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2021 Outlook Theme #3, 6/30/21 Update: Reflation or Inflation?

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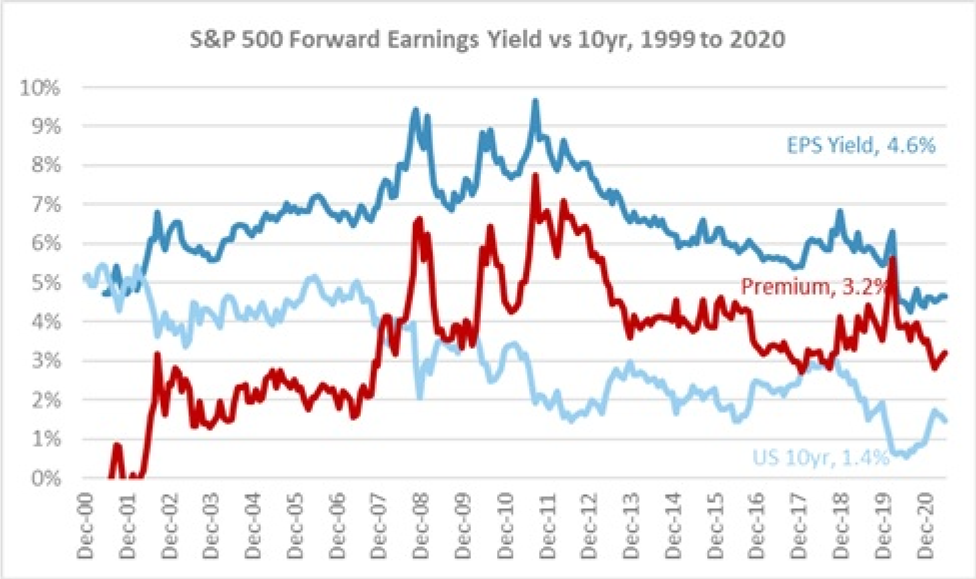
The question becomes how can shifting inflation expectations impact financial markets. On 12/31/20 we observed: *A healthy recovery with growth and a modest uptick in inflation would be reflationary. A rapid one, inflationary.* The interaction between profits, valuation, and interest rates was the primary driver in the Q1'21 stock market. This is a concept we introduced on 12/31/20.



While PE ratios are above average, historically low interest rates make such valuations reasonable, as a PE ratio is simple short hand for discounting future earnings to the present. The following chart compares the forward earnings yield (the inverse of the forward PE ratio) and the 10yr Treasury.The difference, or premium, is shown as well. On 12/31/20, the forward eps yield (4.4%) was below the 2000 peak, but thanks to the 0.92% 10yr, the premium of 3.5% was in line with the 20yr range. Moving forward to 6/30/21, the eps yield is actually slightly higher, at 4.6%, even though the stock market has risen. This reflects the improved economic outlook. As of the end of Q1, the 80 bps jump in the 10yr had pushed the premium down to 2.8%, the low end of the post 2008 period. During Q2 the earnings premium did improve, to 3.2%, but somewhat surprisingly it was mostly due to the 10yr declining 30 bps, not the earnings yield rising. As discussed in prior Investment Themes, this framework shows how rising rates can compress the PE multiple and thus offset some, or all, of the benefit from higher profits.

After this valuation analysis of the overall market, on 12/31/20, we noted: *This pressure would not be even across the markets. Low rates have favored Growth over Value, as high multiples are based on future earnings. Higher rates favor current earnings and would be an advantage for Value. In addition, if it's a "good" reflation cycle paired with an improving economy, that could further help Value style companies that are typically more economically sensitive.*

The two charts to the left demonstrate how the relationship between rising rates and the Growth/Value relationship was one of the most prominent drivers of 2021 thus far. The top chart shows the average daily return for the S&P 500 and Value minus Growth (ie how much Value outperformed Growth) overall, and then broken down based on if the 10yr Treasury was up or down that day. While daily S&P 500 returns were better on days the 10yr declined, the Value minus Growth numbers were mirror opposites, delivering 26 bps of daily outperformance on "10yr up" days versus 40 bps of lagging on "10yr down" days.

Looking at cumulative year to date, Growth and Value are about even, as Q2's decline in interest rates allowed Growth to make up ground on Value. Value is +16% while Growth is +14%. The cumulative performance has been highly conditional to the 10yr. On days the 10yr has risen, Value outperformed Growth by 21%. On days the 10yr declined, Growth outperformed Value by an identical 21%. This is another good example of the market seeming steady but seeing notable shifts when looking below the surface. During Q1, Value drove the market, as rising rates and an improving profit outlook favor low PE, cyclical stocks. In Q2, rates declined, and Growth took the baton of market leadership back from Value. Shifting the baton of market leadership from Value to Growth has allowed the market to do well thus far in 2021, whether rates were rising or falling.

Therefore, the calm surface suggested by rising markets and low volatility do not fully reflect the churning going on below the surface. During Q1, the market reflected reflation, with rising rates and economically sensitive value stocks outperforming. But in Q2, the market reversed course modestly, with rates down and growth stocks outperforming. If the shift in inflation expectations proves only modest and comes with continued growth, that would be favorable. But if growth has really peaked and inflation pressures linger due to ongoing supply chain issues, that would be more problematic. This is the crux of *Reflation or Inflation*. And it will impact the Fed's policy decisions as 2021 progresses.

-The S&P Municipal Bond Index is a broad, comprehensive, market value-weighted index. The S&P Municipal Bond Index constituents undergo a monthly review and rebalancing, in order to ensure that the Index remains current, while avoiding excessive turnover. The Index is rules based, although the Index Committee reserves the right to exercise discretion, when necessary.

-The BofA Merrill Lynch US Emerging Markets External Sovereign Index tracks the performance of US dollar emerging markets sovereign debt publicly issued in the US and eurobond markets.

-The HFRI Fund of Funds index is compiled by the Hedge Funds Research Institute and is intended to represent the total return performance of the entire hedge fund universe.