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OUTLOOKS

March 2021

ECONOMIC OUTLOOK

Summary

Inflation has been a hot topic to begin the year, with increased expectations lifting bond yields higher while rapidly rising long-term interest rates are seemingly putting equity valuations at risk. But will this expectation of higher inflation turn into reality?

You can certainly make the case for several textbook causes of demand-pull inflation to occur throughout the remainder of the year, such as increased consumer spending due to pent-up demand, accommodative monetary policy and deficit spending—including direct transfer payments from the government in the form of stimulus checks. While upcoming stimulus payments will help many individuals in need, these are still just somewhat targeted one-time payments intended to help those with financial hardship. Any portion of these funds that go toward helping those behind on mortgage payments, or decreasing other debt such as credit cards, will not be increasing the aggregate demand for goods. With that said, it's known that not everyone who receives a stimulus payment is currently experiencing these hardships, and the savings rate remains roughly two and a half times higher than its traditional levels; so we do ultimately expect to see an overall increase in demand, and therefore, increased inflationary pressures as the economy fully reopens.

But outside of stimulus payments, will the impetus for higher long-term inflation be the job market? The aggregate employee isn't currently thriving. Sure, the February jobs reports crushed expectations and the unemployment and underemployment rates have improved vastly since the onset of the pandemic, but we are still at 6.2% and 11.1%, respectively—both nearly double the pre-COVID rate. The labor force participation rate remains nearly 2% below the pre-pandemic levels and will likely not recover until students are allowed back in the classroom, allowing some parents to return to work. While many lost jobs are expected to be recovered as the economy reopens, it's currently unknown how many jobs from small and medium businesses will be permanently impaired or how long it will take for those jobs to be replaced by new businesses. Don't forget, prior to the pandemic with hardly any slack in the labor market, it was difficult for wages and inflation to grow. We are waiting to see if that will change as we enter a new business cycle, and if this will ultimately be a case of short-term reflation, or true long-lasting inflation.

Positives

Retail sales surged higher than estimates (5.3% vs 1.1%)

Unemployment continues its march lower (6.2%)

Personal income remains highly elevated (10%) courtesy of Government stimulus

Negatives

The labor force participation rate remains at the lowest levels since June 2020 (61.4%)

ISM Services declined and missed expectations (55.3 vs 58.7)

Initial jobless claims remain in excess of 700k per week (745k)

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EQUITY OUTLOOK

Summary

Equity markets resumed their upward trend last month following a brief pause in January. The S&P 500 climbed 2.8% in February partly buoyed by continued optimism around the reduction in COVID-19 cases and hospitalization rates. It also seems likely that Congress will send some sort of additional coronavirus relief bill to President Biden's desk to be signed into law within the next two weeks. We appear to be thawing from a long, dark winter.

The reopen theme continued in February with a rotation into value and cyclical stocks. The Russell 1000 Value index rose 6.0%, while the Russell 1000 Growth index was largely unchanged. Energy was the best performing economic sector rallying 22.7% on the back of surging crude oil prices. Financials were a distant second but still gained 11.5% on the month. Utilities and health care were the laggards falling 6.1% and 2.1% respectively.

We remain constructive on equity markets given the accommodative stance from central banks around the globe and the pent up consumer demand. A sharp rise in interest rates gave the stock market a little heartburn in February, but at current levels, fixed yields still offer weak competition to equity investing. As long as virus case trends remain favorable and the vaccination pace continues to accelerate, equity markets should be able to sustain their momentum.

Positives

Accommodative Federal Reserve and global central bank policy

Herd immunity may be able to be achieved in the U.S. by this summer

Lack of return competition from other major asset classes

Negatives

Stock valuations, by some traditional measures, look relatively stretched

British and South African strains of COVID-19 could cause a setback

Unknowns

How long before the inflation threat forces a reaction from the Fed

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FIXED INCOME OUTLOOK

Summary

Longer maturity Treasury bonds are making new post-pandemic highs in yield as investors brace for a burst of economic activity following the roll-out of vaccines and a fourth round of stimulus that could be as monstrous as $1.9 trillion, almost 10% of GDP. The yields on the 10-year and 30-year Treasury notes increased by over 30 basis points (bps). The 2-year note was up only 2 bps. The February curve steepening led to one of the worst months for the Treasury market in the past decade. The Treasury market returned -2.75% for the year with Intermediate maturity Treasuries returning -1.08%.

Investors fear the reopening of the economy will drive inflation stronger than the Federal Reserve can tolerate and that they will be forced to raise the overnight rate, curtailing asset purchases. Inflation readings above the Fed's 2% long-run target on consumer prices, excluding volatile food and energy costs, should be of little concern since they have stated exactly that as an objective. It is their hope that slightly higher inflation for a reasonable period will make up for the vast majority of the past 25 years when the measure was below that target. Investors selling bonds are fearful that inflation will be much higher, say 3, 4 or 5% annually because of the fiscal stimulus along with the bottled consumer demand.

Fed Chair Jerome Powell told lawmakers the nation was still a "long way" from the Fed's goals for full employment and price stability, signaling the central bank will maintain ultra-easy monetary policy for some time. Their talk has done little to sooth markets and many are now questioning whether the Fed has "lost control" of the bond market since the more dovish they sound, the higher rates move.

We believe inflation is certain to increase from the below-target (2%) levels to something above as weak readings from a year ago drop off and the burst of spending occurs as the economy reopens. But we also agree with many, including the Fed, who expect that these pressures will be temporary or transitory and unlikely to become embedded and persistent. We also agree that it is likely to take years for the labor market to recover the jobs lost due to the pandemic. As such, we believe it is very unlikely for the Fed to alter their policy outlook that calls for nearly three more years of a zero-bound interest rate policy.

Regarding longer interest rates, we believe momentum can carry markets beyond rational levels in either direction. We are not saying this move upward in yields is irrational given the bottled-up enthusiasm for the economic reopening, but there is plenty of momentum trading pushing yields higher. If we are correct that the overnight rate will not increase for years, then the rise in longer maturity yields should be restrained. No one knows what that exact level is, but as it moves closer to 2%, we believe there will be an abundance of buyers which will ultimately push yields back lower.

Positives

Longer maturity bonds more attractive with a steep yield curve

Increase in U.S. yields greater than in other developed high quality global markets

Elevated equity prices are leading to rebalances into bonds

Negatives

Inflationary concerns fueled by large stimulus package

Fear of Fed reversal with the economic reopening

Incremental Treasury market borrowing for years

Unknowns

Oil and energy prices

Foreign demand for U.S. debt

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