Weekly Market Commentary
March 1, 2021

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Once again, we are reminded that the markets do not travel a straight line up. Stocks underwent a brutal tumble this week, the first back-to-back weekly decline in the S&P 500 index in four months. Not surprisingly, many are wondering if the party is over, even though the Federal Reserve has no intention of taking away the punch bowl. Time will tell, as only the most brazen soothsayers are convinced they know which way the market is heading. That said, there is no shortage of explanations regarding why stocks took it on the chin this week, including the usual suspects – stocks are overvalued and primed for a fall, inflation is rearing its ugly head, and, most notably in recent weeks, spiking bond yields are eating the lunch of stock investors.

Of the three, the latter seems to have garnered the most attention, mainly because long-term rates are actually rising – and rising at a rapid clip. To be sure, bond yields are still at historically low levels. But as is often the case with unfolding events, it is not the historical perspective that matters to market participants as much as the rate of change in the events themselves. In this regard, the increase in the bellwether 10-year Treasury yield has been the swiftest since 2016 over a comparable time span. Since finally piercing the one percent threshold in January, this rate ratcheted up to 1.60 percent at one point this week before settling down to 1.42 percent on Friday. At its low point last August, the 10-year yield stood at .50 percent.

Increasing bond yields by itself does not necessarily spell doom for the stock market. In fact, history shows that up to a point, stocks perform quite well in a rising rate environment. It is how investors perceive the reasons for the rate rise that determines their mindset. For example, in 2016 the Federal Reserve was in the early stages of a rate-hiking campaign, which market participants increasingly viewed as a growth-stifling influence that would soon choke off the fledgling recovery. The rate hikes, which continued through the end of 2018, eventually surpassed the increase in bond yields, resulting in a flattening of the yield curve that is a time-honored market barometer of recession fears. In retrospect, the Fed admitted the rate hikes were premature, designed to stave off an inflation outbreak that never occurred.

This time, the climb in bond rates is occurring amid a much different policy backdrop. Fed officials, as noted, have no intention of adopting a preemptive rate-hiking strategy to ward off inflation, planning to keep short-term rates at near zero until they see the whites in inflation eyes and the labor market is restored to full employment. Not surprisingly, the Fed's intentions together with the unprecedented fiscal stimulus coursing through the economy have lifted both growth and inflation expectations, underpinning the climb in bond rates now underway. This mindset is fully captured in the yield curve, which in sharp contrast to the earlier rate-hiking episode, has been steepening dramatically so far this year alongside another inflation gauge, the spread between the yield on Treasury securities and Treasury inflation-protected issues.

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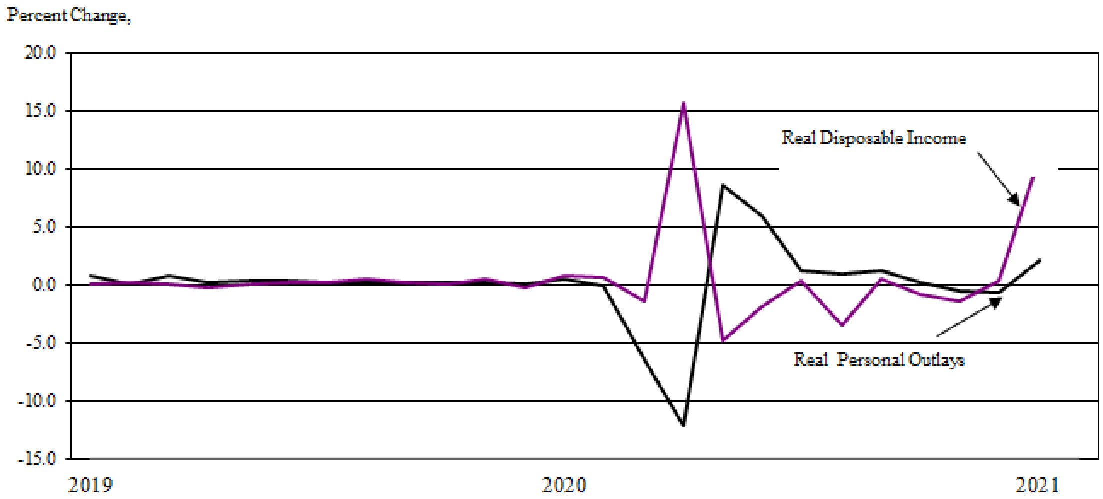
To be sure, just as the Fed can misread unfolding events, so too is the bond market not an infallible indicator of future developments. Indeed, even bond investors have a jaundiced view of future inflation, as other measures – such as the five-year/five-year forward rate – indicate that inflation would rise temporarily and then recede. The Federal Reserve and most private economists also adhere to this view; however, their conviction would understandably waver if the economy rebounds more vigorously from the pandemic recession than expected and concerns grow that the Fed would overstay its turbo-charged easy policy. These concerns may be having a bigger influence on market expectations, thanks to incoming data that depict an ever-muscular breakout in economic activity during the first quarter.

That clearly was the overriding message conveyed by this week's batch of economic data. The most dramatic illustration came from Friday's income and spending report, which depicted a highly energized consumer sector, the economy's most important growth driver. Armed with $600 checks sent to most households and expanded unemployment benefits contained in the $900 billion fiscal relief package passed in December, consumers went on a spending spree last month. Real consumer outlays surged by 2.0 percent in January, more than offsetting declines in the final two months of last year, and setting the stage for a robust first-quarter growth rate in personal consumption. The January spending surge – the largest monthly increase since last June – lifted the level of spending to within two percent of its pre-COVID level.

