Second Quarter 2021 Investment Outlook

The Main Event

"Economists and investment managers across Wall Street say if anything in the Fed's latest assessment surprised them, it's that Fed Chairman Jerome Powell expressed even more dovishness than they had expected. The fact that the Fed has no interest rate increase built into its forecasts before 2024, despite hotter-than-anticipated inflation projections, is behind the bond market's anxiety."

– Barron's

"Everyone has a plan, until they get punched in the face."

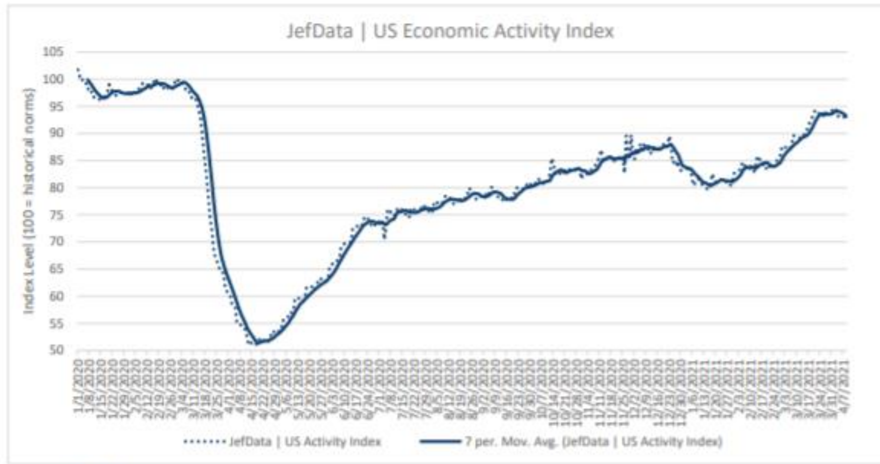
– Mike Tyson

"Marvelous" Marvin Hagler passed away recently at the age of 66. Hagler was from rough and tough Brockton MA. He was one of the greatest middleweight boxers of all time, becoming middleweight champion of the world in 1980. One of the greatest boxing matches of the 1980's was the middleweight championship fight between Hagler and Thomas "Hitman" Hearns in April 1985. Hearns was the junior middleweight champion and moved up to middleweight to challenge Hagler for the title Hagler had held for five years. Hearns was a devasting puncher, knocking out 30 of his 32 opponents. The fight was fought in Caesar's Palace in Las Vegas and afterwards became known as "The War". It was a barroom brawl from the opening bell of the first round, with both fighters throwing everything at each other to knock the other out. Round 1 may have been the greatest round of action in boxing history and somehow both fighters survived and made it through Round 2. Hearns cut Hagler badly over his eye in Round 3 and the fight was briefly stopped but the referee allowed it to continue. Hagler knew a bad cut could eventually stop the fight so he went hard after Hearns, finally knocking him to the canvas with a series of devastating punches. Hearns got to his feet by the 9 count but the referee ended the fight. It was a short match but the intensity over three rounds has never been matched since. Tommy Hearns let the world know via Twitter that his former opponent was struggling and drew the public's attention back to a boxer who had a major influence on the popularity of boxing in the 1980s. There are very few boxers today that carry a bulldog attitude and back it up with actual boxing skill the way "Marvelous" did throughout his career.

Like "The War" at Caesar's Palace in 1985, there is another main event going on today in the financial markets between bond investors and the Fed. This one is a brains instead of brawn showdown. Since the C19 pandemic hit in early 2020, the Fed has been very aggressive with its use of monetary policy (in truth, it goes back to 2008) to help support the U.S. economy. It cut interest rates to zero, increased monthly bond purchases under its Quantitative Easing program, and initiated new programs to support liquidity in the corporate bond market. The goal of all of these policies was to stabilize financial markets, drive bond yields lower, and incentivize borrowing to help the U.S. economy recover from its historic plunge caused by the C-19 pandemic. Congress also passed several large fiscal stimulus bills, including another $1.9 trillion in March, which helped stabilize the U.S. economy and provide financial support to those most negatively impacted by the pandemic.

