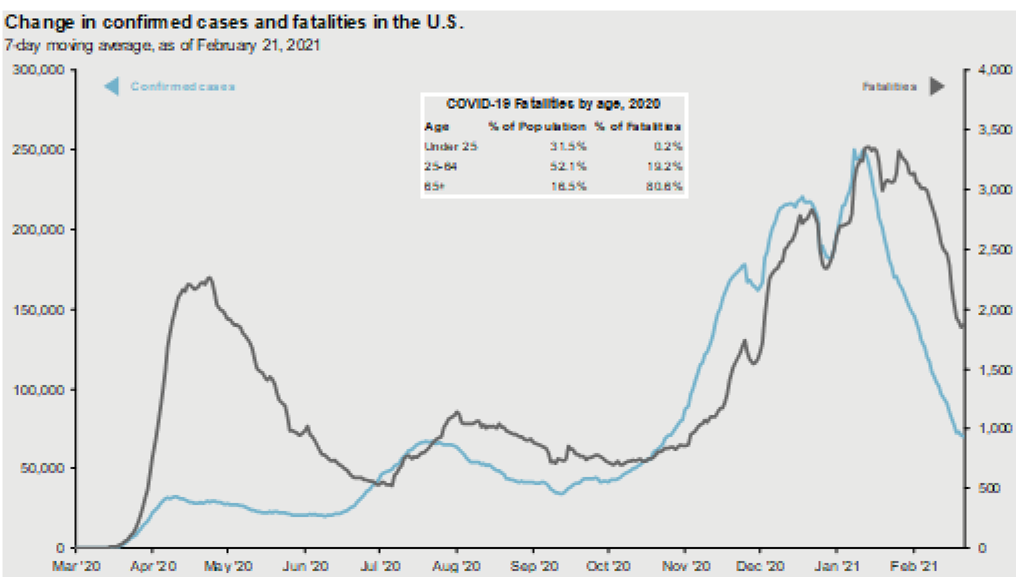
Stronger Growth Ahead: Reflation and the Economic Boom

March 2021
By Brian Luster

ECONOMIC REOPENING BY EARLY SUMMER

The path of the pandemic impacts the level of economic activity in the United States, and fluctuations cause a lot of uncertainty. However, the approval and distribution of several very effective vaccines in the U.S. should allow for life to largely return to normal by the summer of 2021.

Over 73 million doses of the Pfizer and Moderna COVID vaccines have been distributed to date in the United States. By the end of March, that number should reach 220 million. By the end of July, over 600 million doses are expected to be distributed. This does not include the approval of Johnson and Johnson's one dose therapeutic, which is expected to be distributed later this week. It is therefore reasonable to believe that by July 4th, every American adult that wants a vaccine, will have been inoculated (there are ~210 million adults in the US). As a result, we expect the pandemic should be largely behind us by early Summer.



Source: Centers for Disease Control and Prevention, Johns Hopkins CSSE, J.P. Morgan Asset Management. U.S. Data are as of February 21, 2021.

BOOK YOUR VACATIONS NOW – AN ECONOMIC BOOM IS COMING

As the economy reopens, the demand for services will outstrip the supply. Unlike the global financial crisis, which was a demand driven recession, the COVID recession has been largely the result of supply shocks resulting from activity and capacity restrictions (i.e. travel and dining restrictions). As Americans are vaccinated, and the economy reopens, supply will return, and pent-up demand will be realized. Unfortunately, many businesses did not survive the pandemic (or were forced to right size their operations), creating what we believe is insufficient supply to meet this pent-up demand. As a result, consumers will not be able to get a table at a restaurant, a seat on an airplane, or a room at a hotel.

