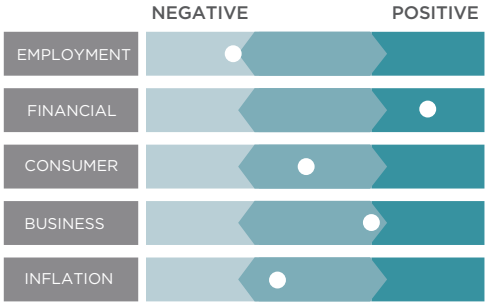
Economic and financial commentary as of February 2021

Business Cycle Update



The recently reported annualized GDP growth rate of 4.0% for Q4 represented a solid finish to the year but was slightly below expectations. In the end, total economic activity in 2020 fell by 3.5% on a year-over-year basis, the biggest yearly decline in GDP since 1946. Weakness in consumer spending and service businesses carried over into January from the end of last year. We expect the current soft patch is nearly finished, with the expansion likely to accelerate as COVID-19 vaccines are more widely distributed, potentially as soon as Q2. Current expectations for real GDP growth for 2021 projects the most rapid pace of expansion in nearly 40 years.

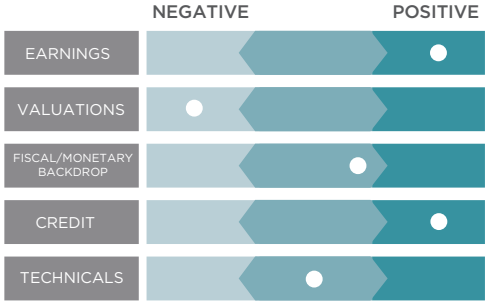
Economic Review



Nationwide Economic Dashboard, February 2021

The slowdown in the economic recovery extended into early 2021 as consumers and businesses struggled with record COVID cases and increased government restrictions. Service sector employment saw a renewed hit with significant job losses in the leisure and hospitality sector and rising weekly jobless claims. Small businesses owners, many in services sector, became much less optimistic about the outlook. An additional round of direct stimulus payments and expanded unemployment insurance may help consumer spending rebound in coming months. Additionally, the manufacturing sector showed its strongest growth in two years. The Federal Reserve kept interest rates near zero in January while emphasizing that, despite rising expectations for growth, no change in monetary policy should be expected soon.

Financial Review



Nationwide Financial Market Dashboard, February 2021

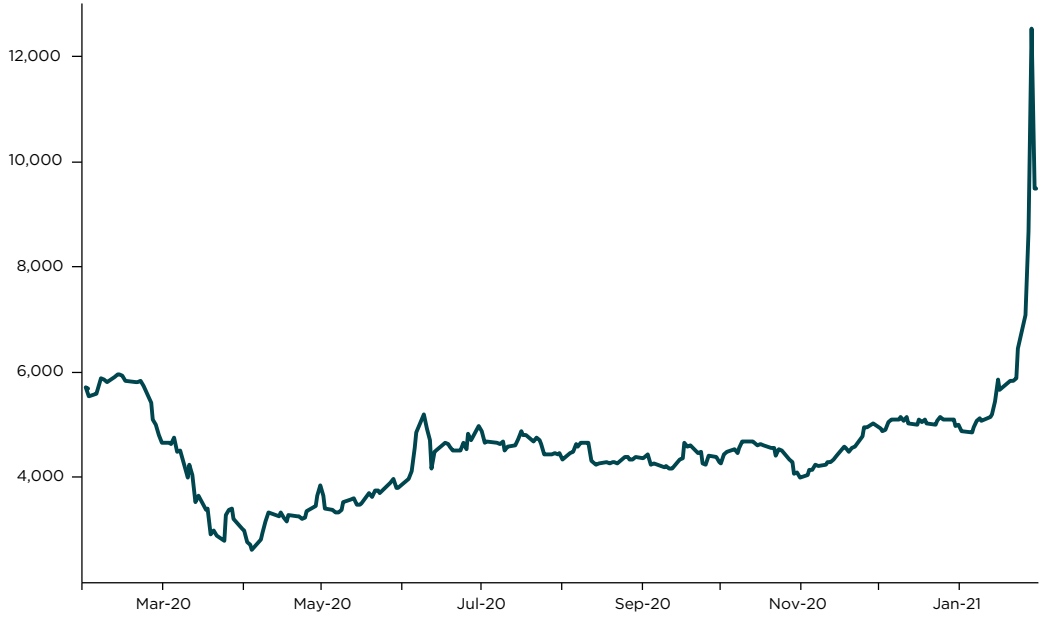
Equity market volatility continued in January as choppy investor confidence and a wild conflict between retail investors and hedge funds wrestled against positive earnings surprises and encouraging COVID-19 data. January was fractionally negative for the S&P 500® Index for the second consecutive year, though markets remain near record-highs. While investor sentiment has deteriorated, valuations remain elevated with the price-to-earnings ratio for the S&P 500® Index at its highest level since the technology bubble. Long-term interest rates jumped in January on expectations for faster growth, higher inflation and larger government budget deficits. The yield curve steepened with the spread between 1-year and 10-year Treasury yields reaching its widest point since October 2017.

