First-Quarter 2021
American Portfolios Quarterly Market Commentary

by Chief Investment Officer Clifford T. Walsh, CFA

WE EXPECTED 2021 to offer significantly more impact-producing events than average, driven by the reopening of the economy and new presidential and Senate leadership; so far, we have not been disappointed.

Despite some downside volatility that arose in the back end of the quarter, the U.S. equity markets surged higher in the first quarter, fueled by two drivers: an accelerating vaccine rollout and larger-than-expected government stimulus.

A STIMULATING RECOVERY

As we look out to the rest of this year and into 2022, we foresee a roller coaster ride of economic activity. The worst of the pandemic seems to be behind us. Vaccines are being distributed and administered around the world, fueling forecasts of a significant pickup in economic growth this year. 2021 GDP growth could top 6 percent or even 7 percent, peaking in Q2 (estimates call for 9 percent-plus) before falling back to trend in 2022. Adding fuel to the fire is government stimulus and expected social spending.

The $900 billion stimulus passed at the end of 2020 and the $1.9 trillion relief package passed in March 2021 equate to nearly 14 percent of U.S. GDP, a huge sum that has been very exciting to investors. Even though a significant portion will never make it to the real economy (e.g., foreign payments, personal debt paydown), the sheer size of this spending is bound to accelerate significant growth.

Furthermore, the American Jobs Plan offers an additional $2.25 trillion in spending geared largely toward improving transportation, communication and power infrastructure. The Biden administration is also targeting a $1 trillion plan focused on social programs. While it remains to be seen how much stimulus will be passed by Congress, the markets appear to appreciate the effort, likely expecting a solid portion of the proposals to pass, despite the funding implications of higher taxes and more debt. To fund the infrastructure plan, the Biden administration is looking to push the corporate tax rate from 21 percent to 28 percent. This could cut almost 10 percent from S&P 500 earnings in 2022. We're expecting significant resistance to a 28 percent rate, so the negative impact from higher taxes might only hit earnings by 5 percent, but the rest will have to come from somewhere (e.g., capital gains taxes, personal income taxes, more debt).

These bursts of fiscal policy have created a roller coaster economy fueled by fits, starts and a lot of volatility. We are concerned about the sustainability once government stimulus runs out. Despite the strength of this reopening and stimulus surge, we think it is very possible that the stimulus begins to wear off as early as the third quarter, similar to what we saw in October of last year. The withdrawal of such a

huge amount of policy stimulus could easily fuel a stagnant or even a contractionary GDP quarter in the fourth quarter; not to mention, there is no way this rate of spending can continue without serious negative consequences (e.g., debt ceiling is hit, tax hikes weigh on growth and spending, and/or long-duration bonds sell off hard, taking equities along with it).

Even if the euphoria lasts throughout the year, we expect growth to decelerate meaningfully in 2022 as the sharp decline in the fiscal spending is offset by the continued reopening and recovery, albeit weighed down by a still troublesome employment picture. So, as exciting as the reopening is, it's also likely that most of it is already factored into equity prices. Is an economy based on government aid one that deserves a 20-times multiple on estimated earnings two years out? We don't think so. That being said, there are always sectors that outperform. The infrastructure package in its current form will drive investment opportunities in traditional industrials (e.g., cement, aggregates, engineering), as well as in technology and energy (e.g., broadband, clean energy, grid upgrades). Furthermore, the reopening of the economy should favor value over growth and fuel opportunities in travel and entertainment, among other areas hard hit by the economic lockdown.

THE FED, BONDS AND INFLATION

Despite all the talk and concern about a surge in inflation, which fueled a significant backup in long-duration bonds, we think inflation is likely to remain below Central Bank targets over the next two years, notwithstanding a temporary spike over the next several months. Our inflation forecast is muted because we believe there is still significant slack in the U.S. economy and labor markets, taking longer than expected to reach a sustainable inflation rate that will force the Federal Reserve (the Fed) to act.

