AndCo's Monthly Market Update

March 2021

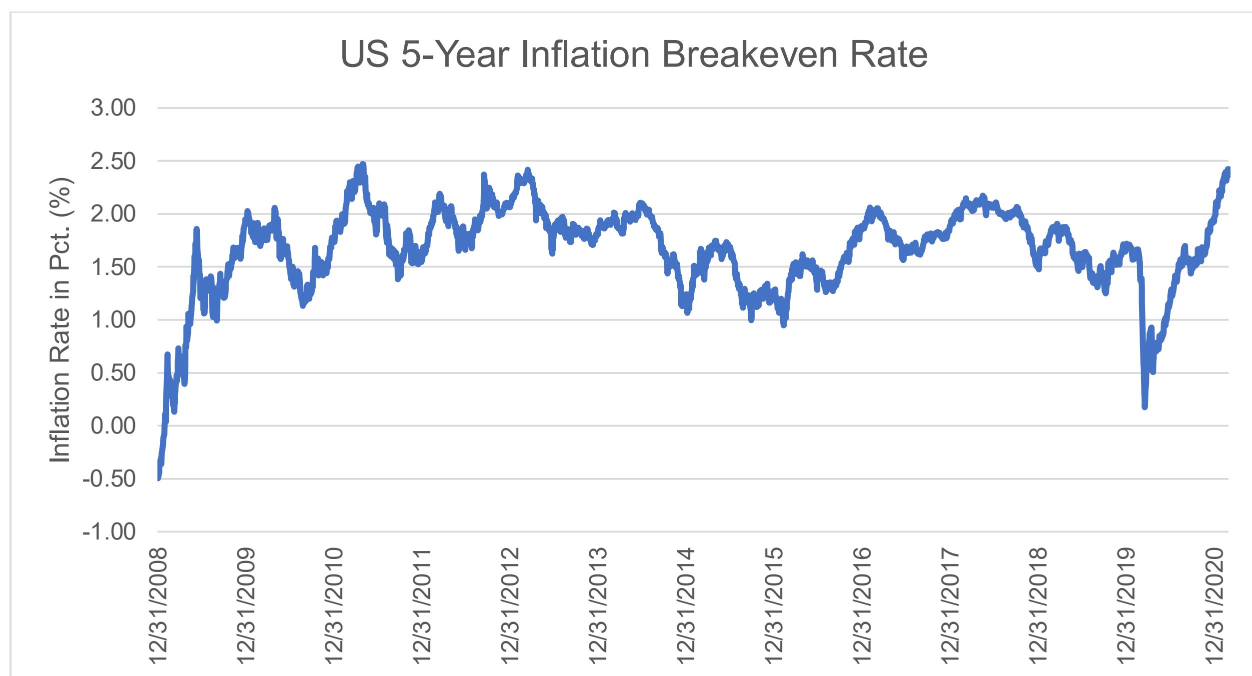
THE ECONOMY

"The Times They Are -A-Changin'" – Bob Dylan, 1963

Nearly 60 years after Bob Dylan wrote "The Times They Are-A-Changin'", the song resonates with new meaning today. In previous updates, we outlined how the economy has continued to heal from the pandemic in recent months despite the lingering restrictive measures designed to mitigate the spread of COVID-19. While much remains to be done as we carry on with recovery, in recent weeks we have begun to see signs that the narrative surrounding the economy is changing. Several states have started to ease or remove their restrictions and provide guidance on how businesses can begin the process of reopening. While it is too soon to assess the impact, it is reasonable to expect that the near-term effect could be a significant positive catalyst as pent-up consumer demand is unleashed on the economy. Despite our positive outlook, we acknowledge that numerous challenges and risks remain. However, the tone of the conversation amongst Wall Street pundits has shifted from worry over a prolonged extension of the current recession to worry over the potential for the economy to overheat in the coming months. In thinking about all that has transpired over the past year, Dylan's lyrics about the passage of time and the constant of change has never been more appropriate.

On balance, most economic indicators we follow remained positive during the month of February. Indicators such as unemployment, consumer confidence, housing, and business activity all made gains during the period. US unemployment improved in January with the rate dropping to 6.3%, down from 6.7% in December.[1] Not surprisingly, with Americans beginning to head back to work, US consumer confidence increased to 91.3 in February, up from 89.3 in January.[2] The improvement in the labor market is due in no small part to the rollout of vaccines which provided the catalyst to begin easing restrictions.

