Lowe, Brockenbrough & Company

1st Quarter 2021 Commentary

# Q1 2021: Bust to Boom

U.S. equity markets surged higher in the first quarter. And underneath the surface, the powerful rotation out of the COVID-19 winners and into recovery plays continued. The S&P 500 Index rose 6.2% during the quarter, a handsome result, but compared to the 12.7% returned by the small cap Russell 2000 Index, not so much. Digging a little deeper, the quarter's best performing sector, energy (up nearly 31%), was last year's laggard, while technology, the hot sector for much of last year, returned only 2%. It was only a few short months ago that oil somehow briefly traded at a negative price, and we can recall Jim Cramer, the ubiquitous and sometimes sage CNBC commentator, declaring that energy was "uninvestable." Ours is a profession with almost no concrete rules for establishing its most basic element: the value of businesses. Investors stampede in one direction and then back again, occasionally overshooting wildly, especially if they're confronted with unique circumstances…like an economy crushed by a deadly pandemic that elicits a work from home boom and the largest stimulus ever.

Fixed income investors were bloodied in the first quarter, as 10-year Treasury yields leapt from 0.9% to 1.7%. The Barclays U.S. Aggregate Bond Index lost 3.4% in the quarter. Evidence of gathering economic strength and mounting expectations for possible boom-like GDP growth conditions fed the rate move. While the rise is sharp, it appears justified. And rates could go somewhat higher, perhaps 25 to 50 basis points, but there's a limit, tied generally to debt service and specifically to housing refinancing and turnover, which have been robust thanks to very low rates. Simply put, you don't refinance and you tend not to move when your existing mortgage rate is lower than that currently available. Reversing the housing benefit would quickly cool things off. And at the risk of this paragraph becoming tedious, just one more fact: March Nonfarm payrolls rose by 916,000. That's big. And this is before a fully vaccinated public charges out the front door, flush with several trillions of stimulus in their back pockets. Can there be much doubt that the economy is primed to boom?

But what kind of boom? There are already serious bottlenecks in the global supply chain. The west coast ports are backed up and shipping containers aren't in the right places globally. There's a semiconductor shortage hitting equipment and auto manufacturers, some of which have announced production halts. On top of this, the Texas deep-freeze crippled critical plastics manufacturing equipment. Materials from PVC to insulation are in short supply, also hitting autos and housing. It's not at all clear what's going to happen when the tsunami of cash slams into these issues. Price spikes are guaranteed. Some desirable stuff, like that tricked-out F-150, may not be available for months. Housing inventory stands at a three decade low. Airlines, hotels and restaurants can only accommodate so many, given a year of driving costs down to stay afloat. It simply won't be possible to spend all the excess savings and stimulus in a quarter or two. Jamie Dimon, the CEO of JP Morgan and arguably the most respected voice on Wall Street, believes the boom "could easily run into 2023."

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And, of course, this has raised inflation concerns, as it seems inevitable that stuff in short supply will be rationed through price hikes. But can temporary supply issues really cause longer-lasting inflation? Our reasoned bet is no. Shortages aren't embargos and will be solved. Honestly, this letter doesn't have enough readers to risk losing even one to the dullness of a comparison of 1970s inflation versus today. To us, these two periods seem comfortably dissimilar. And we hope it will suffice to say that our broad reading of the experts on this subject, while not uniformly dismissive of more problematic inflation, suggests they aren't overly concerned. Furthermore, the powerful forces holding inflation down over the last couple of decades (ageing western societies, tech adoption, emerging markets) haven't abated. For those of you fretting about trillions of unfunded spending, we have a few hopeful words: Treasury Secretary Janet Yellen believes the important number is debt service relative to GDP. This measure has not moved much as exploding debt has been offset by collapsing interest rates and a growing economy. That may be thin porridge for some of you, but it's something.

And now, finally, back to this bull market and near historic rotation. With the inevitability of a period of very strong growth and the possibility of it lasting for a couple of years, the markets are expecting strong, perhaps explosive, earnings growth from an overheated economy. Normally, there'd be concern about the Federal Reserve tightening monetary policy, but they've repeatedly stressed their desire for the economy to run hot. They've even pondered, perhaps rhetorically, forcing rates down, essentially green-lighting the surging stock market. Investors have rightly focused on recovery plays of late, as the earnings surge there could be historic. This isn't to say that some tech won't continue to do well, but their earnings won't look nearly as lustrous, by comparison. And some COVID-19 winners will find that they were just lucky and suffer a fade in business as we re-reorient our consumption habits. Unhelpfully, many of the aforementioned are still quite expensive. We believe all of this continues to favor the reopening trade, but as we said in the beginning, this won't be a smooth ride. There will be surprises. The fiscal and monetary authorities are experimenting on a scale rarely, if ever, attempted. We hope Mr. Dimon is correct and the Fed hasn't miscalculated.

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