Investment Perspective

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HERD ON THE STREET

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This year, equity markets have generally continued to rally on signs that the coronavirus will ultimately be contained, prompting hopes of economic healing and, for society, a return to something approaching normalcy. Indeed, since last fall, market strength has broadened with the *pandemic* trade giving way to the *reopening* trade.

Immune response

The Centers for Disease Control and Prevention (CDC) estimates that over 110 million Americans have received at least one dose of a vaccine. At three million a day, the current vaccination pace suggests that the country will approach *herd immunity* (>75% vaccination rate) by July. The latest, one-dose offering from Johnson & Johnson will speed up the process and potentially help address the hard-to-reach population. And although still uneven, the rollout has accelerated in recent weeks in a race to head off several virulent COVID-19 strains that have emerged.

Notwithstanding the new upswing in cases, economic momentum has picked up considerably. The Federal Reserve Board now forecasts that U.S. Gross Domestic Product (GDP) will expand by 6.5% in 2021. The central bank's current outlook marks a significant upward revision to December's forecast for 4.2% growth this year.

"Real time" indicators of economic activity such as credit and debit card transactions, seated diners, hotel occupancy, TSA checkpoint traffic, and usage of navigation apps are all trending higher. And purchasing managers' indexes for both manufacturing and service sectors point to burgeoning demand. The labor market still shows signs of stress, but employers did add (back) 1.6 million jobs during the first quarter while the unemployment rate dropped down to 6%.

More jabs, more jobs

America's economic recovery clearly has traction and is progressing faster than most of the globe's. First, vaccine doses have been much more widely available. Last year, the federal government moved aggressively to secure hundreds of millions of doses of then unproven compounds. Clinical trials subsequently determined that those vaccines were safe and effective. Despite the U.S. accounting for one-quarter of the world's COVID-19 cases, the early vaccine launch has allowed states to begin rescinding lockdown measures.

As of early April, 52 doses have been administered in the United States for every 100 individuals, a pace exceeding all but a handful of nations. Among major economies, only the United Kingdom has performed better than the U.S. Meanwhile, the hard-hit European Union has only administered 18 doses per 100 citizens. The global vaccine rate stands at a mere 9 doses per 100 with wealthier nations having more success than developing ones.

And Keynes to the rescue

Second, multiple rounds of aggressive fiscal stimulus have buoyed the U.S. economy, ameliorating the downturn and setting the stage for a sharper snapback. The $1.9 trillion *American Rescue Plan Act* passed in March marks the latest edition. That legislation provides another set of direct payments to lower- and middle-income households, extends and expands unemployment benefits, and grants aid to state and local governments.

The U.S. fiscal response to the pandemic equates to 25% of GDP, a staggering amount of firepower. For some context, initiatives enacted to help alleviate hardship from the Great Recession (2007-09) totaled 5% of GDP. The Federal Reserve's extremely accommodative policies have amplified the impact of the various fiscal initiatives.

Thanks to sizable government transfer payments plus the ability of many white-collar workers to telecommute, overall personal income actually *increased* during the recession, a sharp contrast to the typical downturn. Therefore, with spending levels depressed, American households have built up $1.5-2.0 trillion of excess savings. Some will be kept in reserve; other funds will be used to pay down debt. But as the economy reopens, a portion of this cash hoard should propel future spending, particularly for services.

Another shell game?

March 23rd marked the one-year anniversary of the stock market's pandemic lows. Between mid-February and late March 2020, stock prices fell off a cliff. But the Dow, S&P 500, and NASDAQ have not only recovered from those losses, they have hit a series of new records, stretching valuations. Some analysts have likened the current market environment to the *dot.com* bubble of the late 1990s.

In fact, there are some striking similarities, most noticeably a dramatic increase in investor risk appetite, leading to pockets of euphoria and froth. Day traders are back, this time egging on one another via Reddit and Twitter rather than Yahoo message boards. Zero stock commissions and apps like Robinhood have goosed trading activity. Memes form around certain investments; the securities gain a constituency with prices rapidly bid up. For much of the period, some investors flocked to buy whatever was performing, with little regard for the fundamental prospects or valuation of the underlying entity or company. Sounds familiar.

The market for initial public offerings perhaps best exemplifies such ebullience. Not since the heady days of the *dot.com* era have so many private companies gone public. According to FactSet Research, nearly 500 IP0s came to market in 2020, raising a record $175 billion of capital. Moreover, half stemmed from so-called *Special Purpose Acquisition Companies* (SPACs). These are blank-check, shell companies that raise funds on an exchange and then later seek out private firms to fold in. Even baseball great Alex Rodriguez has gotten into the game and formed a SPAC.

Not partying like it's 1999

Despite some parallels, today's backdrop contains one crucial difference: the Federal Reserve's stance. After cutting rates in 1998, the Fed reversed course in mid-1999, eventually taking the fed funds rate up to 6.5% in 2000. High stock prices collided with an onerous interest rate picture; the yield curve inverted, foreshadowing a recession.

In contrast, the fed funds target rate range currently stands at 0.00%-0.25% and Jay Powell anticipates holding short-term rates at rock bottom levels for another two years. Yes, the 10-year Treasury yield has tripled over the last nine months but that move was merely from 0.52% to 1.70%. Consequently, the yield curve is steepening, signaling expansion. And relative to bonds, stocks are much more reasonably valued than they were in 2000. For instance, back then, the S&P 500 dividend yield was well below the 10-year bond yield; today, their yields are roughly the same.

Expectations matter

Nevertheless, higher rates *will* present a risk to stocks. Above some threshold, yields would certainly begin restricting economic activity and threaten stock valuations. But below that tipping point, rising rates and equity prices typically go hand in hand, particularly during the early stages of a business cycle.

The future path of inflation expectations will drive long-term rates. Today, market-based measures indicate that expectations have returned to pre-pandemic levels but are not particularly troublesome. However, with all the stimulus in the pipeline, we expect the conversation to turn from whether the economy is growing fast enough to whether it is in danger of overheating.

Last August, Chairman Powell announced a major Fed policy shift toward “average inflation targeting”. Going forward, the bank will allow inflation to run “moderately” above its 2% target “for some time” following periods of low inflation. As a practical matter, this move suggests that the Fed will not hike rates until it witnesses a sustained inflation overshoot. But if the Fed waits until seeing the “whites of their eyes”, inflation (and inflation expectations) could gain a foothold.

The Fed’s more relaxed view of inflation may be tested this year as the economy reopens, supply disruptions persist, and some consumer prices spike (e.g., hotel rooms, airline fares, gasoline). But the central bank (and investors) should view these as transitory price hikes, not a structural change to underlying inflation trends. The U.S. economy still possesses substantial slack that must be absorbed.

Guns, butter...and infrastructure

The cyclical bull market in stocks will eventually end when inflation moves high enough that the Federal Reserve is forced to tighten. And looking farther out, policymakers could be sowing the seeds for a more persistent bout of inflation than the market anticipates. Ultra-easy monetary policy itself can lead to economic overheating, rising prices and ultimately, high interest rates. Add expansionary fiscal policy to the mix, as in the late 1960s, and the potential for inflation increases further.

This year, a friendly Fed along with widespread vaccinations and the release of pent-up demand will be a powerful brew for economic and corporate earnings growth. The operative question is the extent to which stock prices already reflect this backdrop. For now, the bulls have been running because our herd is achieving immunity to the coronavirus; however, we will never be immune to the occasional correction.

— Christopher J. Singleton, CFA, Managing Director

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