MARKET COMMENTARY

A New Epoch

February 2021

- As we cross the one-year anniversary of the WHO's formal declaration of the COVID-19 pandemic, the market's attention has shifted from rampant excitement over stimulus and the reopening to anxiety over rising interest rates.
- The rise in the 10-year Treasury yield from 0.92% on December 31 to above 1.5% on March 4 is one of the sharpest relative jumps in history, with implications for the relative valuation of asset classes.
- Rising yields will continue to benefit value stocks over growth, and will also put pressure on longer term government bonds. But remember: yields may not be able to rise indefinitely.
- Should interest rates increase much more, policymakers could try to cap interest rates in order to protect the fragile pandemic recovery.

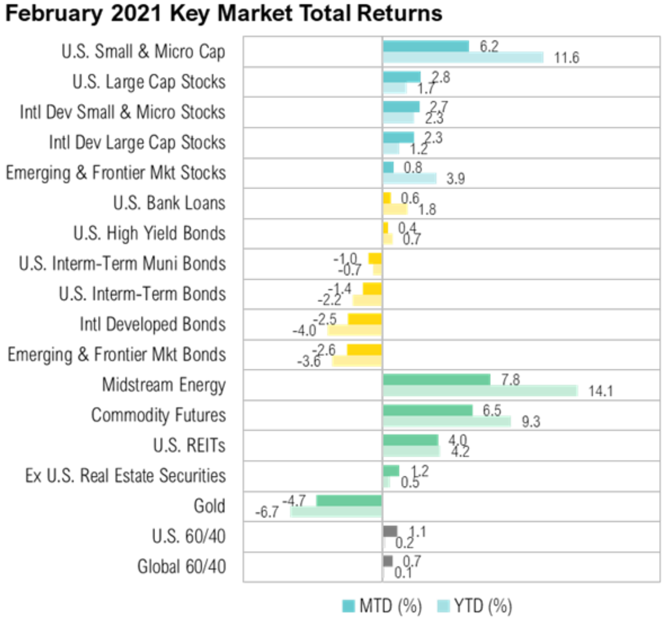
Overview

March 5, 2021 marked the one-year anniversary of the World Health Organization's declaration of the COVID-19 pandemic. The world has changed dramatically over the past 12 months. Entire segments of the economy shut down, along with thousands of businesses. Many of those will not reopen. Millions of people were put out of work.

Central banks and lawmakers alike stepped in to patch up the sinking ship that was the global economy. Now, like the warming March weather, the economy is also starting to thaw, especially in areas frozen out by COVID-19. The February jobs report showed a 379,000 increase in nonfarm payroll employment, with 355,000 of those jobs in leisure and hospitality. Of those gains, roughly 80% were in food services and drinking places.[1] Markets seem to anticipate that fundamentals will continue to improve. According to

One year after the WHO declared COVID-19 a pandemic, parts of the economy that were hit hardest by economic shutdowns showed signs of recovery in the February jobs report.

February 2021 Key Market Total Returns



Source: Bloomberg

Factset, for calendar year 2021, analysts are projecting corporate earnings growth of 24% and revenue growth of 9.2%, relative to 2020.[2]

In the U.S., over 50% of those over the age of 65 have received at least one dose of a vaccine. This has been a positive development as the 65+ age group made up over 80% of COVID-related mortalities.

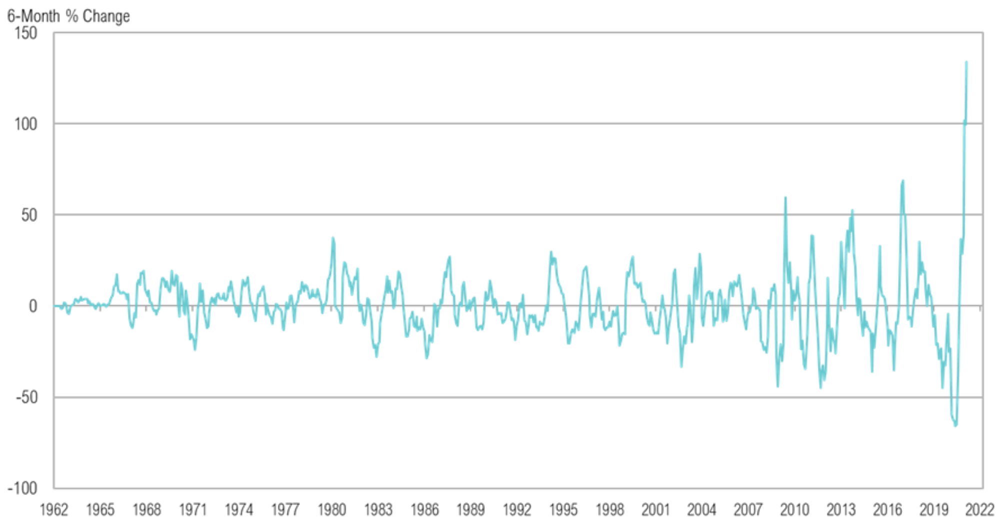
In terms of the virus itself, as of March 8, 2021, nearly 10% of the U.S. population had received both doses of the COVID-19 vaccine, and 20% had received at least one. Over 50% of those over the age of 65 have received at least one dose of a vaccine, an age cohort that shouldered over 80% of mortalities.[3] As if to mark the end of the pandemic era, the popular website, "The COVID Tracking Project," announced it will stop collecting data on March 7. The press release detailing their decision began with the pronouncement: "It's time."[4]

Rising Interest Rates

Perhaps no other measure chronicles the market's decline and recovery during the COVID-19 era more succinctly than long-term interest rates. The 10-year Treasury declined to an all-time low of 0.4% on March 9, 2020. As of March 8, 2021, this widely quoted barometer of economic growth and inflation sat at 1.59%. While the move seems insignificant in absolute terms, the relative increase is one of the most drastic in history. Even more surprisingly, it comes on the heels of its largest ever six-month percentage decrease leading up to March 2020.

