Market Perspective
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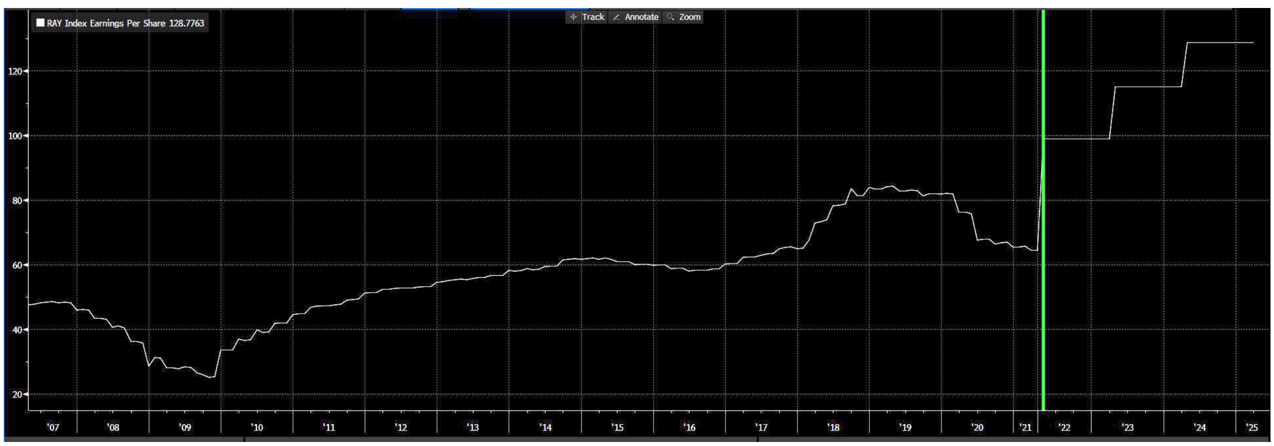
In the last several quarters, I have written about the valuation of risky assets and the apparent speculative behavior of investors. I have little to add on that front, as the liquidity-driven market seems to have limited interest in responding to metrics that have had historical meaning. The one item of note on this front, as we enter the second quarter of 2021, is the newfound optimism of analysts regarding future corporate earnings.

The graph below shows the aggregate earnings per share of the Russell 3000. To the left of the bright green line are historical results since 2007. The COVID-19 induced earnings decline is evident in 2020. Of note, though, is the consensus bottom-up expectation for earnings beginning in 2021 and the ratcheting up of those expectations through 2025. If these estimates come to fruition, today’s elevated valuation will not look so out-of-line three or four years from now. For the time being, it appears that this dynamic is supporting valuations. I will leave it to the reader to decide whether the expectation for future earnings is credible considering past results, and whether today’s valuations should reflect them.



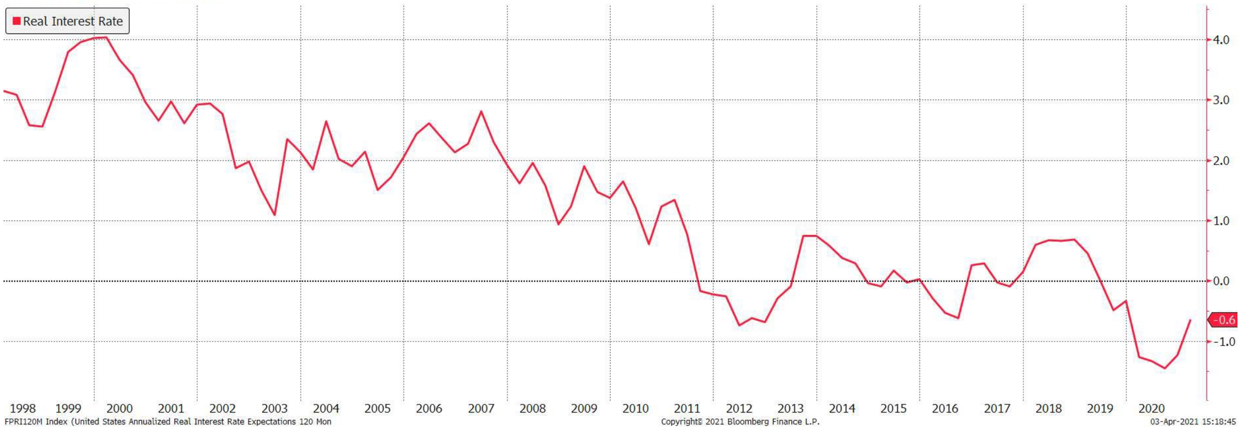
The topic I would like to focus on this quarter is the current environment for inflation and interest rates. Inflation is a very distant memory for most of us. Consider the graph below, which tracks the Federal Reserve’s preferred method of measuring inflation – the Personal Consumption Expenditure Index.

