Weekly Market Insights

March 8, 2021

Recovery intact, volatile markets and has the three-decade era of low interest rates come to an end?

Equity markets were quite volatile this past week for a number of reasons, some of which appear to be counterintuitive. The Dow closed up 1.82%, the S&P 500 up 0.81% and the NASDAQ down 2.06%. The major reason for the volatility was the fear that the U.S. economy was recovering faster than anticipated which would accelerate any rise in interest rates. This fear was, according to most sources, related to a presentation made by Jerome Powell, the Chairman of the Federal Reserve. His speech was interpreted as saying that the economy was accelerating faster than expected and interest rates would rise. The equity market's knee-jerk response was to sell off severely. Powell did say that, but he, in the same breath, made the caveat that this would be "temporary!" He also said that after a quick burst, growth would slow to its pre-pandemic level and the Fed had no plans to hike interest rates.

Interestingly, there appears to be a continuation of the rotation out of growth stocks into those that will benefit from a faster pace of economic growth. Is this a major change or just temporary? No one really knows but it is important to follow nonetheless.

The Economy

The economy appears to be on the road to recovery. If there seems to be a bit of concern in that statement, it is because economic modelling is uncertain, and, alas, change is constant. Today we cover two items—a report of the forecasting committee of the National Association for Business Economics (NABE), and the question of whether the long period of low interest rates has come to an end.

The forecast by the committee is quite positive. The committee believes economic growth will accelerate and inflation will move up but stay well within the Fed's acceptable range. The forecast only goes out to 2022, which makes abundant sense because anything longer than that, in our opinion at least, is more of a guess than a forecast.

The forecast for GDP growth is quite positive— an increase to 4.8% in 2021 and decreasing slightly to 4.0% in 2022. The panel is less optimistic about the job market than GDP. Most believe employment will not return to pre-COVID levels until 2023. The unemployment rate should average 5.8% through 2021 and 4.7% in 2022. This will be an important factor in our next section. The two-year Treasury yield is expected to rise to 1.45% by year-end 2021 and 1.8% by year-end 2022. The Fed Funds Rate should remain unchanged with an upper limit of 0.25% at year-end 2021. There is, of course, a lot more in the forecast than we have room for in this report. If readers have specific questions, don't hesitate to write.

We now have the most important of questions. Has the decades-old bull market in interest rates come to an end? As Professor James Stock of Harvard points out, "this phenomenon has been going on for decades, so it cannot be attributed to a single business cycle or to monetary policy." Not only is this question very important but it is very interesting.

Weekly Market Insights (cont'd)

In order to come to a sensible conclusion we have to look at inflation. Historically, economists have considered two variables—money supply and demand. They focus on money supply because, as our friend Milton Friedman tells us, "Inflation is always and everywhere a monetary phenomenon." But even he would argue that demand has an important part to play. We think there are two related and important points to consider—the enormous impact of technology and the rapid expansion of globalization.

We concede that it is evident there is an excess of liquidity (money) in the system, so the question revolves around demand. We will make the argument that there is insufficient demand in the foreseeable future to create enough pressure to move interest rates much higher for at least 18 to 24 months.

First, there is the aging of the work forces in most of the industrialized world. It is generally accepted that as workers get older their propensity to save increases. They save for retirement and pay off debts accumulated during their younger years. This lowers demand and increases savings. The rapid economic growth in Asia, particularly in China, contributes significantly to savings that is most often directed to the West, which of course keeps interest rates down. The late 20th and early 21st century expansion of globalization, which has kept prices low.

Asia not only has a high propensity to save, but has added millions of motivated workers to the global system at very low wage rates. Finally, new technology and the growing substitution of capital for labor in economically developed countries lowers the cost of production.

There is a strong case that inflation will continue to be low for some time to come. For most of economic history, high levels of liquidity and excessive government spending would produce high inflation and interest rates. So, here is history's most dangerous phrase, "this time it is different." Perhaps there are plenty of smart analysts who may and will argue the opposite, but, given our arguments above, it does not appear that a high inflationary period is in the immediate future.

Conclusion

For the United States to fully participate in future global growth, what is paramount is a highly educated work force, an atmosphere conducive to technological investment and advancement, along with a strong commitment to infrastructure.

Equities do not appear to be in any immediate danger, although volatility is likely. A change in equity leadership may be occurring. Investors should not take extraordinary steps, such as dramatically changing their asset allocation.

P.S. There is more to the economic NABE forecasting report, and if readers have particular questions please email us.

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