Largest Six Month Percentage Change in the U.S. 10-Year Yield On Record

U.S. 10-Year Treasury Yield Rolling 6-Month Percentage Change, *1/1/1962 - 3/8/2021*



Source: Bloomberg

The low rates over the past year favored companies positioned for high growth far off in the future. They also spurred a wave of speculation by doing the following: 1) making low-yield safe-haven assets less attractive, 2) lowering discount rates used to value assets, and 3) making leverage more affordable.

The low rates over the past year favored companies positioned for high growth, far off in the future, and minimized the focus on current cash flow. They also spurred a wave of speculation, akin to some of history's great manias, via three avenues. First, they made low-yielding safe-haven investments less attractive and encouraged investors to move out on the risk curve. Second, by lowering the discount rate used in valuation calculations, they increased the present value of longer-duration growth assets relative to value. Third, they made leverage more affordable for individuals and corporations.

The recent spike in interest rates has taken the wind out of growth investors' sails. This is best captured by the -12.8% decline of the MSCI USA Momentum Index, relative to the -2.3% performance of the S&P 500 Index over the week ending March 5. The Federal Reserve, however, is likely not too bothered by the recent rise in interest rates because stocks are within 5% of their all-time highs and the federal government is on the verge of passing a $1.9 trillion spending bill. However, we believe the Fed will need to take further accommodative action if interest rates rise much further—and will be especially likely to do so if broader equity markets collapse, as well.

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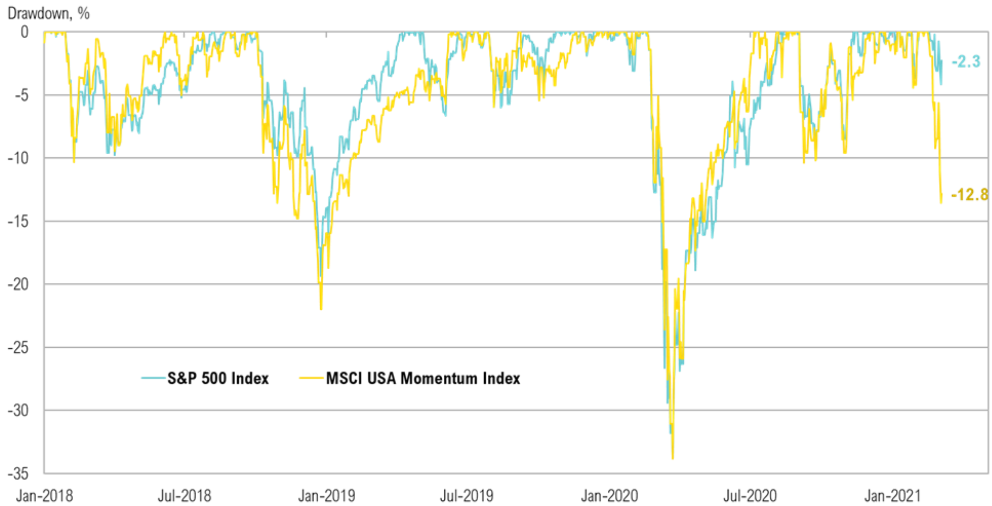
Recent Market Volatility Has Been Concentrated In Momentum Stocks
Drawdown: S&P 500 Index vs MSCI USA Momentum Index, *1/1/2018 - 3/5/2021*



Source: Bloomberg

Energy Markets

Crude oil closed above $66/barrel on Friday for the first time since April 2019. The rally continued last week after OPEC+ talks unexpectedly announced that there would be no increase in oil production through April 2021.[5] In addition, outlooks were also bolstered by President Biden's announcement that the U.S. expects to have enough doses to vaccinate the entire adult population by the end of May.[6] At the same time, U.S. oil production has come offline given the treacherous February weather. The U.S. Energy Information Administration said production was less than 10 million barrels per day in the last two weeks of February, a rate last seen in early 2018.[7] These developments all point to a sustained rebound in oil prices.

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WTI Crude Oil Prices Reach Highest Level Since April 2019
WTI Crude Oil Price ($/bbl), *1/1/2018 - 3/8/2021*

Source: Bloomberg

Looking Forward

We continue to position our portfolios for higher inflation, but we believe it will emerge in fits and starts over the next few years. Also, as inflation becomes more widely anticipated, prices will increasingly reflect that expectation, and as a result, the potential gains of investing according to this belief will decrease while the associated risks will increase. It's worth noting that inflation becomes likely only if both monetary and fiscal stimulus continue consistently, which takes time. Regardless of future inflation, at 1.5%, long-term interest rates are currently below the rate of expected inflation and imply negative real returns over the long term. For this reason, we do not find them a compelling investment.

We recommend a diversified portfolio of risky assets, tilted toward investments that will perform well during inflation.

Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

Citations

1. BLS: https://www.bls.gov/news.release/empsit.htm
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DEFINITIONS

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Intermediate-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Intermediate-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

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