Economic & Investment Perspectives

Figure 1: Returns – 2/28/2021 (source: Yahoo!, ACIMA)
Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	MTD	YTD	1YR	Max Draw Down	Current vs. 52-wk High	Current vs. 52-wk Low
US Aggregate Fixed Income	AGG	-1.5%	-2.3%	1.4%	-11.5%	-3.7%	9.3%
U.S. Treasury Bonds	GOVT	-1.8%	-2.3%	-0.2%	-6.2%	-6.8%	1.5%
Investment Grade Corp Bonds	LQD	-2.3%	-4.1%	2.8%	-26.9%	-5.1%	26.0%
Muni Bonds	MUB	-1.6%	-1.2%	1.2%	-15.3%	-2.2%	15.6%
High Yield	HYG	-0.2%	-0.6%	5.7%	-23.7%	-1.5%	28.0%
Non-US Fixed Income	BNDX	-1.7%	-2.3%	-0.3%	-9.1%	-2.7%	6.1%
Emerging Markets Bond	EMB	-3.0%	-4.8%	0.4%	-27.5%	-6.0%	29.4%
Global Equity							
ACWI Global Equity	ACWI	2.3%	2.0%	30.1%	-34.8%	-4.6%	73.5%
United States	VTI	3.1%	2.8%	35.4%	-36.5%	-4.0%	82.7%
International Developed	EFA	2.2%	1.4%	21.8%	-35.1%	-4.1%	61.8%
Emerging Markets	EEM	0.8%	4.0%	34.7%	-35.0%	-7.8%	78.5%
Global Equity by Region							
United States	VTI	3.1%	2.8%	35.4%	-36.5%	-4.0%	82.7%
Europe	IEUR	2.8%	1.9%	20.3%	-38.5%	-3.3%	68.9%
Asia ex-Japan	AAXJ	1.2%	5.6%	40.1%	-30.7%	-7.6%	78.8%
China	MCHI	-0.5%	7.6%	41.8%	-26.3%	-10.7%	74.2%
Japan	EWJ	1.8%	1.0%	30.3%	-31.5%	-5.6%	64.0%
Latin America	ILF	-2.3%	-9.6%	-3.1%	-56.0%	-14.1%	70.7%
US Equity							
US S&P 500	IVV	2.8%	1.7%	31.5%	-35.3%	-3.5%	73.3%
NASDAQ 100 QQQ	QQQ	-0.1%	0.1%	53.5%	-30.5%	-7.1%	90.5%
US Large Growth	IWF	0.0%	-0.8%	43.6%	-33.5%	-6.4%	86.5%
US Large Value	IWD	6.0%	5.0%	21.5%	-39.4%	-3.3%	70.7%
US Eqwt S&P 500	RSP	6.1%	5.2%	32.0%	-40.7%	-3.1%	90.2%
US Mid Cap	IJH	6.8%	8.4%	39.7%	-44.1%	-3.3%	111.4%
US Small Cap	VTWO	6.1%	11.2%	50.7%	-43.8%	-5.3%	128.9%

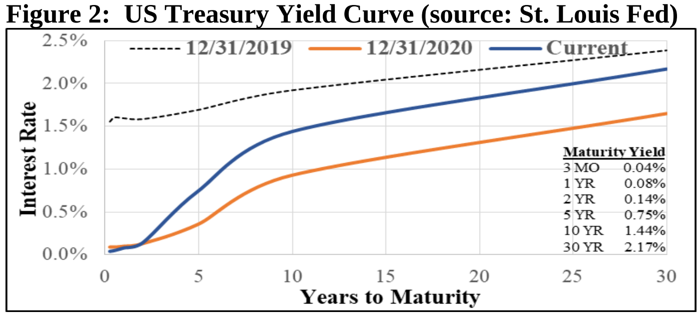
Equity markets rallied in the first half of February before reversing course but still posted solid gains for the month. Rising interest rates led to a significant dispersion of returns across markets, styles, sectors and capitalizations (size). Performance highlights for the month and quarter include the following:

- Bonds: The US Aggregate index (AGG) fell 1.5% in February (-2.3% YTD) as interest rates spiked. Corporate (LQD -2.3%, -4.1% YTD) and non-US bonds (BNDX -1.7%, -2.3% YTD) also fell, but high yield (HYG) lost just 0.2% (-0.6% YTD).
- Global equity (ACWI): +2.3% this month (+2.0% YTD).
- US Equity: The broad market (VTI) rose 3.1% during the month (+2.8% YTD) and the S&P 500 (IVV) gained 2.8% (+1.7% YTD). Large stocks continued to under-perform as small caps (VTWO) rose 6.1% (+11.2% YTD). A comparison of the returns of growth (high earnings growth and valuations) and value stocks (lower growth and valuations, higher dividends) underscores the changing leadership in a rising interest rate environment: Large Value (IWD) trounced its Growth counterpart (IWF) for the month (+6.0% vs. 0.0%) and YTD (+5.0% vs. -0.8%) but trails dramatically over the past 12 months (+21.5% vs, +43.6%) and for the last several years.
- Non-US Equity: Emerging markets (EEM) under-performed developed markets (EFA) for the month (+0.8% vs. +2.2%) but lead YTD (+4.0% vs. +1.4%) and over the last 12 months (+34.7% vs. +21.8%), led by China (MCHI +41.8% one-year).

