

INSIGNEO | Market Commentary

How Much is Too Much?

March 2021

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Given that current and forward EPS estimates were cratering in 2020 due to the pandemic and subsequent shutdowns, there is little doubt that much of the S&P 500's rapid ascent last year was due to an expanding multiple. The US 10-year touched a cyclical and all-time low of 0.50% back in August. The equity risk premium, which refers to the excess return that investing in stocks provides over the risk-free rate, made equities very attractive because sovereign bonds were so unattractive. In other words, **it was not so much that equities were cheap, it was that the alternatives were very expensive.** Indeed, the world looked quite grim during the depths of the pandemic.

Flash forward to now, the present economic malaise has fallen well short of the direst predictions, and the economic future is looking increasingly bright. Thanks to the stellar vaccine results and the rapid inoculation of the population in the US, it is safe to say that the return to economic normalcy is progressing swimmingly. Just last week, I went on record to predict, with a high degree of confidence, that the pandemic will effectively end in the US (i.e., the nation will reach herd immunity) by the end of April. Next, one must account for the extraordinary and growing levels of both fiscal and monetary stimulus. That cocktail was deployed so quickly and decisively that the normal secondary and tertiary effects of recessions (e.g., corporate bankruptcies, long-term scarring in the labor market, etc.) failed to materialize. It is a little-known fact that aggregate US disposable income increased last year compared to 2019 thanks to massive fiscal transfers by the government which more than offset the income losses in many sectors. This year will similarly eclipse last year's figure as well thanks to, you guessed it, more fiscal stimulus on the way and a rapidly decreasing unemployment rate. For

comparison, it took a full seven years after the Global Financial Crisis of 2007/08 for the unemployment rate to reach its current level in less than a year after the COVID-19 recession. The US savings' rate remains elevated, bringing excess savings in US consumer accounts to over USD 1.5 trillion. And debt service as a percentage of disposable income is at its best levels since the 1980s. In sum, US household balance sheets are in great shape, ready to unleash a wave of pent-up aggregate demand and reflationary spending as soon as they are allowed to by the government.

It is no wonder then that US nominal rates are rising as the market comes around to our house view. In theory, rates will increase if either economic growth expectations improve, or if the central bank tightens monetary policy. In this environment, the former would be benign, while the latter would not. In my opinion, rates are going up for all the right reasons. Even a "benign" increase in rates could be bad if it is disor-

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derly – too fast or too much. So, **how much is too much? Of course, we will only know how much is too much when equities take a hit, but the spectacular earnings season we just had suggests that equities can comfortably digest a US 10-year yield up to 2%, but likely slightly higher still up to 2.25%.** It should be noted that my analysis suggests that a 1% increase in longer-dated bonds would subtract approximately 3 turns from the equity multiple.

But as if we needed some comfort, some certainty, that the backup in rates will not get out of hand, cue in the world’s central banks. Within the past few days, the European Central Bank has verbally intervened, the Reserve Bank of Australia has increased its asset purchases, and the Bank of Japan has purchased ETFs in the secondary market. And lest you think the US will be far behind, we get this very important and overlooked quote from Fed vice-chair for financial supervision, Randall Quarles:

“

It may be that there is a simple macro fact that the Treasury market being so much larger than it was even a few years ago... that the sheer volume there may have outpaced the ability of the private market infrastructure to support stress of any sort there... There is thus an open question about whether there will be an indefinite need for the Fed to participate as a purchaser to support market functioning.

