First Quarter 2021 Commentary

An Oxford Harriman & Company Market Commentary

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Pandemic Passes One-Year Anniversary Mark

One-year after the commencement of the pandemic, the U.S. continues to make significant progress in battling the virus. Vaccination efforts are in full swing, with the U.S. administering nearly 2.5 million vaccine doses per day in the second half of March.[1] Daily new confirmed cases are down from their early 2021 spike. The data is encouraging and signals the pandemic's loosening grip.

Positive progress on vaccinations and new cases is allowing public officials to ease restrictions. States are removing capacity restrictions on restaurants and bars and allowing public venues to reopen. However, restriction easing comes as virus variants are emerging and as of this writing new daily confirmed cases are ticking higher. The risk remains that new cases counts increase in the months ahead.

Congress & Federal Reserve Remain Supportive

The federal government and Federal Reserve both remain committed to supporting the economic recovery. In March, Congress passed the Biden administration's $1.9 trillion fiscal relief package, which distributed $1,400 checks to individuals and extended unemployment benefits. The relief comes despite improving virus trends as the Biden administration and Treasury Secretary Janet Yellen reiterate the biggest risk is not acting big enough.

Currently, the Biden administration is drafting a $3 trillion infrastructure and jobs package. The infrastructure portion is expected to focus on repairing the nation's roads, bridges, waterways, and rails and tackling climate change. A domestic priorities bill focused on education and childcare is expected to follow. The bills' expensive price tags are prompting questions about funding, with the Biden administration considering corporate and individual tax increases to offset some of the spending.

The Federal Reserve held interest rates and bond purchases steady in the first quarter. The central bank is walking a tightrope by maintaining its current policy. Its own internal projections point to stronger growth and higher inflation ahead. However, Chairman Powell reiterated it will take time to reach the bank's goals of maximum employment and 2% sustained inflation. Also, the Fed wants to see actual progress, not forecast progress, before removing support. As a result, the Fed does not expect to raise interest rates until 2023.

Markets Forecast a Reflationary Period

The combination of positive virus progress and more fiscal and monetary stimulus drove the first quarter's reflationary narrative. Reflation is defined as a period of price increases when the economy is striving to achieve full employment and growth. The general market consensus appears to be that the combination of positive vaccination momentum, fiscal stimulus, and low interest rates will supercharge 2021 economic growth.

Recent spread movement indicates the market is gaining confidence as the economy prepares to reopen with significant fiscal stimulus and monetary policy support.

One of the first quarter's big stories was the Treasury yield curve's steepening, which occurs when the difference in yield between two bonds widens. We have discussed the 10's-2's yield spread for several years in these commentaries. As a refresher, markets track the 10's-2's spread for signals about future economic expectations. A steeper or widening spread signals expectations for stronger growth, higher inflation, and/or interest rate increases. A flatter or tightening spread suggests markets are concerned about the economy. Recent spread movement indicates the market is gaining confidence as the economy prepares to reopen with significant fiscal stimulus and monetary policy support.[2]

Market Rotates into Cheaper Cyclical Stocks

Performance during the first quarter was volatile at times as the market rushed to buy companies and sectors that benefit from stronger economic growth.

The reflationary environment impacted equity returns. Performance during the first quarter was volatile at times as the market rushed to buy companies and sectors that benefit from stronger economic growth. Cyclical sectors, such as Energy, Financials, Industrials, and Materials, outperformed, while defensive sectors, such as Health Care, Utilities, and Consumer Staples, underperformed.

The steeper 10's-2's spread also created a speed bump for growth stocks during the first quarter. Higher interest rates reduce the present value of future earnings and the recent rise in rates, along with expensive valuations, caused many high-flying growth companies to trade lower.

Bond Returns Hurt by Rising Interest Rates

The bond market had a difficult first quarter due to an increase in interest rates. Yields on longer maturity bonds rose the most as the market priced in stronger economic growth and higher inflation expectations. Rising interest rates lead to lower bond prices. As a result, longer maturity bonds experienced sharp losses to start 2021.

Rising interest rates also hurt investment grade corporate bonds. However, lower quality high yield corporate bonds were less impacted by rising rates. Demand for high yield debt remains strong as investors hunt for income. The market's growing risk appetite allowed companies to issue a record $140 billion in junk bonds during the first quarter.[3]

Is the Market Getting Ahead of Itself?

The Federal Reserve increased its 2021 GDP growth estimate to 6.5% from 4.2% in December 2020. The economy has not expanded that fast since growing 7.2% year-over-year in 1984.

The economic outlook brightened significantly in the first quarter due to positive vaccination efforts, declining COVID case counts, and strong stimulus efforts. Real-time data, including TSA security screenings and OpenTable reservations, are likewise rebounding.[4] The market expects the economy to strengthen further in the coming months. As an example, the Federal Reserve recently increased its 2021 GDP growth estimate to 6.5% from 4.2% in December 2020. The economy has not expanded that fast since growing 7.2% year-over-year in 1984.[5]

We have three big questions as we navigate the second quarter: First, how much future economic growth is already priced into the equity market? February economic data was messy, and investors are questioning if cold weather or a slowing recovery is to blame. The result is an uneasy market trying to figure out what occurs next. In our opinion, the economy has big expectations to meet in the coming months.

Second, will the recent uptick in COVID cases subside as more of the population gets vaccinated, or are we going to experience a 4th wave, leading to more shutdowns, and a delay of the economy reopening?

Third, what unexpected events may occur. As always, there are economic, macro, and geopolitical risks that are not being widely discussed or forecasted to occur.

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We should be prepared for more volatility during the second quarter. There is more proposed government spending planned and, on the surface, this may be viewed as a positive. However, proposed spending is not the same as stimulus, and we should be prepared for negative headlines during this legislation. Additionally, it is likely this additional government spending will come with higher taxes and we will have to see how the markets digest any future tax increases.

Sincerely,

Dennis P. Barba, Jr.
President & Managing Partner

Sources:

1. Our World in Data: www.ourworldindata.org/covidvaccinations
2. Data sourced from the Federal Reserve
3. https://www.ft.com/content/87e1ddd6-c613-4e51-bb7a-8db6d5fffe03
4. https://www.cnbc.com/2021/03/11/covid-19-economic-impact-five-charts-that-tell-the-story.html
5. Data sourced from the Federal Reserve

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