Financial market insight: How will the short squeeze game stop?

Wild swings in the stock market during the last week of January focused attention on retail investors to a level not seen since 1999. The "short squeeze" initiated by a band of retail investors, coordinated on social media and executed on low-cost trading apps, forced several institutional investors to absorb losses on short positions for several stocks, including GameStop, Express and AMC Entertainment. An index of the 20 most-heavily shorted companies was up 157% year-to-date through Thursday, January 28. (See chart at right.) While this battle was pitched in the media as small investors vs. Wall Street, the magnitude of dollars in play and the record number of options traded suggests hedge funds participated in the mania as well. While some of this activity seems to indicate a throwback to the late 1990s, the euphoria does not indicate an unhealthy broader market, which is benefiting from ample liquidity, a rebounding economy and improving earnings.

Retail investors spark "short squeeze" rally

Index of 20 most-shorted stocks, January 29, 2020 to January 29, 2021



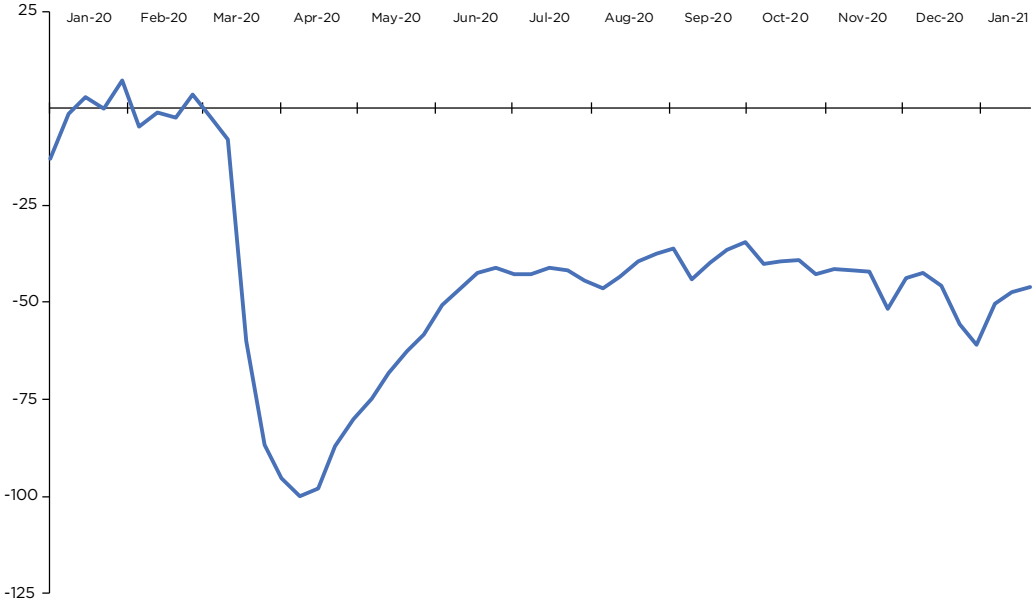
Source for chart data: FactSet Research Systems

Economic insight: The "soft patch" in the economic recovery should end soon

Consumer spending slumped at the end of 2020 and into January as record levels of new COVID infections caused many state and local governments to place additional restrictions on in-person activity. While these restrictions may be in place for a few more months, there are early signs that consumer and business behavior is picking up again as the pace of infection slows. The Dallas Fed's Mobility & Engagement Index began to rise again in the second half of January and is close to levels prior to the recent case spike. Weekly jobless claims also moved lower in late January as service sector businesses rehired laid-off workers. Fiscal stimulus checks and extended unemployment benefits should help boost spending too, while acting as a bridge to the projected post-vaccine surge in activity and economic growth.

Early signs of consumer activity returning to normal

Federal Reserve Bank of Dallas Mobility & Engagement Index, relative to normal, through Jan. 23, 2021



Source for chart data: Federal Reserve Bank of Dallas

Key takeaways

1. Renewed fiscal stimulus and increasing vaccine availability should help the economy get through its recent "soft patch".

2. Highly accommodative monetary policies should sustain growth even after the stimulus surge ends.

3. Stock valuations are elevated, but positive earnings reports support the ongoing market rally.

Cycle Watch is a collaboration between Nationwide Economics and Nationwide's Chief of Investment Research. Our goal is to present a monthly update of where we are in the business cycle and insights from both perspectives to help investors and advisors understand the factors driving economic and financial market performance.

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