New Albany
Investment Management

February 25, 2021

Market Insight: Hot Economy, Hot Market

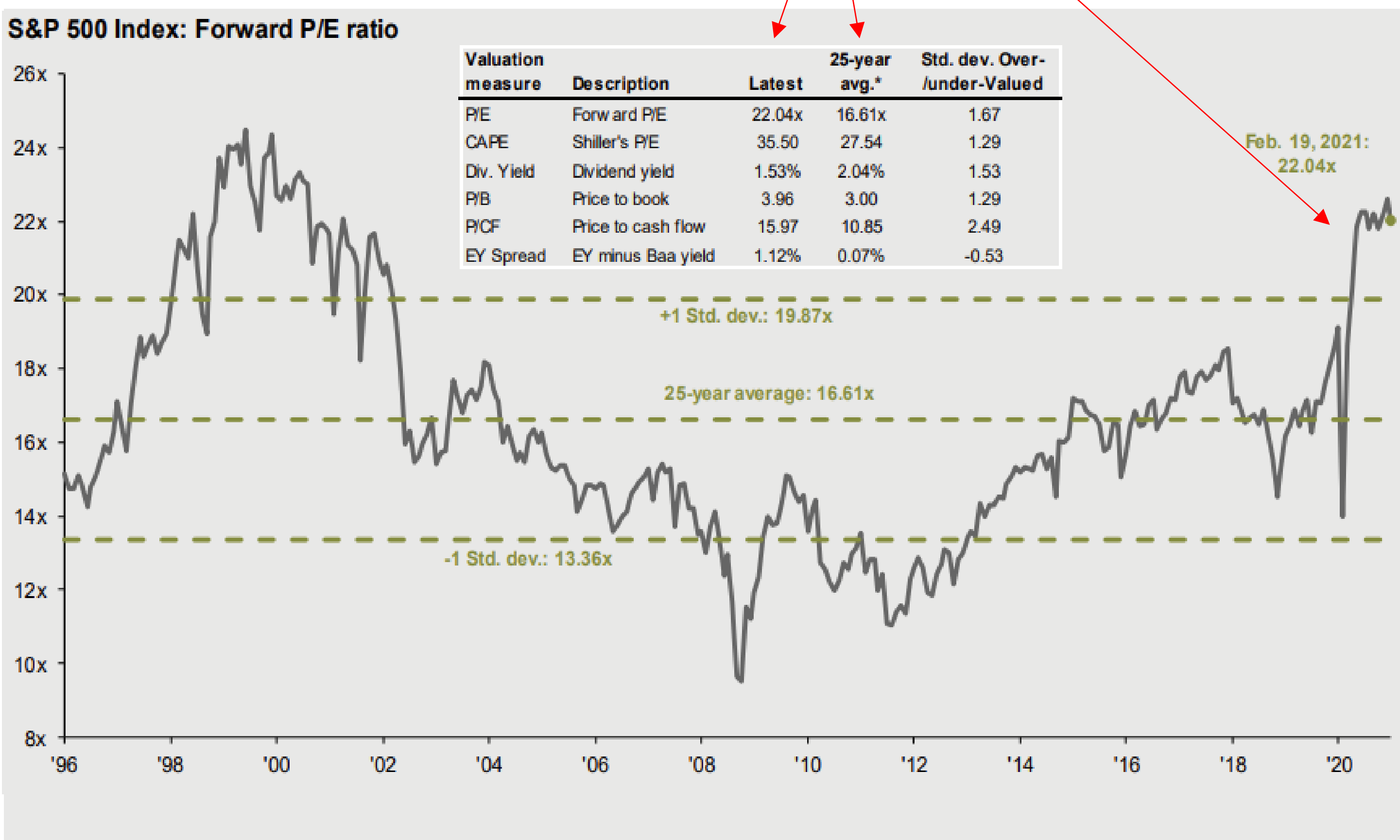
- Rapid and widespread dissemination of vaccines globally is setting the foundation for strong growth momentum for 2021.
- In the US, another round of $1.9 trillion of fiscal stimulus is expected, adding to the economic momentum. GDP is likely to push well above 6%, a level not seen since 1984!
- The Federal Reserve is content to reinflate the economy, allowing ample credit (liquidity) to fuel growth and asset price appreciation (inflation).
- Market expectations and valuation are quite high, betting the global reinflation narrative is a sure thing.

