March 4, 2021

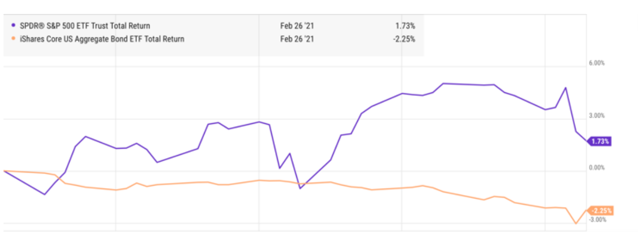
Overview

February saw most equity indices rise, sometimes sharply, in spite of a late reversal in the month due to rising interest rates. The S&P's 500 rose **2.76%** on a total return basis while the Nasdaq Composite was up **1.01%** and the Russell 2000 (Small US Caps) continued to catch up, rising **6.23%.**

Internationally, the broad EPAC BMI (developed economies) was up **2.37%** and the MSCI EM (emerging markets) a more modest **.76%.** The USD was mostly stable against a basket of diversified trading partners' currencies, although it did rise 1% against the €.

The story of the month is about what happened in the US bond market. In a nutshell, talk of "too much economic stimulus" associated with the bill currently debated in the Senate AND signs of inflationary pressures due to rising commodity prices caused investors to sell US Treasury notes and bonds, pushing the yield on 10-year notes up by close to .50% in the course of the month. When the yield on such instrument is 1% to begin with, finishing at 1.40%-1.50% in the space of three weeks is very significant. The losses that this caused for bond investors were meaningful. As expected, the tumult throughout the bond market bled onto the equity market, causing a few days of volatility and negative returns. We are still dealing with this, as of this writing.

The table below illustrates the performance of the US equity markets on a YTD basis (SPY ETF-purple) and contrasts it with that of the bond market overall (AGG ETF-orange).

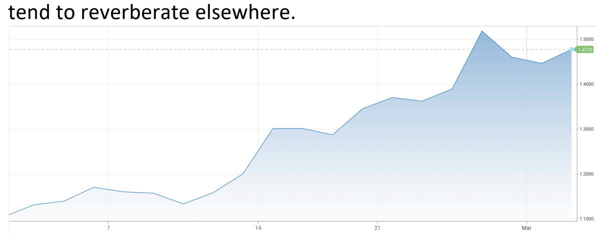


AGG is down **2.25%** on a YTD basis, while SPY is up **1.73%** over the same period.

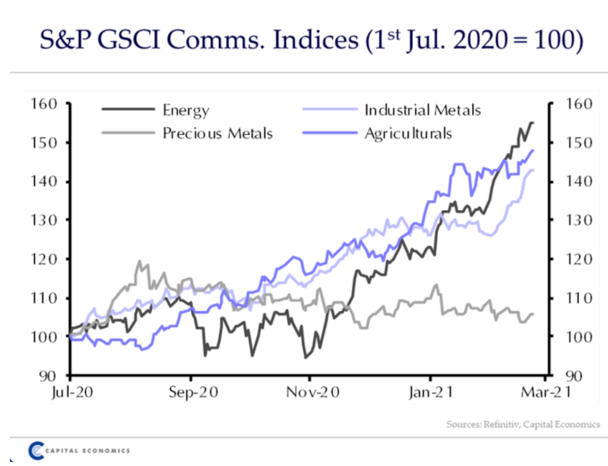
In February, the performance of our clients' portfolios hovered between **1.15%** and **- .17%.** Over the same period, a portfolio consisting of 50% ACWI (World Equity Index ETF) and 50% AGG (US bond aggregate proxy) rose **.39%**. After two months, our portfolios are mostly flat for the year, compared to a **-.14%** performance for our benchmark. As a reminder, the equity allocation in our clients' portfolios ranges currently from 40% to 70%, depending on risk profiles.

Market developments

Below is the chart that illustrates the rising yield of the 10-year US Treasury Note, over the past month. It went from close to 1% in early February to about 1.47% by the end of that month. On a relative basis, this is a momentous increase. It was bound to generate havoc in fixed income portfolios and cause some trouble for other assets classes, as losses experienced in one sector often tend to reverberate elsewhere.



