Quarterly Commentary: Q1 2021

VALLEY NATIONAL FINANCIAL ADVISORS

Fixed Income

Fixed income securities declined, in aggregate, during Q1 2021, as interest rates rose; bonds prices fall when rates increase. The 10-year treasury bond, the most widely referenced proxy for U.S. interest rates, has nearly doubled during the first three months of the year, from 0.95% to 1.65%. While the increase has been sharp and brisk, rates remain extremely low relative to historical standards. For perspective, in the near-decade leading up to the 2008 financial crisis, the 10-year government bond resided around 5%. Rates have remained structurally lower post-2009, but in the year or two pre-COVID, the 10-year was at 2-3%.

Low interest rates facilitate economic activity because they mean that it is cheap to borrow money. Borrowed money is used to finance businesses and personal expenditures, thereby buoying economic output. Moreover, fixed income represents the prime alternative to equities; low rates are less appealing than high rates, all else equal, to investors, and therefore, when rates are low, demand for – and therefore, the price of – equities tends to be elevated. The main risk to the low rate paradigm is inflation; should inflation materialize at a rate greater than that of current expectations, the Federal Reserve will likely hike rates. Higher rates curb inflation because it boosts the expected return on savings, thereby encouraging investors to park money away rather than spend it (and hasty spending is the driver of inflation). For now, inflation expectations remain moderate, around 2%; in turn, rates are likely to remain relatively low.

Equities

The S&P 500, Dow Jones Industrial Average, and Nasdaq 100 were up approximately 6%, 9%, and 3%, respectively, in the first three months of 2021. The Dow's leadership – and the Nasdaq's lag – are a reversal from 2020, during which time the tech-heavy Nasdaq outperformed the industrial-laden Dow. Clearly, in 2020, tech stocks benefitted from "stay-at-home" trends; in 2021, however, travel and leisure are set to uncoil as the American population gets vaccinated.

As touched on above, stocks are benefitting from an accommodative interest rate environment in which investor demand for fixed income is muted owed to low rates. On top of this, the tremendous volume of fiscal stimulus combined with reopening trends imply a highly favorable 2021 outlook for U.S. corporations.

Outlook

As of mid-April, between 25-30% of the U.S. population has been vaccinated. The pace of inoculation is highly encouraging and suggests that sometime during the summer, a great enough portion of Americans will be vaccinated such that "normalcy" – or something resembling it – will resume. Reflecting the pent-up demand that will be truly unleashed, economists believe U.S. GDP could be as high as 6% during 2021, the most productive economic year in America since the 1980's. While equity valuations appear high relative to historical figures, the stock market is not expensive compared to fixed income, the more salient measure. As fiscal stimulus flows through the economy and amplifies the pent-up demand, corporate earnings are likely to increase meaningfully and support current stock prices. As discussed, the key risk facing financial markets is inflation, because high inflation would likely force rates up, hindering equity valuations. At this point, though, we note that inflation expectations remain moderate and therefore, inflation is unlikely to interfere with the near-term outlook.