First Quarter 2021

In the months ahead, as the economic recovery gains momentum and the vaccine distribution accelerates, many investors are wondering how the Federal Reserve (the Fed) will react. Fed Chair Jerome Powell and the Federal Reserve Open Market Committee have communicated regularly how accommodative they will be in the coming years keeping short-term interest rates low and keeping the flow of money supply supportive of the expansion. The effect of this support, along with the recently passed $1.9 trillion fiscal stimulus package, could lift 2021 economic growth (as measured by Gross Domestic Product, or GDP) to its fastest rate since the 1980s.

After many years of subdued growth and low inflation, robust economic growth should be welcomed with open arms. Yet, it is bringing on a new set of concerns from investors regarding inflation and rising long-term interest rates. Both are a normal progression of better economic data. The Federal Reserve, in its recently published set of economic projections, expects core inflation to average 2.2% this year before dropping to 2.0% in 2022. Fed governors have acknowledged feeling comfortable with rising inflation while economic growth bounces back and the unemployment rate falls. This is partly because some sectors of the economy may take longer to recover from the pandemic than others.

Over the last 50 years, the 10-Year Treasury has averaged about 2.3% after inflation (the rate of return received after subtracting inflation is known as the real rate of return). We are currently in a territory where real interest rates (with the 10-Year at 1.65%) are just about zero after inflation. With the economy improving, it is not a surprise to see the 10-Year moving higher and for the real rate of interest after inflation to eventually turn positive. There are many factors that are contributing to the economic growth – the new fiscal stimulus measures that Congress passed, the continued monetary stimulus path with which the Fed is engaging, the pent-up demand from consumers to go out to restaurants, travel and spend, the healthy housing market, and business investment and spending continuing to move higher. All these things have the potential to create strong economic growth in 2021 and inflation will undoubtedly be a by-product of this growth. So, we welcome moderate inflation and higher yields on long-term bonds as this will certainly mean our economy is growing nicely.

Financial markets tend to be forward looking with asset prices moving on future expectations. The 10-Year Treasury yield has done just that, rising to 1.65% after it began the year at a yield of 0.93%. The anticipation of higher inflation and better economic growth can best be seen in the following chart from the Federal Reserve Bank of St. Louis which shows the spread (difference) between long-term rates (represented by the 10-Year Treasury) and short-term rates (represented by the 2-Year Treasury). The current spread of around 1.50% is the highest that it has been since 2015.

We expect inflationary pressures to climb in the coming months, especially as we get into the annualized comparisons in April, May, and June versus last year's shut down. Yet, it is undetermined how much of that reflation is already priced into the recent move in bond yields. It is also uncertain how much is transitory from the recent move higher in oil prices and recent supply chain bottlenecks that have disrupted certain industries, such as semiconductor, plastics, and automobile manufacturing. Nonetheless, we do not envision hyperinflation and/or a huge selloff in bonds causing a spike in bond yields. The more likely scenario could be a higher range of inflation versus the prior 10 years and a steady gradual move higher of interest rates.

In terms of how equities are reacting, financial stocks have moved higher this year as the interest rate yield curve has steepened. Energy stocks have also moved higher with the rise in oil prices in anticipation of better economic growth. This has provided higher returns for small and mid-cap stock indices that have higher weightings in those areas, along with industrials and cyclical stocks. Clients with a diversified portfolio that include these asset classes have generally seen higher returns so far this year.

One can make the case that equity valuations as measured by a price-to-earnings ratio are high compared to the historical average, but perhaps warranted given the low interest rate environment and outlook for robust corporate earnings growth. An unexpected shock (e.g., Covid-19) could derail this outlook, but for now everything is lining up positive for 2021. We are seeing better relative valuations in the international area, including emerging markets which has more cyclical exposure than the U.S. and a rising middle class that has growth trending higher than the U.S. At the beginning of the year, we increased our international equity exposure in client portfolios where appropriate.

History has shown that it is certainly possible to have rising interest rates alongside a rising stock market during a sustained recovery. The chart below demonstrates that while bear markets are unavoidable and tied to economic recessions, bull markets last much longer and with larger returns. Since 1956, the average bear market has lasted one year two months with a decline of 36%. In contrast, the average bull market has lasted five years nine months with a return of 192%.

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LEGACY WEALTH
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U.S. Stock Market

Stock Market Bull and Bear Cycles

S&P 500 price index since 1956 bear market with recessions shaded.
For the purposes of this chart, bear markets are 20% declines in price from prior peaks.
Bull markets begin at each market bottom.

Latest data point is Mar 31, 2021

Source: Clearnomics,
Standard and Poor's

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In summary, we believe the Federal Reserve will be patient in raising short-term interest rates. However, the financial markets could continue to gradually lift long-term interest rates while pricing in the prospect of strong economic growth. We expect inflation to tick up but remain under control, and nowhere near the 1970s. Moderate inflation and rising rates are a natural and inevitable part of the business cycle. Furthermore, we believe interest rates will remain low enough to keep the cost of capital for business investment down and not disruptive. This coupled with healthy consumer spending should foster a lengthy economic recovery throughout the next few years.

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