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A few trillion here… a few trillion there… soon, we'll be talking real money!

Sustainability Isn't Just a Buzzword

The number one question on clients' minds these days is, "can the market continue going higher?" This comes from a feeling of dread regarding the sustainability of economic growth in this environment. They see interest rates at historic lows, an accommodative Fed, trillions being spent to keep individuals, businesses, and municipalities afloat, and asset prices at historic highs… how long can this continue? That is a fascinating question. Most economists are forecasting robust GDP growth in the US this year and into next as the recovery from the flash COVID recession continues. Then what? Politics will influence economic policy and those policies could have an effect on growth. It's important to focus on the fundamentals. Where do we begin?

COVID-19 Update

Let's start with the elephant in the economy. After surging in the winter months, the U.S. has begun to make considerable progress against the pandemic. Declining cases and fatalities beg the question: where are we on the road to herd immunity? Continuing inoculations, natural immunities spread with infections, and better testing and therapeutic drugs should allow the number of cases and fatalities to drop precipitously over the Summer. Many States and businesses are signaling a willingness to allow life to return largely to normal by the Fall of this year. Time will tell.

Economic Growth

The retreating pandemic coupled with new fiscal support is priming the economy for a surge over the course of 2021. Growth will be driven by pent-up demand and pent-up supply in those sectors that have been most impacted by the pandemic. These areas may reopen very quickly, leading to high-single-digit economic growth in the second half of 2021 and going into 2022. This could push the economy closer to a full recovery. Growth thereafter is expected to retreat closer to the roughly 2%/yr pace it saw in 2019 at the end of the last long economic expansion. There is also a significant disparity between States with continuing economic restrictions and those more "relaxed." The economic average is strong.

Unemployment

While the partial recovery in the labor market is welcome, the pace of recovery has slowed. Much of the remaining employment decline from the pandemic is in sectors that will have a hard time reopening while the pandemic continues, including the leisure, hospitality, travel, retail and food services industries. In addition, state and local government cutbacks continue to weigh on payroll employment. Moreover, the unemployment rate likely understates the degree of economic distress as almost 4 million people have dropped out of the labor force since the start of the pandemic, and are thus not counted among the unemployed.

However, as the service sector rebounds strongly in late 2021 and early 2022, strong job growth is expected and the unemployment rate could fall to between 4.5% and 5% by the end of 2021, and to between 3.5% and 4% by the end of 2022.

The U.S. labor market added 266,000 jobs in April, a moderate improvement in employment but a sharp miss from consensus expectations. Some of the blame has been attributed to expanded unemployment benefits reducing the availability of willing employees. Job availability is at an all-time high. April was the one-year anniversary of the trough of the coronavirus pandemic recession, which saw jobs reduced by a record 22.4 million. April 2020 also saw the fastest wage growth in recent memory, with wages rising 8.2% year over year.

The composition of the U.S. workforce sharply changed as a result of the pandemic, as millions of low-paid workers lost their jobs while relatively high-paid workers remained employed, telecommuting to work and even clocking in more hours than usual. This composition effect can help explain the spike in wages—but even removing this effect by holding sector weights and hours worked fixed at pre-pandemic levels, wage growth was much faster than average and remains above long-term trends. The U.S. has now recovered 63% of jobs lost from the pandemic and wage increases have remained robust.

Inflation

While rising commodity prices and supply bottlenecks may cause inflation that is only transitory, robust wage increases may signal longer-term inflation ahead. This is of crucial importance to bond investors, as sustained wage inflation could potentially pull forward the Fed's timeline for policy normalization.

The onset of the recession, combined with a collapse in oil prices, triggered a decline in already low inflation in 2020. Since then, inflation signals – such as oil and wage growth – are getting hotter, with the potential to boost inflation going forward. It's important to note that though stronger growth is likely to be accompanied by higher inflation, the Federal Reserve views this outcome as mostly transitory, and expects to maintain its accommodative stance for years to come—unless events change their timeline. Consequently, inflation expectation—using both CPI and personal deflator measures—may edge over 2% by the middle of 2021 and stay at close to this pace into 2022.

Equity Markets

U.S. equities have recovered significantly from the March 2020 lows, and at record speed. However, as markets look through the virus and the downturn to the recovery, valuations are well above historical averages. Investors should recognize that earnings are likely to continue to grow quickly in the year ahead which should lead to some compression in these ratios. Moreover, a continuation of relatively low interest rates likely justifies some elevation of valuation measures above their historical averages. Still, rich valuations may constrain equity returns over the long-run. Consequently, investors may want to

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Continued from the front:

consider diversifying their equity exposure adding more to value stocks as well as reducing weightings to the very largest companies in the stock market.