Perspective: One of the (few) benefits of getting older is the accumulation of experiences that provide a lens to which to look through when considering the road ahead. This can be applied when observing market behavior over many economic cycles. Though the current events may seem quite different, the foundational forces that drive the financial markets do not change. There are four primary forces: economic momentum, Fiscal tax/spending policy, Monetary Policy (the Federal Reserve), and the cost of credit. Each force has a unique impact on the market direction and valuation. There have been periods where one or two of these forces have been in motion together and each time the outcome was quite impactful to the economy and investors. But, in my forty years of following the markets, there has NEVER been a period where all these forces have been in motion in the same direction at the same time. Except for today. Hmmm. Surely, if history is a road-map for the future, the combined power of these forces will likely bring forth an amplified outcome.

Turbo Charged: Today there are multiple sources of stimulus fueling the fire on an economy that is already gaining momentum. The Fiscal spending spigot is wide open; the Federal Reserve continues to aggressively inject liquidity into the credit markets; personal and corporate tax rates are low; and ultra-cheap and easy credit is readily available. WOW! What could go wrong? It sounds like an investor's paradise. But the compounding effect of all these forces at once will produce outcomes greater than we've seen in the past. Though we are still in the 'early' stages of this new cycle, the rapidity and widespread reach is already impacting prices, supply chains, and consumer/business behavior. Crazy bidding wars in residential real estate, huge demand for luxury and recreational goods, skyrocketing prices of digital currencies and art, and inventory depletion are just some of the areas of the economy being impacted. But it is not just these areas, it is all-financial assets, including the stock market. The fuse for rampant inflation has been lit. The question is how long and how hot will this fire burn before it burns out? Again, looking back gives perspective on the road ahead.

Market Extremes: The two charts below give a good visual of where we are today in terms of market extremes and duration of moves.

The first chart shows the forward Price/Earnings ratio of the S&P 500 since 1996. This chart shows various valuation measurements against the 25yr avg and the standard deviation. Today, the P/E is at 22, well above its 25yr avg.; but more importantly, it is above its standard deviation or range of normal when it comes to valuation. However, just because the market valuation is quite high, it does not signal a correction will ensue immediately. In fact, given todays' strong stimulus/inflationary environment, it is quite likely the market could reach a new 'extreme'.

