NEW PROVIDENCE

Investment Outlook Series
April 2021

Our View

The first quarter was remarkably uneventful compared to one year ago. Equity market returns were positive while bond markets declined (Table 1). The general narrative for investors has been that global economies are poised to rebound with vaccine rollouts generally on or ahead of schedule, historically high fiscal and monetary stimulus, consumer and business confidence improving, high savings levels, and pent-up consumer demand poised to be unleashed. All of which paints a favorable environment for taking risk.

Table 1: Q1 2021 Total Return

U.S. Equity	6.2%
Non-U.S. Equity	3.6%
U.S. Bonds	-3.4%
Global Bonds	-4.5%

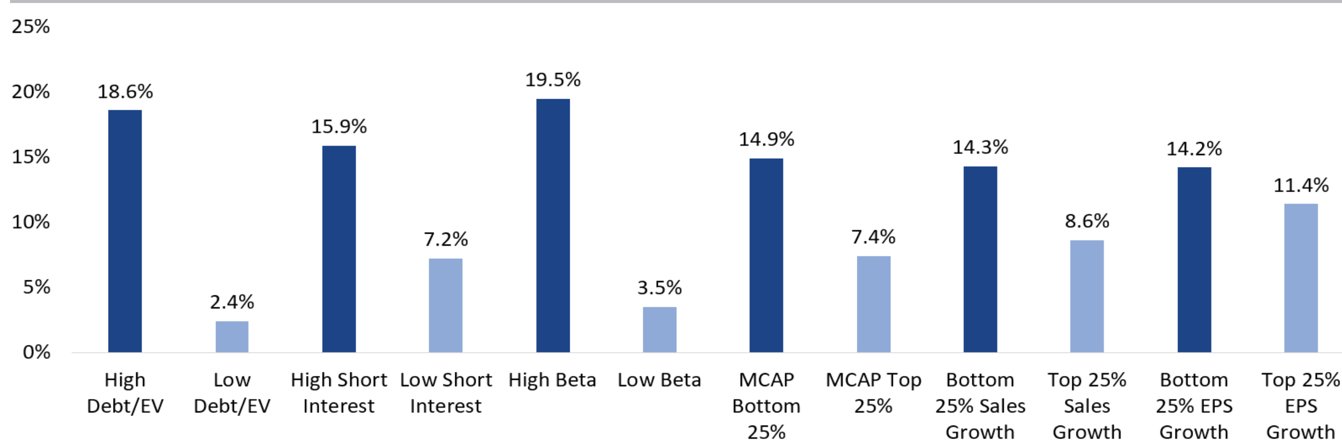
Source: Bloomberg.
Note: Indices are S&P 500, MSCI ACWI ex-U.S., Barclays Aggregate and Barclays Global Aggregate.

Evidence of a willingness to take equity risk can be seen through a review of the first quarter's best performing style factors, which were: high debt levels, high short interest, high beta, smaller caps, and low sales and earnings growth (Chart 1). A consortium of these, collectively described as "lower quality", is typically an indication that equity markets are closer to the beginning of a cycle rather than the end of one. The one potential problem with this goldilocks narrative has been the persistent increase in bond yields, which could be a sign of a less positive, perhaps ultimately negative, inflation scenario.

The U.S. Treasury 10-year bond yield nearly doubled in the first quarter to 1.7%. A culprit for the increase in bond yields has been the expectation of rising inflation as global economies lap the pandemic stricken second quarter of 2020. A simple example is the extreme price increases year-over-year in a variety of commodities (e.g., oil, copper, agriculture, etc.). However, an examination of the U.S. Treasury yield curve indicates most of the increase in yield and inflation expectations occurred in longer duration bonds, suggesting the Fed is not likely to increase rates imminently. The 2-year U.S. Treasury yield rose just 4 basis points (bp), a modest increase compared to the 83 bp increase in the 10-year yield.