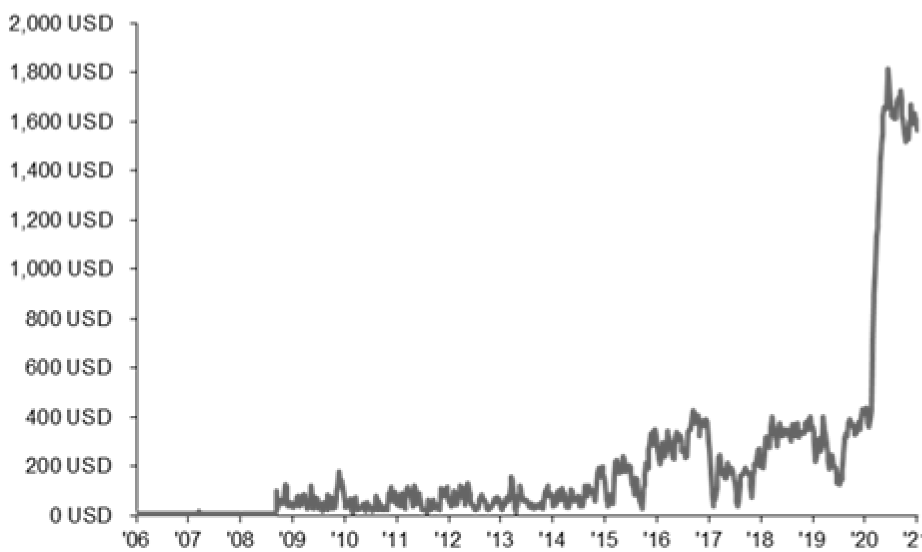
By the 4th quarter, we expect economic growth will be booming. Energy will also boom. This will lead to inflation above 2% by year end. Just as the pandemic is starting to recede, we expect an additional $1.9 trillion of stimulus to enter the economy through President Biden's "Rescue Plan". Of that total, $1.2 trillion must be spent by the end of this fiscal year, which ends in September 2021. This means $1.2 trillion of spending will be squeezed into the next seven months, including stimulus checks, enhanced unemployment benefits, and cash for ailing businesses, providing a significant boost to an already fast recovering economy.

US TREASURY IS FLUSH WITH CASH

At this moment, the US Treasury is sitting on a record amount of cash (nearly 4X their historical average). This cash accumulation was the result of raising $2.4 trillion from Treasury bill issuance in the second quarter of 2020 to finance pandemic related relief measures. Nearly $1.6 trillion remains unspent (compared to normal levels of cash of ~$400M). This money will either be drawn down to fund further stimulus or taken from the Fed and given to the banking system, who, in turn, will lend this money to businesses and consumers (as these banks would instantly become flush with cash). Either way, this should support economic growth in a significant way. In fact, the biggest risk to our thesis is that short-term interest rates turn negative, which would encourage savers to either spend or invest (all of which would further support markets). And we haven't even included the additional liquidity that will occur if Congress successfully passes an additional $1.9 trillion stimulus package in the weeks ahead.

U.S. Treasury General Account

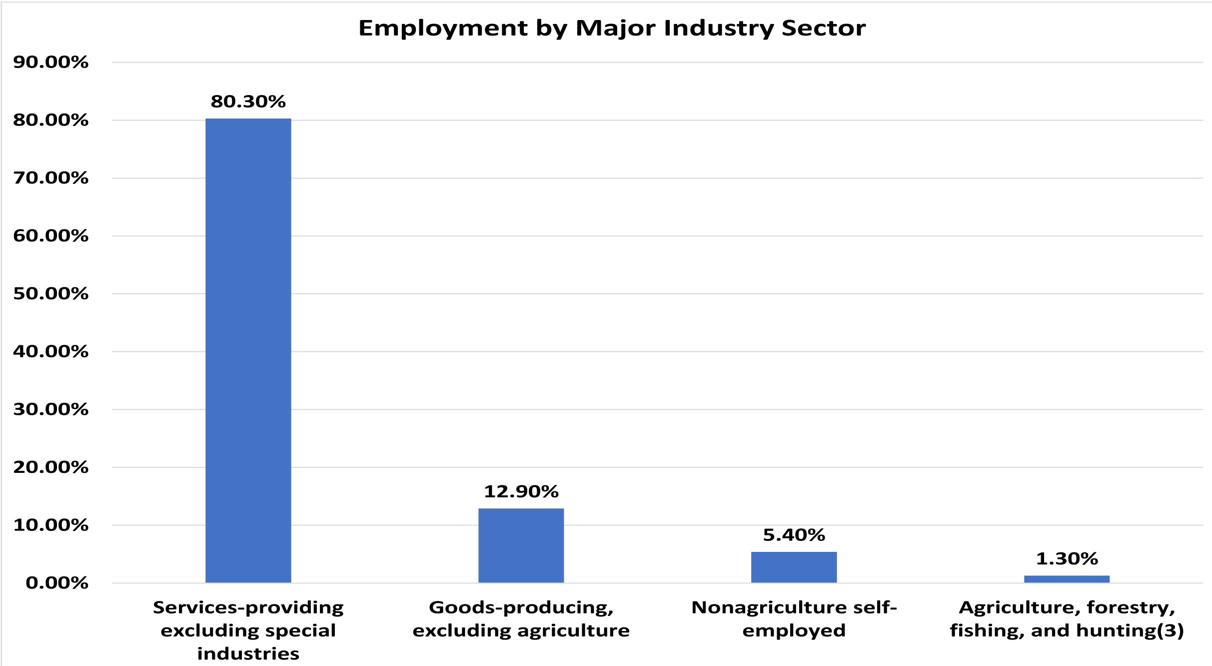
USD billions, week average, balance



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management. Data are as of February 18, 2021.

