Outlook for March 2021

Key Market Drivers

Rounding the Corner on the Path to Economic Recovery

Fiscal policy relief and the prospective reopening of the economy have been important upward drivers for U.S. equities over the last several months. The anticipated third fiscal relief bill should further boost consumption. This boost, combined with strong production and housing increases, has many economists scrambling to increase first-quarter and full-year 2021 growth estimates. The most significant risk to this outsized GDP growth is the inflationary implications of higher-than-expected demand and relatively lean inventories. Assuming supply catches up to demand quickly, any inflation this year should be transitory. Intense global competition and productivity-enhancing capital investment are vital for preventing longer-term inflation.

Japan should also experience positive first-quarter growth thanks to a smaller-than-expected drop in sales and strong corporate and capital spending. The country's production and export-driven economy is well-positioned for a sustained rebound. It should benefit from continued growth in the U.S. and China. Of all the major countries, China appears the strongest right now. Its expected GDP growth for 2021 is 8%, although this number could decrease if Chinese consumers don't fully re-engage. Despite all this positive news, not all regions are improving. Europe is experiencing a slight recession. A second-half recovery is possible for this region if vaccination rates increase as expected in the second quarter.

Our Perspective

Equity Markets

- With fourth-quarter earnings exceeding expectations and estimates for future quarters being revised upward, the backdrop for U.S. equities remains solid. Higher interest rates could stall the advance and even cause a correction until the Fed acts more directly to stop further rate increases.
- European equities have also seen surprisingly good earnings growth. Arguably, they will benefit more from an economic rebound because of their higher weighting in cyclical and consumer sectors.
- Japanese equities are poised for outperformance heading into spring due to a weaker yen and the positive effects of the global recovery.
- Mainland Chinese equities have pulled back recently, thanks in part to a stronger currency. We expect some relative underperformance as these markets may have already priced in the economic rebound. Additionally, the vaccine rollout will have less of an impact since the economy has effectively reopened.

Bond Markets

- With the 10-year Treasury trading at roughly 1.50%, the Fed has hinted it may shift its purchases towards intermediate and longer-maturity bonds. The bank may also consider actual yield curve control with a stated target for the 10-year Treasury if rates continue to rise and threaten economic growth.
- The yield spreads of below-investment-grade bonds have tightened and have not completely followed the increase in government bond yields. The spreads are not likely to decline much further from current levels.
- Municipal bond yields have not risen at the same magnitude as taxable ones. As such, municipals appear expensive relative to Treasurys across most of the maturity spectrum.
- A stabilizing dollar and higher fiscal deficits in many constituent countries could restrain any near-term advance in emerging market debt.

Outlook for March 2021

Our Perspective (Continued)

Monetary Policies/ Currencies

- The year-to-date increase in inflationary expectations has caught the attention of global central bankers. The Fed appears confident that the price increases are cyclical. It will be watching the rise in bond yields closely for any negative effect on the economic recovery and expansion.
- The European Central Bank and Bank of England seem more nervous about the increase in medium-term yields and the potential impact on the region's fledgling recovery. With limited tools at their disposal due to negative yields, these banks will likely resort to verbal guidance before adjusting their asset purchase programs.
- The Bank of Japan has targeted 0% for the 10-year JGB yield. The recent rise above this level will test the central bank's commitment to its current monetary policy.
- The Chinese central bank is the only one tightening its policy. The resulting increase in the renminbi's value against other developed market currencies is likely to pressure the export industries. However, it may fit the government's desire to skew the economy toward domestic consumption.
- While the dollar has begun to stabilize, increased deficit spending could lead to renewed downward pressure. Although, relatively higher U.S. interest rates should make U.S. assets more attractive to foreign buyers.

Commodities

- After reaching highs last seen more than a year ago, oil prices should stabilize as OPEC+Russia increase production beginning in April. U.S. shale producers' willingness to resume drilling remains uncertain, but current price levels appear profitable for many of these companies.
- Gold seems to be digesting the strong 2020 advance and is backing down to more buyable levels given continued, and perhaps enhanced, monetary ease by most global central banks.

What This Means for Investors

Asset markets continue to face more tailwinds than headwinds. However, the recent upward shift in the yield curve bears watching. At this point, the higher rates primarily confirm a cyclical recovery and vindicate the aggressive policy response. We are closely monitoring the ultimate impact on inflationary expectations and the subsequent monetary policy response, given current market valuations.

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