



# Mount Yale Market Commentary

## 1Q, 2021

### Summary

- ◆ At the end of the quarter, investors enjoyed the robust returns of riskier asset classes and policymakers' continued commitment to extraordinary accommodation.
- ◆ The celebratory mood is also due to the great work from vaccine developers and distributors as more than 109 million Americans had received at least one dose of the COVID-19 vaccine by the end of the quarter.
- ◆ These developments overshadowed the bear market in longer duration bonds and the implosion of a few high-profile hedge funds.
- ◆ Inflation remains the key to decoding how long this unsustainable policy support can last. As long as inflation remains contained, investors may continue to throw the confetti.

Global Markets	QTD	YTD
MSCI ACWI	4.57%	4.57%
Barclays Global Aggregate	(4.46%)	(4.46%)

Source: Bloomberg

### Overview

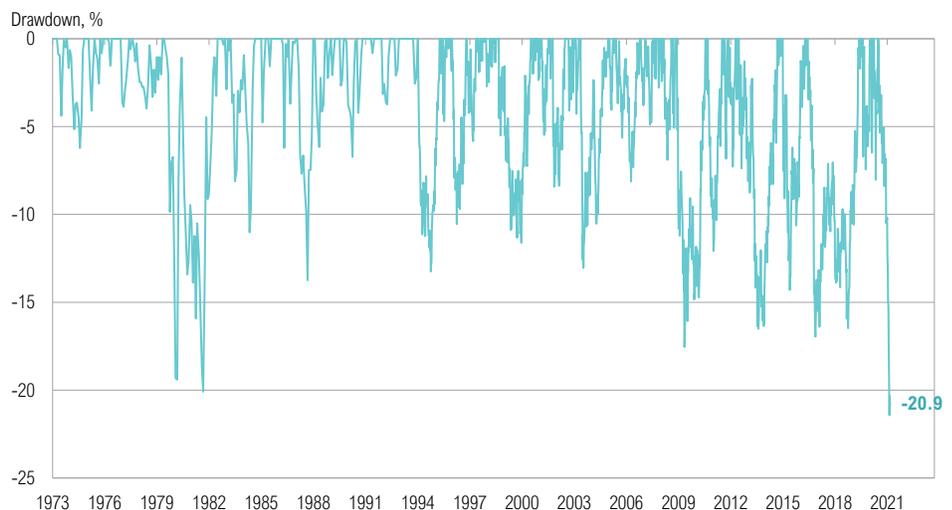
The quarter was filled with so many colorful events that it made the first three months of 2021 feel like an entire year. In the end, investors had much to celebrate. Equity returns were decidedly positive, and both fiscal and monetary policymakers reiterated their extraordinarily accommodative stances. An even bigger reason to throw confetti was in celebration of the remarkable work of healthcare professionals, essential workers, and vaccine developers. To date, over 109 million Americans have received at least one dose of the COVID-19 vaccine—an amazing feat given the virus hit the U.S. just over one year ago.<sup>1</sup>

During the quarter, the S&P 500 Index rose 6%, and other risky assets, such as commodities, were up nearly 7%. This helped overshadow an unusually weak bond market.<sup>2</sup> The BarCap U.S. Aggregate Bond Index lost 3%, posting its worst quarterly loss since the third quarter of 1981, when it lost 4%.<sup>2</sup> To put this return into perspective, there have only been three quarters in its history, all in 1980 and 1981, when the index lost more 3%. During the recent quarter, the 10-Year Treasury yield increased to a high of 1.75%. While the move seems insignificant in absolute terms, the relative increase is one of the most drastic in history and has brought the long end of

the Treasury market, as proxied by the Bloomberg U.S. Long Treasury Index, into bear market territory (declining by over 20% from peak prices last year). The move in rates is not that surprising given the recent confluence of factors: multi-trillion-dollar stimulus, the vaccine rollout, and the Federal Reserve's formal notice to markets that it is willing to tolerate higher inflation. That said, the magnitude and swiftness are historically unrivaled.<sup>2</sup>