It has been a long time since we have seen this measure meaningfully above 2%. Indeed, the increase for 2020 came in at 1.4%. The Federal Reserve has told us unconditionally that it wants inflation to average 2% over time and that it will tolerate an above 2% level to get the average up from its current reading. The Fed's own forecast for this measure in 2021 is 2.2%.

I would like to pose a few questions that I think are worthy of consideration as we consider our current investment strategy.

1. If the Fed is successful in getting inflation to average 2%, what will be the level of short and long- term interest rates in the market? Currently, the two-year Treasury yields 0.2%, while the ten- year Treasury yields 1.7%. Both levels imply negative real interest rates (i.e., Nominal Interest Rates – Inflation Expectations). This phenomenon has only been with us for the last decade. Consider the following graph.

Real Interest Rates

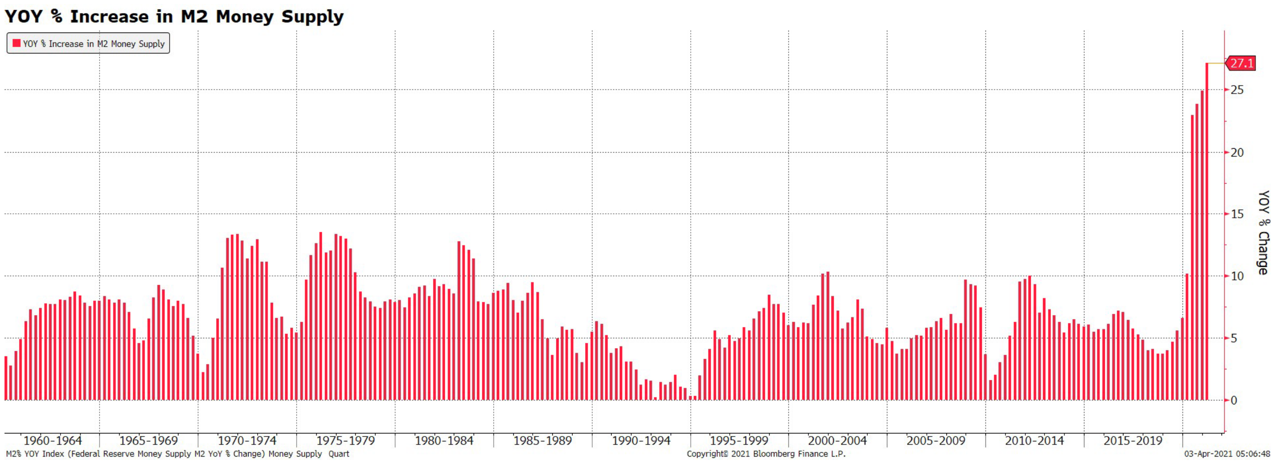


If inflation increases at the same time as real rates return to a positive level, what is the implication for nominal rates?

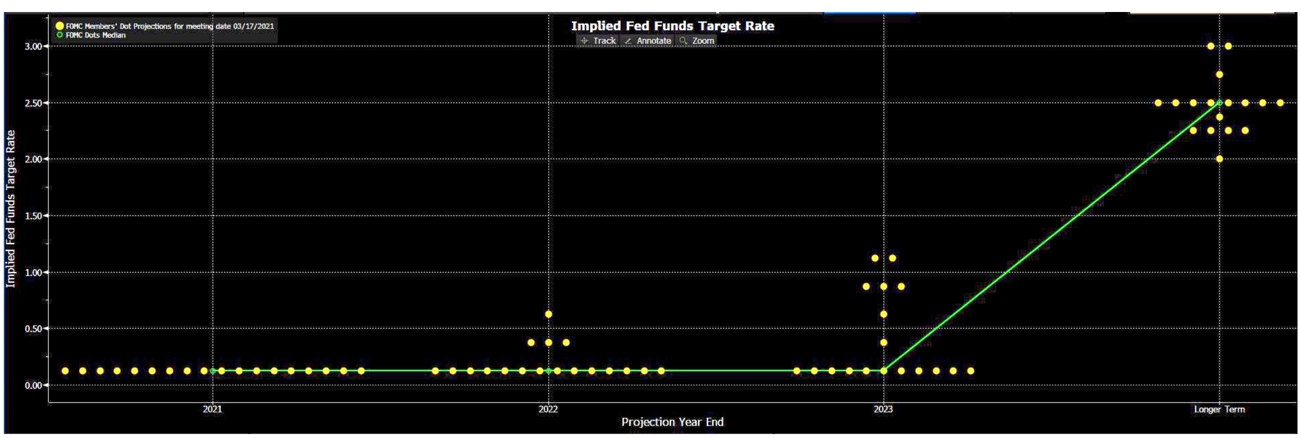
2. Is the US economy already healing to a degree that the monetary and fiscal stimulus being applied will cause prices to increase, rather than stimulating the real economy? Consider the Capacity Utilization of our economy. Clearly, during the COVID-19 downturn, this measure suffered. But where is it headed in the future?

