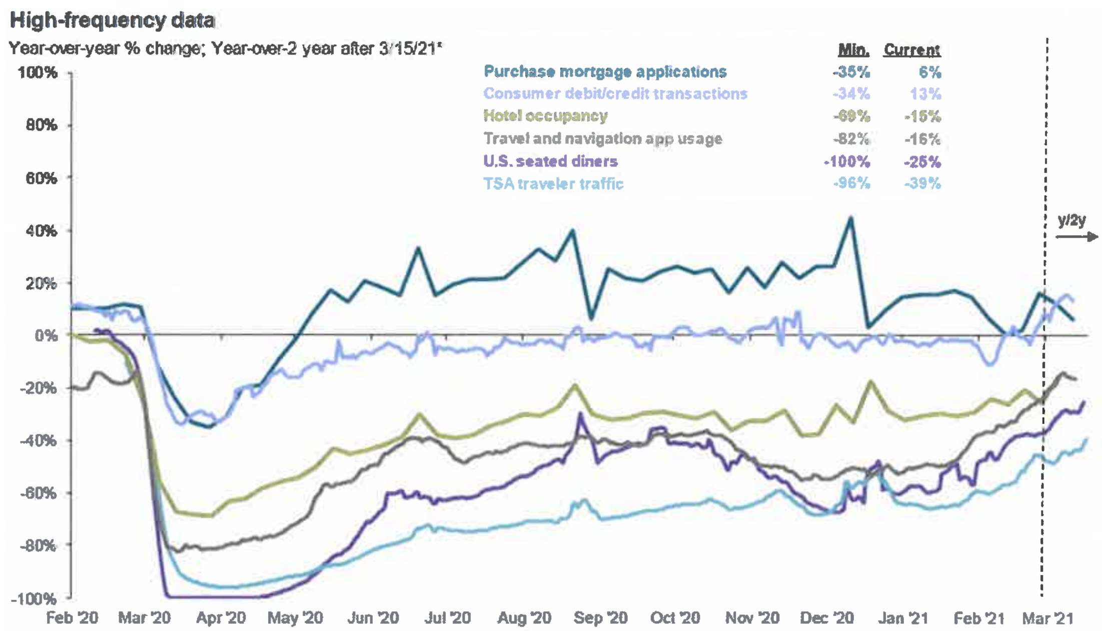
The Longer View

Comments & Outlooks from Longer Financial

April 6, 2021

Markets Reach New Highs on Economic Reopening Hopes

Major stock indices continued to rise in the first quarter of 2021, carrying forward the momentum that we've seen in markets ever since COVID vaccines were approved for emergency use late last year. As of March 31, the DJIA, S&P 500, and NASDAQ had gained 8.29%, 6.17%, and 1.76% for the year, respectively. Value and Small Caps have exhibited very strong performance, with the CRSP U.S. Large Cap Value index gaining 10.99% and the Russell 2000 adding 12.70% in the first quarter. Fixed Income has been one of the only laggards for the year, as the bounce in longer-term interest rates has put downward pressure on bond prices, causing the Bloomberg Barclays U.S. Aggregate to dip -3.37%. With the rollout of vaccines rapidly accelerating, we have seen an eagerness for a return to 'normalcy' through economic reopening. As illustrated in the chart below, consumer spending (measured by credit/debit transactions) remains robust, as does the housing market (measured by purchase mortgage applications). Hotel occupancy, seated dining, and TSA traveler traffic, while still well below pre-pandemic levels, have also been sharply improving in recent months.



Source: App Annie, Chase, Mortgage Bankers Association (MBA), OpenTable, STR, Transportation Security Administration (TSA), J.P. Morgan

This increase in mobility, along with a historic level of stimulus both from the Federal Reserve and from Congress, is likely to fuel rapid growth in our economy in the next few quarters as we continue to recover from the haunting impact of the COVID-19 pandemic.

Inflationary Concerns on the Horizon?

As we mentioned above, we have seen an incredible amount of stimulus pushed forth in efforts to support the economy in the last 12 months. The Federal Reserve has held short-term interest rates near zero and continues to expand its already enormous balance sheet through open-market asset purchases. Congress has authorized nearly six trillion dollars' worth of spending to support items such as enhanced unemployment benefits, direct payments to households, expanded healthcare resources, and aid to state and local governments. In addition, we expect to see an infrastructure package pushed through in the coming months, which will also carry a price tag in the trillions. In the short-term, stocks tend to react positively to this type of cash injection, as it leads to enhanced consumer and business spending. But over the long run, two other factors inevitably come into play: taxes and inflation.

We have seen proposals to raise the corporate tax rate to a mid-point range between the Obama-era rates and the cuts that Trump Administration pushed through a few years ago. We've also seen ideas that could impact individuals more directly, such as an increase in the capital gains tax rate, elimination of the step-up in basis at death, reduction in the estate tax exclusion, and upward adjustments in the rates for the top federal tax brackets. Though higher taxes do tend to dampen the spirits of investors, inflation can be just as ominous if not reasonably controlled. The Federal Reserve has signaled their willingness to ignore "transitory" inflation, seeking to hit a long-term average rate rather than a fixed target. But if transitory inflation turns into runaway inflation, their hand will be forced to raise interest rates quickly, which is a classic recipe for a future recession, and in this case, could be quite problematic given the record level of debt and deficit spending the U.S. government has taken on. We have already seen rapid increases in home prices and a significant rebound in fuel costs, which is to be expected given the amount of liquidity that has been pumped into the economy. We will be closely monitoring any potential spillover into the other core components of the Consumer Price Index (CPI) in the coming months, and with the Federal Reserve's new stance in mind, how long those price increases persist.

Moving Forward

We've had a fantastic start to the new year in our portfolios, and the optimism that comes from getting back to a world *not* dominated by a terrible pandemic stretches far beyond just the economic numbers. While we still have a long road ahead to get the virus fully under control across the globe, we are hopeful that the recovery will continue to play out, with unemployment dropping and those most directly impacted by the downturn experiencing relief. Inflation and tax policy changes will be top of mind for us as we navigate the remainder of 2021, and we will remain disciplined in our investment process to participate in the economic expansion, but protective as stocks hit all-time highs. We thank you for the continued opportunity to serve as your investment advisor, and look forward to our next visit, be that in person or by phone. As always, please don't hesitate to reach out to us at any time with questions or concerns.

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