ROCKLAND TRUST | Investment Management Group

March 15, 2021

The Markets & the Economy - What We're Watching

Top Theme of the Month:

- Economic optimism is on the rise

A year ago, our country plunged into a deep recession as our economy shuttered in the wake of a global pandemic. Today, with COVID cases declining, vaccine development and distribution accelerating, and a continued backdrop of extremely accommodative monetary policy and supportive government policies - the most recent being the American Rescue Plan totaling $1.9 Trillion - our economy continues to heal and to grow, generating a palpable wave of guarded optimism across our country. One area we see this being evident is in the most recent readings of business and consumer confidence.

- The Conference Board's Measure of CEO Confidence increased to a 17 year high in Q1 with 82% of CEOs expecting economic conditions to improve in the next six months up from 63% last quarter, reinforcing the economic optimism[1]
- Consumer confidence shows continued signs of improvement. Reported in March, University of Michigan Consumer Sentiment rose to 83, a post COVID high but still well below pre-pandemic levels, with increases not only in current conditions, but expectations signaling optimism for big gains in sentiment in the spring.[2]

While many have endured hardships due to the economic effect of the pandemic, in general, the majority of consumers are emerging from this recession in a strong financial position and are increasingly optimistic about the future. Consumers have benefited from huge increases in the value of their homes and portfolios, and some have aggressively paid down debt over the past year leaving them with a strong household balance sheet and an elevated level of savings. In such cases, these consumers appear to not only be able to spend, but are more willing to spend as Covid cases fall and herd immunity approaches, and our economic recovery is more certain.

With the passage of the $1.9 Trillion American Rescue Plan, our economy is now expected to generate the fastest annual growth in nearly four decades with economists forecasting close to 6% Gross Domestic Product (GDP) growth this year.[3]

Click HERE to read more on the major relief provisions contained in the new American Rescue Plan Act of 2021 (ARPA 2021)

2021 may be the year where progress on Main Street exceeds gains on Wall Street with the economy closing the output gap and recovering to pre-pandemic levels in the second half of the year. Economic optimism is readily apparent in the markets; challenging the investment themes that worked in 2020 when growth was scarce. Interest rates are rising, value stocks are outpacing growth stocks, and inflation expectations are growing – all reinforcing the expectations of stronger and sustained economic growth.

[1] The Conference Board
[2] Trading Economics
[3] WSJ

Rising Rates

It is likely we'll see interest rates rise as we experience a boost in economic growth. In March 2020, the 10 year Treasury note yielded 0.6%, and more importantly only 1% in early February as compared to 1.6% today. As rates rise, it is important to keep in mind that we are coming off emergency induced levels and despite their rise to 1.6% last week, they still remain at historically low levels. The movement in our benchmark 10 year Treasury rate is closer to its 1.9% pre-pandemic level, which is analogous to a GDP recovery to pre-pandemic levels, and may be indicating a return to normalcy.

Often times, rising rates is a reflection of strong economic growth being priced into the bond market more so then a prolonged period of elevated inflation due to accommodative monetary and fiscal policies. In fact, history shows us that markets can continue to post solid gains as rates rise, as long as growth expectations, as opposed to inflationary pressures, are the root cause of rate increase.[4]

