"The Magic Of Low Interest Rates"

Market Commentary – May 2021

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The advance estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 6.4% in the first quarter of 2021. This is even stronger than 2020 Q4's robust reading of 4.3%. The components of the 2021 Q1 GDP number are: consumer spending +7.02 percentage points, investment -0.87 percentage point, net exports -0.87 percentage point, and government spending +1.12 percentage points. The sum of these numbers equals +6.40%. Consumer spending is on fire, including spending on goods (durable and nondurable) and services. Investment was stronger than it initially appears, since inventory depletion penalized the investment reading by -2.64 percentage points. Inventory readings tend to be volatile and not sustainable (in either direction). The U.S. economy is roaring back from its COVID-19 slumber.

The Federal Reserve continues to believe that accommodative monetary policy is critical to keeping the economy on track. In its scheduled announcement on April 28, the Federal Reserve wrote that "the ongoing public health crisis continues to weigh on the economy, and risks to the economic outlook remain." They maintained the target federal funds rate in a range of 0% to 0.25%, and they continue to buy $120 billion of Treasury and mortgage-backed securities each month. As of April 28, the Fed had $7.83 trillion in assets on its balance sheet. Fed Chair Jerome Powell has stated that spikes in inflation would be transitory and the Fed would tolerate inflation "moderately above 2% for some time". With the economy red hot, however, investors need to ask if we are closer to the end of this period of extraordinary easing.

Low interest rates are the primary fuel behind the post-COVID-19 rally in stock prices. When interest rates are low, valuations of assets like stocks and real estate can "magically" float to high levels. Mathematically, this is due to smaller denominators in discounted cash flow models (interest rates are in the denominator). Mathematics aside, this intuitively makes sense because in a low interest rate environment, it is difficult to earn income. In turn, the income companies generate can command a higher premium (in the form of higher valuations). Many stocks benefit from low interest rates, with mega-cap technology stocks benefitting disproportionately. But what happens when interest rates rise? Valuations have to come back down. That part of the cycle is not as pleasant for investors. We must recognize that the current nirvana of low interest rates, low taxes, and low regulations will not last forever.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) during 2021 is $178.09, which implies a price-to-earnings (P/E) ratio of 23.5 with the S&P 500 at 4,181. The earnings yield (E/P) of 4.26% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.65%. Over the past month, expected earnings for the S&P 500 in 2021 jumped 3.4% higher (more empirical evidence of the economy gaining steam).

The S&P 500 blasted through 4,000 and indeed a new round of buying was unleashed. As of now, the index is struggling to close above 4,200, but it is essentially at all-time closing high. Support levels should be near 4,000 (50-day moving average) and 3,750 (near March 2021 low). It is amazing how quickly investors forget the pain of the severe March 2020 stock market collapse, even though it was short-lived. A modest correction in stock prices is inevitable. It is not a question of "if", but "when".

Stock market action since the beginning of 2020 illustrates the importance of a balanced investment strategy including stocks and cash. When a portfolio is 100% stocks or 100% cash, the investor needs to be correct in assessing market direction. In contrast, a portfolio balanced between stocks and cash is more stable. In a rising market, the balanced investor enjoys upside gains from stocks. In a falling market, the same investor has cash to buy at lower prices. When stocks enter a trading range, dividends provide income to patiently wait. A balanced portfolio provides a plan for whatever comes our way…even COVID-19.