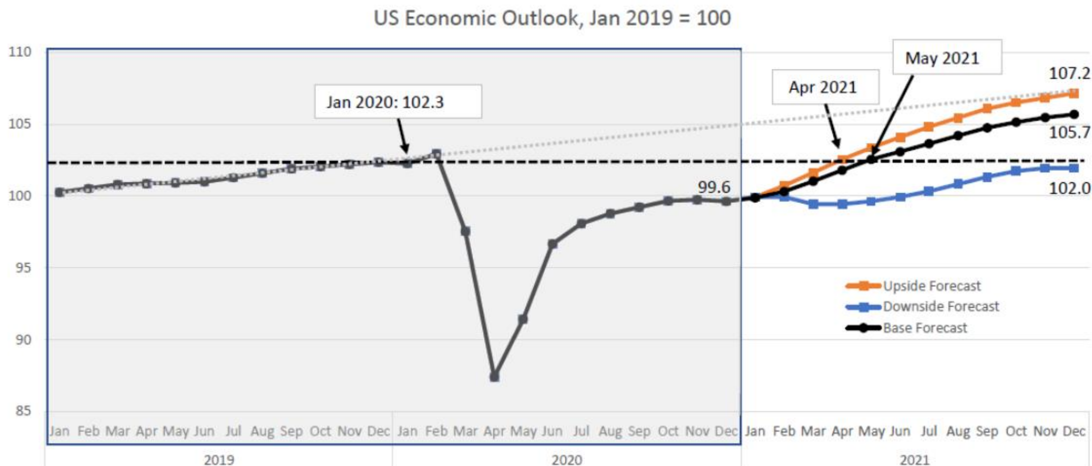
Except for a brief period when a second C-19 wave hit last winter, the U.S. economy has been showing continuous improvement, especially after several C-19 vaccinations were approved in November and

Americans began to get vaccinated. The next chart below shows the Jefferies U.S. Economic Activity Index, which captures a broad range of economic activity and shows the progression of the U.S. economic recovery since the 50% plunge over two months starting in February 2020. Based on the latest reading, U.S. economic activity is now just 5% below where it was before the C-19 pandemic hit. Given the accelerated availability of C-19 vaccines, it is possible that economic activity may get back to the early 2020 levels by this summer or approximately 18 months after the start of the pandemic.



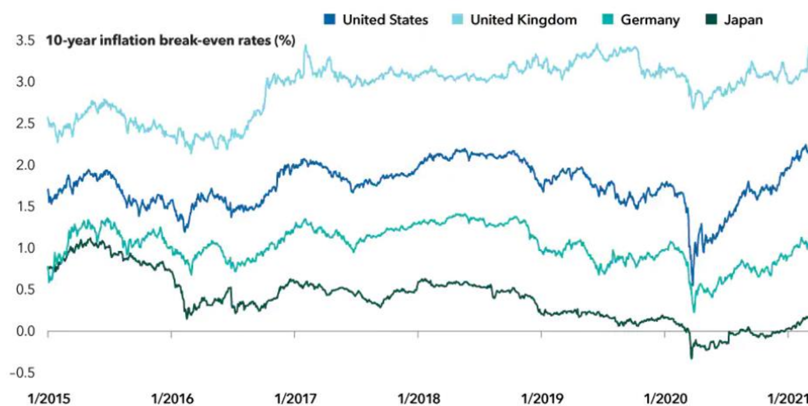
Source: Jefferies

The next chart shows the U.S. economic growth outlook from the Conference Board. The base case (black or middle line) assumes U.S. real GDP growth will be 5.5% in 2021. Since the Biden Administration made it a high priority to accelerate the availability of C-19 vaccines (everyone in U.S. qualifies by April 19th), U.S. economic growth consensus forecasts have become more bullish. The upside forecast (orange or upper line) assumes 6.5% real GDP growth in 2021. Based on this upside case projection, the U.S. economy will get back to its pre-pandemic level within the next few months. The ISM Manufacturing Index in March hit its highest reading since December 1983 and various measures of sentiment including CEO confidence, U.S. consumer confidence, and help wanted online job postings now indicate the upside forecast is the more likely outcome for the U.S. economy during 2021.



