Retirement Income Solutions

Helping to grow and preserve your wealth

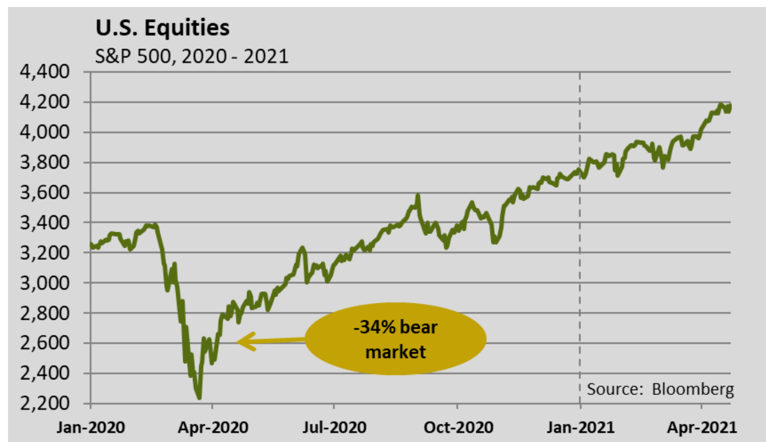
An Ongoing Recovery

April 2021

Summary

One year ago, financial markets were in turmoil over uncertainty created by the COVID-19 virus. Fears of a deep recession – and even depression – were commonplace. Data on the virus was quite limited, and unemployment spiked to 15%. Determining appropriate actions for individuals, government, and investors was unclear.

Twelve months later, financial markets have recovered, and the economy appears to be on track. Some aspects of the economy are still struggling, but the stock market has hit new highs, unemployment has fallen to 6%, and 140 million people in the U.S. have received at least one dose of a COVID-19 vaccine.



Since the pandemic began, investors felt a roller coaster of emotions. First came anxiety over the health and financial risks posed by the virus. Second was relief that the panic in markets and the grocery store had subsided. Third was disbelief that the stock market could continue its recovery. And finally came reluctant acceptance that continued risk from the virus could co-exist with a strong stock market.

The U.S. stock market has been steady so far this year; looking forward, several factors will be important:

- While over 40% of the U.S. population have received at least one dose of a COVID-19 vaccine, only 7% of the entire world has received one dose. The U.S. economy is regaining momentum, but the strength of the rest of the world is uncertain.
- The second year of a bull market is characterized by bigger swings and positive but lower returns. Historically, the median intra-year drawdown is -14.8%, and median stock returns are 7.2%.
- The Fed continues to affirm that accommodative conditions (low interest rates) will be present for a period measured in years, not months.
- ISM data on manufacturing and services hit record levels, and such indicators are typically followed by solid economic growth and stock market returns.
- While technology and growth stocks led markets in 2020, value stocks have made-up ground in 2021 and are poised to continue that trend.
- Investment grade bonds realized negative returns in the first quarter of the year, losing -3.4%.

Summary of Current Positioning

The massive fiscal and monetary stimulus creates a very friendly environment for the economy; however, this environment is uncharted territory. BCA Research summarized the challenge succinctly, “The U.S. has never before injected 25% of a year’s output into the economy across just two years. There is no way, then, to use past history to build a model regressing consumption growth against fiscal stimulus or a sudden surge in household savings driven by sweeping temporary constraints on activity.”

While history can often be a guide to patterns and outcomes, each business cycle is unique. With a strong fiscal and monetary backdrop, consumer confidence has grown substantially, and such extreme optimism may have left the stock market vulnerable to a pullback over the summer. It has been over a year since the stock market saw a -10% drawdown and almost 6 months since the last -5% pullback.

S&P 500: Mean Market Days Without Corrections
1928-2021

	5%	10%	20%
Secular Bulls	84	331	1105
Secular Bears	31	91	486
All periods	51	172	716
Current Case	115	270	270

Source: Ned Davis Research

There are a few known issues that could threaten financial markets, but the most destabilizing events tend to be unforeseen. Some of the potential roadblocks to the ongoing recovery include:

- A resurgence of the COVID-19 virus or another vaccine-resistant variant.
- The proposed tax legislation on corporations could be a drag on markets since lower after-tax profits have a direct impact on valuations. However, given the strong correlation between equity returns and economic growth, the equity bull market will likely survive a tax increase.
- There is some concern over rising inflation, particularly given the increasing federal debt and deficits. This could be a factor that is destabilizing in a few years, but it is unlikely to be a burden in the short run. The Fed is seeking higher inflation. There have been concerns about inflation for the past 10 years and the highest inflation reading over that period was 2.1%. The Fed’s target is 2%, and 107 of the 120 readings since 2011 were below target.

