

“Don’t judge each day by the harvest you reap, but by the seeds you plant.”

Robert Louis Stevenson

IN FOCUS: Implications of Unprecedented Federal Reserve Accommodation

The U.S. economy entered this year poised for strong growth as COVID-19 incidences ebbed due to increasing vaccinations. With the Democrats establishing control over both chambers of Congress in January, the U.S. growth outlook has become more supercharged, starting with the sizeable additional round of fiscal relief currently making its way through Congress. We expect that the Biden administration’s US \$1.9 trillion proposal will clear Congress via the ‘budget reconciliation’ route in March. If passed, this stimulus would amount to approximately 7% of GDP. Adding it to the US \$900 billion of fiscal aid passed at the end of last year, it would imply a fiscal stimulus of over 11% of GDP this year. Clearly, the scale of fiscal support provided in this crisis is historically unprecedented; remember that the total fiscal aid passed during the Great Recession in 2008-2009 was 7.5% of GDP.

What’s going right? All those government checks sent by the Treasury to provide support to consumers boosted their incomes and spending. For the first time ever, personal income rose during a recession, as government benefits well exceeded the drop in wages and salaries. Record-low mortgage rates and deurbanization triggered by the pandemic caused home sales to soar. Technology spending has also soared.

The unprecedented two-month recession during March and April was followed by an unprecedented V-shaped recovery that, by Q2-2021, could return real GDP to its previous record high during Q4-2019. Treasury Secretary Janet Yellen last week claimed that the economy could be back to full employment by 2022 if the administration’s \$1.9 trillion American Rescue Plan is passed.

As a result, we should expect stock prices to continue to move higher following a trajectory similar to the one from early October 1998 through March 10, 2000. Over that period—covering from the Nasdaq’s bottom through its tech-bubble peak—the Nasdaq soared 255.8%. Since its March 23, 2020 low, the Nasdaq is now already up 105.5% so far through mid-February.

In terms of the S&P 500, we believe the index could continue to climb from here, based on our forecast that S&P 500 forward earnings per share could rise to \$190 at the end of 2021 - and perhaps as high as \$205 by the end of 2022. That implies forward P/Es of 22.6 and 23.4 by the end of 2021 and 2022.

We would be more concerned by a potential melt-up scenario if the S&P 500 rose too early in the year, anticipating even more robust GDP growth numbers greater than 5-5.5% for 2021. It is worth noting that one big difference between 1999 and today is that home prices are also accelerating at a much higher pace, as they did prior to the Great Financial Crisis (GFC). The median price of a single-family home climbed 14.9% to \$315,000 in Q4-2020. That was the biggest surge going back to 1990, according to the National Association of Realtors. According to our sources, nearly 90% of metro areas saw double-digit y/y price gains in Q4.

CLOSE-UP: The Economic Landscape as the First Quarter Unfolds

What could go wrong? A significant rebound in inflation could result from excessively stimulative fiscal and monetary policies. We are finding some pressures building among input materials and labor costs, but these haven't yet shown up in consumer prices. One explanation could be that faster productivity growth is most likely offsetting the upward price pressures.

With a large fiscal stimulus package looking increasingly probable in the U.S., and the Fed unlikely to push back on higher inflation expectations, we think the yield of 10-year U.S. Treasuries may rise further. We expect this to be driven mainly by higher wage inflation, rather than higher real yields.

