Market Review & Outlook

April 2021

More than a year on from the 35% market plunge of late February-March 2020, the remarkable recovery from the pandemic-induced economic downturn continues apace as the Fed shows no signs of tighter monetary policy. According to last month's policy statement by the Federal Open Market Committee, current easy money policies—pegging the federal-funds rate target at 0% to 0.25%, plus $120 billion in monthly bond purchases—are to continue until the labor market reaches "maximum employment" and inflation runs "moderately above 2% for some time". The FOMC members' consensus view was that the fed-funds target would remain near zero through 2023.

Meanwhile, Congress has voted $5.5 trillion in fiscal stimulus over the past year to fill the economic hole caused by COVID lockdowns. They are now in early negotiations for a multi-year 'social' and 'physical' infrastructure recovery package for later this year. With at least $2 trillion in excess disposable income and confidence growing, pent-up consumer demand should lead to a summer surge in economic activity as a sense of normalcy returns. Given that consumer spending accounts for 70% of GDP, the demand for goods and services is the most important driving force in the domestic economy. The massive amounts of stimulus have meant big returns for most financial assets in the 13 months since the lockdowns started. For a closer look at how various asset classes performed in recent periods, please refer to the table.

Index	March 2021	1st Qtr. Perfomance	One Year Performance	Description (what the index is comprised of)
S&P 500	4.38%	6.17%	56.35%	Large cap stocks
DJ Industrial Average	6.78%	8.29%	53.78%	Large cap stocks
NASDAQ Composite	0.48%	2.95%	73.40%	Large & mid cap tech stocks
Russell 1000 Growth	1.72%	0.94%	62.74%	Large cap growth stocks
Russell 1000 Value	5.88%	11.26%	56.09%	Large cap value stocks
Russell 2000 Growth	-3.15%	4.88%	90.20%	Small cap growth stocks
Russell 2000 Value	5.23%	21.17%	97.05%	Small cap value stocks
MSCI EAFE	2.30%	3.48%	44.57%	International stocks
MSCI EM	-1.51%	2.29%	58.39%	Emerging markets stocks
Credit Suisse HY	0.43%	1.35%	24.14%	High Yield Bonds
Bloomberg Barclays US Aggregate Bond Index	-1.25%	-3.37%	0.71%	Primarily U.S. Government Bonds

While the recovery has been stronger than expected, the nature of the pandemic and way different states have dealt with restrictions means it has been uneven both geographically and on a sector-by-sector basis. The travel, leisure and hospitality areas of the economy continue to lag other sectors, but as herd immunity builds because of vaccine distribution and other factors, things should continue to normalize barring any serious outbreaks of more deadly strains of the virus.

This past Friday, the Labor Department reported the economy created 916,000 jobs, much stronger than estimates of 675,000 and the strongest monthly print since last August. The official (U3) unemployment rate fell to 6%, while the broader U6 rate that includes discouraged and underemployed workers fell to 10.9%. Despite these strong numbers, the economy is still down more than 8 million jobs from where it was immediately before the pandemic broke out.

The bond markets did react to the strong jobs number, as rates rose across the yield curve with increases steeper in the middle of the curve. Eurodollar futures were pricing in four 25 basis point rate hikes by the end of 2023, despite Fed proclamations to the contrary. For sure, a sharp rise in interest rates has been a major theme in the markets this year, reflecting the stronger outlook for economic growth. The Fed itself is forecasting that GDP will grow 6.5% in 2021, with various private forecasts coming in even higher at 7% or more. Whatever the final number ends up being, it will be the strongest in the US since the economy grew 7.2% in 1984.

With the economy heating up and the Fed expanding the money supply at historically high rates over the past year, inflation has been a hot button topic in the financial community for months now. The Fed has downplayed concerns that rising inflation will be anything other than transitory, but most experts have raised their inflation forecasts.