In contrast, the US housing market came under pressure in February as rising interest rates resulted in higher mortgage borrowing costs and fewer mortgage applications.[3] However, despite rising mortgage rates, new home sales increased 4.3% during the month as buyers continued to their migration from urban centers to the suburbs.[4] Broad housing prices have continued to show strong gains with the S&P CoreLogic Case-Shiller Index jumping 10.1% for the full year ending in December 2020.[5] As a result, housing prices surged at their fastest pace year-over-year since 2014.[6] Finally, business activity has continued to show signs of improvement with both durable goods orders and industrial production increasing 3.4% and 0.9% in January, respectively.[7]In recent updates we have focused on inflation and the potential headwind it can create for clients' portfolios. Despite the continued improvement in the broad economic environment, the US Congress recently passed a $1.9 trillion stimulus bill to provide direct consumer and business support. As part of the package, eligible Americans will receive up to an additional $1,400 along with the extension of jobless benefits. While this new round of stimulus should go a long way toward easing some of the financial distress felt by those most affected by the pandemic, it also has the potential to act like a "shot of steroids" to an economy already pumped up by various programs (e.g., previous stimulus and quantitative easing) implemented since the pandemic began. As seen in the chart below, the market's inflation expectations have increased dramatically since the initial shock of the pandemic and are at their highest level since 2010.

