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U.S. Financial Markets
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Stock Market Development

Bond yields climbed in the first quarter of 2021 on mounting expectations of stronger economic growth, and faster inflation during the course of the ending pandemic. This led to a selloff in bonds and a transition from high valuation stocks, which are sensitive to rising yields, to undervalued sectors, which are likely to benefit from the expected sharp upswing in the economy. Ten-year Treasury yields climbed above 1.75% while the 30-year Treasury breached 2.5%. In order to calm the markets, the Federal Reserve Bank reiterated that they view a spike in inflation, which could reach 2.5% this year, as temporary, and, therefore, will not raise interest rates.

Lowest graded bonds, with average coupons of 7.7%, gained 3.58% YTD, outperforming high-grade bonds, which posted a 4.65% loss, and mortgage bonds, and Treasuries.

Although the overall trajectory of the stock market is positive with the S&P 500 Index up 5.78% in the first quarter, there is a roiling volatility and a rotation between different industry sectors which was triggered by the unexpected rise in bond yields. The Bloomberg Barclays US Aggregate Bond Index, the broad-based fixed income flagship benchmark, was down 3.37% in Q1, its worst quarter since 2016. Higher yields led to double digit advances in the energy, finance and industrials sectors, while leaving the technology sector, with its high valuations which are harder to justify in a rising interest environment, up just 2% the year. This sector rotation is expected to continue.

Federal Reserve Monetary Policy

As Joe Biden's $ 1.9 trillion stimulus program is tilted towards direct aid (unemployment benefits, and stimulus checks), and mainly concentrated on this year, the economy is unlikely to overheat. Until full employment is restored, which requires the creation of nearly 10 million jobs, the Fed will look past any temporary distortions in which the stimulus program will result, and not adjust monetary policy. History shows that consumer inflation trails the broader economic trend with an approximately six-quarter lag. Disrupted supply chains, such as the current microchip shortage, and pockets of heightened demand will create localized price pressures. With economic growth to exceed 7% this year, inflation could rise to 2.5%. The Fed is committed to keeping short-term interest rates near zero until the labor market has reached maximum employment, and core inflation is on track to exceed the Fed's goal of 2% in a sustainable way. As the structure of the U.S. economy has changed over the past 50 years, most notably lower labor bargaining power, globalization keeping a lid on pricing power, and technology driven improved productivity, the likelihood that inflation history, as seen in the 1970s repeating itself, is, in our opinion, diminished.

Economy

The stimulus program is large enough to accelerate the trend in GDP growth above pre-pandemic levels to estimates ranging between 6.5% -7.5% for this year, 3.3% in 2022 and 2.2% in 2023 when the impulses from pent-up demand and fiscal policy stimuli fade.

U.S. consumers have doubled their savings rate from 7.2% to 13.7%, and accumulated around $ 1.7 trillion in excess savings in 2020, which is also double the average annual increase during the last economic cycle. Although, we do not know the change in human behavior after the pandemic at this point in time, polls are suggesting that savings for retirement, and building up cash reserves have become a priority for a majority of consumers. A conservative estimate is, in our opinion, that only one third of the savings will be allocated to consumption.

Personal income is likely to surge in the first half year driven by stimulus checks, and additional fiscal stimulus when Biden's infrastructure plan becomes law. According to the Federal Reserve's forecast employment is expected to reach pre-pandemic levels of 3.5% by the end of 2023, with inflation slightly above its target of 2%. In this scenario wages and salaries should remain below trend.

Corporate Earnings

Corporate earnings are expected to increase overall by 29% this year, and 6% from pre-pandemic levels in 2019. If 23.3% is the actual growth rate for Q1, it will mark the largest year-over-year growth in earnings reported by the index since Q3 2018 (26.1%). Eight sectors are projected to report year-over-year earnings growth, led by the Consumer Discretionary, Financials, and Materials sectors. Consumer discretionary is likely to see the largest jump (97%) followed by industrials (89%) and materials (37%). Three sectors are projected to report a year-over-year decline in earnings, led by Energy. Looking at future quarters, analysts also project double-digit earnings growth for the remaining three quarters of 2021, with earnings growth peaking in Q2 2021 at 51.9%. The forward 12 month P/E ratio is 21.6, which is above the 5-year average, and above the 10-year average.

Outlook

Against the backdrop of a strengthening economy, robust corporate earnings, the historically low interest rate environment to continue for quite some time, the stock market is expected to do well this year. Consensus is 14% for the S&P 500 versus 16% in 2020. Sector preferences continue to change towards pandemic-hit, undervalued sectors which have started to see a comeback. We started to rebalance our portfolios in February by reducing exposure in technology, and increasing investments in Consumer Discretionary, Financials, Materials, and Industrials.

Low quality bonds with average interest income of 7.7%, compared to 5.9% for high yield debt overall, and 3.7% for investment-grade corporate debt are likely to have more room to perform well, as higher coupons offer insulation against rising yields.

We are letting bonds mature and are not re-investing in individual bonds at this time. The bond market remains overvalued, and is likely to continue to react negatively should inflation fears re-surface.

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