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An Unusual Recession and Recovery

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Summary

In the recent PIM Quarterly News Release, we proposed that the equity market had overreacted to inflation concerns. We suggested that bond yields would fall and that as a result, value equity outperformance would give way to growth. During the month of April, the yield on the ten-year US Treasury bond moved from 1.78% to 1.62% largely due to Japanese investor demand. Large domestic growth equities outperformed value by 68% (6.8% v. 3.9%).

Market based inflation expectations for the next few years have indeed moderated modestly over the past month, even as the pace of the US economy has reached full sprint. The US manufacturing sector, as measured by PMI, hit its 2nd highest ever reading in April. The service sector PMI hit an all-time high in the same month. Another economic activity data provider, the ISM composite, registered its highest reading since 1983.

The US economy is likely to maintain a rapid pace of growth for the remainder of the year, though it will likely peak this quarter. As equity investors it is important to note that the market is generally more concerned with the rate of change in economic data than the current level of economic activity. While we expect the economy to maintain near record growth for several more months, the rate of change is beginning to moderate, suggesting that the second quarter will be the peak of economic activity for the recovery.

Using data back to 1973, US equity market returns in the twelve months following peak activity are, on average, 1%. Simply put, US equity market prices already reflect expected growth through 2021. This is consistent with our observation from the beginning of the year that 4,100 on the S&P 500 would be a rich valuation and put a speed limit on further gains. Before we are likely to see the next major move higher, equity prices must wait for corporate earnings to catch up. As of the end of April, the S&P is trading at 4,181.17.

Nature of the Recession and Recovery

COVID-19 produced the most unusual recession in history, comprised of both the fastest 30% equity market decline ever and the quickest equity market recovery in a century. The coming months/years will likely be characterized by more typical market behavior. What follows is our assessment of the global capital markets moving forward.

Domestic View

A typical recession is characterized by reduced household spending on large purchases in response to uncertainty about employment, wages, and the state of the economy. The COVID-19 recession was different. The following data points illustrate that consumers, who drive 70% of the economy, did the exact opposite of what happens in a normal recession. Remember, US GDP declined by 3.5% (largest drop since WWII) and the employment rate fell by 5.7% last year.

2020 annual average percent change:

•Real personal income: +4.9% (adjusted for government transfers and inflation)

•Household savings rate: +75% (year over year change)

•Real durable goods spending: +6.3% (i.e. washing machines, refrigerators, electronics, automobiles)

•Equity returns: +18.25% (S&P 500 2020 Total Return)

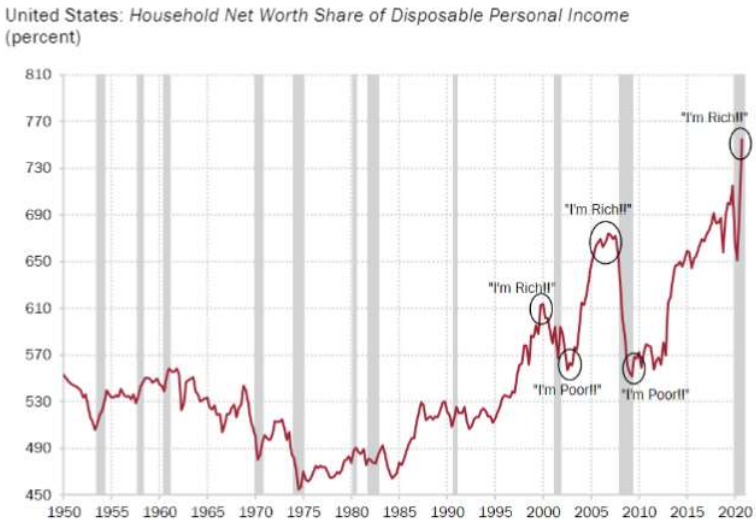
•Home prices: +9.4%

•New home sales: +20.1%

•Residential construction: +11.5%

•Home renovation expenditure: +18.0%

These unusual datapoints are explained by the government sending transfers (stimulus checks, enhanced unemployment insurance, etc.) to individuals as well as changing housing preferences in response to the pandemic. This type of spending (and equity market recovery) is typically seen in the first years of a recovery, but the US saw its recovery in consumer spending *during* the worst downturn in economic activity in 75 years.



The adjacent chart shows that the ratio of household disposable income to net worth actually increased during the pandemic. Thanks to increasing asset values (homes, equities, bonds) and government assistance, households in the US have more disposable income relative to net worth than ever before. By presenting the data over the past 70 years, one can quickly understand the unusual economic impact of the pandemic.

Post-COVID-19 household spending habits will define the recovery. Some analysts point to the chart and see years of above average consumer spending. Others will look at the bullet points above and wonder how many washing machines, new cars and computers households will continue to purchase.

Context is important. The above data is presented in terms of the average household. Averages can be misleading due to historic levels of inequality. The top 1% of households own 53% of all US equities and earn over $500,000 annually. The median household income in the US is $68,400 (2019 figure). The bottom 50% of households, ranked by wealth, collectively own 1% of the US equity market.

It is our view that the US economy will likely see peak growth during the current calendar quarter, at 8-10%. Over the following 3-5 quarters, growth should moderate and level off at approximately 3%, roughly the pace of economic growth pre-pandemic. US consumers are notorious spenders and people will be excited to get out and make-up for lost time before moving back to more normal levels of spending. Translated to equity market performance, remember that much of this future spending may already be priced in.

Global View

The global recovery from COVID-19 has been very uneven. Outside of the US and the UK, no major economy has made significant headway with the vaccine distribution process. Areas of continental Europe and several cities in Japan remain under mobility restrictions. Parts of Asia and South America are experiencing extraordinary and truly terrible infection rates. As such, economic recovery for much of the rest of the world has yet to materialize.

As vaccine distribution accelerates in the rest of the world, we can expect to see more optimism priced into foreign equity markets. Beyond COVID-19 concerns, foreign markets are most sensitive to the actions of central banks, which have, in recent weeks, almost uniformly pledged to maintain accommodative monetary policy for the foreseeable future. The Central Bank of Canada has been the lone exception thus far, choosing to normalize policy sooner than later.

Near Term Prognosis

We do not expect to see a significant change in domestic equity market prices in the coming months. Summer tends to be slow in normal years. The old Wall Street adage "Sell in May and go away." was coined for a reason. Large capital markets participants may step away temporarily during summer holiday season, as COVID-19 restrictions further ease, which suggests lower trading volumes. So, for the US markets, we anticipate sideways movement for the near-term. With a bit of luck, foreign economies will begin to see the impact of increased vaccination rates. If that does develop, overseas equity markets should drift higher.