WEALTH MANAGEMENT & TRUST
FRANDSEN BANK & TRUST

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OUTLOOKS

May 2021

ECONOMIC OUTLOOK

Summary

With stimulus payments deployed and vaccinations readily available (at least in the U.S.), there has been a chorus of market participants questioning whether we are nearing "peak" economic data, meaning growth would be slower from here. Those voices grew louder with the release of the most recent ISM Manufacturing PMI data. Although the April data came in historically strong (60.7), it was still four points lower than the March reading and it missed consensus expectations by 4.3 points. Remember, this is a diffusion index, so a reading above 50 represents growth and below 50 signals contraction.

This month's reading is particularly important when considering the "textbook" economic cycle. Early in the cycle, companies typically slow production in response to softening demand. As demand picks back up, so does production as companies race to replenish inventories while the economy normalizes. Traditionally this part of the cycle will often involve price increases, partially due to shortages and supply chain issues—all of which are currently occurring. It's generally after this initial economic rush that activity begins to stabilize.

The ISM data set could certainly highlight this process as we reached a low of 41.7 in April 2020, and then raced all the way to 64.7 in March 2021—the highest level in nearly 40 years. The lower but still elevated levels in May 2021 could represent the beginning of the economic stabilization that typically occurs, or it could just be a one-month blip.

Obviously, we haven't been living through a "textbook" scenario, and thus we shouldn't assume that traditional rules will apply. The service side of the economy has not yet fully re-opened, and we have seen an unprecedented amount of stimulus flow from the government to citizens. Although it missed expectations by 0.3%, first quarter GDP grew at a 6.4% annualized rate quarter-over-quarter, which was likely boosted by the smaller stimulus package from January, and not the most recent $1,200 payment package. With the latter now in hand, we saw growth in personal income of 21.1% month-over-month, and the savings rate has reached 27.6%, which is its second highest level, outside of the month following initial CARES Act stimulus payments. While it remains to be seen, if we have reached peak data, we expect the economy to remain robust through the remainder of 2021.

Positives

- Retail sales up 9.8%, nearly double the consensus expectation
- Core PCE lower than expectations (2.3%) and still within the Fed's expectations
- University of Michigan Consumer Sentiment continues to grow (88.3)

Negatives

- Existing home sales declined for a second straight month (-3.7%)
- Durable goods orders missed expectations materially (2.3% expected vs 0.5%)
- The trade balance continues and becomes more negative (-$74.4b)

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OUTLOOKS

May 2021

EQUITY OUTLOOK

Summary

The S&P 500 rose another 5.3% in April as economic data continued to improve and interest rates stabilized. Growth stocks outperformed their value peers with the Russell 1000 Growth Index climbing 6.8% versus a 4.0% increase in the Russell 1000 Value Index. The Russell Midcap, Russell 2000, developed international MSCI EAFE and MSCI Emerging Market indexes all rose 5.1%, 2.1%, 3.1% and 2.5% respectively.

Weeks into corporate earnings season results have widely been impressive and many companies have also provided strong forward guidance. The market's reaction to better than expected earnings and guidance has been lackluster. This could suggest recently surging stock prices had baked in the results and may signal a pause in the upward trajectory of the market. The old adage of "sell in May and go away" may very well apply this year. The market does feel a bit tired after performing so impressively over the last year.

That being said, the market conditions are still favorable for equity investors. The Federal Reserve has made no hint they plan to move from their accommodative policies. The economic strength should continue to boost corporate profits assuming companies can find enough workers and producers can pass through rising material costs. Changes in tax law appear to be tabled for the time being.

It's important to remember a 10% correction in the market is normal. Corrections in recent years have for the most part been short lived as markets have viewed pullbacks as buying opportunities in a low yield environment. Even if the market appears to be losing a bit of steam, as long-term investors it's important we focus on fundamentals, which are clearly bullish.

Positives

Accommodative Federal Reserve and global central bank policy

Wide spread vaccinations and many "reopenings" in the U.S. by this summer

Lack of return competition from other major asset classes

Negatives

Stock valuations, by some traditional measures, look relatively stretched

Rising input costs for producers

Unknowns

How long before the threat of inflation forces a reaction by the Fed

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OUTLOOKS

May 2021

FIXED INCOME OUTLOOK

Summary

After increasing for nearly eight straight months, longer maturity Treasury note yields peaked on the final day of March and modestly receded during April. The 10-year and 30-year note each declined about 11 basis points (bps) to end the month at 1.63% and 2.30%, respectively. The yield curve flattened as the 2-year Treasury yield remained nearly unchanged at 0.16%. Corporate bond spreads were also little changed during the month. Thankfully, the broad bond market returns were positive for the month, as they followed the worst calendar quarter in over 30 years.

With the economy booming and inflationary pressures emerging, many strategists and investors question whether this was simply a pause in a long-term upward trend, or whether yields have reached a fair valuation level. Based on history, it is easy to conclude that the 10-year Treasury note should not yield about 1% less than the rate of overall CPI inflation. But this scenario has happened a few other times in the past 20 years. On each of those occasions, inflation spiked, only to subside shortly afterward.

One of the determinants of the direction in rates will be whether today's spike in inflation is again temporary and transitory in nature, or whether it will be persistent, occurring year after year. The Fed has banked its reputation on the belief that inflationary pressures will subside over reasonable time frames. Others look to the growth of money in circulation, with low interest rates and further massive fiscal stimulus ahead and see no end to the pricing pressures. From what we know now, we are siding with the Fed. Our analysis of commodity prices, labor markets, demographics, trade and productivity trends leads us to believe that sharply higher inflation for a prolonged period is unlikely. We still believe that longer maturity rates can move slightly higher but the 10-year is unlikely to reach 2% anytime soon.

The incremental yields available on investment-grade corporate bonds remain near the lowest level seen in the last three years and well below the average of the last decade. With the economy rebounding and investors desperately searching for yield, we believe there is little reason to expect credit spreads to move significantly wider. Corporate bonds should modestly outperform similar maturity Treasury notes over the remainder of the year.

Positives

With short rates anchored by Fed policy, long rate will remain contained

U.S. yields are still attractive to foreign investors

Rising equity prices will lead to further account rebalancing into bonds

Negatives

Rapidly rising commodity prices and rising wages

Fear of a Fed reversal on policy

Massive treasury borrowing levels for years to come

Unknowns

Ability of economies to open around the world

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