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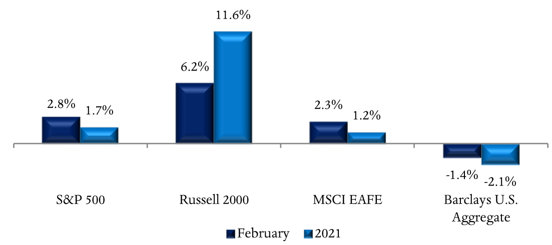
Markets

Equity markets ended February with generally positive returns, despite a month-end pullback due to a steep rise in interest rates. The drop in coronavirus infections and accelerating vaccine roll-outs led to increased investor optimism. In a continuation of the ongoing rotation, small capitalization and value equities (led by energy and financial services) outperformed large growth stocks, driven by post-pandemic normalization and rising bond yields. This divergence was most stark in the performance of the Russell 1000 Growth index (large capitalization focused) which declined -0.1% versus the Russell 2000 Value benchmark (small capitalization oriented) which surged +9.4% to an all-time high. The bellwether S&P 500 index also touched record highs, ending the month +2.7% higher (+1.7% ytd).

Foreign equities rose in February. The MSCI EAFE developed market index, appreciated +2.3% (+1.2% ytd), and the emerging market index, added +0.8% (+3.8% ytd). European equities closed the month up +2.5% (+1.8% tyd), with value sectors such as banks outperforming. In Asian markets, Tokyo's Nikkei 225 index rose +4.8% (+5.6% ytd), while the Shanghai composite added +0.8% (+1.0% ytd).

Bond yields rose as markets priced in higher future growth and inflation expectations, spurred by ongoing and robust government spending. Notably, the 10-year Treasury yield ended February at 1.49% (up from 1.08% at the start of the month and 0.91% at the start of the year), with an associated 25 basis point yield curve steepening. In this context, the Bloomberg Barclays US Aggregate Index declined -1.4% (-2.2% ytd). Overseas, the 10-year German Bund yield rose to -0.28% (from -0.52% at the start of the month). Meanwhile, increased investor optimism in high-yield credit resulted in US "junk bonds" yielding below 4% for the first time ever.



Rising industrial and energy commodity prices contributed to higher inflation expectations. Crude oil exceeded its pre Covid-19 level, with the WTI benchmark ending February at $61.50 per barrel, boosted by hopes of a recovery in demand coupled with supply constraints (exacerbated by the frigid Texas temperatures that closed in a significant amount of production). Copper also appreciated significantly, related to increased infrastructure usage as well as its inclusion in green energy technologies.

Geopolitics

President Biden kick-started his administration by signing a series of executive orders aimed at regaining control of the pandemic. Data on infections continued to trend down and the vaccine rollout accelerated (producers are expected to provide 600 million doses, covering the adult US population, by the end of July). Further, the President reentered the United States in the Paris climate agreement, mapped out a $2 trillion clean energy and green jobs plan, pledged to cut emissions from electricity to zero by 2035, and achieve net-zero emissions by 2050.

Developed nations are progressing with their Covid-19 vaccination programs, with the percentage of the population that has received at least one dose reaching 30.9% in the UK, 16.2% in the US, and the mid-5% region in various EU countries. These trends will hopefully allow for large-scale reopening of economies in the second half of the year.

United States

Congress is in the final stages of debating the passage of President Biden's $1.9 trillion fiscal "Rescue Plan." Coupled with December's Covid-19 relief package, economic stimulus may reach 13% of GDP in 2021. Notably, this is in addition to the massive stimulus already delivered last year, which has meaningfully boosted household savings. Looking ahead, the projected stimulus checks and unemployment benefits could lead to a significant acceleration in consumption, particularly once social distancing restrictions are lifted. The risk is that the immense stimulus, combined with ample liquidity in the system, possible post-pandemic bottlenecks in supply chains and pent-up demand, may lead to excessive inflation. According to the latest reading, the core consumer price index has risen by a moderate 1.4% over the past year, a figure that is expected to rise in the intermediate-term. Nevertheless, Treasury Secretary, and former Federal Reserve Governor, Janet Yellen reiterated her support for the fiscal plan, showing more concern about unemployment than inflation, arguing that it is expected to recede in 2022. As we go to press, US hiring was reported to have roared back in February, with 379,000 new jobs created, amid a meaningful decline in new Covid-19 cases. The unemployment rate edged down to 6.2%, yet the country still has 9.5 million fewer employed than a year ago.

February featured a bevy of growth-positive economic releases, ranging from retail sales to personal income to industrial production. US retail sales bounced 2.4% in January, boosted by the late-2020 $600 stimulus checks. Manufacturing and services purchasing managers' indices (PMIs) jumped to 60.8% and 55.3%, respectively according to ISM, indicating a more favorable outlook, particularly for the hard-hit services sector.