Interest Rates and the Economy

The story of 2021 so far has been rising interest rates. Figure 2 graphs the US yield curve, which plots yields (Y-axis) for various maturities (X-axis) of US Treasuries. Short-term yields remain near zero and will likely be anchored there for several years according to the Federal Reserve (Fed). Long-term interest rates have moved materially higher and are now approaching pre-pandemic levels. The US 10-year bond yield spiked above 1.5% before settling at 1.44%, and the 30-year bond breached the 2% level (now 2.17%). We explore rising yields on page 2.

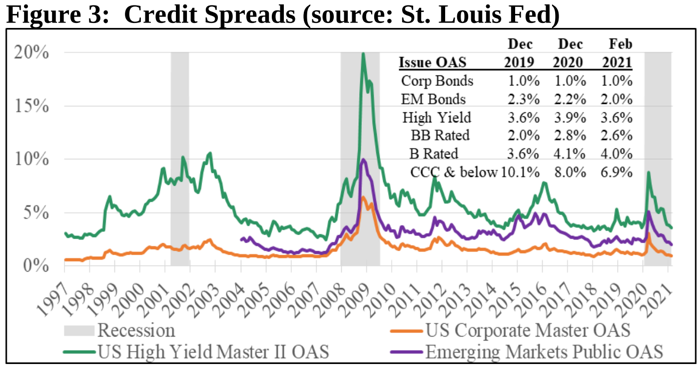
Figure 2: US Treasury Yield Curve (source: St. Louis Fed)



For bonds other than US Treasuries, we focus on the option-adjusted spread (OAS) between various bond yields and comparable US Treasuries. Low or narrowing spreads signal optimism as investors are willing to accept lower returns for riskier assets. Credit spreads spiked on pandemic fears last March but have tightened since and are now at or below pre-pandemic levels. Narrowing spreads have offset rising interest rates so far in 2021.

- Investment grade corporate bonds yield 1.0% over Treasuries, unchanged this month and versus pre-pandemic levels.
- Emerging market bonds carry an average yield premium of +2.0% versus +5.1% in March and +2.3% at 2019 year end.
- High yield (non-investment grade) spreads narrowed to +3.6% and remain tighter than before the pandemic. The riskiest bonds (rated CCC & below) carry credit spreads well below 2019 levels (+6.9% vs. +10.1%) and below historical averages.

Figure 3: Credit Spreads (source: St. Louis Fed)



Reflation vs. Inflation

The accelerating rise in interest rates has been a key markets driver year-to-date (YTD) and for the last six months. The yield on the US 10-year bond dropped precipitously in the wake of the pandemic (economic concern, flight to quality), bottoming at 0.5% in August before recovering to just under 1.5% today. If yields rise for the right reason (stronger economic growth), higher borrowing costs can be absorbed, offset by growth in revenues and profits. The risk is that yields are reacting to rising inflation expectations, which could force interest rates higher, potentially derailing recovery and making the global debt load unsustainable.

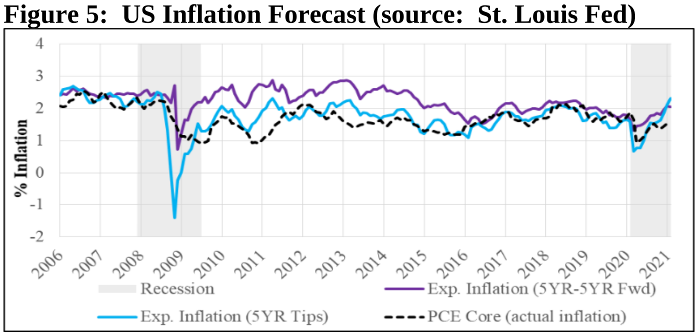
The recent rise in yields coincides with a distinct change in stock market leadership. The "reflation trade" has been fueled by low interest rates, massive government spending and money printing and favors assets most sensitive to economic growth. Tech and e-commerce stocks have taken a back seat over the past six months as small stocks have trounced large (Russell 2000 +42% vs. S&P 500 +10%), value has out-performed growth (+19% vs. +5%), and emerging markets have out-paced developed markets (+23% vs. +12%). Returns have been led by energy, financial, materials and industrial stocks, while defensive sectors have lagged (Figure 4). Economically-sensitive commodities (oil and copper) have surged, while defensive precious metals have fallen.

