MARKET SIGHT LINES

Spring 2021 Quick Pulse Check:
Broadening Our View

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A year ago, the world seemed to have a singular focus. How rapidly would the coronavirus spread? How many lives would be lost to COVID-19? Would we develop a vaccine? And what would be the implications of a shutdown economy? Fortunately, today we have effective vaccines, are reopening, and are well into a robust recovery. And we've all appropriately widened our focus to other important topics.

This week's Sight|Lines provides a quick pulse check on the pandemic and other important topics.

The Pandemic – Getting to herd immunity

Just over 50% of the U.S. population has received at least one vaccine dose, and while the pace of daily vaccinations has slowed, we seem to be getting very close to herd immunity. Or perhaps we're there, as daily cases have declined substantially. So, as we look forward, we're watching for troublesome variants, the need for and logistics for booster shots, and how quickly the rest of the world will advance their vaccinations. Of course, the recently revised CDC guidelines allowing for more regular engagement between vaccinated individuals were a welcome step, and our activity back out in the world is getting back to normal.

The Fed – Signals about signals

In addition to the historic fiscal packages to help during the pandemic shutdown, the Federal Reserve (Fed) has maintained a highly accommodative policy comprised of two primary tools: a near 0% fed funds rate and a bond-buying program to inject more liquidity into the economy slowly. We know the Fed must, at some point, reverse its policy, tapering purchases and raising rates. The questions are when, and will they give us some warning? So, the Fed has signaled no urgent change, but some officials are now signaling it's time to talk about tapering. The Fed is telling us to get ready.

Inflation – Transitory or sustained?

Inflation has heated up recently, and there are two schools of thought looking forward. Many, including the Fed, believe this upward move results from temporary reopening pressures and is transitory so that inflation will settle down in the second half of the year to run between 2% and 3%. We tend to agree. Others believe the higher inflation levels will remain, which may force the Fed to adjust policy more quickly.

Economic Growth – Building strength for the future

The U.S. is in a robust recovery, with consensus forecast GDP growth of 6.6% in 2021 and 4.0% in 2022. The job market is healing, with the unemployment rate down to 5.8% and getting better. So, some questions are coming into focus. Where are we in this economic cycle? When the fiscal stimulus fades, and the Fed tightens monetary policy, will our economy have been healed enough to stand on its own? And what will be the future "trend growth?"

Equity Earnings – Future growth?

In many ways, positive economic growth and growing earnings go hand in hand. And we've seen that in the numbers. For example, S&P 500 earnings have grown 52% over the last year ended March, and 2021 earnings growth is forecast to be 34%. So, as with the economy, we're asking similar questions: Are businesses healing, and where will long-term earnings growth settle out?

Market Valuations – A shift in performance dynamics

Equity returns are driven by essentially two forces mathematically: Price/Earnings (P/E) expansion and earnings growth. And in periods of heavy policy support, which most often include lower interest rates, P/E expansion accelerates and drives the market higher. This positive force can make the quality and growth of earnings appear less relevant. But as we make our way through this economic cycle, the effects of fiscal stimulus fade, and the Fed eventually unwinds its policy, equity returns will be driven by earnings growth, with P/E ratios not expanding, and perhaps contracting. At this stage, market valuation levels and equity returns will depend on the quality and growth of earnings.

DC Effects – Big agendas, with signs of a split government

At any time, the current administration and Congress agendas impact people, businesses, and the economy by driving tax policy, government spending, and fiscal policy. And the Biden administration and a Democratic-controlled Congress have offered bold agendas, with historically high spending, proposed higher taxes, more fiscal spending that includes infrastructure, and big spending in the proposed budget. But with a razor-thin majority, the features that create balance in our federal governmental process are present, like the Senate filibuster. With that, and moderate Democrats expressing a preference for less aggressive measures, we'll see some effort to negotiate some of these proposals down to lower levels.

And, like the healing we look for in the economy and earnings, not only will we look for signs that the government will begin to curb this historic spending, but we'll also look for signs of an effort to reduce the annual deficit further and pay down government debt. But this will take time.

Conclusion

A year ago, we all focused, appropriately, on the coronavirus pandemic. We're blessed to be closer to herd immunity, and with that, we've all widened our focus to other important topics. We'll continue to monitor these critical topics, and we expect to share additional quick pulse checks in the future.

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