Consequently, client portfolio equity allocations were recently reduced, but remain sizeable. Generally, portfolios are positioned halfway between their Maximum and Neutral equity targets; therefore, accounts are still overweight to equities, just a modest reduction from the Maximum equity allocation. Two days after the presidential election, portfolios were moved to their Maximum equity position as markets tend to rally around new leadership optimism. This stock overweight was a positive contributor over the last six months, as David Kelly of J.P. Morgan recently noted, “President Biden’s first 100 days have already delivered the strongest post-election equity returns in at least 75 years.”

With a strong policy backdrop, absent a major resurgence of the virus, a recession and major stock market drawdown is unlikely. However, markets are likely overdue for a pullback, and the presidential cycle indicates potential weakness in the back half of the year.

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What to Expect in Year Two

After one of the swiftest stock market declines in history, financial markets recovered steadily through the year and into 2021. The last twelve months saw extremes in unemployment, consumer confidence, fiscal stimulus, monetary stimulus, and economic growth.

The second year of a bull market is typically characterized by continued improvements in unemployment, strong corporate profit growth, and rising interest rates. The stock market is typically positive, but with greater swings as investors recalibrate expectations for the future. The strongest stock market returns typically occur in year one, when markets recover from recessionary losses. According to Ned Davis Research, year two is weaker than year one 88% of the time. The median stock market gain is 5.6%, and the median intra-year drawdown is -11.6%.

Year Two of Bull Market	All periods	Post Recession	Non Recession
U.S. stock returns (median)	5.6%	7.2%	4.8%
Maximum stock drawdown (median)	-11.6%	-14.8%	-11.2%
S&P 500 earnings growth (median)	16.2%	19.1%	14.4%

Source: Ned Davis Research

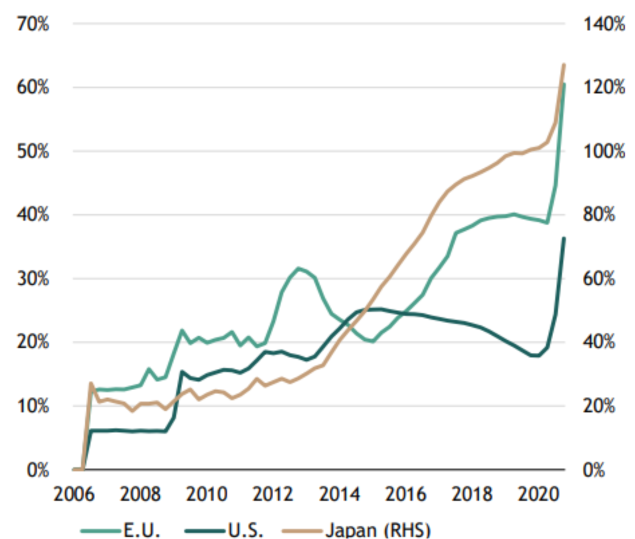
Every cycle is unique, and a few important factors stand out in assessing the ongoing recovery. In post recessionary periods, stocks tend to have a slightly stronger recovery (7.2%) in year two; however, such periods also tend to see much larger drawdowns (-14.8%) as investors assess the strength of the recovery. In addition, markets moved swiftly in 2020. The strong recovery over the last twelve months may have pulled in future gains from year two, lessening the potential for continued stock gains in 2021.

Friendly Central Banks

In 2020, the Fed cut short-term interest rates dramatically and purchased over $3 trillion of securities (up over 80% from 2019). So far, easy monetary policy has helped stabilize financial markets. An important question is, "how long will that easy policy last?"

