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Investment Commentary—April 2021

The U.S. economic recovery accelerated significantly during the first quarter. Full-year GDP growth is now expected to be 6% or higher, the strongest since 1983. We'll discuss the reasons below (the short version is vaccines and trillions in Covid relief), but it's worth dwelling on just how encouraging the current economic outlook is.

The chart below, courtesy of the Goldman Sachs economics research team, shows GDP growth and goods and services consumption relative to the previous trend. Anything above the line marked 100 is above the pre-Covid trend. Goldman forecasts that over the summer U.S. economic activity will not only reach pre-Covid levels but **exceed what it would have been had Covid never happened.**

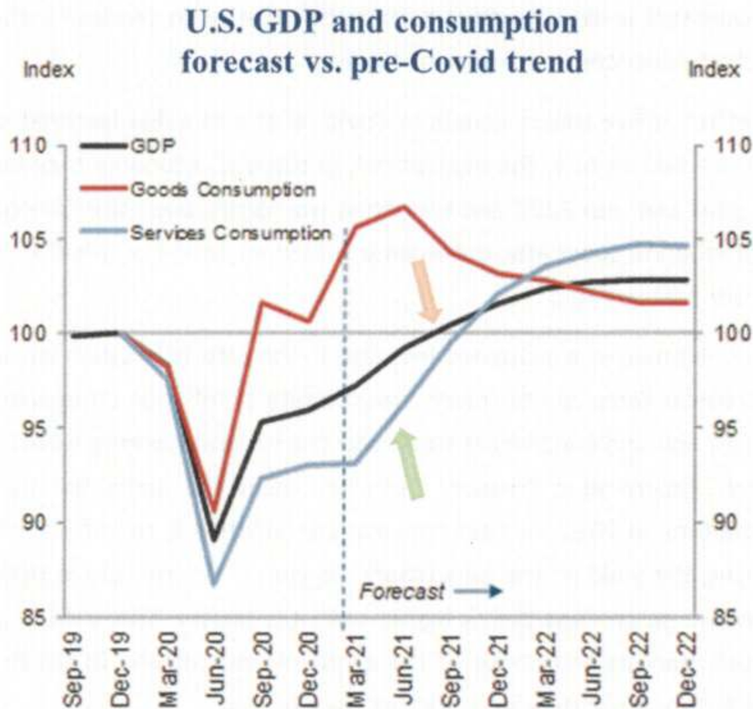

Chart prepared by Spencer Hill/Goldman Sachs Economic Research
Data Sources: Dept. of Labor, Dept. of Commerce, Bloomberg, Haver Analytics, Federal Reserve System, Goldman Sachs Global Inv. Research

Constraints on travel, dining and entertainment caused services consumption to rebound more slowly than goods consumption. As vaccinations permit more travel, etc., services consumption will surge.

U.S. economic activity (GDP) may soon exceed what it would have been had Covid never happened!

The difference between the red line and the pale blue line is important. While both goods and services consumption rebounded last summer, the recovery in services consumption was much weaker. Spending on dining, travel and entertainment was held back by state-imposed as well as self-imposed restrictions. In the meantime, the $2.2 trillion CARES Act kept many small businesses afloat and put hundreds of billions of dollars in consumers' bank accounts. With incomes propped up by the CARES Act, money that would have been spent at restaurants, hotels and movie theaters was spent at Home Depot, Wayfair, Amazon and the like buying things. The sharp spike in the red line reflects this skyrocketing goods consumption[1]. When some of the benefits from the Covid relief package wound down in the fall, goods consumption fell off a bit but in December Congress stepped in with $900 billion of additional Covid relief and the recovery began to regain momentum.

In the months ahead the economy seems nearly certain to accelerate further, propelled by another $1.9 trillion in Covid relief passed last month and tens of millions of fully vaccinated Americans eager to spend money on all the things they couldn't do last year. A wave of spending on dining, travel and entertainment is likely to drive a dramatic increase in services consumption (the pale blue line in the chart) over the remainder of the year.

The cumulative effect of five trillion dollars in Covid relief and a few hundred million doses of vaccine will be powerful. In fact, the biggest risk to the U.S. economy may be that it gets too strong later this year and into 2022 and triggers a worrisome bout of inflation. The odds of 1970s style double-digit inflation seem low, but even a sustained period of inflation in the mid-single digits could be very problematic.

