Quarterly Market Outlook

April 2021

Robust Recovery Underway

The global economy is on track for a robust recovery in 2021, driven by expanding vaccine availability, easing economic restrictions, and record fiscal stimulus in the US and Europe. The IMF forecasts global GDP growth to reach 6% this year as life returns to normal and the effects of the stimulus proliferate.[1]

Vaccine Rollout Progresses, But Risks Remain

The U.S. has now fully vaccinated 23% of its population (38% has received at least one dose) and is currently administering over 3 million doses per day, bringing the goal of herd immunity by summer within reach.[2] Although a few other countries have made rapid progress (the UK, Israel, Chile), most of the world has not. Vaccination rates in Europe and elsewhere will likely pick up as manufacturing expands, supplies grow, and rollouts adjust to new safety information. But further supply and/or safety issues remain risks, and slow vaccination rates globally could lead to vaccine-resistant variants. We remain cautiously optimistic.

Unprecedented Fiscal Stimulus Expected to Spur Growth

In January, Democrats won both Senate run-offs in Georgia, giving the Democrats control of Congress and the Presidency and paving the way for the largest peacetime fiscal expansion in history. President Biden has already signed into law the American Rescue Plan Act, a $1.9 trillion economic relief package, and the administration has also proposed a $2 trillion, 10-year infrastructure and jobs plan that is now being negotiated.

The U.S. has started mailing stimulus checks, extended unemployment benefits and given childcare tax credits to millions of low- and middle-income Americans – those most likely to spend that money. With spending already up, household savings at elevated levels, employment recovering, and positive wealth effects from higher home and equity prices, consumption is highly likely to increase further, particularly given consumers' pent-up desire to travel, shop and eat out after a year in on-and-off lockdown.

China is set to taper its stimulus but will benefit as American consumers increase imports. It remains to be seen whether Europe will follow the U.S. with another package in 2021.

The Specter of Inflation

With global monetary policy accommodative and so much stimulus being pumped into the U.S. economy (more than offsetting wage declines), the prospect of inflation is on the horizon. Commodity prices have already risen – oil is up 27% year to date – and producer price indices have reached 10-year highs of ~6%.[3] The U.S. inflation rate has increased to 2.6%,[4] and the market's long-term expectation for inflation has risen rapidly, with the 10-year "breakeven" inflation rate now at 2.3% – a level not seen since 2013.[5] This expectation is in line with the Fed's 2% long-term average inflation target.

While markets expect this higher, more normalized rate to persist, supply chain disruptions due to the pandemic and other causes (chip shortages, shipping container shortages, weather events, trade wars, etc.) pose added inflation risks beyond the upward price pressure from rising demand. On the other hand, elevated unemployment and excess capacity should limit inflation. Strong crosscurrents are also at play longer-term. Huge debt levels weigh on growth, for example, but create offsetting pressure to monetize that debt by printing money.

Given the wide range of potential inflation outcomes, we believe it is critical for investors to ensure that their portfolios are protected in case inflation rises from here.

Improved Global Outlook Boosts Equities; Bonds Sell Off

With the U.S. vaccine rollout going better and faster than expected, and the stimulus already enacted, a lot of uncertainty has been removed. Equities continued to rise last quarter, with the S&P 500 hitting new all-time highs. At the same time, the 10-year bond yield rose 0.83% in Q1, leading to the worst quarterly return for treasuries since 1980.[6] Notably, the 1.74% yield at quarter-end remains below 2019 pre-pandemic levels.[7]

In general, assets that do well when growth rises (e.g., equities, industrial commodities) outperformed, and those that do well when it falls (bonds, gold) underperformed. This is the opposite of what happened in Q1 2020, when growth collapsed, equities and industrial commodities sold off, and bonds and gold rallied.

