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2021 Outlook Theme #3: Reflation Or Inflation?

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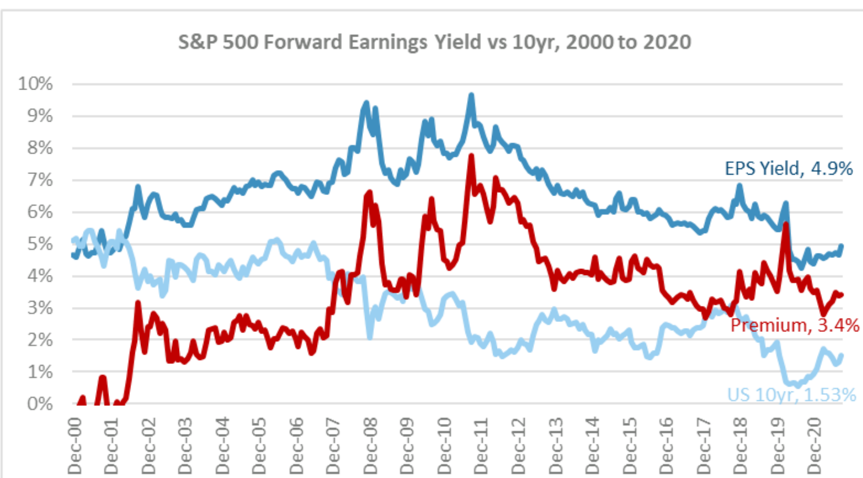
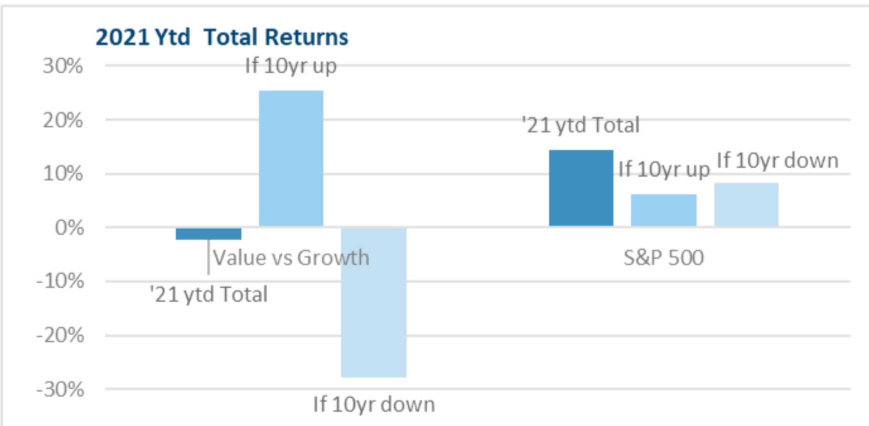
The question becomes, how can shifting economic expectations impact financial markets? On 12/31/20, we observed: A healthy recovery with growth and a modest uptick in inflation would be reflationary. A rapid one, inflationary. The interaction amongst profits, valuation, and interest rates was the primary driver of the 2021 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 shorthand 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 9/30/21, the EPS yield is higher, at 4.9%, even though the stock market has risen. This reflects the improved economic outlook. And this means that, despite the higher 10yr at 1.53%, and the 16% ytd increase in the S&P 500, the earnings premium has been steady. This is the first way the equity markets have held up, despite rising rates.

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 chart demonstrates how the relationship between rising rates and the Growth/Value relationship was one of the most prominent drivers of 2021 thus far.

Looking at cumulative year-to-date, they are about even, Value is +15% while Growth is +16%, but the performance has been highly conditional to the 10yr. On days the 10yr has risen, Value outperformed Growth by 25%. On days the 10yr declined, Growth outperformed Value by a comparable 28%. The see-saw between Growth and Value has allowed the market to appear steady, despite rate moves being felt below the surface.

As an indicator of how fast it can shift, after the Fed's meeting on 9/23, through the end of the quarter, the 10yr rose 20 bps from 1.33% to 1.53%. In this period, Value outperformed Growth by 2.7%, cutting, what up until then appeared to be a strong Growth over Value quarter, by over half, to just 2% relative performance. This could be a sign of the reflation trade returning. With concerns over the recovery losing steam and/or inflation pressures picking up, the market's focus remains if this is *Reflation or Inflation*. Reflation would be favorable for equities, while Inflation would be a headwind. Figuring this out will occupy the markets in Q4'21.

The information contained herein is based upon sources believed to be true and accurate. Sources include: *Factset Research Systems Inc.,* Bureau of Economic Analysis, Bureau of Labor Statistics, Congressional Budget Office, Board of Governors of Federal Reserve System, Fred: Federal Reserve Bank of St. Louis Economic Research, U.S. Department of the Treasury

-The Standard & Poor's 500 is a market capitalization weighted index of 500 widely held domestic stocks often used as a proxy for the U.S. stock market. The Standard & Poor's 400 is a market capitalization weighted index of 400 mid cap domestic stocks. The Standard & Poor's 600 is a market capitalization weighted index of 600 small cap domestic stocks.

-The NASDAQ Composite Index measures the performance of all issues listed in the NASDAQ stock market, except for rights, warrants, units, and convertible debentures.

-The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of 21 emerging markets. The MSCI All Country World Index is a free float adjusted market capitalization index designed to measure the performance of large and mid and cap stocks in 23 developed markets and 24 emerging markets. With over 2,800 constituents it represents over 85% of the global equity market.

-The Barlcays Aggregate Index represents the total return performance (price change and income) of the US bond market, including Government, Agency, Mortgage and Corporate debt.

-The BofA Merrill Lynch Investment Grade and High Yield Indices are compiled by Bank of America / Merrill Lynch from the TRACE bond pricing service and intended to represent the total return performance (price change and income) of investment grade and high yield bonds.

-The S&P/LSTA U.S. Leveraged Loan 100 is designed to reflect the largest facilities in the leveraged loan market. It mirrors the market-weighted performance of the largest institutional leveraged loans based upon market weightings, spreads and interest payments.

-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.