February has seen a steady climb in longer-term Treasury rates with the 10-year T-Note at 1.35%, which is well above the sub-1% level where they began 2021 (Exhibit #1). Given President Biden’s aggressive push for a $1.9 trillion stimulus package (nearly 10% of GDP) plus plans for a similarly expansive infrastructure and green energy package to follow, this rise in yields certainly makes sense and likely has more runway. It’s important to note that the current level on the 10-year T-Note still sits well below where forecasters expect inflation to remain over this time period, making the “real yield” after subtracting inflation from Treasury yields negative at present.

In addition to massive fiscal injections, the ongoing vaccine rollout, sharply declining COVID-19 cases and deaths have begun to shift the focus from “will we turn the corner?” to “what is actually around that corner?” We do expect the Fed’s actions to follow Chairman Powell’s recent dovish statement, but the markets will no doubt wonder what is meant by “moderately” and “for some time.” Markets are now contending with what is considered by some to be IPO froth, cheap-money fueled speculation, rising margin balances, and perceived equity market overvaluation.

In this context, massive stimulus that drives up inflation expectations and longer-term interest rates creates certainty for the economic trajectory but uncertainty for the equity markets. It is, however, important to remember that equities generally provide an inflation hedge as rising prices lead

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Executive Summary

Treasury yields and inflation expectations have risen as the economy turns the corner and large injections of fiscal stimulus come into focus

Equities provide a long-term inflation hedge and earnings growth has turned positive

Robust M&A activity in 2021 should help underpin the equity market

The big picture is about vaccine efficacy, earnings, and the level of interest rates which we expect will level off well below historical norms
to rising revenue for companies. This hedge may not be apparent on a daily or even monthly basis but does play out over time. That said, inflation is not uniform across the economy and some companies will have pricing power that exceeds their cost increases while others will have margins squeezed. Ultimately, both the markets and the Fed will focus not on the short-term rise in inflation and yields, but on the longer-term trends. Looking past the short-term, we believe it is unlikely that inflation and rising yields will derail the equity markets and the economy. Fed messaging over the coming quarters should soften the market’s concerns.

Amid the big macro headlines, the bottoms-up earnings trends have already sprung to life. As of February 19, Factset reported an exceptionally high 79% of S&P 500 companies reporting positive EPS surprises in Q4. Year-over-year earnings in Q4 have been positive by about 3%, which is extraordinary considering the expectation at year end 2020 was for Q4 earnings to be down about 9%. Looking forward to Q1, analysts have been raising bottoms-up EPS estimates by a few percent which contrasts with typical quarters in which the first month usually sees EPS estimates decline by a couple percent. There is no guarantee this trend will continue, but it is consistent with a more vigorous rebound than initially forecast and such momentum tends to build on itself.

Adding to the market underpinning, mergers and acquisition activity is also off to a robust start to 2021 (Exhibit #2). Our expectation is for continuation of this trend. It’s noteworthy that two sizable acquisitions announced on February 22 (Goodyear buying Cooper Tire for $2.5 billion and M&T Bank buying People’s Bank for $7.6 billion) both resulted in the acquirer’s stock price also rising on the news despite the premiums being paid for the acquisitions. In a rising cost environment, scale matters. Other corporations along with private equity will also be sizable “buyers” in the market this year.

At present, we see neither dangerous financial imbalances nor, perhaps controversially, concerning levels of equity overvaluation that would indicate a late-stage bubble environment. Yes, P/E ratios are well above historical averages, but the combined impact of low interest rates, growth, and stimulus are likely to mean elevated P/E ratios will abide. While it may be quite some time before everyone’s activities return to pre-pandemic patterns and routines, for the markets that may be missing the point. The big picture is about vaccine efficacy, earnings, and the level and trajectory of interest rates. Those are the inputs into the navigation system as we head into the turn.

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Michael earned a BA in economics from Northwestern University and an MBA with distinction in finance and decision sciences from the J.L. Kellogg Graduate School of Management at Northwestern University in Evanston, Illinois. He is a member of the Beta Gamma Sigma International Honor Society, holds a Chartered Financial Analyst designation, and is a member of the CFA Institute, CFA Society of Chicago, and the Chicago Quantitative Alliance. He is also a graduate of the American Bankers Association – National Trust School. Yung-Yu Ma, Ph.D.
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