While the Fed can change course at any time, recent communications about monetary policy have been consistent – accommodative conditions will be present for a period measured in years, not months. In February, Fed Chair Jermone Powell stressed the central bank's plan keep interest rates low until the economy reaches full employment and inflation rises to 2%. Importantly, the chairman noted an extended timeframe for such accommodative policy, "We are just being honest about the challenge… we believe we can do it, we believe we will do it. It may take more than three years."

In addition to the U.S. Fed pegging short-term interest rates at zero, central banks around the world present a unified front to help keep long-term rates low by buying bond securities (see chart, right).



Source: Blackstone, Haver Analytics

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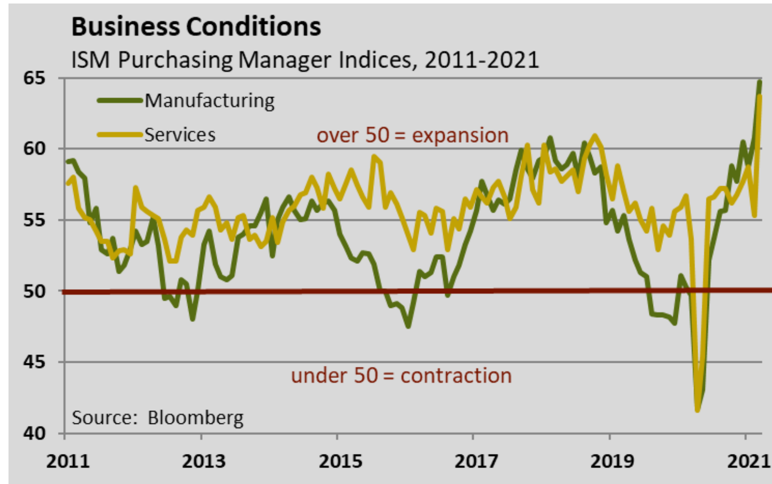
Business Conditions are Strong

The ISM Report on Business publishes data from purchasing and supply executives that is seen as a barometer on the overall economy. The ISM surveys are split into manufacturing and services sectors, and both indicators are at record highs, indicating strong, positive momentum for the economy.



Analysis by Ned Davis Research indicates that economic growth is strongest when the Services component of ISM is above 55. Such survey strength historically generated 3.3% GDP growth annually. Corporate profits also have a strong correlation with the Manufacturing index. In conjunction, when the average of the Manufacturing and Services components is above 54, stock market gains are the strongest. Such survey strength historically generated 11.5% returns annually. While the level of the index has been correlated with solid stock returns, the data are not all positive. Stock market performance tended to do best when the combined index is increasing, which will be difficult to continue given both surveys hit the highest reading in over 20 years.

ISM Services	GDP growth	% of time
Above 55.4	3.3%	50%
Between 50.2 and 55.4	1.1%	38%
50.2 and Below	-0.1%	12%

ISM Average Manufacturing + Services	S&P 500 annual gains	% of time
Above 54	11.5%	52%
Between 51 and 54	4.2%	30%
Below 51	-5.2%	18%

Source: Ned Davis Research

Asset Class Returns

Many stock investments had a strong start to the year. Through March 31st, the S&P 500 saw a 6.1% return, and the index tacked on an additional 5.3% in the first few weeks of April. International stocks were also positive, up 3.5% through March 31; the last few weeks have been positive as well, adding 3.6% in April alone. While the S&P 500 and technology indices garnered most of the headlines over the past year, two other trends are notable to start the year – the performance of growth versus value stocks and negative bond returns.

For most of 2020, technology stocks generated the positive momentum for the U.S. stock market. While many companies struggled during the recession, numerous technology company business models benefited from the pandemic – more home deliveries for Amazon, more Netflix for teenagers, and more computing equipment needed for those working from home.

Growth versus Value

	Q1'20	Q2'20	Q3'20	Q4'20	Q1'21
Growth	-14.1%	27.8%	13.2%	11.4%	0.9%
Value	-26.7%	14.3%	5.6%	16.3%	11.2%

Source: Bloomberg

Those technology stocks make up a large portion of the growth component of the stock market. Traditionally, U.S. stocks were broken into growth or value sectors. For the past several years, growth stocks have steadily outpaced those classified as value. Over that same multi-year period, client allocations were weighted with a bias towards growth. In the fall of 2020, allocations to growth sectors were reduced, and they have been reduced again in the spring of 2021.

