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2021 Mid-Year Market Outlook: Peak or Pause?

QUARTERLY MARKET OUTLOOK

by Schwab Center for Financial Research

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As a result of the pandemic, the U.S. economy and corporate earnings essentially went from a depression-like bust to a wartime-like boom in the span of a year.

Companies cut operations to the bone amid the early phase of the pandemic, then, amid record-breaking monetary/fiscal stimulus, the economy quickly found its footing.

The question as we head toward the second half of the year is whether we're facing a long-lasting boom, a boom-settle, or a boom-bust scenario. At this point, we lean toward the boom-settle scenario, in part because we may be facing another peak in the growth rate for both the economy and corporate earnings (which does not mean growth itself is peaking, just the rate of change). In the second quarter of 2020, U.S. gross domestic product (GDP) shrank by -31.4% on a quarter-over-quarter annualized rate. That was followed by the eye-popping initial rebound to 33.4% in the third quarter of 2020, then more moderate growth of 4.3% in the fourth quarter of 2020 and 6.4% in the first quarter of 2021.

Growth in the second quarter of 2021 is expected to jump to 9.4% as the economy further reopens, according to Bloomberg's tracking of economists' estimates. These consensus estimates suggest the second quarter will be followed by steadily descending, but still positive, growth rates in the subsequent two quarters.

Looking ahead to the second half of 2021, we think there are some notable market risks associated with the combination of peak economic/earnings growth rates, higher inflation, Federal Reserve policy, and some stretched investor sentiment conditions. Specific to Fed policy, the Fed has been trying to establish hotter inflation to counteract the negative effects of inflation having run cold for so long. Formally, the Fed has shifted its reaction function associated with both its mandates—inflation and employment—from being outlook-based to outcome-based. In essence, it means policymakers have gone from driving via the windshield to driving via the rearview mirror. They might still get where they want to go, but there is the risk that markets decide they're getting behind the inflation curve.

Europe is poised to outperform

In the first half of 2021, the world economy seems to have rebounded to above its pre-pandemic peak, transitioning from the recovery phase to the start of a new economic expansion. To be sure, some countries, businesses and families have not fully recovered from the pandemic-led recession. Yet, overall, global GDP had fully recovered by the end of the first quarter, and continued economic expansion in the second quarter likely

lifted output above its pre-pandemic high. This pattern marks the sharpest economic V-shape in history, with its deep recession and rapid recovery both contained within just five quarters.

The new economic cycle has seen stock market leadership pass from the United States to Europe. European countries are only now starting to ease their restrictions on economic activity just as Europe's largest-ever stimulus plan is about to be deployed. This suggests eurozone growth still has some way to go before peaking, and that eurozone stocks likely can still deliver further gains after outperforming in the first half of the year. Strong confidence by business leaders and consumers should help cushion the markets against any soft spots in jobs or manufacturing output. Meanwhile, continued solid growth combined with signs that inflationary pressure may be transitory could ease concerns that central banks will tighten policy prematurely, a fear that weighed on emerging market stocks in the first half of the year.

Eurozone economies have performed strongly, even though vaccination programs lagged those in the United States. Ending restrictive lockdowns, ramped-up bond buying by the European Central Bank, and the nearing rollout of Europe's largest-ever stimulus plan should aid growth heading into the second half of 2021. This could mean the peak in eurozone economic momentum may not come until later this year, unlike other major economies such as the United States, where growth may have peaked in the second quarter of this year, or China where it apparently peaked in the fourth quarter of last year.

However, among the risks to economic expansion is the prevalence of COVID-19 variants, and potential for antibodies to wane over time, which could lead to wave of infection in the late fall/winter.

Bond yields pause: What's wrong with this picture?

Bond yields have fallen in recent months, shrugging off wide swings in economic data, a spike in inflation readings, and uncertainty about the direction of fiscal and monetary policies. It reminds us of one of the puzzles in children's magazines where you're supposed to figure out "what's wrong with this picture".

In our view, what's wrong is that bond yields at current levels aren't consistent with the likelihood of continued strong economic growth, and the risk of higher inflation. Even if economic growth and inflation revert to pre-pandemic levels over the next year—an outcome we see as unlikely—yields still appear low and offer little room for error. Considering the unprecedented fiscal stimulus in place to boost economic growth and the Federal Reserve's willingness to tolerate higher inflation, we see room for bond yields to move up in the second half of the year. Short-term interest rates should remain anchored near zero by Fed policy, but we expect 10-year Treasury yields to rise to the 2.0% to 2.5% level.

What investors can do now

For the stock-pickers out there, we suggest a hybrid approach—with an eye toward sustainable growth, but at reasonable valuations—as well as quality factors, like balance sheet strength. For the asset allocators out there, we suggest this is a time for discipline, including around diversification (across and within asset classes, international as well as U.S.) and periodic rebalancing. As a reminder, just as panic is not an investing strategy, neither is FOMO (fear of missing out).

For fixed income investors, due to our expectations for higher bond yields in the second half of the year, we continue to suggest investors keep the average duration1 in their portfolios below their normal benchmark. For example, for an investor with a portfolio of core bonds that is similar to the Bloomberg Barclays U.S. Aggregate Bond Index, which has an average duration of 6.5 years, we would suggest reducing it to the three- to five-year region. If yields do move higher, with real yields in positive territory, we would view it as an opportunity to gradually extend duration through a laddered approach.

On the positive side, expansive fiscal policy and improving economic growth are supportive to the credit quality of corporate and municipal bonds for core bond holdings. For investors willing to take more risk, higher-coupon bonds with lower durations, such as high-yield and emerging-market bonds, can provide higher returns, although we would still limit allocations to no more than 20% of an overall portfolio.

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