

ECONOMIC OUTLOOK

Summary

Coming out of one of the most drastic, yet shortest recessions on record, a consensus expectation has been for above-trend GDP growth in 2021. We can now add the Federal Reserve to the list of prognosticators upping the ante for GDP expectations. During their mid-March meeting, they revised their full-year growth estimates from 4.2% to an astounding 6.5%. Of course, it's not too hard to imagine a surging economy as vaccinations become more commonplace and certain sectors begin re-opening. In addition, a vast number of stimulus payments have been direct-deposited or mailed to an estimated 85% of American households. With that being said, do the recent economic data releases support this optimism?

Though the net impact from the vaccines and stimulus payments haven't quite made their way into the data yet, there are certainly positive signs. For example, U.S. consumer confidence rose to a one-year high in March (109.7), indicating that many people are optimistic about the economy and labor market. It's likely not a coincidence that during the same month the government provided \$1,400-per-person payments, this economic data point had its largest one-month increase in roughly 18 years. It exceeded even the highest estimates from economists and is a sign that spending will likely pick up during the next few months.

Also, the ISM Services PMI rocketed higher with a reading of 63.7, its highest level since the index was created in 1997. This is a diffusion index, so a reading above 50 represents expansion, while a reading below 50 indicates contraction. It's now had 10 consecutive readings in expansionary territory, which is especially noteworthy considering the U.S. economy is roughly 70% services versus 30% goods. Goods and manufacturing have been leading the way throughout the recovery but once services can pick up where they left off pre-pandemic, it should provide another economic jolt.

Lastly, the February jobs data came in very strong. Payrolls increased by 916,000, beating expectations by more than 250,000 jobs. While the headline data was strong, the underlying data did not disappoint. Job growth in leisure and hospitality increased by 280,000 and education employment climbed nearly 125,000. The underemployment rate declined by 0.4%, and the labor force participation rate increased by 0.1% (which is a positive, though it's still well below pre-pandemic levels). This all caused the unemployment rate to decrease by 0.2% to 6.0%.

Vaccines and stimulus have put the economy on a path to success, and while it's just starting to show up in the data, the party is likely just getting started.

Positives

Continuing unemployment claims have decreased for 12 consecutive weeks

ISM Manufacturing (64.7) and Services (63.7) PMI's remain very elevated

The GDPNow (Atlanta Fed) first quarter GDP estimate is currently 6.0%

Negatives

The labor force participation rate remains roughly 2% below pre-pandemic levels

Severe winter weather in Feb slowed parts of the economy (construction, home sales, etc.)

Likely temporary, personal income (-7.1%) and spending (-1.0%) fell during February

EQUITY OUTLOOK

Summary

Domestic markets continued their recent strength in March capping off a very upbeat quarter to start 2021. The S&P 500 rallied 4.4% for the month bringing the index's performance for the quarter to 6.2%. Robust economic data in addition to growing optimism regarding the pandemic have been two of the catalysts for the market's rally.

Value stocks once again outperformed their growth peers in March extending the relative outperformance to levels not seen since 2001. The Russell 1000 Value Index, fueled specifically by companies expected to perform well in a fully reopened economy, climbed 5.9%. The Russell 1000 Growth Index, by comparison, rose just 1.7%. The incredible rally in middle and small-sized U.S. equities cooled a bit in March with their representative Russell Mid Cap Index and Russell 2000 Index returning 2.7% and 1.0% respectively.

Throughout the quarter, worries that rapidly rising interest rates and potential for inflation caused some near-term profit taking in equity markets. However, those concerns seem to be fading in recent days. The focus now is clearly on the strengthening economy, the bullish corporate earnings outlook, the COVID-19 vaccination pace and post-pandemic life. Each of these items, in general, are trending in a positive direction.

Occasional concerns regarding equity market valuations, rising bond yields or pandemic setbacks will continue to cause volatility and temporary market declines. However, the overall environment today for long-term equity investors appears constructive.

Positives

Accommodative Federal Reserve and global central bank policy

Herd immunity goal for U.S. by the summer

Lack of return competition from other major asset classes

Negatives

Stock valuations, by some traditional measures, look relatively stretched

COVID-19 variants could cause a setback

Unknowns

Fed reaction to inflation forces and low unemployment

FIXED INCOME OUTLOOK

Summary

The March increase in the 10-year Treasury note yield proved to be just as powerful as the February move with the rate rising by 34 basis points (bps) to 1.74%. Meanwhile the 2-year Treasury note has traded in an 8 bps low-high range since August and ended March at 0.16%, up 4 bps since the start of the year. The spread between the 2-year and 10-year Treasury note yields has increased to 1.58%, a level last seen about four years ago when the Fed was about to embark on a series of rate hikes that would take the overnight Fed Funds rate up to 2.5%.

By pushing longer maturity bond yields higher, the market is signifying that the Fed will be forced to begin a series of rate increases to combat a rapidly expanding economy that will lead to unwanted inflationary pressures. Investors are challenging the Fed's forecast that no change in the overnight rate will occur before the end of 2023. In an effort to preempt these concerns, at the Fed's March Federal Open Market Committee meeting they acknowledged the pending boom in economic activity by significantly increasing their forecast for GDP growth for 2021 from 4.2% to 6.5%. They also revised lower their expectations for unemployment and increased their forecast for inflation. Their consensus forecast is that the overnight rate will remain in the 0.00% to 0.25% range through the end of 2023.

For longer maturity yields to rise further, or even hold the current levels, we believe the Fed must begin a series of rate increases by the spring or summer of 2022. In 12 months to 15 months, the unemployment rate could fall into the 3.5% to 4% range, but that alone will be of little concern to the Fed as they have stated that they will no longer consider a low unemployment rate to be a condition that will necessarily indicate an overheating economy that requires a more restrictive policy. So that leaves us looking toward the actual inflation rate for policy guidance. Again, it is possible, and even likely that inflation, as measured by the core PCE, will be above the Fed's stated objective of 2%. But again, this will raise few alarms at the Fed since they have stated that their new policy

is to allow inflation to run above the target for a period of time to make up for periods when inflation was below that target.

We are siding with the Fed on this one and see little evidence that the pending inflationary increases will be little more than a statistical blip that will prove to be neither embedded nor persistent. While no one knows to what exact level this move higher will bring, we consider a move closer to 2% to be a tremendous buying opportunity.

Positives

A steep yield curve makes longer maturity bonds more attractive

U.S. yields are more attractive to foreign investors

Quarterly rebalancing will fund bond purchase

Negatives

Inflationary concerns and the fear of a Fed reversal

Incremental Treasury market borrowing for years

Unknowns

Ability of vaccines to combat variants around the world
