Flat-Shifting the Recovery

It has been several decades since I owned a manual transmission car, but learning how to drive stick was a rite of passage for most teenagers back in my day. After stalling the car several times, you gradually gained confidence in shifting and things went a lot smoother. With proficiency, one of the many tricks you tried to learn was flat-shifting the car (aka power shifting). This was effectively shifting the car without lifting your foot from the accelerator pedal. This would allow the car to launch forward at an even faster rate than possible through regular shifting techniques. It was all very fun, however quite risky for the car's transmission. In our view, the recovery from the pandemic-induced recession appears to be flat-shifting to a more accelerated rate as an improving economy combines with new fiscal policy initiatives and ongoing easy monetary policies to push the economy, interest rates and returns higher in the coming year. This shift to higher growth comes with some risks, which includes the potential transmission of higher inflation, adjustments to monetary policy and elevated market volatility in the months ahead.

Figure 1

Asset Class *(returns data as of 6/11/21)*	QTD	YTD	12M
Fixed Income			
U.S. Treasury Bills	0.00	0.03	0.11
U.S. Investment Grade Bonds	1.72	-1.71	-0.20
U.S. Investment Grade Credit	3.01	-1.78	3.67
High Yield	1.52	2.11	12.32
Equity			
S&P 500	7.21	13.83	43.39
Nasdaq	6.36	9.50	49.66
International Equities	7.53	12.34	43.61
ESG Stocks	6.86	12.55	47.00
Commodities			
U.S. Dollar Index	-2.87	0.69	-6.39
Oil	19.86	46.15	95.13
Raw Commodities	7.78	19.62	45.31
Gold	9.94	-1.10	8.67

As the economy has gradually reopened in 2021, investors have continued to enjoy very strong returns during the past year. (Figure 1) Positive fundamental and technical factors have pushed higher valuations across most asset classes and certain sectors of the market are quite frothy, including commodities and single- family housing. Given the amount of liquidity in the system, this has been expected to some degree. However, we have been somewhat surprised at the spending resilience of individuals, corporations and public entities. This is a giant improvement from last spring when the ramifications of the pandemic were extremely difficult to handicap. While the pandemic certainly is not over, as evident in the new delta variant, current vaccination levels and global reopening support stronger economic growth in the year ahead.

Equity and credit market returns have been particularly robust as corporate earnings rebounded to pre-pandemic levels faster than we expected. Earnings projections continue to increase with current S&P 500 expectations of 35% growth for the upcoming fiscal 12 months and 10% growth expectations for the subsequent two years. Given that backdrop, it is no surprise that equities have led the way on an absolute return basis during the recovery with double digit returns both year-to-date and over the past year. The breadth of the rally has been especially nice to see as international equities and commodities have performed well. Momentum has also shifted discernably within the equity markets over the past six months. Value stocks have significantly outperformed growth stocks as investors grappled with the prospect of higher inflation, higher interest rates and the corresponding impact on valuations.

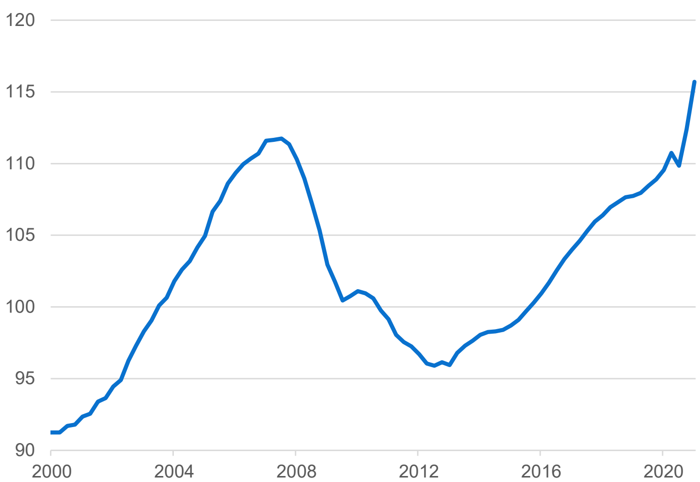
Overall, while U.S. investment grade bond returns were modestly negative over the past 12 months, due to higher absolute rates and a much steeper yield curve, risk sectors outperformed despite the uncertainties related to the pandemic and massive amounts of bond issuance. The high yield sector has earned 12.3% the past year, while investment grade credit has returned 3.67% as spreads whipsawed from decade-wide to tight levels during this period. Elsewhere in the fixed income market, Treasury returns have turned negative on the year as economic growth and inflation projections pushed yields higher. While the Fed gave some relief to money market investors by adjusting RRP and IOER rates in their June meeting, the front end of the U.S. curve has been weighed down by Fed policy, negative net supply and increased investor demand given the excess liquidity in the market. U.S. dollar weakness has continued over the past year and any upside will likely be capped until monetary policy becomes less accommodative.