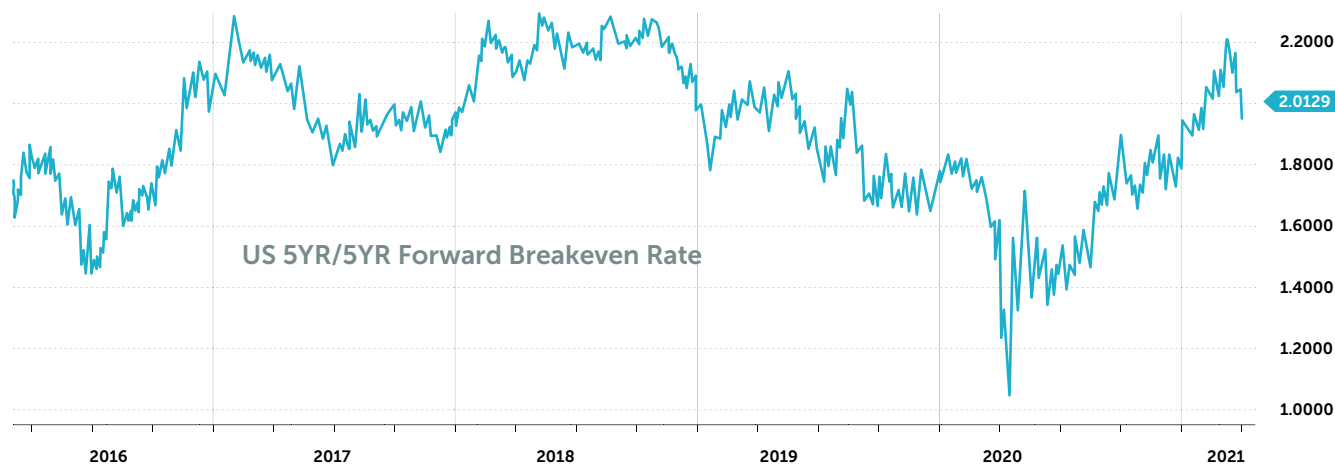
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In other words, the Fed might be giving itself another mandate: order and stability in US Treasury markets. Of course, many market participants have already guessed as much. When you factor in its other “new” and unspoken mandate of making sure that the Federal government can fund its massive fiscal spending spree at low rates, this all means that any sharp (too fast) or prolonged (too much) rise in yields will be met with swift Fed action. In other words, the Fed (and ECB, and BoJ, and the RSA et al.) have your back.

Of course, this party (i.e., financial repression) will be over when inflation finally does break out. As our devout readers know ([All Roads Lead to Inflation](#)), I am a longer-term inflation hawk in the sense that I think we will be entering a paradigm-shifting period in the next 3 to 4 years where structural economic, political, and demographic factors in the world economy will officially end the deflationary cycle began by China’s reintroduction and reintegration into the world economy. But that is a story for another day. In the meantime, major central banks remain committed to ultra-accommodative monetary policy insuring that yields never rise by enough (or fast enough) to derail the market and/or economic recovery.

US inflation expectations remain anchored below the Fed’s worry threshold of 2.3 to 2.5%

Source: Bloomberg (as of 3/2/2021)



House Views Matrix

US Equities¹

TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)	STRATEGIC (12 TO 36 MONTHS)
NEUTRAL	OVERWEIGHT	OVERWEIGHT
<p>› The long-term view remains constructive on the pillars of historic monetary and fiscal support, mass inoculation on the back of readily distributable and efficacious vaccines leading to a strong reflationary impulse in 2021; US GDP could print with a 7-handle this year</p> <p>› The near-term picture is more uncertain given stretched</p>		<p>positioning, very bullish investment sentiment, and potentially disorderly and accelerated back in rates</p> <p>› Fiscal and monetary support are expansive and should facilitate the unleashing of pent-up aggregate demand throughout the year; US consumer balance sheets are in great shape and savings accounts are sitting on over USD 1.5 trillion in excess savings</p>

European Equities

TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)	STRATEGIC (12 TO 36 MONTHS)
OVERWEIGHT	OVERWEIGHT	NEUTRAL
<p>› Once this current wave of the pandemic abates and the vaccines are distributed growth will rebound sharply next year as the higher-beta European markets could benefit from this trend</p>		<p>› The EUR 750 billion recovery fund should systematically reduce break-up risk premia throughout the Continent, but uncertainty over its structure and implementation leave the longer-term picture a bit murkier</p>

Japanese Equities

TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)	STRATEGIC (12 TO 36 MONTHS)
OVERWEIGHT	OVERWEIGHT	NEUTRAL
<p>› Japan, together with other East Asian nations has outperformed other nations in its handling of the pandemic.</p>		<p>› In addition, Japanese fiscal and monetary stimulus has been robust</p>

Emerging Market Equities

TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)	STRATEGIC (12 TO 36 MONTHS)
OVERWEIGHT	OVERWEIGHT	NEUTRAL
<ul style="list-style-type: none"> › The US Presidential election outcome and the arrival of the vaccines will benefit EM immensely › EM fiscal and monetary response is increasing relative to the earlier part of the pandemic, although it will still fall short of 		<ul style="list-style-type: none"> DM due to lower starting points, higher debt levels, and limited fiscal capacity › Not all EMs are created equal, and recoveries will differ on a regional and sub-regional basis