Another explanation for the increase in bond yields may be the actions of foreign entities that are holders of roughly $7 trillion in U.S. Treasury debt. Their calculus could be evolving as they see the U.S. willing to absorb trillions of dollars of debt via pandemic relief programs and infrastructure spending. If the U.S. is willing to raise more debt and accept a potentially weaker currency, then it would be intuitive to conclude that some of the increase in Treasury yields was due to capital flight from U.S. bonds by foreign investors repatriating and investing

Chart 1: Style Factor Performance Q1 2021[1]



Source: Hedgeye.
[1] Mean performance of Top Quartile versus Bottom Quartile, S&P 500 Companies.

their capital where real yields are higher, and the currency is preferable. For equity investors this is a more benign reason for yield increases, even if it does nothing to placate bond holders.

The changing environment requires investors to re-examine portfolio construction. Historic affinity to a simple ratio of stocks and bonds (e.g., 70/30 or 60/40) is likely to be less successful going forward than it has been since the early 1980s when interest rates and bond yields peaked (Chart 2), creating a 40-year tail wind for increasing bond prices and lower yields, as well as expanding equity valuation multiples. More granularly, the investments that worked best in 2020 are likely to be joined by a new list of leaders in 2021.

Portfolio Construction:

Equities. For long duration assets we favor equities over fixed income, with the U.S. and Asia remaining our preferred geographies. We are not making the argument that equities are statistically cheap, U.S. equities are valued at 23.5x 2021 expected earnings.[2] However, we would argue that we are at the beginning of a global economic rebound, where job growth will improve, and savings rates and pent-up demand are high, particularly for services. This should lead to an environment of strong earnings growth versus last year. Equity investors also receive a dividend that is comparable to bond yields, making the combination of equity yield plus earnings growth more attractive than bonds, which still have negative real yields.

Equities typically perform well in the early stages of an inflationary cycle because the primary driver is increasing demand due to improving growth. A more ominous sign would be excessive wage growth due to a shortage of labor. However, with unemployment levels still relatively high, it is unlikely that labor currently has the upper hand to demand meaningfully higher wages. The catalysts for us to revise our view will be determined by the magnitude and duration of inflationary pressures, and/or when the outlook for growth, policy accommodation, and corporate taxes become less supportive.

Fixed Income. Government and investment grade corporate bonds offer an uncompelling opportunity, with yields at the bottom of the lowest decile of attractiveness. Corporate yield spreads are also unattractive. The combination of low yields and low spreads provides a poor risk/reward opportunity. One fear going forward is if interest rates rise bonds and equities could both decline in value, impairing the diversifying benefit of bonds in portfolio construction which has existed for much of the last 40 years.

Alternative Fixed Income. One exception to the lack of attractive yield-oriented opportunities can be found with a subset of loan portfolios, specifically ones that offer the combination of substantially higher yields, covenant and collateral protection, and that are closely monitored by an experienced investment manager. The key is choosing a manager with appropriate oversight and terms.

Cash. In the current environment cash is an asset, with zero duration it is not subject to the price risk of rising interest rates, and it is a source of immediate liquidity, ready to be used by the patient investor to reinvest with

[2] Source: Bloomberg. S&P 500 earnings expectation is $174 as of 4/7/21.

Chart 2: U.S. Treasury 10-Year Bond Yield

Source: Bloomberg.
Note: Gray shaded areas indicate U.S. economic recession periods. Source: NBER.

a clear mind when the next market downturn arrives.

Investing, by definition, is a risk-taking endeavor. In the current environment we see a need for investors to broaden their scope and examine areas outside of their norm. This can mean investors diversifying some of their equity exposure to Asia. It means reducing legacy bond portfolios and looking for diversifying alternatives that are not highly correlated to fixed income and equity markets. It also means looking forward and understanding the rate of change of innovation occurring will be highly disruptive to many businesses and, in turn, previously held investment paradigms. We remain constructive but not complacent, 2021 and the years to follow are likely to keep us all on our toes.