### Long-Term U.S. Treasury Bonds Enter Bear Market

Bloomberg U.S. Long Treasury Index Drawdown, 2/2/1973 - 3/31/2021



Source: Bloomberg



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In addition to COVID-19 vaccine developments and the Federal Reserve's willingness to err on the side of higher inflation, the unwind of a program modification enacted during the depths of the crisis, the Supplementary Leverage Ratio ("SLR"), may have also contributed to higher interest rates. An alteration to the SLR was implemented on May 15, 2020 in order to ease Treasury market strains and promote lending to households and businesses.<sup>3</sup> The adjustment allowed banks flexibility in what assets they could hold to meet regulatory requirements. More specifically, the Federal Reserve allowed banks to exclude Treasuries and cash from their capital requirement calculation. In the past several weeks, Senators Elizabeth Warren and Sherrod Brown made their views public on why the modified SLR should be allowed to expire. On March 19, the Federal Reserve announced it would let the modified SLR expire on March 31.<sup>4</sup>

From a fiscal and monetary policy perspective, several developments gave investors cause to celebrate. First, fiscal policy makers passed the American Rescue Plan Act of 2021.<sup>5</sup> This \$1.9 trillion spending bill included \$411 billion in direct payments to individuals, sending \$1,400 to taxpayers earning up to \$75,000 (\$2,800 for married couples earning up to \$150,000), plus an additional \$1,400 per qualified child. The payments phase out for incomes up to \$80,000 (or \$160,000 for married couples).<sup>6</sup>

On the monetary side, the Federal Reserve did not make any new announcements, but it indicated it would continue its current stance for the foreseeable future, a noteworthy development. In its March meeting, the Federal Open Market Committee (FOMC) conveyed, through its dot-plot projections, that it would likely keep its federal funds rate at zero through 2023.<sup>7</sup> Furthermore, the committee reiterated its stance of conducting \$120 billion of bond purchases per month, a pace that was never reached heading into or out of the credit crisis of 2008-09. The FOMC also released its "Summary of Economic Projections," which included its participants' expectations that the federal funds rate would remain at 0% through at least 2022.<sup>8</sup> On March 19, the *Wall Street Journal* published an article by Jerome Powell in which he wrote, "But the recovery is far from complete, so at the Fed we will continue to provide the economy with the support that it needs for as long as it takes."<sup>9</sup> That support means vast sums of money will continue to be pumped into capital markets and the economy.

Several other events during the quarter revealed the unintended consequences of such abundant liquidity. In January, several so-called "meme stocks" sparked a revolution of sorts. The top performing of these was GameStop, which jumped over 1,000% as part of a short squeeze battle. A large group of traders, many from a popular forum on Reddit, coordinated a buying raid on select stocks that were contending with unusual amounts of short-selling (the percentage of the company's total market capitalization that has been sold short). These raids in turn overwhelmed the supply of shares available to buy and spurred rapid price increases. Melvin Capital, a \$12 billion hedge fund, came under liquidation pressure due to the meteoric rise of these shorted stocks.<sup>10</sup> The fund was down 53% in January due to its short exposure, and as a result, it had to be bailed out by high profile investors such as Steven A. Cohen and Citadel.<sup>10</sup>

At the center of the melee was the free stock trading app, Robinhood. As a self-proclaimed champion of small and first-time investors, the company came under scrutiny for its handling of the GameStop situation, especially in light of the hundreds of millions of dollars it generated from selling trade order flow to market makers. In the aftermath of the market dysfunction and Congressional hearings on the subject, Robinhood reassessed the animated celebrations on its app, ultimately deciding to remove the digital confetti that virtually rained down after users make their first trade.<sup>11</sup>

Late in the quarter, Archegos Capital suffered tens of billions in losses once it was revealed that the firm engaged in highly leveraged speculative bets on media stocks such as ViacomCBS, Discovery, and Tencent.<sup>12</sup> The firm was able to gear up its



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exposure to multiples of its actual capital base using over-the-counter synthetic stock positions, which is why the unwind caught the market off guard. Some of those hit hardest in the unravelling were Archegos' counterparties, Nomura and Credit Suisse. Nomura's stock price endured its largest daily decline in history after the estimated \$2 billion loss resulting from the exposure to Archegos was disclosed.<sup>13</sup> Credit Suisse disclosed a loss of \$4.7 billion and announced a dividend cut as a result.<sup>14</sup>

On top of these implosions, Infinity Q Capital Management mutual fund revealed that one of their portfolio managers had access to and altered the third-party valuation (and pricing) of swap contracts. The fund has suspended redemptions indefinitely while it tries to get to the bottom of the issue.<sup>15</sup>

Although these events seem isolated, there is a common thread: accommodative monetary policies and apparently free-flowing cash have encouraged risk-seeking behavior and reduced the focus on risk management.