Inflation continues to be the major fear/risk in the market today, as inflationary pressures continue to build within the economy. While the Fed continues to believe the current inflation pressures are transitory, near-term inflationary pressures could be more pervasive than consensus expectations. While certain segments of the commercial real estate market remain fragile, the U.S. housing market has been on a tear. The pandemic has created significant positive momentum to housing prices helped along by historically low financing rates. Low inventory, higher raw materials costs and supply chain bottlenecks have made housing increasingly unaffordable (Figure 2). Inflation surprises and anticipated changes to liquidity and Fed policy are potential catalysts for increased volatility in the year ahead, in our view.

Figure 2

UNAFFORDABLE HOMES

Housing affordability gauge



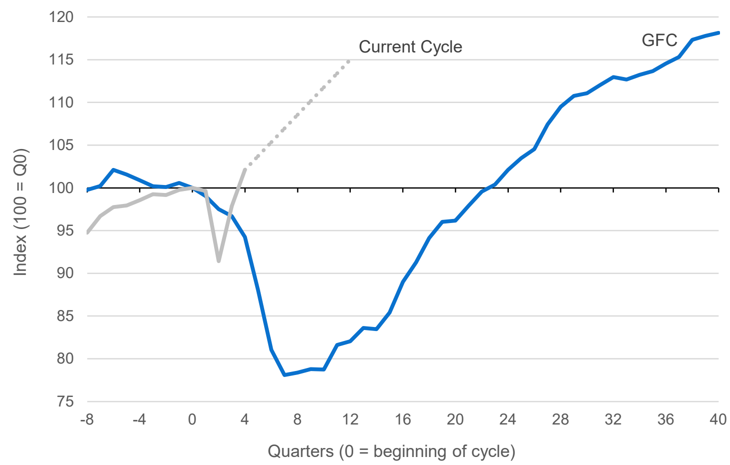
Source: Bloomberg

While prices are expensive for most assets versus historical averages, we would expect valuations to remain firm in the current environment due to stronger economic growth. U.S. GDP grew at 6.4% in the first quarter and consensus expectations are for 6.1% growth in 2021 before slowing to 4.1% in 2022. With an improving economy, labor slack should continue to decline as unemployment moves toward pre-pandemic levels of 3.5%. Consumption will continue to drive growth as labor markets improve and people begin to experience a more normal lifestyle. The path of future economic growth and inflation is the million-dollar question the market continues to struggle with. The current recovery is much swifter than the path we experienced during the Great Recession (Figure 3), although the sustainable pace following a period of pent-up demand remains to be seen. As the global economy continues to open, we expect further improvement in business investment following strong growth levels evidenced recently. Massive new government infrastructure stimulus ($1T+) will ultimately be passed in some form, in addition to the American Recovery Plan Act funds, bolstering economic growth and asset returns by consequence.

Figure 3

U.S. REAL FIXED INVESTMENT

Current Cycle vs. Great Financial Crisis



Source: Bloomberg, BEA, PMA Asset Management

We expect bond returns to remain limited as rates begin to move modestly higher in the next year. The yield curve has steepened quite a bit, so we would not be surprised to see the yield curve flatten in the year ahead as short-term rates begin to price in future Fed rate hikes. Rolling down the yield curve will be an important contributor to returns in the year ahead. While equities provide greater upside potential returns, we expect volatility to increase as the Fed removes accommodation. A large correction in equity prices would not be surprising. If valuation multiples remain above historical averages and earnings growth progress as expected, total returns over the next year could surprise much higher than our base estimation. Overall, risk sectors are poised to continue to outperform once again albeit with the risk of higher volatility and larger tail risk.

Fixed Income Outlook

With an improving economy, solid credit fundamentals and the potential for moderately higher interest rates, our strategy remains focused on income from non-Treasury sectors. We expect to remain overweight corporates, asset backed, agency commercial mortgage backed and taxable municipal securities despite relatively narrow spreads. With valuations driven by ongoing Fed purchases and the scope for some interest rate volatility this year, we view agency mortgages as less attractive than other spread sectors. Should an end to Fed purchases cause the sector to cheapen materially, we would reassess MBS.

From an interest rate perspective, we are cautiously defensive on the market, expecting moderately higher yields. However, the very sharp increase in intermediate and longer yields earlier this year means that longer term markets have priced in meaningfully higher rates. With the potential for a drawn-out Fed cycle and uncertain long-term economic growth, this has created some value in the market despite relatively low rates, particularly for yield curve rolldown in selected segments. The relatively steep yield curve continues to underscore those opportunities exist, even in a rising rate market, as well as the importance of proper curve positioning.

At a spread of 85bp, the corporate index is hovering near historical tights seen in 2018 and 2007. Nonetheless, supportive fundamentals and credit conditions mean corporate spreads can hover at historically tight valuations for an extended period. Income advantage is key in a low-rate environment. Credit selection is particularly important, with forward-looking fundamental analysis key to avoiding future negative credit events or spread-widening episodes. Simply yield shopping for widest spreads can be dangerous at this point in the cycle, so a focus on risk/reward is key, and we have a quality bias at the margin. Location on the yield curve is equally important for credit (beyond base Treasury rate effects) because the curve of spreads available across maturities differs meaningfully across industries and presents opportunities for rolldown aging returns, even in a stable spread environment. In addition, we look to limit duration in credits which may have the potential for elevated risk, providing a better cushion for potential price volatility.