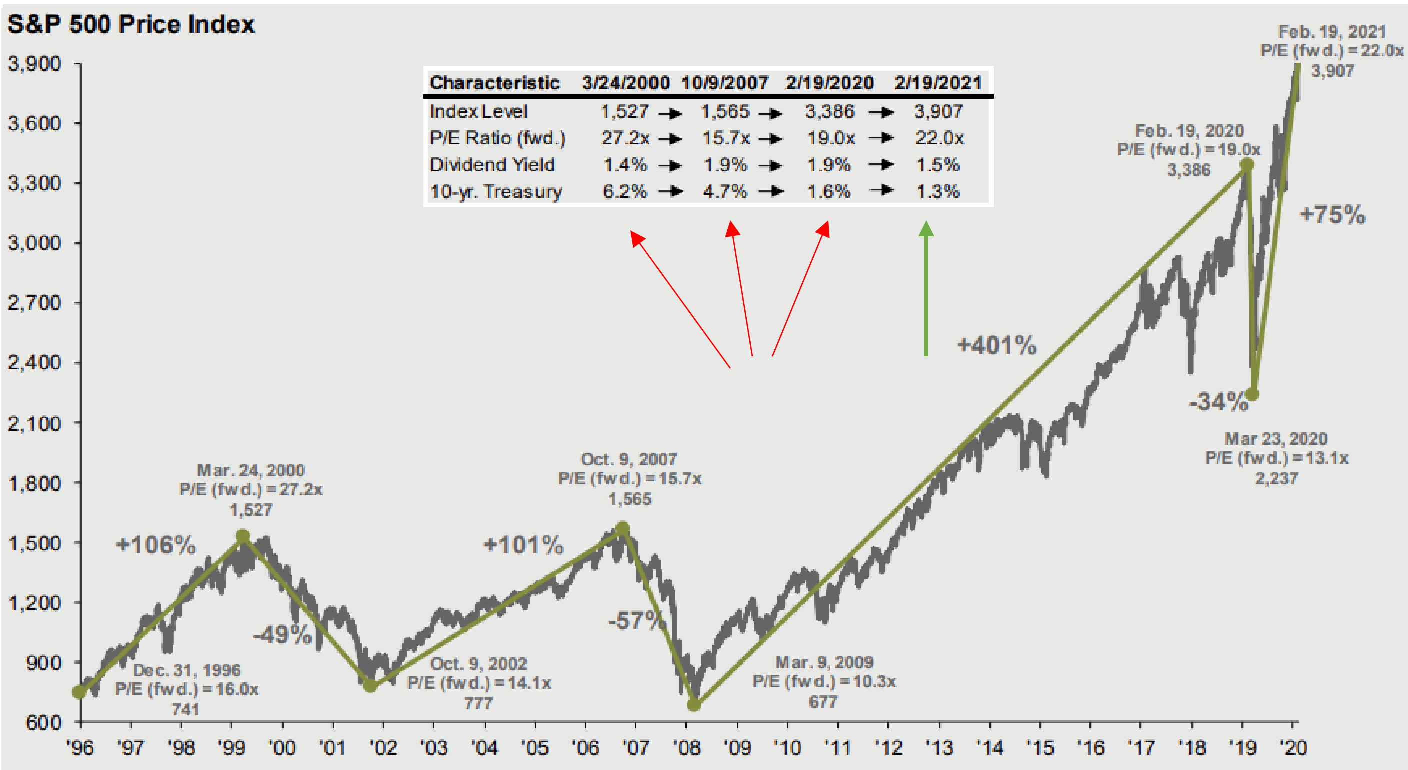


Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	22.04x	16.61x	1.67
CAPE	Shiller's P/E	35.50	27.54	1.29
Div. Yield	Dividend yield	1.53%	2.04%	1.53
P/B	Price to book	3.96	3.00	1.29
P/CF	Price to cash flow	15.97	10.85	2.49
EY Spread	EY minus Baa yield	1.12%	0.07%	-0.53

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

The next chart is even more enlightening when it comes to understanding market extremes. The solid line shows the path of the S&P500 since 1996 and the labels indicate the magnitude of increase and decline during various market cycles. Notice how market declines have ALWAYS been much faster than market ascents, except for the current cycle. Hmmm. Make no mistake, the meteoric rise since April of last year is directly due to the powerful stimulus forces at play.

But there is more to consider. The insert on the chart shows the dates and data at market extremes in 2000, 2007, and 2020 in comparison to where we are today. Notice the yield levels of the 10yr Treasury at each time and how much higher they were compared to the 1.3% level today. Lower rates support higher valuations. So even though the market is courting the 'extreme' zone, it likely has yet to reach its ultimate level.



Source: Compustat, FactSet, Federal Reserve, Standard & Poor's, J.P. Morgan Asset Management.

Long Term Rates, Key to Market direction and valuation: Changes in Long Term Interest Rates are typically the most immediate and impactful influence on stock prices, even more so than Fiscal and Monetary policy, because they dictate both the cost of borrowing today and the value of assets/spending in the future. In today's environment of cheap and accessible credit, the hurdle for investment return is low, and assets (including stocks) still look attractive. But nothing will put the brakes on faster than rising rates and the prospect of inflation.

Changes in bond rates are a good leading indicator of the economy and reveal expectations of future inflation. Since the beginning of this year, the 10yr Treasury yield has risen over 40bpts to 1.4%, a level not seen since pre-Covid. A significant move above this level would likely give pause to the recent rally. But as long as rates stay here or lower, there is plenty of stimulus that will continue to support a rally in stocks.

In sum, the power supporting this rally cannot be underestimated, however, its force can quickly fizzle if rates rise too high too fast. History has shown how rapid and violent a correction can ensue. Thus, a well-disciplined and managed investment strategy is paramount. Volatility is assured.

Investment Strategy: Our 'Balance' strategy between Value and Growth sectors is performing quite well. Recently, the Value sectors of the market including Small Cap have outperformed Growth sectors, a phenomenon not seen in many years. Total risk is slightly above targets and will be adjusted as market large market moves develop. Bond duration is kept moderate to avoid the negative impact of rising longer term rates.

Best Regards,

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