### **Policy**

It is unlikely that the Federal Reserve is overly concerned by the recent rise in long-term interest rates, especially given that the S&P 500 surpassed 4,000 and hit new all-time highs in early April. That said, the Fed may already be using various tools to slow the pace of the rise in rates. On March 17, the FOMC kept in place its \$120 billion per month of purchases of Treasury and agency mortgage-backed securities.<sup>16</sup> This consistent source of buying may prove to significantly shape the yield curve in the quarters ahead.

Of the \$120 billion in fixed income securities the Fed purchases every month, \$80 billion are U.S. Treasuries. Considering that the U.S. Treasury issued approximately \$400 billion in bonds during the first quarter, the Fed effectively monetized sixty percent of total issuance.<sup>17</sup> In the second quarter, the Treasury expects issuance to be just \$95 billion, implying effective monetization of roughly three times the amount to be issued. While issuance is generally low in the second quarter because of federal tax receipts, it remains especially low in 2021 because the Treasury began the year with a colossal \$1.7 trillion in cash. As of the end of March, the Treasury had a cash balance of \$1.1 trillion.<sup>18</sup>

### **Markets**

Value stocks outperformed growth stocks during the quarter while smaller companies outperformed larger companies. The Russell 2000 Value Index, a measure of small cap value stocks, outpaced all other equity asset classes with a gain of 21% during the first quarter. This followed a 33% gain in the fourth quarter of last year. The Russell 1000 Value Index, a measure of large cap value stocks, was higher by 11% during the quarter (following a 16% increase in the final quarter of 2020). The Russell 1000 Growth and 2000 Growth indices were up 1% and 5%, respectively. Energy was the best performing sector for the quarter, up 31%, while the technology sector rose just 2%. This performance reversed a portion of the 77% spread between the energy and technology sectors last year. Equities outside the U.S. once again trailed during the quarter. Developed market countries, as measured by the MSCI EAFE Index, returned 4% while emerging market stocks, as measured by the MSCI Emerging Markets Index, were higher by about 2%.

Investor optimism has also extended to corporate earnings. Estimates for S&P 500 operating earnings in 2021 are currently \$172 per share—a 41% increase from 2020.<sup>19</sup> This would represent a new high for earnings, eclipsing the \$157 per share mark set in 2019. The S&P 500 currently trades at a one-year forward price-to-earnings ratio of 22 times, close to the tech bubble high of 26 times.

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Municipal bonds, as measured by the Bloomberg Barclays Municipal 1-10 Year Bond Index, fared much better than investment-grade taxable bonds during the quarter as they lost less than 0.5%. The Bloomberg Barclays High Yield Index was able to absorb the rise in interest rates and post a gain of 0.8%.

### **Looking Forward**

At the end of the quarter, the Biden Administration announced an infrastructure plan, the American Jobs Plan, and the Made in America Tax Plan.<sup>20</sup> The infrastructure spending bill seeks to invest \$2 trillion over the next decade, including 1% of GDP per year invested in infrastructure over the next eight years. The tax plan is designed to fund a portion of that investment by increasing the corporate tax rate to 28% and increasing the minimum tax on U.S. companies to 21% to avoid multi-national U.S. companies receiving an exemption on foreign asset returns. It is clear policymakers want nothing more than to keep accommodation at unsustainable levels for as long as they can. A key to this is the Federal Reserve's ability to continue to monetize these enormous spending bills. Given that risky assets and the U.S. dollar are relatively stable, capital markets appear willing to tolerate this path. Interest rates, too, appear well-contained, even with their recent rise.