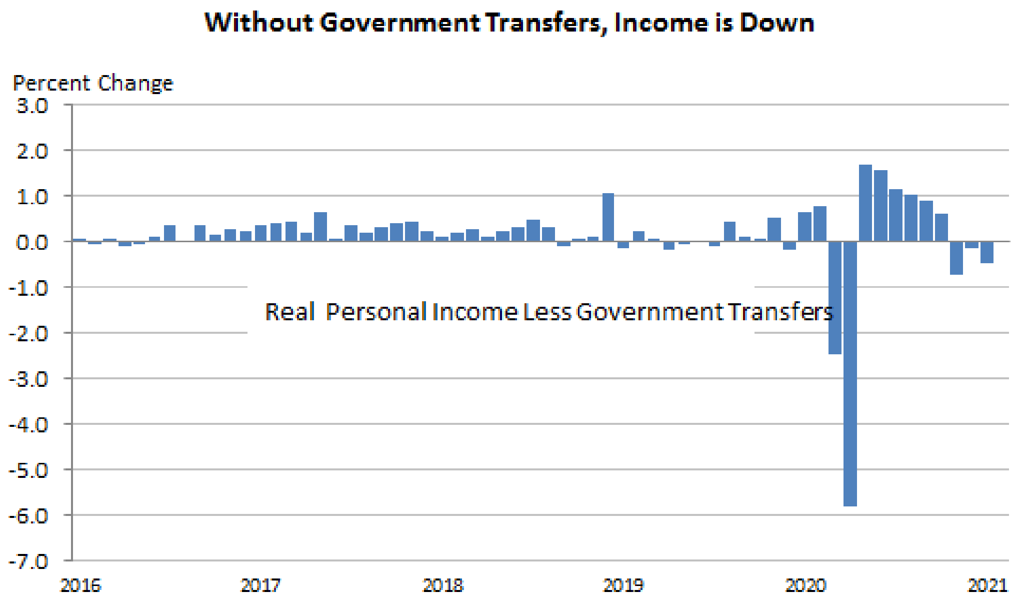
What's more, there is plenty of fuel in the pipeline to sustain spending over the near term. Even as households splurged on everything from cars, household equipment, clothing and recreational services, their bank accounts swelled even more. Those aforementioned checks and unemployment benefits contributed to an eye-opening 11 percent spike in real disposable income, leaving a huge amount of unspent funds that could be unleashed in coming months. Our calculations show that since the onset of the pandemic last year, household bank accounts have ballooned by about $1.8 trillion. The personal savings rate in January surged to 20.5 percent, up from an already high 13.4 percent in December.

Income Outpaces Spending



That's the good news. The not-so-good news is that virtually all of the increase in savings has accrued to upper income and wealthier households, those who retained jobs throughout the health crisis and could not spend at restaurants, gyms or barbershops, or book vacation trips because of business restrictions. No doubt, the unspent funds will flood back to these outlets when the health crisis is brought to an end, opening the door to a growth boom over the summer. But such recreational spending has an upper limit – a gym membership is purchased once a year, people won't get haircuts more frequently than they did before COVID and they probably won't eat more meals at restaurants or book more vacation trips.

Simply put, the pandemic has injected a feature into the evolving recovery whose longer-term implications rest in the hands of politicians and the will of their constituents – the increased role of government support, both to sustain growth and to address the issue of inequality that has worsened during the health crisis. The government's contribution to the economic recovery is strikingly evident in the income and spending reports. The astonishing 9.7 percent increase in real personal incomes last month is entirely due to government transfer payments. Take out that Federal income support, and real personal incomes actually declines by 0.5 percent in January. In fact, January was the third consecutive month of declining real incomes, the longest such stretch since the Great Recession in 2009.



It is also abundantly clear that without those transfer payments – the direct checks sent to households as well as expanded unemployment benefits – the recovery would never have gotten off the ground, much less morphed into the vigorous upturn now underway. Even as the upper income and wealthier households spent only a small fraction of the paychecks they retained throughout the pandemic, the lower quintile of households spent almost every penny of the income support received from the government on essential goods and services – rent, food and home goods – needed to survive. No doubt, some among the lower-income groups stashed part of the government benefits into savings, particularly those who kept their jobs. As business restrictions are lifted, those funds will also flow into the spending stream, amplifying the summer boom in activity that looms ahead.

However, for a sustainable recovery to gain traction, the economy needs to demonstrate it can grow without the outsized income support the government has provided over the past year. With the job market still employing 10 million fewer workers than was the case before COVID-19 struck, that is not likely to happen any time soon. But the $1.9 trillion American Rescue Plan on track to take effect by mid-March will inject even more fiscal thrust into the economy, fueling the growth resurgence expected over the summer. What's more, if the pace of vaccinations continues to pick up, as expected, and stays ahead of the new variants of the virus, the pandemic should be mostly in the rearview mirror by the second half of the year. That, in turn, will enable households to unleash the massive savings built up over the past year as business restrictions are lifted and customers return to reopened restaurants, bars, gyms, hotels and other service providers once again.

We suspect that the economy will be operating on its own two feet as it moves into 2022, and support for government intervention will diminish. However, it will still be years before all the slack in the product and labor markets is used up, which argues against an inflation outbreak that would spur the Federal Reserve into a growth-stifling rate-hiking campaign. That said, with inflation expected to run at or above the Fed's two percent target, monetary policy will likely be at a crossroads next year, heightening speculation in the markets as to what direction it should take. The recent volatility in the financial markets is a taste of what we might see later this year and in 2022.