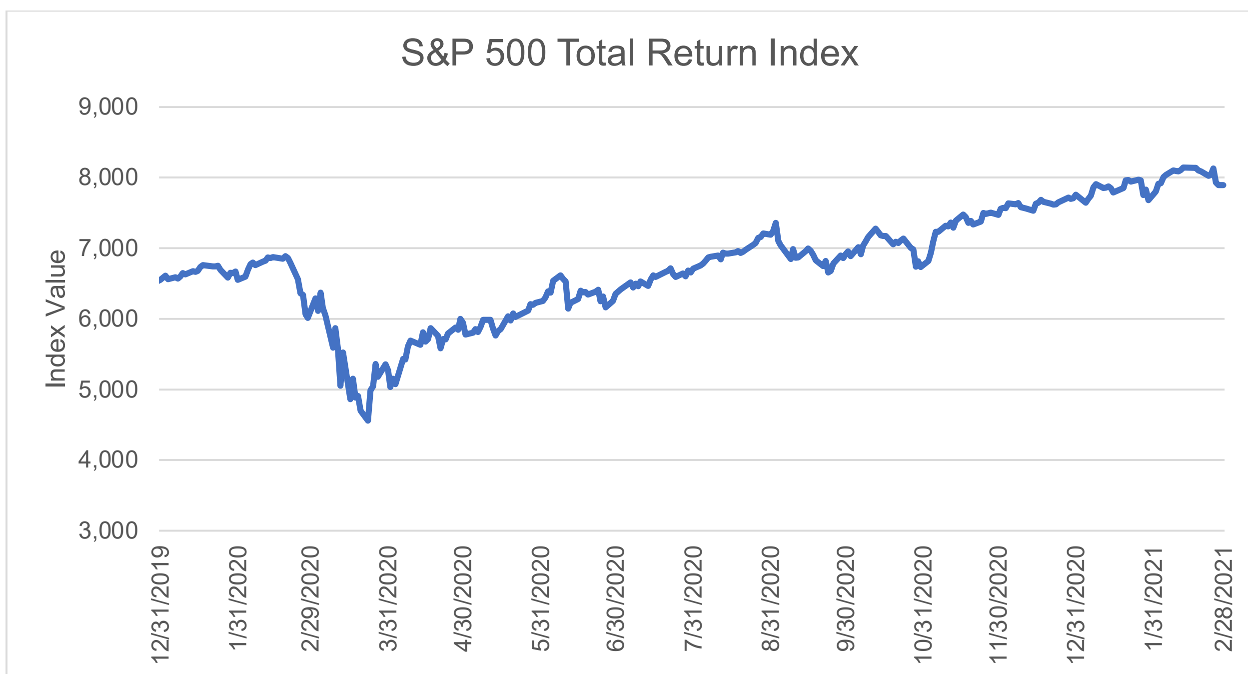


Source: Bloomberg as of February 28, 2021

Recently, the Federal Reserve (the Fed) Chairman Jerome Powell characterized inflation as being "soft" and remained committed to maintaining easy monetary policy due to the unemployment rate remaining relatively high.[8] Historically, rising inflation acts as a headwind for bonds as interest rates must increase to compensate investors for the added risk. Additionally, rising inflation has not always been kind to stock valuations as a rising risk-free rate can result in lower P/E multiples and stock prices. While it is too soon to tell if the combination of the latest stimulus package and an improving US economy results in higher inflation, the risk, from our perspective, is that the Fed allows inflation to run at a faster pace for too long. This could result in a swift change of monetary policy if inflation spikes beyond expectations. Such a change most likely would result in much higher US interest rates in the future.

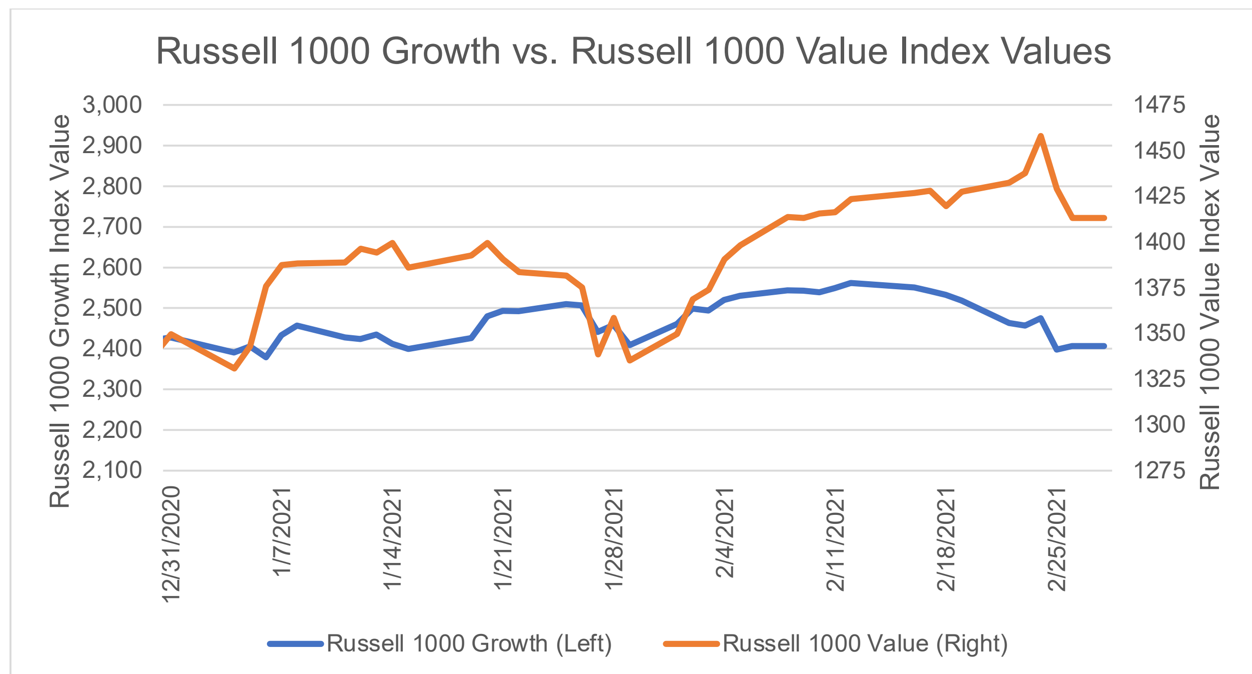
EQUITIE

US stocks rose broadly across most market capitalizations and styles during the month of February. Smaller company stocks continued their outperformance relative to large company stocks while value-oriented companies outperformed growth-related companies. For the month, the large company S&P 500 Index rose 2.76% compared to 6.23% for the small company Russell 2000 Index.[9] The lone index with a negative absolute return during the month was the tech-heavy Russell 1000 Growth Index which returned -0.02%.[10]

