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Complexity to Clarity

Weekly Market Insights

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Equities fall amidst confusion about inflation and interest rates

Equity Markets

Equity markets struggled this past week. The Dow was down 1.78%, the S&P 500 fell 2.45% while the NASDAQ fell 4.92%. Although markets attempted to make a recovery towards the end of the week, the markets remained in negative territory. There are a number of reasons for this; they can be taken jointly or singularly. Among the possible causes are a general rise in interest rates, along with a steepening of the yield curve,[1] a quicker and more predictable decline in the pandemic, changing equity leadership from growth to value, or the market may just be taking a break.

It is very difficult to be confident in exactly what is happening, although market followers will find plenty of firm opinions as they read newspapers or watch television. To us it seems reasonable that all of the above contribute in one way or another. As you will read in Ryan Schutte's section on economic indicators, at the moment, there do not appear to be any great fundamental changes in the economy, but it is important to remember that markets are anticipatory and the crystal ball is always cloudy.

Economics

Next week we will know a great deal more about President Biden's stimulus package. Much about the future trajectory of the economy depends on what is in it, and we will cover it carefully when the details are released. This week the National Association for Business Economics (NABE) released their March 2021 Economic Outlook Survey. In fair disclosure, I happen to be one of the members surveyed, and we spend some time explaining one important statistic that investors should know about—the yield curve.

The Survey

The panelists have grown more positive about economic growth. Last quarter, the forecast for 2021 real GDP growth was 3.4%. This quarter, it is a far more optimistic 4.8%. Panelists are asked to rate risks to their forecast, both on the upside and downside. Again, this quarter was more positive than the last—51% view the risk to the upside compared to last quarter's 37%, and less than 25% felt the downside risk was greater than in December. Most feel the growth spurt will occur in the second half of 2021.

The Yield Curve

The yield curve is an important tool that both economists and market analysts use it to judge future inflation, as well as economic and market direction. One aspect that is important to them is whether or not the yield curve is steepening. An important economic indicator is determining whether yields on longer maturity debt instruments are increasing relative to shorter maturity debt instruments, or the opposite. The most obvious benefactors of steepening are banks and other financial companies whose business it is to borrow short term and lend long term. It also encourages investors to extend the maturities in their portfolios. It helps to think with the mindset of a fixed income investor. We will exclude junk bond managers for this explanation. Fixed income portfolios are normally managed with a greater degree of caution than stock portfolios. In most periods short-term rates are lower than long-term rates, and riskier instruments have a higher yield than safer instruments. An extreme example of both maturity and credit differences is the 3-Month Treasury

[1]A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of interest rate expectations and economic activity. There are three main types of yield curve shapes: normal (upward sloping curve), inverted (downward sloping curve) and flat.

Bill, which has a much lower yield than a thirty-year junk bond. The first thing that a fixed income investor should think about is, is the economy getting stronger or weaker. The other is the calculation of risk-reward. There are three paramount risks—maturity, credit, and interest rate risks. The yield curve helps the investor analyze part of the problem—maturity risk.

Is the difference in yield of buying the longer maturity sufficient to offset the risk of rising inflation as the economy strengthens? This almost always is a judgment on the economy, so analysts pay a lot of attention to both the shape and steepness of the yield curve. The yield curve is only one of a host of tools used by analysts and portfolio managers to divine the future of the economy.

Economic Indicators

As we approach the one year mark since the pandemic began, it may be beneficial to review the path the recovery has taken. We saw economic activity plunge in March and April, followed by an encouraging bounce off of the lows as stimulus measures were enacted and partial reopenings took place throughout much of the U.S. However, as we warned at the time, month-over-month improvements from unprecedented lows were misleading, and a second wave of the virus ended hopes of a "V" shaped bounce. As 2020 came to a close, economic improvements were harder to come by, and the recovery stalled. With vaccine distributions picking up steam and another round of stimulus on the horizon, we may start to see a re-acceleration of growth and a recovery resembling that of a delayed "V".

We will again focus on indicators relating to the consumer, with February's releases showing the positive impacts from recent stimulus measures. Retail sales came in stronger than expected, increasing 5.3% in January following a 1% decline in the prior month. The gain came after another round of stimulus checks and enhanced unemployment benefits were distributed to many Americans in early January. For this reason, the retail gains can be seen as stimulus-driven rather than employment-driven. Personal income and consumption readings were boosted by stimulus measures as well, increasing 10% and 2.4%, respectively.

The employment situation continues to struggle with nearly 10 million jobs still missing from the labor market. While the unemployment rate decreased from 6.7% to 6.3% in the most recent release, the improvement came primarily from a decline in the labor force, as employers added fewer jobs than expected. Weekly unemployment claims were volatile throughout February but ended the month with the lowest reading since late November. Winter storms plagued parts of the country, disrupting businesses in those regions. While weather-related issues may cause an increase in layoffs in the short term, they could also hinder laid off workers from filing their claims and their state governments from processing them. Furthermore, recent guidance from the U.S. Department of Labor that expands the eligibility for jobless benefits may boost the already high claims numbers when they become available in late March.[2] Cleary, there is still a long road ahead when it comes to the labor market recovery, and significant improvements look hard to come by until herd immunity is achieved and full reopenings can take place.

[2]New guidance from the U.S. DOL expands eligibility to three categories of workers. 1) Workers receiving unemployment benefits who had their continued regular unemployment benefits' claims denied after they refused to work or accept an offer of work at a worksite not in compliance with coronavirus health and safety standards. 2) Workers laid off, or who have had their work hours reduced as a direct result of the pandemic. 3) School employees working without a contract or reasonable assurance of continued employment who face reduced paychecks and no assurance of continued pay when schools are closed due to coronavirus.

Weekly Market Insights (cont'd)

Employment struggles, particularly in the lower-wage segment of the population, resulted in mixed Consumer Confidence and Sentiment Index readings. The Consumer Confidence Index increased three points, with most of the gain coming from an improvement in consumers' assessment of current conditions. Expectations fell marginally, although the details of the reading appear contradictory. For example, expectations for more jobs in the next six months declined, but so did the anticipation of fewer jobs. The same phenomenon occurred for both the business and income assessments as well. Perhaps consumers are still digesting the recent positive news concerning the virus and are not yet ready to adjust their outlooks. The Michigan Sentiment Index[3] declined slightly, with the expectations component falling the most. Importantly, all of the decline came from households with less than $75,000 in annual income and were concentrated in the future economic prospects component. Those without a college degree recorded the least favorable economic prospects giving further credence to the idea that there has been an unequal impact from the pandemic on lower earners. While COVID-19 trends are improving and the pandemic appears to be abating, lower-income consumers do not anticipate a quick bounce back to prior employment levels.

With more stimulus coming, the question remains—is there enough aid going to the areas of the economy that need it most? While retail sales, income, and consumption seem to have support in the short term, lackluster employment and confidence readings suggest that lower income households and many service sector businesses require additional support.

[3]The Michigan Consumer Sentiment Index (MCSI) is a monthly survey of how consumers feel about the economy, personal finances, business conditions and buying conditions.

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