SERVICES ARE THE TAILWIND TO SUPPORT THE ECONOMIC RECOVERY

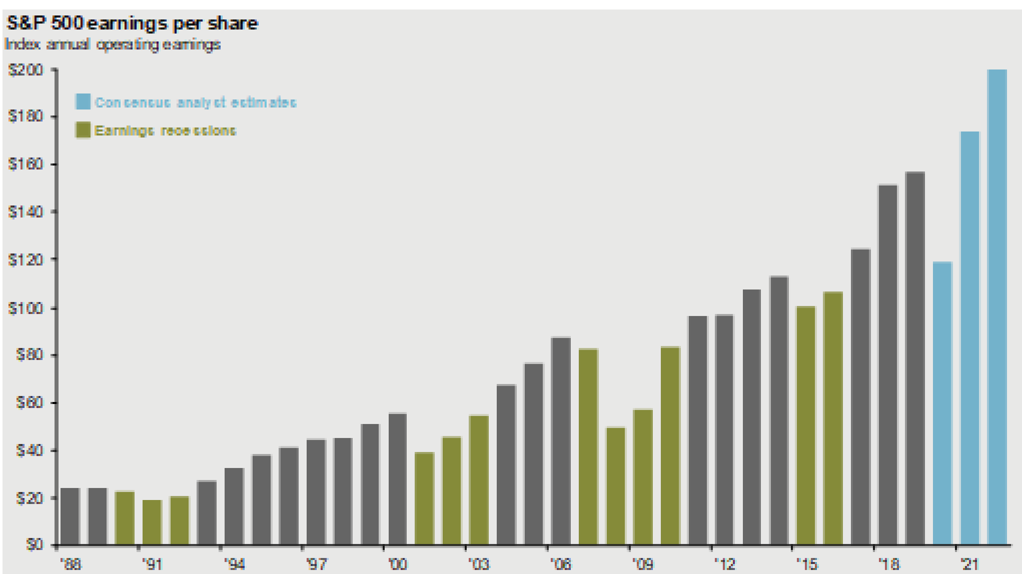
During the pandemic, consumers shifted their spending online, housing boomed, and auto sales quickly recovered. As a result, the consumption of goods in the US is 7% higher today compared to pre-pandemic levels. Yet the consumption of services is still down 5% compared to pre-pandemic levels. Since the consumption of services ($9.7 trillion) represent nearly 2X the value of goods consumed in the US ($5.1 trillion), and services dominate employment (~80% of US jobs), an economic reopening should create a significant post-pandemic tailwind.



Source: Bureau of Labor Statistics, Collective Family Office. Last modified September 1, 2020.

