Independence Asset Advisors

MarketMatters

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Covid-19 Update: "Herd Immunity"

The number of new confirmed Covid-19 cases declined by the end of the first quarter after surging during the winter months. In the U.S., the seven-day moving average of new confirmed cases decreased from a high of 260,000 in early January to 50,000 by the end of March. Reported fatalities followed a similar trend, decreasing from 3,500 per day to 1,000 by quarter-end.

It should be noted that while the U.S. benefitted from the widespread distribution of three viable Covid-19 vaccines, other less developed countries regressed, including the leading global copper producer, Chile, which elected to close its border for the month of April to quell a sudden surge in new confirmed cases and reported fatalities.

Here in the U.S., nearly 30% of American's had received at least one dose of the vaccine by the end of the March, with a rate of inoculation averaging three million doses per day. When combined with the total number of naturally immune individuals (infected and recovered), analysts estimated that nearly half the U.S. population had some resistance to the virus by the end of the quarter.

According to most experts, the spread of the virus would effectively be neutralized if a population could reach an immunity range of 70% to 80%, which seems likely to happen at the current immunization rate. At this range, "herd immunity" would occur, and we would reach the point at which there would be enough naturally immune or vaccinated people that the virus would not be able to sustain transmission withing the community (Table 1).

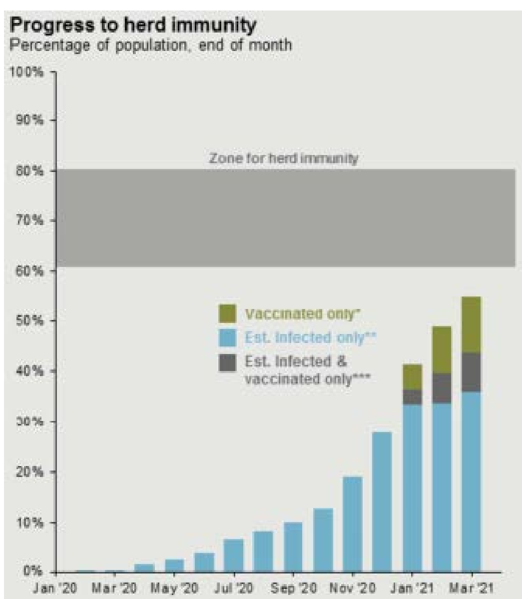
Guidance suggests the U.S. should return far closer to normal by the fall of 2021.

Market Overview & Key Themes

- The rollout of three viable Covid-19 vaccines reduced confirmed new cases and fatalities in the U.S. by 80%; less developed countries reported a spike in new cases and fatalities.
- Global equities performed well during the first quarter amid a value-led equity market rally.
- Bond yields rose considerably and prices declined, leading to negative investment grade bond returns.
- The U.S. passed a $1.9 trillion stimulus package worth 9% of U.S. GDP.
- Consumer prices rose 2.6% in March from a year earlier; above the Fed's 2% target rate.

The first quarter felt like breath of fresh air compared to the disorderly market conditions in 2020. Global equity markets got off to a sluggish start but accelerated with the announcement of a historic U.S. fiscal support package and the quickened rollout of Covid-19 vaccines. On the fiscal front, the $1.9 trillion "American Rescue Plan" was estimated to pump $1.2 trillion of additional spending into the U.S. economy during the second half of the year. On the Covid-19 front, the U.S. vaccinated citizens at a faster rate than expected, which led to an 80% decline in reported new cases and fatalities.

Table 1



The global effort to provide fiscal support and the progress by developed countries to reduce the spread of Covid-19 provided a positive backdrop from which to build a case for a sustained period of synchronized global growth.

That said, it will be months before we have full clarity around the pace of the global economic recovery and if further fiscal support will be needed to sustain growth momentum. In the meantime, investors are beginning to take note of an increased cost of goods and services and speculation has grown about how long dovish central banks, like the U.S. Federal reserve, can keep interest rates low (see page 2).

The other theme from the first quarter was the dramatic increase in bond yields and the accompanying reduction in prices, a combination that resulted in broadly negative total returns for most investment grade bond sectors. We discuss this further in our near-term global market outlook commentary (page 3), in which we also discuss the value-led equity rally and global equity market positioning.