- **The 10-year U.S. Treasury yield has risen by ~40 bp so far this year**, mostly due to a jump following the Democrats' win in the Georgia Senate runoff elections. The bigger picture is that it has increased by ~85bp from its low in April. Overall, we expect the 10-year U.S. Treasury yield to rise further over the next two years, driven by higher inflation. We have revised our end-2021 and end-2022 forecasts for the Treasury yield to 1.75% and 2.00%, respectively. This compares with our previous forecasts of 1.60% for both years.
- **The Federal Reserve in tandem with the Treasury are providing an unprecedented amount of fiscal and monetary stimulus.** They have clearly embraced and implemented Modern Monetary Theory since the March 2020 low in the markets, by announcing quantitative easing "as far as the eye can see" with the Coronavirus Aid, Relief, and Economic Security (a.k.a. CARES) Act providing \$2 trillion for the Treasury to spend on pandemic relief. As a result, the Treasury's budget deficit swelled to a record \$3.5 trillion over the past 12 months through January, while the Fed's holdings of U.S. Treasury securities soared by \$2.4 trillion. Of course, we acknowledge that we've come through the pandemic in remarkably good shape considering how much worse the outcome might have been without all this support.
- **It is still our view that Fed policy will "keep a lid" on the real yield.** Even if the economy recovers quite rapidly, we think the Fed will tighten very slowly, in order to achieve its new goal of a period of sustained above-target inflation. Chairman Fed Powell has emphasized the importance of avoiding a repeat of the 2013 "taper tantrum", where real yields increased sharply as market participants reassessed the likelihood of Fed policy tightening. We suspect that the Fed would push back against any rise in real yields if it occurred before significant progress had been made against its unemployment and inflation goals, perhaps by jawboning or even adjusting its asset purchases.
- **However, we think wage inflation could rise further still.** The economic outlook has improved lately, with data suggesting the economy has proven somewhat more resilient than might have been expected. The vaccination rollout – which had been a significant source of uncertainty about the outlook – has been improving relatively smoothly. The outcome of the Georgia Senate runoff elections increased the chances of a significant fiscal boost to the economy. Additionally, even if only temporary, the demand/supply ratio in some pandemic-suppressed sectors is pressuring price levels. In contrast, rents are experiencing disinflation which could cap rent growth even as activity returns to pre-pandemic levels. However, all of this taken in concert, in our view, increases the prospects of a more rapid recovery and higher inflation this year.

CONCLUSIONS - AND WHAT THIS MEANS FOR THE MARKETS:

We would emphasize that the forthcoming round of fiscal stimulus will cause growth to surprise the consensus GDP forecasts significantly on the upside, potentially reaching as high as a 6.5% rate this year, and between 4 - 5% next year. Core CPI inflation, currently at 1.4% YoY, could potentially reach 3.0% later this year. We then expect it to subsequently return to, and remain around 2.7% through the end of next year, before moving sustainably higher in 2023. We expect the Fed to begin tapering QE early next year and expect the first policy rate hike in 2023. The growth impact of the Biden stimulus alone is not sufficient to cause sustained economic overheating. However, persistent fiscal stimulus or a meaningful upward reset in inflation expectations could act as a potential trigger. The Biden administration can potentially pass another major spending package later this year focusing on infrastructure, but the Democrats' slim majority in the Senate places a significant roadblock in its potential passage.

The sell-off in the U.S. Treasury market is approaching a near-term extreme as February closes. Bond yields should soon stabilize. Despite the recent backup in bond yields, financial and monetary conditions remain expansionary. The combination of improving economic prospects and rising inflation expectations will put further upward pressure on bond yields, once near-term oversold conditions in the U.S. government bond market unwind. We continue to recommend a moderately pro-growth investment stance, with a focus on relatively inexpensive cyclical sectors that still have catch-up potential such as Financials and Energy.

We would expect U.S. equity prices to come under pressure as a response to a rapid rise in bond yields, as government fixed-income markets have begun to discount stronger-than-expected economic growth and higher inflation. The move in long-term interest rates has the potential to unnerve some equity investors given the high valuations for stocks, and would help explain any recent weakness in markets. As the relief package finalizes in March, we would expect it will calm financial markets. We remain cautious on the near-run outlook for the equity market given what appears to be an overbought technical condition. However, with economic prospects improving and 12-month forward earnings likely to continue climbing as vaccines enable the global economy to re-open, the longer-term outlook remains positive. Although high valuations could limit returns.

Current valuations for health care stocks significantly undervalue the earnings power and intellectual property of the sector, encouraging us to maintain our overweight stance. Rising bond yields and a recovery in the overall profit cycle are consistent with our value orientation in portfolios away from growth. Accordingly, we are more neutral on sectors such as Tech, Communication Services, and Consumer Discretionary, given their relatively large exposures to growth companies. We are monitoring profit margins that could get squeezed if rising costs can't be passed through to prices. But so far, the forward profit margins of the S&P 500 and most of its 11 sectors have been recovering nicely from their declines during the first half of last year.

The opinions expressed in this commentary are those of Altman Investment Management, LLC as of the date appearing on this material only and are subject to change. The material is based upon information we consider reliable but we do not represent that it is accurate or complete and should be relied upon as such. This material does not take into account the particular investment objectives, financial situation or needs of the individual client and should not be viewed as an endorsement of any particular investment. Certain investments give rise to substantial risk and are not suitable for all investors.