One of the likely outcomes of a sustained increase in the rate of inflation would be much higher interest rates. Interest rates can be lower than the rate of inflation ("negative real rates"), but normally only when economic activity is weak and the Federal Reserve wants to use low rates to spur the economy. According to Treasury Secretary Yellen the economy may be at or near full employment some time in 2022. If that happens and inflation is running at 4% (for example) with no pullback in sight, the yield on the benchmark 10-year U.S. Treasury is likely to be at least 4%. That's more than two percentage points higher than it is today. That kind of a spike could spook the bond and stock markets and choke off the economic expansion. In the long run, stock prices are correlated to inflation but the ride could get very bumpy!

Right now, capital markets and most analysts seem to think that inflation will remain manageable. But the truth is that no one really knows. Disinflationary forces such as cheap overseas labor and internet-enabled price transparency have made fools of inflation fearmongers for over a decade.

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[1] There are several components of GDP (such as home construction and spending on busines equipment) that are not shown on this chart, but goods and services consumption represent the vast majority of the economy, so the chart illustrates the most important twists and turns of the recovery.

But we haven't seen anything close to this level of federal fiscal stimulus (even scaled for the size of the economy) since World War II, so we are truly in uncharted waters.

While inflation might become a problem in the U.S., it's a problem many countries would dearly love to have. Despite its many missteps in handling the pandemic, the U.S. is leading the way in its aggressive fiscal response and in vaccinations. The economic picture outside the U.S. is decidedly mixed. Broadly speaking, most of Asia is in the midst of a vigorous recovery, while Europe and South America, neither of which are as far along as the U.S. in vaccinations, are facing a more protracted recovery.

Although the economic outlook in Europe and South America is murkier than in the U.S., this may be a case of "buy the rumor, sell the news." The S&P 500 Index of U.S. stocks is now up 25.7% since the end of 2019, significantly outpacing non-U.S. stocks (and coming after many years of outpacing non-U.S. stocks). U.S. stocks may have fully priced in the very strong economy that seems to be on the horizon. While other countries may lag on vaccinations, they'll get there eventually, and it could make sense to invest ahead of the robust economic growth that will ensue.

Are U.S. stocks more than fully priced? Is the extreme behavior of "meme stocks" such as Gamestop a sign of a speculative bubble? It's rare enough that a stock goes up 100-fold in six months, but it's downright bizarre when the rise is totally divorced from the company's financial prospects. And all of this has been driven by groups of Redditt users aiming to inflict losses on hedge funds betting against these stocks. There are signs of speculative excess elsewhere as well--Tesla and Bitcoin are partying like it's 1999[2].

While there have been some signs of speculative excesses in recent months, in some respects the stock market has been behaving a bit more rationally. Most notably, value stocks which had dramatically lagged growth stocks for most of 2020 and for much of the previous several years, have now outperformed for two quarters in a row. In the initial months of the pandemic investors looked at rock-bottom bond yields and decided they had to be in stocks but flocked to companies that would prosper no matter how bad the economy got. Stocks like Facebook, Amazon, Apple and Netflix soared. Interestingly, the one "FAANG stock" that didn't outperform the overall market was Google (Alphabet), which depends on advertising revenues and is therefore economically sensitive. Investor sentiment seemed to shift after data on the remarkable effectiveness of the Pfizer and Moderna vaccines was announced last November. Since then, value stocks, which are more dependent on the strength of the economy, have outperformed growth stocks. Not surprisingly, all of the FAANG stocks except for Google (Alphabet) are underperforming the overall market over

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[2] Younger readers requiring an explanation can google "tech bubble" and "Prince (musician)."

that period of time. Given the extent of value's underperformance over many years, we may still be in the "first inning" of a rotation from growth to value.

Traditional valuation metrics, such as price-earnings ratios, do make the stock market look very expensive. But stocks are being fueled by a powerful confluence of factors: the prospect of a booming economy and surging corporate profits, interest rates and bond yields that remain extremely low, and a Federal Reserve committed to maintaining low interest rates for an extended period of time. The elements of that formula seem likely to remain in place for the foreseeable future. Whether a sustained bout of inflation eventually changes things as we get into 2022 and 2023 is very difficult to know.

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