2020 EARNINGS RECESSION IS OVER

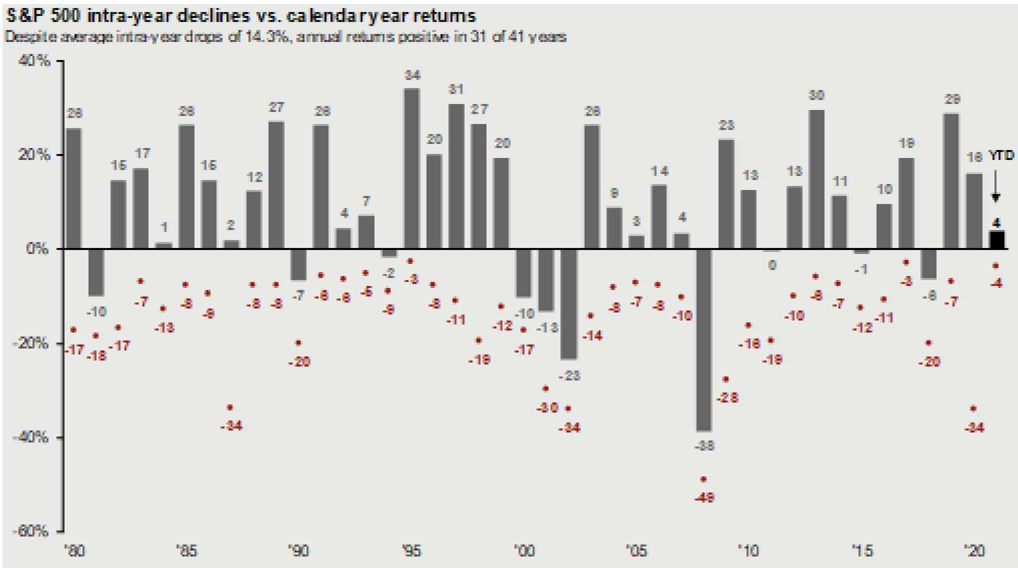
Analysts' estimates for 2021 Earnings are beginning to price in this sentiment as well. Consensus earnings are now expected to be higher than they were when we exited 2019 (pre-COVID). In 2019, the S&P 500 earned $161 per share. Last month Goldman Sachs raised their target earnings estimate to $181, Credit Suisse to $185, and RBC to $168 (just to name a few). Their targets for the S&P 500 year-end value have been revised upward to 4300, 4300, and 4100, respectively. If Goldman and Credit Suisse are correct, that is an additional 10%+ upward move from current levels.



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management. Historical EPS levels are based on annual operating earnings per share. Earnings estimates are based on estimates from Standard & Poor's and FactSet Market Aggregates. Past performance is not indicative of future returns. U.S. Data are as of February 24, 2021.

MARKET VOLATILITY IS TO BE EXPECTED

It is important to understand that even though the S&P 500 has ended the year positive 31 times out of the past 41 years, the average intra-year peak to trough decline has been 14.3%. So, despite our bullish outlook, we should expect to see a pullback at some point during any given year, and we have not experienced that yet in 2021.



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2020, over which time period the average annual return was 9.0%.
U.S. Data are as of February 24, 2021

BOND MARKETS APPEAR TO SUPPORT OUR OUTLOOK

Rising interest rates seem to support our thesis as well. 10-yr US Treasury bond rates have risen from 0.93% at the start of the year, to 1.38% on February 24. This increase is being driven by expected economic growth, rather than inflation, as many fear. Inflation was last reported to be 1.4% in January. Even at current levels, real interest rates are negative 0.02% (1.38% 10yr rate minus 1.40% inflation rate). In a booming economy, real interest rates turn positive, which will require higher long-term interest rates. In fact, we wouldn't be surprised to see long-term rates above 2% by year end, a headwind for bond investors. This is simply the logical reaction to better news on the pandemic front, not an indication that fiscal stimulus will cause inflation in the short-term (it will in the long-term, however, as we have discussed before).

REFLATION TRADE

As a result of our outlook, we continue to believe that a reflation trade will be the single most likely outcome over the next several years. As a reminder, the reflation trade suggests that cyclical industries will outperform defensive industries (and thus value will outperform growth), small cap equities will outperform large cap equities, international stocks (especially emerging markets) will outperform domestic markets, long-term interest rates will rise, and the US dollar will fall.

Risks to our thesis will center around fiscal and monetary policy outcomes and the trajectory of economic growth. Near-term, we are concerned that the virus could unexpectedly delay an economic reopening. Longer-term we fear disappointing fiscal policy or the Federal Reserve becoming less accommodative sooner than the market anticipates. During this recovery phase, small shocks could undermine markets, as investor sentiment remains high and valuations are elevated. It is for these reasons we continue to maintain a balanced approach to investing to reduce volatility through a globally diversified portfolio of stocks and bonds.

ABOUT THE AUTHOR

BRIAN LUSTER is a Principal and Chief Investment Officer of Collective Family Office located in York, Pennsylvania. With over 20 years of Wealth Management experience, Mr. Luster has previously served as Founder and CEO of a boutique Multi Family Office in New York City, as the Managing Member and Portfolio Manager of a long/short US event-driven value-oriented hedge fund in New York, and as a Senior Wealth Manager for BNY Mellon Wealth Management in Central Pennsylvania.

An avid thought leader, he has authored over 60 articles covering investing, tax, trust & estate planning, family governance, and next generation education, featured in such publications as Forbes, Barron's, The Wall Street Journal, Private Asset Management Magazine, Family Office Elite, and The Huffington Post.

ABOUT US

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