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First Quarter 2021 Market Letter

It is Springtime and feels that way in most places reading this letter. Grass is beginning to grow, and so we are going to describe the equity markets' year to date behavior as lawn mowing markets. Why? If you look at a price chart, the markets look like someone is pulling the starter rope a few times trying to get the mower started. The good news is that with each pull, the engine sounds a little better. What remains unclear is whether the engine will catch and allow us to get the grass cut today, or will we just flood the engine and have to wait longer to make real progress. What seems to be working against a smooth start? Not the economy.

The economy is doing fine, making steady progress as our country continues to open up, and pent-up demand is fulfilled resulting in solid growth. S&P500 earnings estimates for the next 12 months have increased about 8.5% since early December. This is obviously a good trend. Perhaps, then, the problem is valuation. The S&P500 index has risen YTD, but a little less than earnings expectations. When markets rise less than earnings, the valuation of the market comes down. In this case, market valuation has decreased 1% over this time-period. To put this in context, however, the S&P500 valuation is still 31% higher than its 25-year average. The sporadic nature of market gains this year might be because earnings are good, but valuations are higher. Market participants want to cheer continued positive economic news by pushing stocks higher, but then pause when they try to square that with current prices. Domestic stocks are up around 6% this year, and international stocks are up about half of that. The valuation of international markets remains quite a bit lower that domestic markets. They seem to be facing more challenges with reopening, and this is tempering returns right now.

Bonds are facing headwinds. The bond bull market that has been in place for over 30 years is now over. Someone made this claim recently, and it certainly feel like it. It speaks to the 30-year trend of falling interest rates having ended. If true, it means that interest rates now will either remain flat or rise…..for years. That would certainly be different and could be a contributing factor explaining the stock market's behavior.

As measured by the iShares Core U.S. Aggregate Bond ETF, bonds fell about 3.5% YTD. That includes interest earned during the quarter. If this return holds for the year, it would be the worst year for bonds in the last 40. The culprit is rising interest rates. The yield on the 10-year Treasury note has increased 81% YTD and 164% over the last 12 months. Those figures seem huge. The actual yield has increased from 0.926% at the start of the year to 1.68% as this is written. Either way, stock valuations can be impacted by rising interest rates, and bond valuations are directly affected.

The U.S. Government will be in the market either issuing and rolling over trillions and trillions of new debt. At some point, one would think that this would impact the price that investors are willing to pay for these bonds. It is interesting to see how this market has changed over the last 15 years or so. Who are the owners of Treasuries, and how has that shifted?

From 2000 to 2008, foreign investors were increasing their share of U.S. Treasuries from about 27% to 43% of all Treasuries. This is more impressive when you realize that the supply of Treasuries was also increasing during this period.

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This means that foreign investors were buying a lot of Treasuries. Over the last four years, with the pace accelerating over the last year, foreign investors had cut their ownership share to 29%. Domestic mutual funds have increased their share from around 5% right before the Great Financial Crisis to about 15% today. The Federal Reserve has also been a strong buyer, increasing its share of ownership from 14% to 22% over that same time-period.

One argument for continued higher interest rates is that the market will demand them in order to buy more product (bonds). This assumes that demand does not increase right along with supply, and we will have to see if this happens. The other argument for higher interest rates is that they will come with higher inflation. What if the liquidity being created does spur demand, but manufacturers cannot keep up? We hear more stories about how supply chains are struggling to provide the products and materials needed for current demand. Inflation is an interesting topic to discuss. It seems to not exist, but then it makes itself known in seemingly clear ways at the same time.

The official inflation statistics can by reflected by the change in CPI (Consumer Price Index). The US Inflation rate has declined over the last 12 months. It fell to 1.68%, down from last year's 2.33% rate. This seems strange when you consider other real-life experiences. The U.S. median sales price for new houses increased over 5% over the last year. The Agriculture Price Index is 20% higher, the Energy Price Index is 21% higher. In the past, workers were able to demand and receive higher pay in response to rising prices. This is another potential source of inflation to watch out for.

Sustained higher inflation would be very bad for bonds, especially longer-term bonds. Stocks can make headway during inflationary period because they have the ability to raise prices over time. But the higher interest rates that would accompany higher inflation would be a challenge to the currently high market valuation. We would feel better if the market could remain steady as earnings gains come through, bringing down valuations while keeping the market close to current values.

Regards,

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