The back-up in interest rates illustrated above is the result of the confluence of two factors: 1) increased concern amongst economists and investors about the inflationary risk that might come with another stimulus package of the size contemplated by the Biden Administration and, 2) early signs of rising production costs, as illustrated in the chart below.



Prices for industrial metals, agricultural commodities and oil have surged about 50% since July of last year. This is mostly the result of China's stimulus program post-Covid. With heavy reliance on construction-related spending in order to stimulate its economy, China has caused commodity prices to surge, particularly with respect to industrial metals. Those metals are used throughout the manufacturing supply chain and are expected to push up prices for manufacturing goods and contribute to inflation.

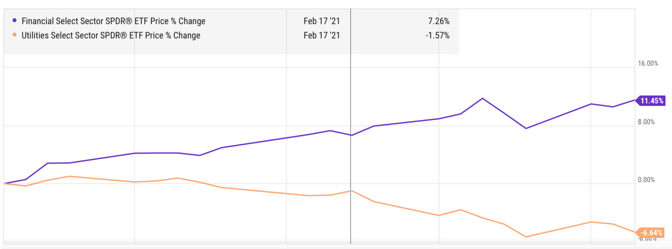
This concern was made real when the Producer Price Index for January, released on February 17, came out stronger than expected at +1.3%. Bond prices have declined since.

Tilts and Allocations

The rapid steepening of the US yield curve (*) in February, together with similar developments in other developed economies was bound to profoundly impact equities. In fact, equity portfolios have seen widely divergent performance from one sector to the other in the space of a few weeks, as a result. More sectorial rotations are to be expected in the coming weeks.

However, since this rapid interest rate increase came as a consequence of expectations of a robust economic recovery and not as a result of inflation fears only, equity markets should recover after a period of volatility.

The chart below illustrates the effect of rapidly rising interest rates on two sectors of the US equity markets. XLF is the ETF for the financial sectors (purple line). XLU is the ETF for the utilities sector.



In February, XLF went up **11.45%** while XLU went down **6.65%**. Financial equities (banks) benefit from rising interest rates, particularly when the yield curve steepens at the same time. Banks do not pay much on deposits and they can lend at higher rates, particularly when long-term rates rise fast. They make more money in that environment, hence their performance in February. Utilities do not benefit from that environment. On the contrary, they often borrow heavily to fund their operations and suffer when interest rates rise. They suffer all the more as their costs increase in that environment and their ability to pass higher prices to consumers are most often limited (except in Texas…).

Ground-shifting interest rate movements of the sort that we just witnessed in February, are rare. But their effects on bond and equity investors can be long-lasting. They also provide a great opportunity to re-evaluate investment portfolios and to make the necessary adjustments called on by a new set of financial and economic parameters.

(*) A steepening of the yield curve takes place when long-term interest rates rise faster than their short-term counterparts.

Conclusion

Here is a quote from Bloomberg as of this morning (March 4) that summarizes well our current situation: “The rise in inflation expectations and long-term borrowing costs is stoking volatility and raising concern that a prolonged rally in equity markets may be in jeopardy…”.

While these concerns are real and fact-based, I do not believe that they will prevent equities from pushing forward further in the coming months. There are three significant reasons for that: 1) Monetary authorities around the world have, so far, no wavered in their determination to keep short term interest rates at ultra-low levels until the post-covid 19 recovery is well entrenched. For most economists a change of policy will not happen until the second part of 2022, if not 2023, 2) The Biden Administration is determined to pass a large package of economic measures that will support the US economy over the foreseeable future, 3) The Covid-19 vaccination efforts are gathering momentum in the US and in Europe. If the successful experience of Israel is indicative of what will happen in most developed countries, major economies should re-open gradually between now and the end of the year.

In that context, I do not see how a market correction would be given much oxygen. Market pullbacks should offer us good opportunities to add to our equity investments.

Thank you for your continued trust.

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