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PERSPECTIVE & OUTLOOK

Overview:

The Q1 2021 quarter was buoyed by a strong quarterly earnings season. According to FactSet, roughly 80% of S&P 500 companies reported a positive EPS surprise for Q4 2020. The pro-cyclical rotation that began in November continued throughout the quarter - underpinned by fiscal and monetary stimulus, the Fed's shift in policy framework, rising bond yields, improving coronavirus trends, and vaccine distribution. As a result, the stock market (as represented by the Russell 1000) finished the quarter up by 5.91%.

Q1 Review:

With the short end of the yield curve anchored by Federal Reserve policy, pegging short-term interest rates near zero, the longer end of the yield curve moved higher in response to increased government bond issuance. This was related to the recent fiscal stimulus packages, fears of higher inflation related to the trillions of dollars in monetary and fiscal stimulus, as well as recovering commodity prices, resulting in a steepening of the yield curve (see chart below, courtesy Goldman Sachs).

Predictably, sectors sensitive to the steepening yield curve outperformed (energy +30.79%, financials +16.16% and industrials +10.69%), while longer duration growth stocks underperformed (information technology sector lagged with a +1.3% return). On the fixed income side, since bond prices move inversely to interest rates, a rising rate environment sparked negative returns for bonds.

Q2 Preview:

It is expected that economic momentum persists in Q2 as the economy continues to reopen. Several factors are supportive of continued economic growth and corporate profits.

- It should be noted that consumer spending accounts for two-thirds of economy activity. To this end, many consumers have paid down credit card debt and increased their savings during the lockdowns. The savings rate climbed from 7.2% in December 2019 to as high as 33.7% in April 2020, and currently stands at 13.6%.
- Furthermore, as lockdown restrictions are eased, there is pent-up demand by consumers to go out and spend.
- The additional government stimulus and infrastructure spending should also support economic growth.
- Recent data shows that there is still $4.48 trillion sitting in cash in investment accounts – which should be supportive if investors decide to allocate some of that cash to equities.
- Finally, with interest rates as low as they currently are, extracting returns from the bond market does present challenges, which could force investors into higher-growth equities.

Understandably, with the recent bouts of trillions of dollars of stimulus, many investors are concerned about all this new money chasing limited quantities of resources, which should push inflation (and interest rates) higher. The Federal Reserve is expecting a short-term spike in inflation (mainly due to base effects and the temporary spending impulse), whereafter the inflation rate falls back below the 2% long-run target. Additionally, according to JP Morgan, equities and interest rates can rise together until interest rates hit 3.6%.

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Conclusion:

Equities are slightly undervalued given the current level of interest rates. Considering the list of supportive factors listed above, as well as the current inflation environment we are in, equities are still the preferred asset class. For bonds, most of the move higher in interest rates has occurred and the 10-year Treasury yield should settle in the 1.5% - 2.0% area. Corporate earnings guidance will play an increasingly important role in the short-term direction of the market, but any pullback should be viewed as an opportunity to put spare cash to work.

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