Value Outperforms Growth as the Recovery Takes Hold

The rotation from growth to value that began late last year continued in Q1, with cyclical value stocks outperforming by 10.3%, and a cumulative 17.8% since the November election.[8] Rising oil prices boosted energy stocks, and financials benefited from a steeper yield curve, strong housing market, the improved financial position of the U.S. consumer, and strong IPO and M&A activity. In addition, the hospitality sector priced in a strong rebound in restaurants and travel. Despite this rally, value remains historically "cheap" relative to growth on most metrics.

Equity Valuations Keep Rising

As U.S. equity prices have risen, so have valuations. The market's cyclically adjusted P/E (CAPE) ratio – a popular valuation measure based on 10-year trailing earnings – is now at 37 in the U.S., a level not reached since the tech bubble.[9] Other metrics also suggest valuations are stretched. The market's price/sales ratio is 3.1[10], eclipsing the tech bubble peak, and forward-looking measures (based on projected sales and earnings) are at levels rarely seen before. While valuations are a headwind for stocks, strong economic momentum and ample liquidity are supportive.

The picture in international equities is different, as are fundamentals. As a whole, these markets have not kept pace with the U.S., and valuations are in line with long-term averages. This variance underscores the importance of maintaining diversified exposure to a global basket of equities.

Retail Participation Surges

Retail investor participation has surged. Average U.S. retail trading volume is up ~85% from pre-pandemic levels.[11] The impact has been dramatic in corners of the market like penny stocks, where trading is up 7x, and microcaps have soared.[12] It has also impacted the options market and popular hedge fund shorts (GameStop, AMC). Although the dollar impact remains small, it reflects the speculative behavior typical of a bubble. The trend has not been confined to the U.S., either; millions of new retail accounts have been opened in Japan, for example, and retail trading has reportedly doubled in Singapore and tripled in Malaysia.[13]

A Positive but High-Risk Environment

A strong economic recovery is likely, but we recognize that we are in uncharted territory: extraordinary government intervention, unprecedented debt levels, an ongoing pandemic that is far from over, and some asset valuations that look increasingly stretched. In addition, geopolitical and social risks that receded into the background of late remain unresolved and will likely resurface. Especially in this environment, we believe diversification is essential to helping investors realize their objectives while remaining balanced to a wide range of outcomes.

FOOTNOTES

[1] Source: IMF World Economic Outlook, April 2021, https://www.imf.org/en/Publications/WEO/Issues/2021/03/23/world-economic-outlook-april-2021#Projections.

[2] Source: ourworldindata.org/covid-vaccinations.

[3] Source: Bloomberg, Generic 1st month crude oil futures contract (CL1 Comdty) and U.S. PPI Finished Goods NSA YoY (BLS).

[4] Source: U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers, retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series, April 12, 2021.

[5] Source: Bloomberg, US 10-Year Breakeven Inflation Rate (USGGBE10 Index).

[6] Source: Barrons, "The Treasury Market Just Had Its Worst Quarter Since 1980." April 1, 2021.

[7] Source: Bloomberg, US Generic Government 10-Year Bond (USGG10YR Index)

[8] Source: Bloomberg, Russell 1000 Growth Index (RLG Index) vs. Russell 1000 Value Index (RLV Index)

[9] Source: Shiller PE Ratio, https://www.multpl.com/shiller-pe.

[10] Source: S&P 500 Price/Sales Ratio, https://www.multpl.com/s-p-500-price-to-sales.

[11] Source: CNBC, "Retail investors continue to jump into the stock market after GameStop mania," March 10, 2021, citing Goldman Sachs research; available at https://www.cnbc.com/2021/03/10/retail-investor-ranks-in-the-stock-market-continue-to-surge.html.

[12] Source: Larry R. Tabb, Bloomberg Intelligence, "Retail Trading Drives Massive Speculation," retrieved April 13, 2021.

[13] Source: Stefanie Palma, Financial Times, "Retail investment frenzy a boon for Asia-Pacific brokers." April 14, 2021.

IMPORTANT INFORMATION