HIGHER RATES ARE USUALLY BULLISH FOR STOCKS

S&P 500 Index Returns Under A Higher 10-Year Yield

Rising Rates Start Date	Rising Rates End Date	Duration (Months)	Change in 10-Year Treasury Yield	S&P 500 Gain/Loss
12/26/62	8/29/66	44.7	1.7%	18.3%
3/16/67	12/29/69	34.0	3.6%	1.3%
3/23/71	9/16/75	54.6	3.2%	-18.1%
12/30/76	9/30/81	57.8	9.0%	8.7%
5/4/83	5/30/84	13.1	3.9%	-7.9%
8/29/86	10/16/87	13.8	3.3%	11.8%
10/15/93	11/7/94	12.9	2.9%	-1.4%
1/19/96	7/8/96	5.7	1.5%	6.7%
10/5/98	1/21/00	15.8	2.6%	45.8%
6/13/03	6/28/06	37.0	2.1%	26.0%
12/30/08	4/5/10	15.4	1.9%	33.3%
7/24/12	12/31/13	17.5	1.6%	38.1%
7/8/16	10/5/18	27.3	1.9%	35.5%
3/9/20	2/25/21	11.8	1.0%	39.4%
	Average	25.8	2.9%	17.0%
	Median	16.6	2.4%	15.0%
	% Positive			78.6%

All indexes are unmanaged and cannot be invested into directly. Past Performance is no guarantee of future results.

Growth Stocks

With widespread economic growth and rising rates, the attractiveness of growth stocks is being challenged. Higher interest rates challenge the valuation of companies, with investors no longer willing to pay as much for a dollar of future earnings when growth opportunities are abundant and less expensive in other segments of the market. A significant change from growth at any price in a growth starved economy.

Now, after a decade of dominating performance, growth stocks have surrendered to value stocks amid the potential for a brighter economic future. Year to date, the Russell 1000 Value Index has climbed 10%, reflecting the strong contribution of the cyclically sensitive energy +40.1% and financial +17.5% sectors, while the Russell 1000 Growth Index has returned 0.2%.[5]

[4] LPL – Rising Rates & Stock Market Performance. Image Source: LPL Research, FactSet 3/03/21.
[5] FactSet

Inflation

With pent up consumer demand, supply chain shortages, and massive stimulus, inflationary expectations have come into focus. Over the past year, overall inflation has been muted with last month's CPI at 1.7%, well below the Federal Reserve's average 2% goal. However, by all indications inflation expectations are rising and expected to spike as year over year comparisons bring to light the disinflationary environment induced by the pandemic.

The most widely known inflation expectation yardstick is the so-called break even rate, which measures the gap between yields on Treasury Inflation Protected Securities (TIPS) and standard Treasuries. The difference is an indicator of where the market expects inflation is headed. In gauging inflation one of the most constructive time frames to look at is the 5 year TIPS/Treasury Breakeven Rate, which as of March 11 was indicating a 2.51% inflation expectation in 5 years. This rate is higher than the long term average of 1.82% and significantly higher than a year ago when the reading was .69%.[6]

While there has been an uptick in inflation expectations, what remains to be seen is whether inflation will be transitory based on the rising price of goods in certain pockets of our economy. Such areas include airlines, restaurants, and hotels which have experienced a temporary surge in demand as the economy reopens. Alternatively, inflation could steadily climb and pervade pricing as employment trends improve and wage pressures enter the equation forcing the Federal Reserve to act. With the Federal Reserve Chair Jerome Powell reaffirming the Fed's dovish stance of not thinking about raising rates and asserting that current inflationary pressures appear to be fleeting, it appears that the Federal Reserve remains aware, but not concerned with the level of inflation and plans to stay on the sidelines right now. An uptick in inflation from such low levels may be a positive extension of reaccelerating economic growth.

Our Strategic Approach

Our portfolios are designed to include elements to mitigate the impact of rising rates and inflation. By building shorter duration bond portfolios and adding diversifying fixed income asset classes like high yield and floating rate exposure, we look to lessen the negative impact of higher rates on your bond portfolio. At the portfolio level, the inclusion of TIPS (Treasury Inflation Protected Securities) real estate, precious metals, and dividend paying stocks help combat the effects of inflation on your overall assets. We continue to closely monitor each portfolio to ensure it remains in a protected and diversified position, always keeping in mind outside pressures and your long term financial goals.

For questions or more information, please contact your local IMG professional. For additional insights from IMG experts, please visit our website's Insights page and follow us on LinkedIn.

[6] Y Charts