Both U.S. and international stocks sold off at the height of the COVID crisis, but the valuation gap between U.S. and international stocks that persisted throughout the recent expansion still persists today. However, this dynamic could shift in the next expansion.

The long-term growth prospects of EM economies still look better than for the US. Valuations remain cheaper overseas and the dollar has been retreating which amplifies the return on international equities. Europe, which has been long unloved, may have a catalyst for turnaround with more promising efforts towards fiscal integration. Given the extraordinary disruption to the U.S. and global economies in 2020, it is remarkable how resilient financial markets have seemed to be.

However, investors should recognize that the blessing of strong performance brings with it the challenge of higher valuations. The next few months should answer many questions with regard to our collective success in ending the pandemic as well as the pace and shape of the U.S. and global recoveries from the social-distancing recession. Given all the uncertainties surrounding these and other questions investors would be wise to maintain a somewhat defensive and diversified stance after one of the most difficult and unusual years in modern history.

Those relying on unmanaged indices enjoyed a decade of outperformance relative to the average money manager. The top 10 holdings in the S&P 500 have grown to be almost 30% of the market capitalization of the index. This could mean active managers may have greater influence on returns going forward.

The Fed and Interest Rates

In the first half of 2020, the Federal Reserve took very strong action to support the economy including cutting the federal funds rate to a range of 0-0.25%, opening or expanding a very wide range of facilities designed to support different parts of the bond market and adding dramatically to its balance sheet.

In addition, in August, the Fed adopted an "Average Inflation Targeting" strategy, by which they will aim to achieve inflation of above 2% for some time to make up for years of undershooting this target. In order to achieve this they have pledged to hold the federal funds rate at its current 0-0.25% target range until inflation is at 2% and on track to moderately exceed 2% for some time.

Although the Fed pledged to maintain its current asset purchases until "substantial further progress" has been made in achieving its inflation and employment goals, it is important to note that this timetable suggests that the Fed will reduce its bond purchases well in advance of any increase in short-term interest rates. This, in turn, suggests a steepening of the yield curve as the economy continues to recover in 2021.

With the federal funds rate at 0-0.25%, nominal Treasury yields have fallen to near-historic lows and real yields are negative. In this low rate environment, investors will continue to hunt for yield. Although spreads had widened in riskier fixed income, they have come in meaningfully, making risk-return dynamics less attractive. However, despite unattractive yields, high quality fixed-income may continue to play an important role in providing downside protection and diversification.

Searching for yield in the fixed-income markets can lead to a reduction in the benefits of diversification. Reaching for greater yield, increases the correlation to equities. This means that the average investor, trying to use fixed-income as a diversifying asset to equities, will have to accept low yields in this environment.

Federal Government Finances

A realistic view on the federal budget over the next year suggests that the federal government will hit a new record high debt-to-GDP ratio by the end of fiscal 2021—even higher than in the aftermath of World War II! While this may not result in a fiscal crisis in the next couple of years, a failure to rein in deficits and debt monetization, once the economy accelerates in the wake of a vaccine, could lead to significant problems. In particular, a sharp rise in inflation could result in higher interest rates and higher taxes, and could ultimately set the stage for an economic relapse.

Do Something

Investors should remain vigilant with their portfolios and review their holdings. I believe this environment is where the best managers will have an edge over "passive" managers that seek to match index performance. Sit down with your financial advisor and ensure your investments are prepared for the future and consistent with your objectives. Don't panic when markets become volatile. The average intrayear drop in the market for the last 40 years has been over 14%. Expect it. Be calm.

Plan for the future. Has there been a birth or a death in the family? Marriage or divorce? Graduation or retirement? Each of these will have an impact on existing financial plans.

Summary

My long-term outlook continues to favor equities over bonds —just don't expect higher than average gains. This is an environment for strong investment managers and careful stock selection. Overseas holdings may benefit long-term investors with greater growth potential. Income-oriented investments may struggle in a low interest rate environment. Bonds may have value as a diversifier for managing portfolio risk. However, chasing higher yields may reduce much of the benefit of diversification. Shifting to bonds to reduce portfolio volatility could expose more of the portfolio to interest rate risk.

With bond yields at historic lows, bond investors may realize low income and a risk of capital losses. Greater income will require higher interest rates which may drive down bond valuations. This isn't a recipe for long-term wealth-creation.

What to do now? **Take the long view with your investment assets and review financial plans**. Pipeline disruptions, trade negotiations, and unrest are nothing new. Take a long view of short-term crises. When was the last time you reviewed your plans? Your estate plan should be reviewed at least bi-annually and updated with every change of life. Most importantly, make sure you have carefully delegated who will execute your documents for you. To review existing documents, develop new plans, or do end-of-year planning, talk to an advisor soon.

Source: General economic statistics are from JP Morgan "Guide to the Markets" 2Q2021.