

MARKET PERSPECTIVE

JULY, 2021

“The lack of perceived discipline may foster uncertainty in the public mind and increase the economy’s propensity toward inflation”

Ben S. Bernanke, Inflation Targeting (1999)

IN FOCUS: The Reflation Trade is Not Over

As the third quarter unfolds, equity markets have been hit hard - resulting in a rally in government bonds as yields for the 10-year U.S. Treasury fell from a high of 1.90% to as low as 1.20% by the third week in July. The overbought equity conditions, and less positive news on the virus, triggered a risk-off sentiment. As has been the case since November, equity selling pressure soon dissipates. This occurs because policymakers continue to support keeping the economies open along with hyper-accommodative monetary and fiscal conditions sustaining the corporate profit recovery. The distinction between rules and discretion has played a major role in debates about monetary policy for many decades - and Jerome Powell’s Fed is no exception. Ben Bernanke published in *Inflation Targeting* that “there is no such thing in practice as an absolute rule for monetary policy.” As a result, we continue to support a bullish stance towards equity markets that should trend higher over time as the level of corporate earnings climb - despite that economic growth rates will begin decelerating. However, stocks could be more vulnerable to periodic setbacks when the latter is occurring, while we do believe there remains a very low risk that the economic recovery will end in the next 12 months.

There remains an uncertainty by investors that the past economic pessimism still lingers from the last decade. This sentiment lingers in terms of whether the global economy can escape that period of a below trend growth environment, and consequently whether the uptick in inflation will indeed prove transitory. The acceleration in new virus cases in some countries/regions is preventing a return to normal mobility, thereby sustaining this economic uncertainty and supporting the demand for government bonds. While most high-income countries have now opened up sufficiently to allow near-normal domestic economic activity, international commerce is still heavily constrained, to the detriment of key service sectors such as leisure and tourism.

Equity investors have shown a willingness to look through disappointing virus case trends since effective vaccines arrived the end of last year. We expect this pattern to persist, even as the northern hemisphere enters a higher-risk period in the autumn/winter, and a return to indoor living, schools re-opening, etc. We expect plenty of bumps along the way given generally elevated valuations, but a cyclical peak in risk asset markets will likely only occur after more normal economic activity is achieved and current hyper-accommodative monetary conditions begin unwinding, with expectations that conditions will eventually turn restrictive. We believe that the confluence of events is still a long way off.

We are maintaining a mildly pro-growth investment stance - and view the recent decline in government bond yields as reason to remain cautious chasing bond prices at these levels - while taking advantage of the price weakness in select value and cyclical stocks to rebalance positions accordingly. Government bonds around the globe are expensive, even if our forecast for a decade of better growth and higher inflation than during the 2010s period does not pan out. Real bond yields are now far below the average of the 2010s when the secular stagnation theme dominated the bond market. As the St. Louis Federal Reserve president James Bullard implied, current levels are not justified barring a permanent state of economic emergency.

Our historic perspective shows that the gaps between the global stock market indices and stock/bond ratios have been elevated for some time, and a digestion phase is what typically follows such extremes. Worries about the sustainability of the economic recovery and/or spikes in bond yields are the normal catalysts for such pauses or temporary corrections in equity prices.

The good news for equities is that inflation fears don't appear to be entrenched yet, evidenced by the fact that bond yields still manage to ease as every piece of positive news shifts investors towards a of risk-off sentiment. This rapid relief response is usually not as pervasive late in economic cycles when bond yields remain sticky or continue rising, even as equity prices sink and economic growth starts to slow markedly. The Fed appears determined to keep this relief valve open.

Central banks are still willing to support economies running as hot as possible until after core inflation exceeds their targets for a period of time, and are clearly ignoring the current re-opening surge in inflation. Inflation expectations have recently eased a bit after rebounding solidly, in line with oil prices. However, nominal bond yields still reflect investors betting that inflation and economic growth will falter down the road. We expect more upside in inflation expectations, independent of oil price trends, and for nominal bond yields to move higher in a series of waves as investors gradually recognize the 2010s' world is over, in terms of better growth and a gradual rise in inflation - first in the U.S. and then followed by Europe.

Worries that economic growth will drop significantly once the re-opening surge dissipates is partly a response to past fears, reflecting concerns that the world is still operating in a similar environment to the 2010s when periods of good growth never lasted very long. Most of the headwinds that created what was labelled as a subpar growth environment have faded or are no longer as intense. However, investors will most likely hold on to this narrative until it is proved wrong. Those who share our expectation for a better growth scenario will have to be patient, as today's boom-like conditions and surge in inflation are generally seen as transitory.

A pressing near-term economic concern, which does have some validity, is whether another round of lockdowns might occur as a consequence of the Delta virus variant. So far, the resurgence of new cases has not slowed economic activity and most of the data has remained positive. It is notable that despite not reaching herd immunity, the severity of hospitalizations and mortality has been far less than prior to spikes with the population that has been vaccinated. Consequently, there is less pressure to enact domestic shutdowns - despite the mere presence of the variant has reawakened economic uncertainty and restrained non-essential international commerce.

We expect international travel to improve materially, once a larger number of developed economies attain higher vaccination rates. This, in turn, should provide another broader tail wind to what is already a robust pace of growth. Of course, the next risky phase in terms of COVID will be in the fall in the northern hemisphere, which may already be in the back of many investors' minds. It would take a replay of the acceleration in hospitalizations and mortality rates recorded in late-2020 to trigger widespread economic setbacks. Such an outcome is unlikely given the current pace of vaccine rollouts in our opinion.

CLOSE-UP: Corporate Earnings as the Third Quarter Unfolds

Forward earnings have fully recovered from last year's recession and are in a strong uptrend. At the same time, the momentum of earnings growth as measured by the year-over-year percent change in 12-month forward earnings is already at an historic high, significantly exceeding that following the Great Recession. Forward earnings momentum is closely correlated with swings in the U.S. ISM manufacturing index as a proxy for global growth momentum. In turn, the ISM is elevated by historical standards and may have likely peaked, implying more moderate U.S. and global economic growth ahead. There were two major global growth scares during the last economic expansion, as the ISM manufacturing index declined toward the 50 boom/bust level. Other popular growth momentum measures also point to a moderation in the pace of the economic recovery.

Over the past 50 years, global and U.S. equity returns have experienced mid-cycle equity corrections, but the fundamental trend in stock prices corresponds with that in earnings. The Delta virus variant warrants close investor attention, but we still remain convinced that that global forward earnings will be higher in a year, thereby providing strong support for stock prices. Lots of bullish news has been priced into stocks over the past eight months and slower economic growth could certainly be a reasonable conclusion, but the earnings and economic recoveries are not at risk. A further pullback or consolidation phase for stocks is still possible in the near term, but equity investors should not be swayed by the recent pronounced decline in bond yields to abandon a pro-growth exposure.

CONCLUSIONS - AND WHAT THIS MEANS FOR THE MARKETS:

Equities may still be vulnerable to periodic growth concerns, as the pace of the economic and earnings recovery moderates in the year ahead. Nonetheless, 12-month forward earnings are poised to continue trending higher, which should provide important support for stocks and spur higher price levels. We are maintaining our overweight stance on equity exposure in balanced portfolios.

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