Source: The Conference Board

Unprecedented amounts of U.S. monetary and fiscal support (nearly $8 trillion to date), rising U.S. consumer confidence, excess savings, record high stock prices, and supply constraints caused by rapidly improving demand have combined to create an environment of rising inflation expectations. The next chart shows the 10-year inflation breakeven rate for four major countries. Global inflation has been at low absolute levels since the 2008 Global Financial Crisis hit. When global economic activity collapsed in early 2020, future inflation expectations plunged. Today, global economic activity is accelerating, and inflation expectations are also accelerating. Note on the right side of the chart that U.S. inflation expectations (2nd line from top) are rising more rapidly than the other three countries. There are two reasons why this is happening. First, U.S. fiscal and monetary stimulus relative to the rest of the world has been much greater. Second, with the exception of the U.K., C-19 vaccination rollouts are much farther ahead in the U.S. compared to other major countries, especially Europe. The combination of these factors has led to a higher economic growth rate in the U.S. relative to the rest of the world in 2021. The consensus outlook for 2021 U.S. real GDP growth has increased to 6.5% compared to around 4.0% for Europe and 5.3% for the U.K. The last time the U.S. economy generated this level of GDP growth was in 1984. The difference back then was it was all organic growth while today it is mainly due to massive monetary and fiscal stimulus spending implemented to offset the substantial negative impacts of the C-19 pandemic.



Source: Bloomberg. As of 3/19/21. Break-even inflation rates convey the average inflation required over the life of an inflation-protected bond and similar nominal bond to generate the same total returns.

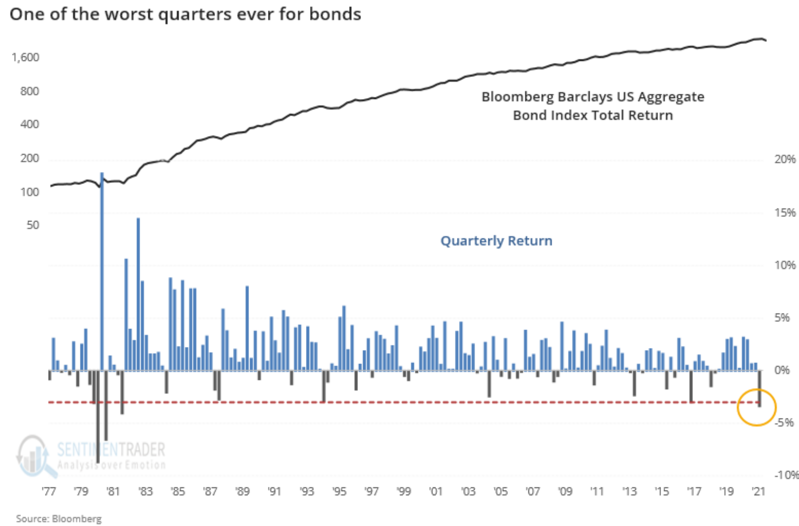
The next chart shows the year over year increase in the U.S. Produce Price Index and Consumer Price Index as of March 2021. The most recent PPI reading was 4.2%, the highest reading since 2011 with CPI lagging but also moving rapidly higher. For the month, wholesale prices jumped 1%, double expectations, while the Core PPI rose 0.7%, well above the consensus forecast of 0.2%. In 2011, the 10-year U.S. Treasury bond yield was around 3.3% whereas today it is at 1.7%. If the Fed and other central banks were not such outsized and price insensitive buyers of bonds, it is fair to say that long maturity bond yields would most likely be much higher than they are today.

Source: Bloomberg

In August 2020, the 10-year U.S. Treasury bond yield bottomed near 0.5% and ended the year at 0.92%. Since then, the yield has risen further to near 1.70%, which is a very large increase over a short period of time. The Fed can only set short-term interest rates, but it is the bond market that determines longer maturity yields. Despite rising inflation expectations, at its March meeting, Fed Chair Powell made a very deliberate effort to signal to financial markets that the Fed would maintain its current policy position through the end of 2023 and even if inflation exceeded its long-term target. The current view of the Fed is it believes any higher inflation will be transitory and not permanent.

