CROSSMARK
GLOBAL INVESTMENTS

June 28, 2021
Issue 1.5

DOLL'S DELIBERATIONS

QUARTERLY EDITION

Peaking Economic and Earnings Growth Will Eventually Lead to Mixed Returns

Meaningful progress continues to be made in vaccinating the world's population against COVID-19. North America and Europe continue to lead the rest of the world based on the share of people who have received at least one dose, but other geographies are also making meaningful progress. However, as evidenced by the recent decision in the U.K. to postpone the lifting of COVID-19 restrictions by four weeks due to the spreading of the Delta variant, the global economy is not entirely out of the woods yet.

Following a recession like no other, American households are flush with cash. Since COVID-19 broke out last March, real disposable income has grown at its fastest 15-month rate ever. The outlook for consumer spending is strong. U.S. consumers are experiencing a dramatic improvement in employment prospects when there are massive sidelined savings and pent-up demand for some services. Household balance sheets are in great shape, reflecting last decade's deleveraging and the current huge tailwind from asset appreciation. The corporate profit outlook remains as bright as it has been in a long time, thus supporting risk assets, assuming that the unwinding of hyper-accommodative monetary conditions is slow and lags the uptrend in inflation. However, the business cycle is at the strongest of the expansion stage and will soon shift into a moderate slowdown. While growth is to remain robust, it has most likely peaked and is starting to decelerate. The pace of earnings growth is also peaking.

The June Fed meeting set up a chain reaction that looked to be the start of a risk-off phase. Treasury yields rose, providing support to a struggling U.S. dollar, which in turn magnified the correction in commodity prices and caused equity prices to decline. This only lasted briefly as the market recognized that the Fed is still a long way from its first rate hike and a shift to a tight monetary stance is still not on the horizon. Nevertheless, the point of maximum friendliness of the Fed towards the stock market has passed. The Fed will eventually taper and then raise rates; the unknown is the pace and magnitude.

The market consensus view remains that stronger growth will have a little lasting impact on inflation. Investors expect inflation will only lift briefly and then recede, remaining well contained over the long haul. This is consistent with the Fed's statements that consumer price pressures will prove transitory. Our view is less benign and that monetary authorities and investors are too complacent about the pace and durability of the move up in underlying price pressures. We believe the current post-pandemic spike in U.S. core inflation will soon peak but will be followed by resilience rather than a return to sub-2% inflation. In other words, the era of 0-2% inflation is over.

The process of moving from the most accommodative policy settings in memory, and probably in the history of modern central banks, to something less extreme will be periodically disruptive for all financial markets. The Fed and other central banks want solid growth and higher inflation and thus will proceed slowly until it is overwhelmingly clear that inflation is higher than they are willing to tolerate. One key implication of the very positive economic outlook is that hyper-accommodative policy conditions are no longer appropriate.

The view that strong corporate earnings growth and negative real interest rates are sustainable foundations for multi-asset positioning is misplaced. If growth remains as strong as we expect over the next 12-18 months, then real bond yields will eventually climb into positive territory, with a parallel up move in nominal yields. Of course, the Fed is determined to forestall such an outcome. Still, bond investors will eventually demand compensation for the inflation and policy risks that sustained strong economic growth will create. The implication is that risk asset valuations will ultimately have to adjust downward (including a drop in equity market P/E ratios.)

The U.S. equity market had a fantastic run since the March 2020 bottom, delivering 90+% returns and is now trading at 30x trailing P.E.; forward-looking P.E. is also elevated at 23x. It seems as though markets have borrowed returns from the future. With valuations close to an all-time high, equity markets do not have much safety margin. They are vulnerable to a correction triggered by hawkish rhetoric from the Fed, or more likely, upside inflation or employment surprises. We think the environment still favors values and cyclical overgrowth and defensive over an intermediate timeframe, although the latter pair could outperform in the short-term. The likely outperformance of value versus growth also has implications for regional allocation within a global equity portfolio. This underscores that investors should favor international markets over the coming year. This stance is also supported by our view that, despite current dollar strength, the longer-term path is downward.

Conclusion:

Equity and credit markets are not cheap, but should remain well supported against a backdrop of solid corporate earnings growth. We continue to see opportunity in overweighting risk assets within a multi-asset portfolio, and maintaining a below-benchmark duration position within a fixed income allocation. We expect modest absolute returns from global equities. A bias toward value over the coming year supports an overweight stance toward international equities.

Source: Bank Credit Analyst, Macro Research Board

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