We are emphasizing sectors which have the ability to do well in a rising rate environment, shorter durations in select lower-rated industrials and longer durations in credits with steeper curves where credit drivers are more manageable. We favor banks, healthcare, and communications. Capital is strong and credit conditions are favorable for banks, while recent large issuance has created attractive spreads in longer maturities. In communication, visibility on capex network costs and recent issuance to fund spectrum auctions combine a nice supply-driven concession with the potential for future improvements through de-leveraging. We are avoiding our underweight energy and materials sectors, given the sharp rebound in these sectors and the still problematic outlook given commodity price dependency. These sectors also have generally elevated risk around climate change, and in many cases broader ESG considerations which raise jump risk.

Risks to fixed income sector spreads are likely more centered in the potential for increased volatility or a shock to market liquidity from changing Fed policy or other events, rather than from a deterioration in fundament credit conditions. Selection remains important as individual companies and industries will increasingly be impacted differently in the environment going forward.

Equity Outlook

The equity markets have a new distraction every week. Whether it's meme stocks, inflation, supply chain issues, rising or falling interest rates, cryptocurrencies, or antitrust matters, something always creeps up to divert attention away from a holistic market view. Future growth was brought forward in 2020 for many companies, resulting in sky-high valuations that have not been seen since right before the tech bubble burst. While valuations have come in, further multiple expansion at these levels will be difficult, but better than expected earnings growth could push equity indices higher.

Small cap stocks have recovered a lot of past under-performance relative to large cap stocks since Q3-2020. Since the beginning of September 2020, the Russell 2000 has edged the S&P 500 by 26%. The second quarter of 2021 has not been as kind to small caps, and we see some further risk to the downside for the small cap space.

The valuation premium of growth over value has narrowed sharply as value has come back. However, the gap is still wider than long-term averages, indicating that value still has plenty of room to run. Value stocks also tend to outperform when economic growth is strong and interest rates are expected to increase. We continue to favor value stocks.

We are still less constructive on foreign stocks compared to domestic equities. However, developed markets have been more successful in their vaccine rollout, so the recovery trajectory in markets like Europe, Japan and Canada should be similar to that of the United States. Emerging markets are still having significant COVID issues, such as Brazil and India with the delta variant.

On a sector basis, we lean away from bond proxy sectors such as real estate, utilities and consumer staples, as rising rates could be a headwind. We favor financials, energy, health care and consumer stocks. There are pockets of information technology and industrials that we favor as well, while we are neutral to communication services and materials. Key themes at the sector level include infrastructure spending, tax rates, further reopening and movement increases, and interest rate sensitivity.

Figure 4

2016	2017	2018	2019	2020	2021 YTD
Russell 2000 21.3%	International Equities 27.4%	US Tbill 1.8%	S&P 500 31.5%	US All Cap Equity 21.0%	US Real Estate 18.6%
High Yield Corps 17.1%	S&P 500 21.8%	Securitized 1.0%	US All Cap Equity 30.8%	Russell 2000 20.0%	Russell 2000 15.3%
US All Cap Equity 12.7%	US All Cap Equity 21.2%	US Treasury 0.9%	US Real Estate 25.8%	S&P 500 18.4%	S&P 500 12.6%
S&P 500 12.0%	Russell 2000 14.6%	Aggregate Bond 0.0%	Russell 2000 25.5%	International Equities 11.2%	US All Cap Equity 12.4%
US Real Estate 8.6%	High Yield Corps 7.5%	TIPS (1.3%)	International Equities 21.8%	TIPS 11.0%	International Equities 10.4%
Investment Grade Corps 6.1%	Investment Grade Corps 6.4%	High Yield Corps (2.1%)	Investment Grade Corps 14.5%	Investment Grade Corps 9.9%	High Yield Corps 2.2%
International Equities 4.7%	US Real Estate 5.1%	Investment Grade Corps (2.5%)	High Yield Corps 14.3%	US Treasury 8.0%	TIPS 1.1%
TIPS 4.7%	Aggregate Bond 3.5%	S&P 500 (4.4%)	Aggregate Bond 8.7%	Aggregate Bond 7.5%	US Tbill 0.0%
Aggregate Bond 2.6%	TIPS 3.0%	US Real Estate (4.6%)	TIPS 8.4%	High Yield Corps 7.1%	Securitized (0.7%)
Securitized 1.8%	Securitized 2.5%	US All Cap Equity (5.2%)	US Treasury 6.9%	Securitized 4.2%	Aggregate Bond (2.3%)
US Treasury 1.0%	US Treasury 2.3%	Russell 2000 (11.0%)	Securitized 6.4%	US Tbill 0.5%	Investment Grade Corps (2.9%)
US Tbill 0.3%	US Tbill 0.8%	International Equities (14.6%)	US Tbill 2.2%	US Real Estate (7.6%)	US Treasury (3.2%)

Source: PMA Asset Management, LLC & Bloomberg as of 05/31/2021

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