February 2021 Economic Statistics

	Feb-21	Dec-19	Dec-18
Federal Funds Target Rate	***0 - 0.25%***	1.50-1.75%	2.25-2.50%
Consumer Confidence Index	***91.3***	126.5	128.1
Manufacturing PMI Index	***60.8%***	*47.2%*	*54.1%*
Unemployment Rate	***6.2%***	*3.5%*	*3.9%*
JPY / USD	***106.58***	*108.61*	*109.56*
USD / EUR	***1.2074***	*1.1210*	*1.1469*
Gold / oz.	***$1,733.49***	*$1,517.01*	*$1,282.73*
Oil (WTI) / bbl	***$61.50***	*$61.06*	*$45.41*

Europe

EU economies have exhibited mixed results, as various sectors strive to navigate the pandemic-related lockdowns. February's Manufacturing PMI strengthened to 57.9% (+3.1%) while the services index remained in contractionary territory, nearly unchanged at 45.7%. Consumer confidence improved marginally, confirming lingering uncertainty. Amid vaccination delays, the EU has set a goal to inoculate 70% of their adult population by summer. In the meantime, many of the union's countries are augmenting lockdowns.

The European Parliament gave the go-ahead for the Recovery and Resiliency Plan. After ratification, individual countries will start to submit projects to the EC for final approval. A rapid implementation could spur economic growth ahead of expectations and draw increased foreign direct investment to the region.

In Italy, the formation of a new government led by Mario Draghi, the former European Central Bank president, was approved by a large majority in parliament, avoiding the undesirable scenario of snap elections during a pandemic. The mandate of the new government is to implement and oversee an effective vaccination plan, provide support to prevent Covid-19 related layoffs, and decide how to best use the resources of the European Recovery Fund. Mr. Draghi is fondly remembered by investors for vowing to do "whatever it takes" to resolve the 2012 eurozone sovereign debt crisis. He is, thus, viewed as a highly competent person to steer the Italian government through the pandemic.

The UK vaccination campaign is progressing remarkably well and has already reached 21 million people. Boris Johnson recently announced a target of achieving full coverage of the adult population by July and announced a gradual reopening, starting with schools, this month. From an economic standpoint, retail sales fell sharply in January as a result of the lockdown. But PMIs surprised to the upside, indicating improving sentiment, with manufacturing and services moving up to 54.9% and 49.7% respectively.

Asia

China continued to weather the coronavirus pandemic in an admirable fashion. Nevertheless, a small rise in new cases led to some mobility restrictions over the New Lunar Year holidays. 2021 is the Chinese year of the Ox, which symbolizes hard work, tenacity, perseverance and loyalty, considered to be foundations of success.

Chinese economic output continues to follow a strong V-shaped recovery, with 6.0% GDP growth forecast for 2021. As per the People's Bank of China, stimulus is expected to remain modest and likely to taper during the coming year. This is a potential concern for local real estate investors that have become accustomed to ever rising housing prices. Meanwhile, the renminbi continues its appreciation, supported by the increased growth gap between China and the rest of the world, positive real rates, and increased global interest in Chinese assets.

Outlook

Expectations of a swift emergence from the pandemic, thanks to ongoing vaccination rollouts, continues to be a tailwind for financial markets as well as consumer confidence. Given the imperative, governments remain focused on a mix of pandemic control as well as fiscal and monetary support measures to ensure favorable health and economic outcomes.

Stock rotations from growth to value could continue, as we progress towards the end of the pandemic, supported by the still-wide divergence in valuations, as well as rising commodity prices and higher yields. On the corporate earnings front, with over three-quarter of the S&P 500 index constituents having reported fourth quarter results, 63% have outperformed expectations to the upside, beating estimates by 17.1%, while 56% have done so on revenue, exceeding estimates by 2.4%. The earnings recession is over and, looking ahead, S&P 500 index earnings are expected to rise by 23% in 2021 and a further 15% in 2022, providing solid valuation support for stocks.

The Federal Reserve has pledged to grow its balance sheet by roughly $120 billion per month by buying $80 billion of Treasury securities and $40 billion of agency mortgage-backed securities "until substantial further progress has been made toward the Committee's maximum employment and price stability goals." This form of monetary policy, known as Quantitative Easing (QE) has been in force for over a decade, increasing liquidity and suppressing bond yields. However, recently, investors have witnessed a rapid spike in 10-year US Treasury interest rates, as the bond market begins to discount some level of coming inflation. Therefore, it was notable that the Fed's balance sheet grew $180 billion in February. Is it possible that the Fed intervened in the US Treasury market to cap long dated yields? If so, this may be an initial stage of Yield Curve Control (YCC), defined as the central bank targeting a certain yield at a particular point in the curve. Semantics aside, the Fed's 50% greater than normal increase in its balance sheet last month seems to have been generally unnoticed. Ongoing, and potentially increasing, liquidity is likely bullish for equities, commodities and other hard assets, while being negative for the US$.

The presumption of a resurgence in inflation and associated rising yields, off historically low levels, risks unveiling the vulnerability of core fixed income as a stable element of traditional asset allocations. Not only may losses be exhibited in the short-term, but investors risk losing purchasing power over the longer-term. Therefore, we continue to advocate for the avoidance of long-dated bonds in favor of unique portfolios that can deliver solid risk-adjusted returns by favoring variable-rate securities, real assets and non-market correlated strategies.

As we plan for the market vagaries of 2021, and beyond, we have also identified numerous opportunities in merger arbitrage, distressed real estate, hedged credit, European equities, water infrastructure, digital education, and healthcare.

Sources: Barclays, Bloomberg, Bureau of Labor Statistics, Conference Board, Department of Agriculture, Federal Reserve, Financial Times, IMF, Institute for Supply Management, MSCI, Reuters, Russell, Standard & Poor's, and the Wall Street Journal.

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