Figure 4: US Equity Rotation (source: Yahoo! Finance)

	ETF	MTD	YTD	6MO	1YR
US Equity Sectors				(sorted)	
Energy	XLE	22.5%	27.0%	39.1%	13.4%
Financials	XLF	11.6%	9.6%	30.3%	24.7%
Basic Materials	XLB	4.1%	1.6%	17.9%	42.6%
Industrials	XLI	6.9%	2.3%	17.4%	26.5%
Communications	XLC	7.0%	6.1%	13.6%	42.2%
Cons Discretionary	XLY	-0.5%	0.2%	7.8%	40.7%
Technology	XLK	1.4%	0.5%	6.3%	49.7%
Real Estate	XLRE	1.6%	2.1%	5.0%	5.0%
Health Care	XLV	-2.1%	-0.7%	4.9%	23.7%
Utilities	XLU	-6.1%	-6.9%	0.2%	-2.8%
Cons Staples	XLP	-1.2%	-6.2%	-2.1%	12.2%
Commodities					
Oil ETF	USO	17.4%	25.1%	35.1%	-45.4%
Copper ETF	CPER	14.6%	15.5%	32.4%	58.1%
Bloomberg Commodity Index	DJP	7.7%	10.8%	19.0%	23.2%
Silver ETF	SLV	-1.3%	0.4%	-6.0%	58.8%
Gold ETF	GLD	-6.3%	-9.3%	-12.5%	9.1%

The rise in interest rates appears to be due to strong economic growth expectations, evidenced by the out-performance of economically-sensitive sectors and markets relative to defensive segments and inflation hedges such as gold. But given ultra-accommodative monetary and fiscal policy, inflation risk is real and bears watching. Market-derived inflation forecasts are rising but remain close to the Fed's inflation target of 2% (Figure 5),

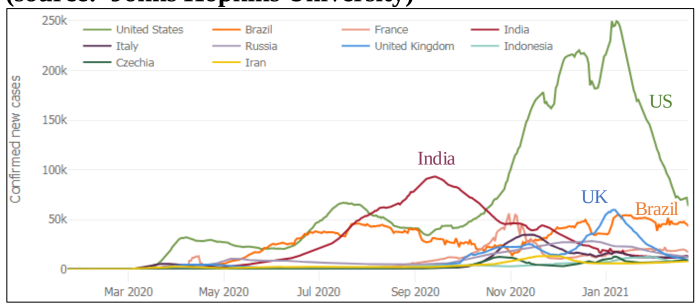
Figure 5: US Inflation Forecast (source: St. Louis Fed)



Pandemic Progress Update

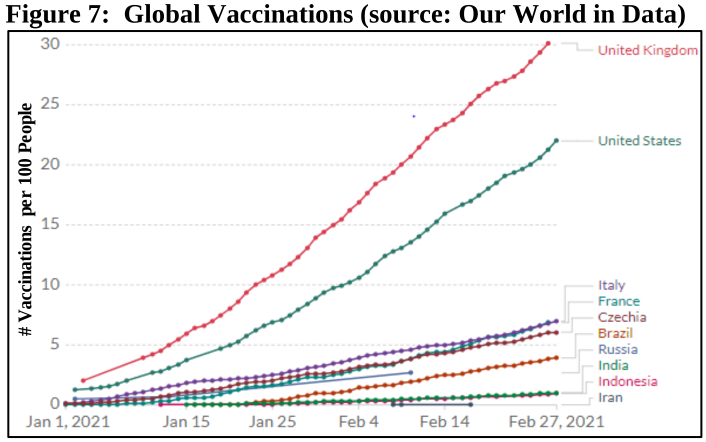
With global equity markets near all-time highs, investors clearly believe that the global economy is poised for rapid recovery. True economic recovery, however, will only follow continued progress against the virus in the US and around the world. Figures 6 and 7 illustrate encouraging metrics on the health front. New reported cases of the virus have declined significantly and mercifully after the holiday surge, though case numbers remain elevated relative to last spring and summer (Figure 6).

Figure 6: Daily Confirmed New Cases (7-day Average) (source: Johns Hopkins University)



More importantly, the pace of vaccinations is ramping up. Figure 7 graphs the number of vaccinations for the 10 hardest hit countries, adjusted by population (number of shots given per 100 people). The early trend in the US and UK is encouraging and improving, but there is still much work to be done globally.

Figure 7: Global Vaccinations (source: Our World in Data)



Bottom Line

Despite recent market volatility around the rise in interest rates, the global economic recovery appears to be intact. The rise in yields appears to be consistent with higher growth forecasts as accommodative monetary and fiscal policy bridge the gap between disaster and recovery. Inflation expectations are rising but remain roughly 2%, a healthy number from the Fed's perspective. Economically-sensitive assets (emerging market stocks and bonds, US small/mid-cap and value, commodities) remain attractive given the improving health and economic rebound.

Last and least, a word about bitcoin: The digital currency continues to rise in value with daily news flow around broadening institutional acceptance and high profile investments. Because it is difficult or impossible to value based on fundamentals, we continue to agree with Treasury Secretary Janet Yellen, Microsoft's Bill Gates and Berkshire Hathaway's Charlie Munger, who view bitcoin as a speculative investment, not a core portfolio holding.

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