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Improved Forecast + Record Stimulus = Higher Inflation Expectations

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After an incredible recovery on the heels of COVID stimulus, equities continue to levitate in the early part of 2021.

In the last several newsletters we forecast that the long reign of the S&P 500 as the perennial top index, thanks to big positions in Large Cap growth, could finally be coming to an end, or at least a pause. The disparity between the trailing 12-month returns of the S&P Growth and the S&P Value hit 33% last year, by far the largest in history, and as the old adage goes: “Trees do not grow to the sky”. As we wondered if it was finally time for other sectors to lead the market higher, that is exactly what happened. As you can see in the table, Small Cap, Emerging Markets and Developed Foreign all beat the S&P 500 index in the fourth quarter, and that trend has continued thus far in 2021. Over the past six months, Value stocks have managed to outpace Growth, as well. As the economy starts to accelerate later in the year, this could continue as economically sensitive segments of markets may still have room to run with the recovery, as investors search for better valuations.

Index	Description	YTD 2021	Q4'2020
S&P 500	Large U.S. Stocks	4.9%	12.2%
Russell 2000	Small U.S. Stocks	14.3%	31.4%
MSCI EAFE	Developed Foreign	4.1%	16.1%
MSCI EM	Emerging Markets	12.0%	19.7%
MSCI ACWI	Global Stocks	5.8%	14.7%
S&P Growth	Growth Stocks	4.8%	10.7%
S&P Value	Value Stocks	5.0%	14.5%

Performance Table for Major Stock Indices (Source: eSignal)

Is the S&P 500 finally passing the baton to other areas of the markets? Value finally outpaces Growth after record disparity of returns

Markets have been responding to the prospect of continued improvement as 2021 progresses. GDP growth expectations

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continue to be revised higher, now expected to exceed 4% for 2021 over a higher base for 2020 than was anticipated last year, and we expect further upward revisions as the year progresses. As of last June, the December 2021 unemployment forecast was 7.5%, but has since dropped to 5.8% today on rising optimism for the rebound. Another round of fiscal stimulus is working its way through Congress and could be as much as $1.9 trillion. Is this too much of a good thing in the long run?

Last year the fiscal response to COVID was $3.1 trillion, or 15% of the size of the entire US economy ($20.9 trillion), in response to a GDP decline of 2.3% in 2020. Let's make this crystal clear: The fiscal stimulus was over SIX TIMES the size of the economic contraction it was designed to offset! To be fair, the economic decline certainly would have been much worse without the much needed stimulus at the time, in particular the $1.1 trillion in direct payments and increased unemployment benefits. Nonetheless, does it really need to be doubled now when we are expecting 4.1% growth and 5.8% unemployment this year? Are we still going to do a massive infrastructure bill in addition to all of this? It is no wonder why inflation expectations have jumped, with 10-year implied inflation (10-year Treasury minus 10-year TIPS) surging from 1.1% last May to 2.3% today – a level above the Fed's stated target of 2%.

10-Year Treasury Yield (Source: eSignal)

Benchmark Treasury Yield has tripled since last summer with implications on asset prices and inflation outlook

The bond market has certainly taken notice as the 10-Year Treasury yield (see Chart) has recently cracked the 1.5% barrier for the first time since before the COVID shutdowns (February 2020), continuing a steady ascent from a low of 0.52% on August 4, 2020. The move higher accelerated on the successful vaccine news in late 2020, and is moving even faster now as expectations remain for a very robust second half to this year, another huge fiscal stimulus package, and the Fed not to tighten in the foreseeable future. Higher inflation expectations equal higher interest rates. If this continues, it could become a stiff headwind for the markets, since as risk-free rates move higher, other investment options become incrementally less attractive and borrowing costs more expensive. Inflation could top the list of market headlines later in the year, especially if we enter an environment where stocks could actually decline on good economic news because of inflation concerns and fear of the Fed raising rates in response. As of yet, stocks have shrugged off the move in bonds, but for how long?

Important Disclosures: Sources include eSignal.com, Bureau of Economic Analysis, Bureau of Labor Statistics and FactSet. Not a substitute for tax or legal advice.

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