Sources: Barron's, JP Morgan, Eaton Vance, cdc.gov, federalreserve.gov

Market Focus – "Inflation"

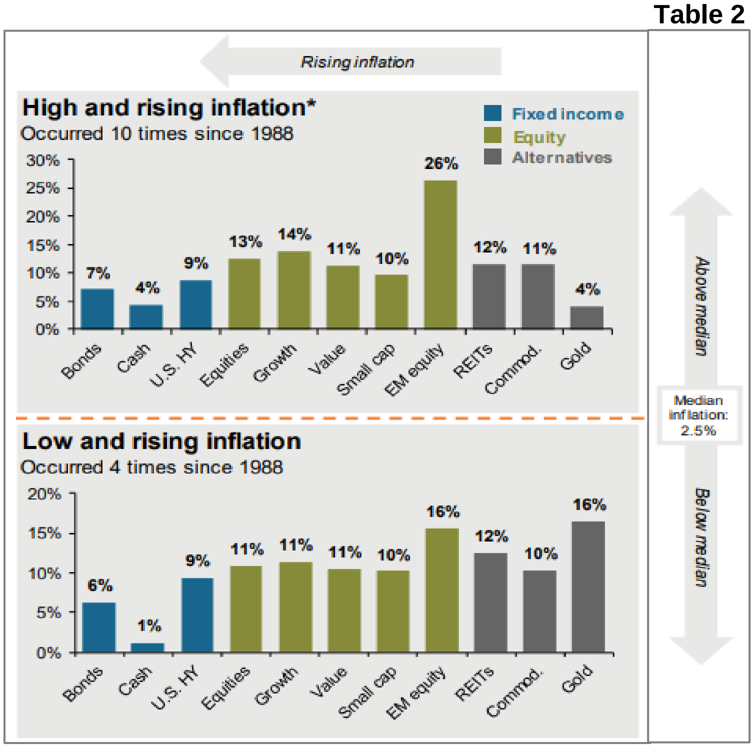
In this section we focus on inflation; will it be transitory?

Consumer prices jumped in March in what many are expecting to be a temporary period of higher inflation readings. Prices began inching higher during the fourth quarter before surging in response to the approval of the $1.9 trillion U.S. fiscal stimulus package. Overall prices that consumers paid for all goods and services increased 2.6% in March from a year earlier, a rate that exceeded the U.S. Federal Reserve's 2% target growth figure. The primary driver of the higher prices was energy costs, as crude oil prices jumped 22% higher during the quarter and broad energy costs rose 13%.

The 2.6% growth rate appeared high because it was calculated off of a March 2020 base, when nearly all business activity ceased in an effort to prevent the initial spread of the Covid-19 virus. But, even on a monthly basis prices surged 0.6% in March, which was slightly ahead of the 0.5% expectation and represented the fastest total CPI monthly increase since the Summer of 2009.

When we back out the more volatile cost of food, which rose 3.5% (to a seven-year high) and energy costs that jumped 13%, the CPI increased by a more reasonable 1.6% rate, year-over-year, and only 0.3% for the month of March.

Table 2



There are conflicting opinions about the March price increases, especially when we consider that a number of closely monitored goods and services categories actually declined in February (e.g., apparel -0.3%, computers -2% and health insurance -0.7%).

According to Oxford Economics, the March price surge was attributable to the reopening of the economy and passthroughs from supply chain bottlenecks, which are likely to continue to drive the pace of year-over-year inflation to 3.5%. However, this "world leader in economic forecasting" does expect the near-term rise in prices to be transitory and not a reflection of an inflationary spiral. Other forecasters disagree, suggesting the March price spike stemmed from soaring prices at the manufacturing level. These producer-level price increases are only now beginning to be passed on to consumers, but the short-term trend is likely to continue as commodity prices push ever higher.

In our view, it is too soon to predict with confidence whether we are looking at a transitory period of higher prices or if the March pricing report may be the start of an upward inflationary trend. What we can assume with more confidence is that the Fed is unlikely to raise interest rates to pump the brakes on an economy that has only appeared overheated for a period five weeks. Guidance from the Fed suggests it will need to see inflation above its 2.0% target rate for a consistent period of months before it would consider adjusting its accommodative stance, so we do not see higher short-term interest rates on the horizon.

That said, there appears to be adequate support to sustain a medium-term period of global growth, and prices are more likely to rise than fall. When considering portfolio positioning for this next period of low and rising inflation, we thought it might be helpful for our readers to view how the primary asset classes performed when conditions were similar in the past.

In Table 2, we show the average returns for fixed income and equity asset classes when median inflation rates were below 2.5% and above 2.5%, and when inflation was both low and rising and high and rising. Please remember that past performance is not a guarantee of future results.