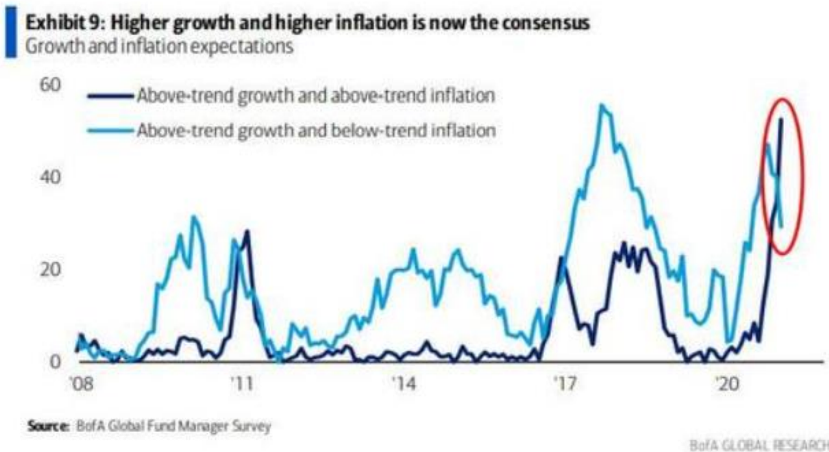
Right now, the bond market is more concerned, as indicated by the large and rapid rise in longer maturity bond yields and forward inflation expectations since last August. This bond market battle royale is the most important dynamic facing financial markets today. The $64,000 question is whether the Fed will have to abandon its dovish policy position and raise interest rates or taper its QE program sooner than it currently expects. Who will blink first in a center of the ring stare down, the Fed or bond investors?

Who ends up being right on inflation is very important for both bond and stock investors. For bond investors, it has been one of the longest and most rewarding bull markets in history since the Fed Funds rate peaked in April 1980 at 17.6% and was cut to zero by the Fed in March 2020. The Fed expects to hold its zero interest rate position until at least the end of 2023. However, the return setup for bond investors reverses when bond yields rise. The next chart shows the quarterly returns of the Bloomberg Barclays Bond Index going back to 1977. The circle on the far right represents the -3.4% return for the broad bond benchmark during the first quarter and shows it was the worst quarterly return for bonds since 2016 and one of the worst quarterly returns over this 45 year time span. The chart shows how the 45 year decline in bond yields has been overwhelmingly positive for bond investors, with negative quarterly returns for the Bloomberg Barclays Bond Index occurring just 18% of the time.



For the past two decades, major factors dominating financial markets include the broad expansion of global trade after China joined the World Trade Organization, aggressive central bank policies including the use of low and negative interest rates to support economic growth, and the dramatic increase of global debt resulting from central bank interest rate policies and government deficit spending. All of these factors have had a major influence on declining and persistently low levels of inflation over this time period. Since the C-19 pandemic forced both the U.S. Federal Reserve and U.S. government to pump trillions of dollars of liquidity into the economy, as the economy normalizes, the "War" between bond investors and the Fed is about whether or not the combination of outsized stimulus combined with an accelerating economy will lead to sustained levels of higher inflation.

Expectations for rising economic growth and inflation are now becoming the consensus opinion. The next chart comes from the latest survey of institutional investors conducted by Bank of America Merrill Lynch. Above trend growth and above trend inflation are now the dominant views of institutional investors and the highest reading in the survey going back to 2008 by a wide margin. This data confirms there is a strong conviction about U.S. economic growth but also that investors are worried about rising inflation and its impact on the value of their bond investments in the future.



What happens to bond yields is not just a concern to bond investors but also important to stock investors as well. If yields rise in a controlled fashion because the economic growth outlook is improving and leads to higher earnings, the stock market is comfortable with that scenario. However, if yields rise too rapidly because central bank and government fiscal policies cause the economy to overheat, causing inflationary pressure to rise more quickly than expected and negatively impact corporate margins and future earnings, then the stock market will react negatively to such an outcome. This situation is the crux of the debate going on now in financial markets. The Fed believes higher inflation will be transitory and eventually recede while the bond market questions the Fed's view as U.S. economic growth accelerates and more signs of inflationary pressures show up in the macro data.

Financial math is such that lower interest rates make the present value of future cashflows more valuable and lead to rising stock valuations. The next table compares the current valuations of the Russell 2000 Index (small cap stocks) and the Russell 1000 Index (large/mid cap stocks) against their long-term averages. For example, the forward PE for the Russell 2000 Index is currently 26.3X compared to its long-term average of 16.3X, or 61% above its long-term average. The Russell 1000 Index currently shows a lower forward PE than the Russell 2000 Index, but a still high 50% overvaluation compared to its long-term average.