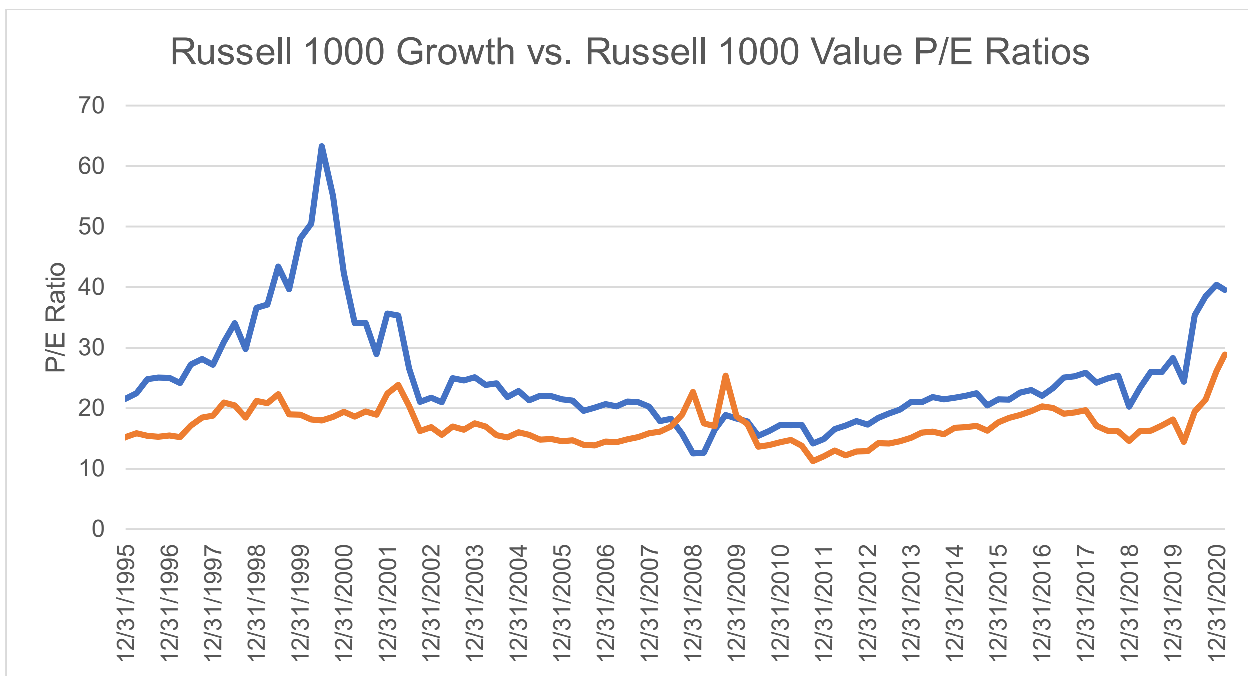


Source: Bloomberg as of February 28, 2021

The story in the stock market since the beginning of the year has been the relative outperformance of value stocks compared to growth stocks. Looking at the chart below, the Russell 1000 Value Index has outperformed the Russell 1000 Growth Index by roughly 5.8% year to date.[11] While the recent relative outperformance of value stocks is notable, over the trailing 10-year period, the Russell 1000 Growth Index (16.45%) has outpaced the Russell 1000 Value Index (10.40%) by more than 6%.[12] That said, growth stock valuations are at their highest level since the Dot-com crash in 2000.[13] While we have observed some retracement since the beginning of the year, the dispersion between growth and value stocks remains. Given the changes we have experienced since the pandemic such as work-from-home, it is reasonable to expect that technology-related companies will continue to perform. However, from a purely valuation perspective, value stocks may offer a higher upside potential as the economy recovers and leadership in the market becomes more dispersed.