Capacity Utilization

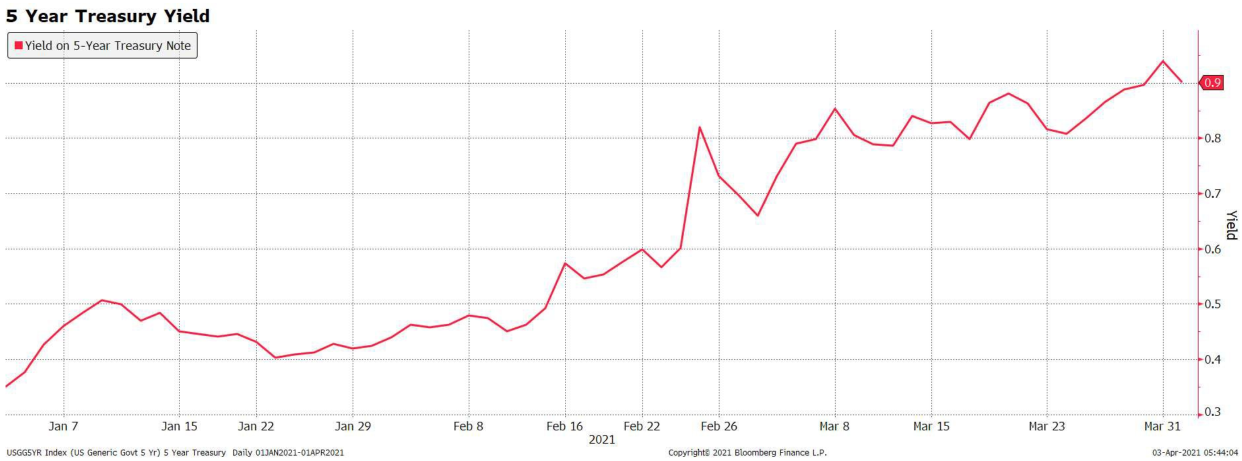
3. Will the Fed be successful at containing inflation to a 2% average? The current thinking of both Chair Powell and Secretary Yellen is that the unprecedented Money Supply growth (see below), coronavirus-related fiscal stimulus and future deficit spending will only create a “transitory” increase in inflation. This experiment has no precedent, so we do not yet know the outcome.



4. How will the prices of risky assets react if the risk-free rate increases from its near-zero level? Much of the thesis for the current high valuation of equities rests on the low discount rate that has resulted from the Fed’s holding of short-term rates near zero. Will the market incorporate a higher discount rate into valuation, or will valuation continue to be a non-issue with respect to the pricing of risky assets?
5. How long will the Fed be able to keep its commitment to short-term interest rates being “lower for longer”? Here is what the Fed is telling us. Each yellow dot represents the expectation of a Fed governor for where the Federal Funds rate will be at a point in time. The green dots are the median expectations of all governors.



But here is what the market is telling us, at least as the five-year Treasury yield indicates.



6. As bond yields increase, does the appeal of TINA ("There Is No Alternative" to stocks) decrease? We have had a milestone last month, as the 10-Year Treasury Yield now exceeds the Dividend Yield on the S&P 500.

I have intentionally posed these issues as questions since none of us can know with certainty what the future course of inflation and interest rates will be. What seems clear from the data, however, is that the risk of higher inflation causing a rise in interest rates is higher now than it has been for some time. Considering how to address this risk would appear to be a prudent move for all investors.