As rates continue up, various pundits have speculated when this might hurt stocks, and the short answer is that 'it depends'. How quickly are rates going up? Rates of change matter in financial markets, and faster would almost certainly be worse in this scenario. The absolute level from which rates are rising also plays a part, though hard to judge when comparing across historical eras. Because rates have been structurally lower since the financial crisis, it's simplistic to say that when the 10 year Treasury reaches a certain yield, stocks will struggle because they did so at a similar yield historically. As an example, rates rose sharply back in 2013 during the so-called "taper tantrum". While stocks in certain emerging markets struggled that year, it was the best year for the S&P 500 (32.39%) of any year since the tech boom of the late 1990s. Different sectors also perform differently in different environments, and all else being equal, rising rate environments are generally more challenging for capital-intensive industries.

We believe rising rates could continue to be a headwind for bonds in the near term, especially for treasuries and other rate sensitive parts of the market. Aside from increasing rates and inflation expectations, other recent themes in the market include strength in small cap stocks and a rotation into value stocks, which have outperformed growth stocks for two quarters in a row. In the post-financial crisis era, growth stocks have outperformed value stocks by a historically wide margin, especially the last few years of the expansion prior to the COVID recession. Value mavens have pointed to this disparity for years, but have been wrong until very recently as large growth and especially technology stocks have been the clear market leaders since around 2013. It is true that value stocks have historically performed best during the early-to-mid part of an economic expansion. If we are in a new business cycle that began last year as most think, it makes sense that value stocks are doing well, and that they could continue to do well as more cyclical sectors of the economy perform better.

We believe the relatively higher growth trajectory of the U.S. equity market makes it more attractive than other developed markets. With its superior vaccination progress, state of reopening and aggressive policy stimulus, the U.S. economy has generated the highest upward revisions to GDP forecasts among the world's ten largest economies so far this year. Moreover, some analysts believe the prominence of its large and profitable technology sector gives the US a structural growth advantage over many other developed markets. While there are definitely bright spots overseas, foreign stock returns looked stronger on a relative basis six months ago versus now. Recent dollar strength has also weighed on emerging market stocks. Looking at the financial landscape over the remainder of 2021, it's hard to be bearish with the ongoing reopening of the economy and historically outsized stimulus. After being elevated for much of last year, equity volatility has continued to decline, which is also bullish for stocks.

Stock market valuations remain at historically high levels, but this has been true for years. A widely cited valuation indicator known as the CAPE Ratio stands at 36.65 as of April 4, higher than any point in history outside a few quarters during the 1999-2000 bubble. This Cyclically Adjusted Price/Earnings Ratio (CAPE) was devised by Yale economist Robert Shiller using the average inflation-adjusted earnings from the previous 10 years and is also known as the Shiller P/E.

If one takes a long view of market history, it has been better to invest when P/E ratios are low. However well high P/E ratios may inform longer-term stock returns, e.g., over the next 10-12 years, they are much less indicative of returns in the short-term, the main reason high P/E ratios are a lousy market-timing indicator. In reality, high market valuations have been a poor indicator of anything over recent market history. Looking at a historical chart of the CAPE Ratio, it has been above its historical mean of 16.80 more than 90% of the time since roughly 1990. Coincidentally or not, this coincides with what market historians would characterize as a more activist era of the Fed that began in August 1987 when Alan Greenspan took over. Given the current positive setup in the market, we agree that a focus on valuation seems misplaced, but would also point out there is no historical instance of a multi-year secular bull market starting from such high valuation levels.

We do find ourselves in "unprecedented" times, so perhaps this time will be different. It will be interesting to see if authorities here and around the world are able to wind down stimulus without violent reactions in the financial markets. With the massive expansion of its balance sheet, the Fed seems to be implementing Modern Monetary Theory – an unconventional economic theory which states that countries which can spend, tax, and borrow in a fiat currency they fully control, are not operationally constrained by revenues when it comes to federal government spending. Will markets force the Fed to continue – indefinitely – the same policies they promised would be temporary when first implemented back in 2008-2009? Would that even work? It recalls when economist Herbert Stein, an advisor to two presidents remarked, "If something cannot go on forever, it will stop."

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