Sources: Barron's, JP Morgan, Oxford Economics, federalreserve.gov

Key Insights:

- Developed countries are more likely to experience faster growth as a result of better access to Covid-19 vaccines.
- Central banks and governments are likely to maintain stimulative measures to ensure growth momentum.
- Inflation is likely to rise, although it is too soon to predict if the March pricing result is anything more than transitory.
- The Fed is unlikely to increase rates anytime soon due to its adoption of "Average Inflation Targeting."
- In the U.S., the pace of vaccinations and natural immunity to Covid-19 should lead towards a return to normal by the fall 2021.
- Guidance suggests high single digit U.S. growth in the second half of 2021 and first quarter of 2022 (2% thereafter).
- Corporate earnings have recovered substantially since the 2020 decline and are set to hit an all-time high in 2021.
- Stock prices are extremely elevated, especially mega cap and growth stocks; value stocks offer more reasonable pricing.
- Investment grade bonds remain subject to rate risk and negative total returns; consider higher quality high yield and loans.

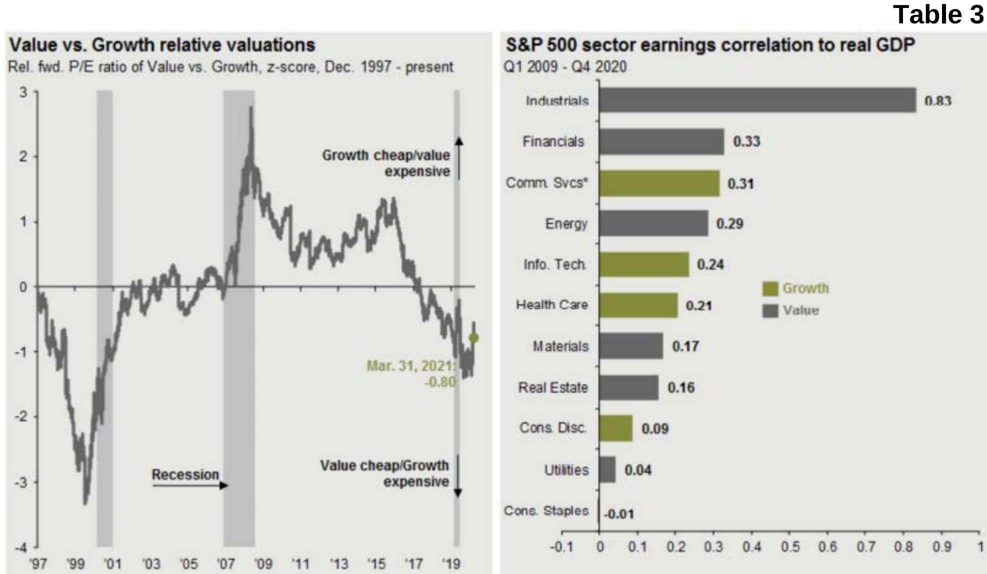
Our outlook for 2021 remains bullish against a backdrop of accommodative central bank posturing and a rapid push towards "herd immunity" in many developed countries. We do anticipate higher inflation as a result of potentially rapid growth, but we have not seen guidance from central banks to suggest we should expect higher interest rates any time soon. Here in the U.S., the chances of a rate hike in 2021 are even lower compared to other developed countries due to the Fed's adoption of the "Average Inflation Targeting" operating system, which involves a pledge to keep rates steady at 0-0.25% until the economy is at full employment and inflation is maintained above 2% for some time.

Within fixed income markets, we expect total returns to remain low for lower yielding investment grade bond sectors. As yields push higher, which we expect them to do, prices will continue to decline and the result will be near-term negative total returns. Longer-term investors may enjoy the higher income as maturities are reinvested at higher yields. Short-term investors seeking a yield advantage over cash may realize losses if the recent yield/price trend continues. Our guidance is to diversify into higher quality high yield bonds or loans, the latter of which offer nearly zero duration risk and a slight discount to par.

Within equity markets, we favor U.S. equities over foreign equities at this time. This is based on the stronger expected earnings growth that will likely accompany an accelerated reopening of our economy. As international developed and emerging markets improve their vaccine deployments it may be prudent to considering topping off allocations to these asset classes.

As a closing thought to this quarterly memo, we consider the recent value-led equity market rally. As value has closed the gap on growth over the past year, should investors consider an overweight? The data suggests that even after a good start to 2021, value still appears cheap compared to growth in terms of relative valuation according to the left chart in Table 3. Furthermore, we can see in the right chart in Table 3 that earnings growth in value sectors appears more likely to rise in what is widely expected to be a short, but robust, economic recovery.

Table 3



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IMPORTANT INFORMATION