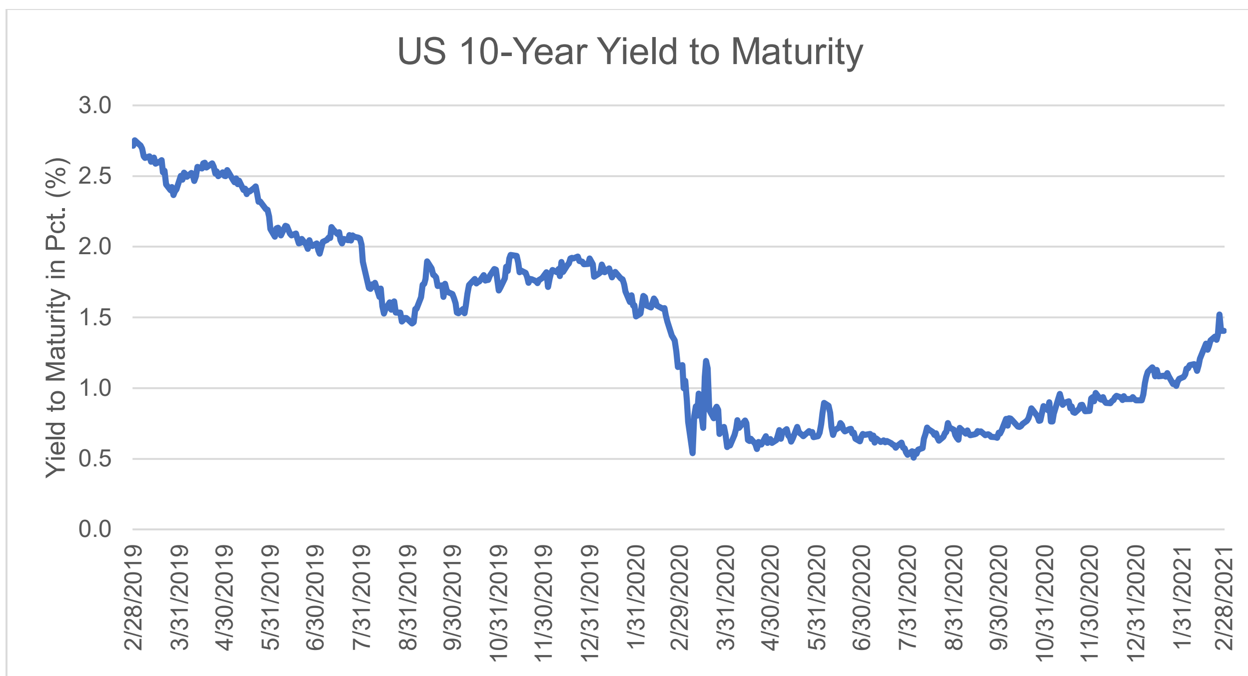
Source: Bloomberg as of February 28, 2021



Source: Bloomberg as of March 10, 2021

FIXED INCOME

The recent trend of disappointing returns in fixed income markets continued in February primarily due to the continued rise in US interest rates. For the month, the Bloomberg Barclays US Aggregate Bond Index returned -1.44%.[14] Shorter duration corporate credit outperformed with theBloomberg Barclays US Corporate High Yield Index returning 0.37%.[15] As seen in the chart below,the yield to maturity on the US Treasury 10-Year bond increased by roughly 32 basis points duringthe month. US interest rates have been steadily increasing since their low last August inanticipation of the rollout of vaccines and the reopening of the economy. However, the rate ofincrease accelerated in February as the Fed stated its intention to keep monetary policy looseand the anticipated passing of additional fiscal stimulus. Investors rightly are expecting inflationto accelerate later in the year as Americans return to work and begin to spend again. As a result,bond investors are requiring higher yields to cushion the inflationary pressures which can eat intoreturns.



Source: Bloomberg as of February 28th, 2021

From a credit perspective, there does not appear to be anything on the short-term horizon that gives us pause. With liquidity flowing into the market, companies will have ample access to refinance their debt, albeit at slightly elevated levels. With consumers expected to increase consumption later in the year, corporate profitability should improve resulting in a continued low default environment. Importantly, sectors that have experienced significant pain in recent quarters such as energy and industrials, both historically large borrowers in the credit markets, should see improved conditions which are supportive of their respective businesses. However, the risk for fixed income markets are to the downside in our opinion as US interest rates continue to rise. In this developing scenario, shorter duration strategies such as bank loans should continue to offer investors opportunities to both hedge against higher interest rates along with the potential to add value relative to higher quality, longer duration core bond strategies.

APPENDIX

1. Bloomberg, February 2021
2. Bloomberg, February 2021
3. Bloomberg, February 2021
4. Bloomberg, February 2021
5. Bloomberg, February 2021
6. Bloomberg, February 2021
7. Bloomberg, February 2021
8. https://www.cnbc.com/2021/02/23/powell-says-inflation-is-still-soft-and-the-fed-is-committed-to-current-policy-stance.html
9. Morningstar, February 2021
10. Morningstar, February 2021
11. Morningstar, February 2021
12. Morningstar, February 2021
13. Bloomberg, March 2021
14. Bloomberg, February 2021
15. Bloomberg, February 2021

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