While the headline S&P 500 continues to be strong, there are some important changes going on inside of the index. After a long period of growth outperformance, value stocks have seen stronger returns over the past two quarters (almost 5% better in Q4 and 9% better in Q1). If the economy continues a broad recovery, it is likely that the value outperformance will continue. [Note: it can be more challenging to implement such allocation changes in taxable accounts where growth funds realized significant capital gains.]

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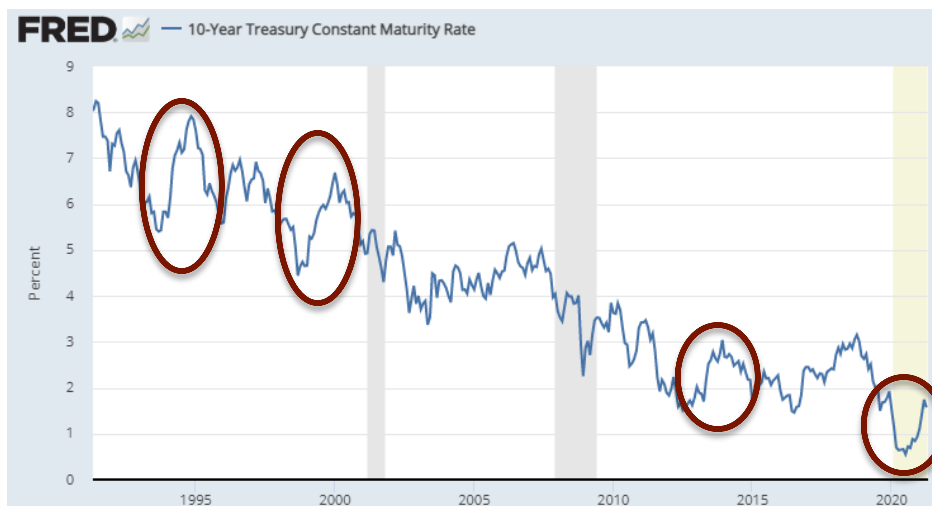
Bonds Were Negative in the First Quarter

Bonds are typically seen as the stable part of a portfolio. This perception makes sense because bonds have only seen negative calendar year returns three times since 1980. As bond prices and interest rates move in opposite directions, bond returns can be negative when interest rates rise.

Negative returns in bonds have been uncommon in the last 40 years since interest rates have generally fallen (lower rates = higher bond prices, and vice versa). Bonds saw negative returns in 1994, 1999 and 2013 when interest rates rose over the calendar year. In the first quarter of 2021, investment grade bonds (represented by the Bloomberg Barclays Aggregate Bond Index) lost -3.4%. Intermediate Treasury bonds were also negative, losing -4.3%, and long-term Treasuries lost -13.5%.



Source: FRED, Federal Reserve

The challenge posed by low (and rising) interest rates is one of the biggest issues facing investors today. There are two important aspects to this challenge. First, interest rates are extremely low. While they can go back down again, current rates are far below their long-term average. If the economy continues to strengthen, there is a good chance that interest rates will continue to rise. While there are many factors that could help keep rates relatively low, a 10-year Treasury yielding 1.5% is likely below where it should be under healthy economic conditions.

Second, the currently low rates leave very little cushion to absorb price changes. Back in the 1990s, bonds were yielding 6-8%, and in the early 2000s they were yielding 4-5%. Therefore, a bond investment could absorb a price decline of at least 4-5% without suffering a loss. Currently, the 10-year Treasury is yielding 1.5%, meaning that even a modest interest rate increase could generate a price decline that would wipe out an entire year of interest.

Low interest rates are good for borrowers (mortgage holders, corporations, and the government), but they create a dilemma for investors – accept low yields and risk of loss if rates continue to rise or invest more aggressively by allocating more to equities or higher risk bond options.

Final Thoughts

The stock market has seen strong returns over the last six months. While the policy backdrop (both monetary and fiscal) continues to be favorable for equities, there have been almost no negative surprises for months. It is healthy for markets to pullback from time to time, and, therefore, it seems prudent to reposition into a slightly more defensive posture.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727. To find an electronic copy of this document and other recent commentaries, please visit our website at www.risadvisory.com.

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