Chinese Equities

TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)	STRATEGIC (12 TO 36 MONTHS)
*NEUTRAL (FROM OVERWEIGHT)	OVERWEIGHT	NEUTRAL
<ul style="list-style-type: none"> › With respect to the pandemic, China is FIFO (First in, first out) › The industrial sector is above pre-pandemic levels, and the services sector is quickly approaching those levels as well › Chinese policymakers unleashed the full arsenal of monetary and fiscal levers in combatting the secondary and tertiary 		<ul style="list-style-type: none"> effects of the shutdowns, but have since turned slightly more hawkish as the Chinese recovery strengthens › Long-term, the rebalancing of the Chinese economy into a more open and transparent system remains the most important factor

Investment Grade Fixed Income

TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)	STRATEGIC (12 TO 36 MONTHS)
OVERWEIGHT	OVERWEIGHT	NEUTRAL
<ul style="list-style-type: none"> › The Fed buying investment grade corporate bonds is a game-changer for the sector › Corporate balance sheets are not in great shape given the deteriorating macroenvironment but Fed purchases will keep 		<ul style="list-style-type: none"> a lid on spreads › Upcoming wave of downgrades of borderline investment credits to junk

US Treasuries²

TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)	STRATEGIC (12 TO 36 MONTHS)
NEUTRAL	UNDERWEIGHT	UNDERWEIGHT
<ul style="list-style-type: none"> › The Fed will remain near the zero-band for at least 3 years, but probably more › The near-term, temporary rise in realized inflation is disconnected from longer-term inflation expectations, and 		<ul style="list-style-type: none"> the Fed should see past this › The longer-term view of higher highs and higher lows in rates should hold as inflation rears its head over the next 3 to 4 years

High Yield Fixed Income

TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)	STRATEGIC (12 TO 36 MONTHS)
OVERWEIGHT	OVERWEIGHT	NEUTRAL
<ul style="list-style-type: none"> › The Fed stepping into the high yield market indirectly via ETF purchases will support spreads › Energy sector should remain well-supported given the 	<ul style="list-style-type: none"> › growing deficit in oil markets › Risk adjusted excess returns of spread product are now slightly more attractive versus government bonds 	

Emerging Market Sovereign

TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)	STRATEGIC (12 TO 36 MONTHS)
OVERWEIGHT (FROM NEUTRAL)	OVERWEIGHT (FROM NEUTRAL)	NEUTRAL
<ul style="list-style-type: none"> › The US Presidential election outcome and the arrival of the vaccines will benefit EM immensely › The relative strength of demand in DM and Chinese stimulus should underpin a recovery in EM growth rates in 2021, but many idiosyncratic stories remain challenging given debt profiles 	<ul style="list-style-type: none"> › Much variance across countries and regions › The Dollar's weakness bodes well for EM balance sheets 	

US Dollar

TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)	STRATEGIC (12 TO 36 MONTHS)
UNDERWEIGHT (FROM NEUTRAL)	UNDERWEIGHT	NEUTRAL
<ul style="list-style-type: none"> › The USD has entered a structural bear market that should last until the next recession pushes demand for the Greenback up again; recent strength should be viewed as a countertrend rally 	<ul style="list-style-type: none"> › Real interest rate differentials have narrowed making the USD less attractive ceteris paribus 	

Energy³

TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)	STRATEGIC (12 TO 36 MONTHS)
*OVERWEIGHT (FROM NEUTRAL)	OVERWEIGHT	NEUTRAL
<ul style="list-style-type: none"> › The resurgence of the pandemic has kept oil down, but the vaccines and a return to economic normalcy will push prices higher throughout 2021 	<ul style="list-style-type: none"> › The market remains in deficit 	

Precious Metals		
TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)	STRATEGIC (12 TO 36 MONTHS)
NEUTRAL	OVERWEIGHT	OVERWEIGHT
<p>› Risk-off, safe-haven status has been reinforced throughout this year, but this year’s outperformance turns us more cautious in the near-term</p> <p>› Longer-term, we see inflation overshooting the Fed’s target</p> <p>› quite sharply as more stimulus is pumped into an economy that should rebound to pre-pandemic levels by late 2021</p> <p>› Attractive as portfolio hedge under many scenarios</p>		
Cash		
TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)	STRATEGIC (12 TO 36 MONTHS)
NEUTRAL	UNDERWEIGHT	NEUTRAL
<p>› Maintain some cash on hand to deploy to buy risk whenever market’s overshoot over the next months, but use it fully next year</p>		

¹ Relative to global equities in USD

² Relative to aggregate fixed income markets in USD

³ Relative to an overall commodity allocation

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