Economic Outlook

First Quarter 2021

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A Healthier World, but a Sicker Bond Market

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SEI recently released its first-quarter Economic Outlook. A summary of the conclusions is provided below:

- The war against COVID-19 is not over, but vaccine rollouts show the path to victory. Vaccine distribution will enable countries to end their lockdowns and reopen their economies. Therefore, business activity is expected to surge during the second half of 2021, not just in the U.S. and Europe but in other advanced nations too. Accordingly, investors appear to anticipate a return to a more normal world.
- This outlook is reflected in the rapid rise in bond yields—which has been the most important change in the financial environment so far this year. Fueled by sharp gains in economic growth and concerns about surging government debt, the 10-year U.S. Treasury bond climbed from 0.92% to 1.60% since the start of the year.
- This jump in yields caused outsized price drops in long-term fixed-income securities (bond yields and prices move inversely) which helped fuel a sharp equity-market rotation away from expensive growth stocks and into value-oriented and cyclical sectors around the world.
- Time will tell whether the turn in favor of value will be more than just another ephemeral cyclical advance like those recorded at other points in the past decade. In our view, the economic backdrop strongly supports cyclical-and value-oriented equities in emerging markets, just as it does in developed markets.
- Higher bond yields raise concerns about rising inflation and may cause bouts of indigestion in the stock market, but we do not think they will derail the bull market. Rather, we expect to see cyclical and value-oriented stocks continue to advance relative to growth and defensively oriented sectors of the market.
- While value-oriented stocks make a comeback against growth in the U.S., other countries' equity markets are making a comeback against the U.S. Since last September, concurrent with the turnaround in relative performance of the U.S. value stocks cited above, other developed-country stock markets have enjoyed a sharp improvement in unhedged, local-currency terms.
- As for U.S. monetary policy, we will be watching whether the central bank can maintain its stance of keeping the federal-funds rate near zero through 2023. It all comes down to the path of inflation. Investors expect demographics, technological disruption and globalization—the forces that have kept inflation low in recent decades—to continue to dominate.
- If the acceleration in measured inflation proves stronger and longer-lasting than investors expect, bond yields could climb appreciably from today's levels. If the Fed brings forward policy-rate hikes to combat it, we would expect a neutral-to-negative reaction in stocks and other risk assets.
- Suppressing the rise in bond yields through even more aggressive policy actions, on the other hand, could lead to a weaker U.S. dollar and a sharper investor focus on inflation-hedging strategies and beneficiaries. Stock valuations could get even more expensive than they are now as investors grow even more exuberant. Interesting times, indeed.

A full-length paper is available if you wish to learn more about these timely topics.

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