	Russell 2000			Russell 1000		
Valuation Metric	**Current**	**LT Avg**	**% Diff**	**Current**	**LT Avg**	**% Diff**
Trailing P/E (Non Negative)	22.5	17.5	28.1	30.0	17.9	68.2
Forward P/E	26.3	16.3	61.3	23.7	15.8	50.4
Price to Book	2.7	2.0	33.1	4.0	2.7	47.8
Price to Cash Flow*	28.1	17.0	65.7	18.7	12.8	46.2
Price to Sales	2.7	1.2	131.8	3.6	1.5	139.8
P/E to Growth	1.9	1.1	67.7	2.2	1.4	65.4

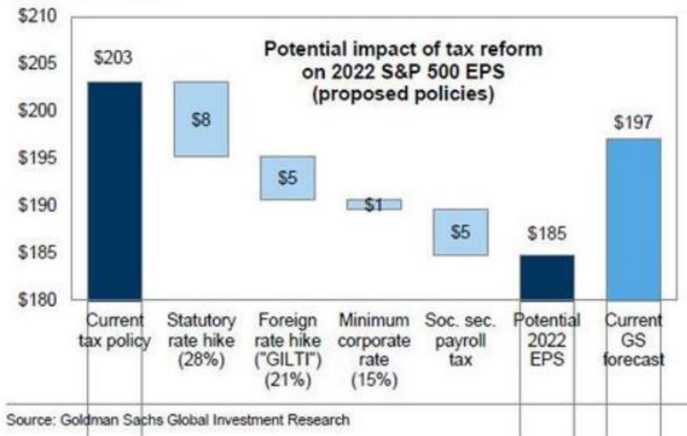
*Price to cash flow started in 2002.

Note: From March 31, 2016 forward Jefferies estimates.

Source: FactSet; FTSE Russell; Jefferies

The main reason the stock market has such high valuations today compared to its long-term average is because interest rates are at such low levels and have been for over a decade. This situation has gone on so long that investors have grown to accept high valuations levels as the new normal. Because interest rates are at such low levels, and stock valuations are significantly higher than historical averages, the stock market is hyper sensitive to any potential increase in interest rates. As bond yields rise, it provides a headwind to the stock market valuations and if bond yields rise rapidly then it increases the chance for the stock market to experience a larger decline.

Investors are currently very focused on future inflation expectations and rising bond yields but there is another issue that could become more prominent later in the year. Recently, the Biden Administration proposed a $2.3 trillion infrastructure bill. Unlike the other $4 trillion of fiscal stimulus plans that were passed since the C-19 pandemic hit, the Biden Administration has proposed raising corporate taxes to pay for the infrastructure plan, the biggest component being the reversal of some of the 2017 corporate tax rate cut from 35% to 21% and raising it back to 28%. There are other corporate tax related items in the proposed infrastructure bill designed to raise the effective corporate tax rate. The next chart from Goldman Sachs shows the potential impact to 2022 S&P 500 earnings if the Biden plan was fully implemented as proposed by the end of 2021.



The current 2022 consensus earnings estimate for the S&P 500 is $203/share (GS estimate is currently at $197/share). If all of Biden's corporate tax code changes were fully implemented as proposed (granted, not a given, but some increase is) then all else being equal, 2022 S&P 500 earnings would decline 9% to $185/share. If we assume the current 22X PE multiple for the S&P 500 holds into next year but earnings are $185/share instead of $203/share, then the fair value for the S&P 500 Index would be 4,070 (22 X $185). As of April 14th, the S&P 500 Index traded around 4,125. Since the Biden infrastructure plan was just recently proposed and debate is just beginning, the stock market is not yet pricing in any corporate tax increases. If the infrastructure bill were to pass as currently proposed, at least for the S&P 500 Index, investors are facing the prospect of a challenging return environment over the next 12 months since higher corporate taxes are not currently priced into U.S. stocks.

Summary

For over a decade, investors have grown accustomed to low inflation, interest rates, strong returns from financial assets, and high stock valuations. The unprecedented negative impacts of the C-19 pandemic forced both fiscal and monetary authorities to respond with trillions of new programs to help support the U.S. economy and give it time to recover. The rapid creation and distribution of C-19 vaccines combined with trillions of monetary and fiscal support is now causing the U.S. economy to accelerate and generate its highest real GDP growth in 37 years. Although these are positive developments, it comes with negative side effects such as supply constraints and rising inflationary pressures. The Fed thinks higher inflation will be transitory, but the bond market is getting nervous that inflation could be a bigger problem than the Fed expects. The Main Event between the Fed and bond market should dominate the investment landscape for the rest of 2022. If bond yields continue to rise because inflationary data that surprises to the upside, then both the bond and stock markets are in for a more challenging period ahead. Should tax increases become another aspect of fiscal policy, it would add another headwind to the U.S. stock market valuations.

Mark J. Majka, CFA
Chief Investment Officer

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