With fiver-year TIPS/Treasury breakeven rates priced for a 2.5 percent inflation rate, the market is implying that the Fed Funds rate will exceed the last cycle's peak levels (also 2.5 percent) and expects the Fed to act sooner than its stated 2023 timeframe for rate hikes. The problem with this is how important wages are to inflation and how important the unemployment rate is to wages. In the last cycle, wages grew at half the rate that a 3.5 percent unemployment rate would suggest based on history. With so many permanent business closures resulting from the 2020 recession, not only will it take years to get back to the previous peak in unemployment (if it ever does), but if the economy didn't fuel significant wage growth or above-target inflation with a jobless rate of 3.5 percent, it appears unlikely that sustainable price hikes are just around the corner with still so much labor market slack considering the 6 percent unemployment rate. Surely, this rate will be lower by year's end, but still far from peak.

We think long-duration U.S. Treasury rates are attractive based on this and offer relative value ($15 trillion in negatively yielding debt around the world and a higher yield than 70 percent of Barclays' aggregate bond index). We could see a gradual tapering of Fed asset purchases later this year or early next year, which could hit long bonds again; however, we expect such a move would likely be signaled well in advance. Overall, we think bond bears are likely to be disappointed in the back half of the year as data trickles out, making the 10- and 30-year U.S. Treasury bonds a solid relative value not only to other sovereign bonds, but also stocks, given current earnings yields in some sectors.

IT'S GETTING HOT IN HERE

The rage of IPOs, the significant increase in retail participation in the markets (e.g., Robinhood, GameStop) and the re-emergence of Special Purpose Acquisition Companies (SPACs) is a concern. SPACs raised just under $100 billion in the first quarter, already breaking last year's record total, and account for about 70 percent of all IPOs this year. It's clear the bullish sentiment is fueling the markets higher, but it also makes us wonder how long it will last and what level of fundamentals the market will return to once this excitement wanes.

SPACs are a somewhat isolated investment opportunity, but the problem is that the issue is broader than SPACs. The share of publicly-listed technology companies that generate zero earnings has risen to 38 percent, breaking above the 36 percent bubble peak in 2000. Not to mention, firms with a 15-times price-to-sales multiple or greater also hit a new high. Companies with bad balance sheets are also soaring in equity value. The most levered companies (with a B rating or lower) currently trade at a 20 percent premium to the market, while the firms with the best balance sheets are trading at a 10 percent discount. Meanwhile, the overall market now trades at 20-times on 2022 EPS estimates, which puts it in the top 10 percent expensive markets of all time. Many other valuation measures are in the top 1 percent of history.

PUTTING IT ALL TOGETHER

The prospect of life returning to normal amid the vaccine rollout and the reopening of the economy is certainly exciting. The economic momentum in the near term is going to be quite strong. That being said, we question the sustainability of economic growth following the reopening surge as the government has taken an increasingly larger role in fueling this growth. We wonder how much government firepower is left. We also must consider how all of this is going to be paid for. The financial markets appear to be focused only on the benefits of more and more stimulus and not on the negatives of taxes and higher debt loads. Additionally, the equity markets are at record highs. One must also consider how much of this recovery is already factored into equity valuations.

As previously stated, there are always sectors that outperform despite what the broader markets do. We think it is possible to see the shift from value to growth continue in a meaningful way within the equity markets, but view it more as rebalancing of valuation or reversion to the mean than a rising tide that will lift all boats. We expect to see a drawdown in the overheated goods sector and those businesses benefitting from the stay-at-home trend, while cyclical value sectors and industries, small cap stocks and international equities—both developed and emerging markets—will continue to close the performance gap with the previously high-flying U.S. large-cap technology and growth stocks.

As far as the fixed income markets are concerned, our position has changed since our last update. We had been advising against owning long-duration Treasuries for quite some time, but with the significant selloff in the first quarter (down 85 bps to 1.75 percent or so), we now view this asset class as attractive relative to quality debt and even equities, given earnings yields.

Overall, we continue to recommend balance with a bias toward areas that underperformed during the economic pressure of 2020 as they are likely to offer the most upside in a recovery scenario. Furthermore, a focus on quality over junk appears likely to pay off with low-quality companies and non-earners seemingly fueled by momentum and appear overvalued on a relative basis. We think avoiding large downswings in charged sectors is likely to be just as important in 2021 as finding the year's winners.

QUESTIONS AND COMMENTS

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