From our viewpoint, inflation is the metric that will determine when the party is over and the confetti is swept away. If inflation creeps up, monetary and fiscal policy accommodation may need to be toned down. In the coming months, however, data on inflation will be hard to gauge because of the substantial stimulus measures, combined with the base effects as current prices are compared to the those of one year ago—the depths of the COVID-19 pandemic. Even more important than the data, though, is investors' reaction to it. As long as inflation remains contained, policymakers can continue to spend and monetize, and investors may be able to continue to throw the confetti.

Sincerely,

Mount Yale Research Team

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### Performance & Market Data

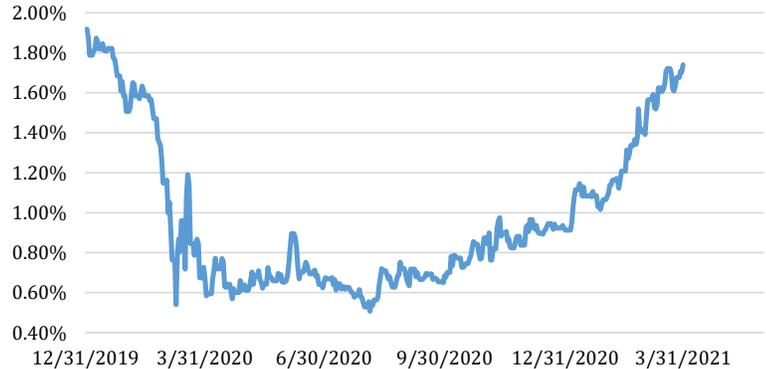
US Equity Markets	QTD	YTD
S&P 500	6.17%	6.17%
Russell 1000 Growth	0.94%	0.94%
Russell 1000 Value	11.24%	11.24%
Russell 2000	12.69%	12.69%
MSCI US REIT	8.50%	8.50%
Alerian MLP	21.87%	21.87%

S&P GICS Sectors	QTD	YTD
Consumer Staples	1.15%	1.15%
Health Care	3.18%	3.18%
Utilities	2.84%	2.84%
Communication Services	8.08%	8.08%
Consumer Discretionary	3.11%	3.11%
Energy	30.84%	30.84%
Financials	15.90%	15.90%
Industrials	11.41%	11.41%
Materials	9.08%	9.08%
Real Estate	9.02%	9.02%
Technology	1.97%	1.97%

US Fixed Income Markets	QTD	YTD
Barclays US High Yield	0.85%	0.85%
S&P/LSTA Leveraged Loan	1.78%	1.78%
Barclays US Aggregate	(3.37%)	(3.37%)
Barclays Municipal High Yield	2.11%	2.11%
Barclays Municipal	(0.35%)	(0.35%)

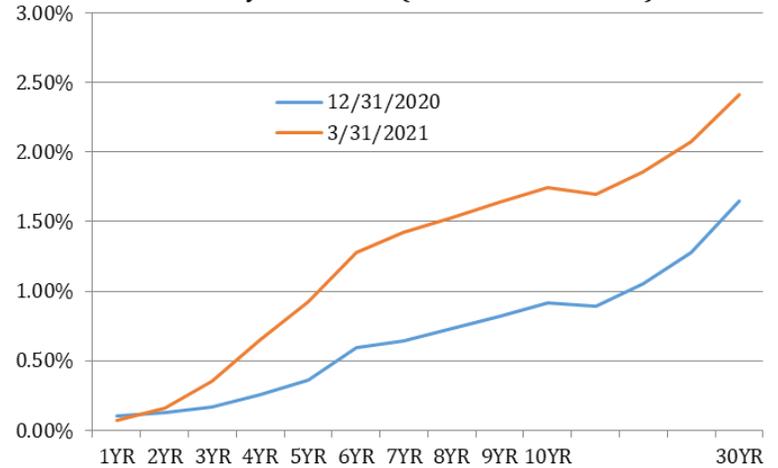
Foreign Markets	QTD	YTD
MSCI EAFE	3.61%	3.61%
MSCI EAFE Small Cap	4.60%	4.60%
MSCI EM	2.21%	2.21%
MSCI EM Small Cap	7.69%	7.69%
S&P Global Ex-US REIT	2.22%	2.22%
JPM EMBI Global Diversified	(4.50%)	(4.50%)
S&P/Citigroup Int'l Trsy Ex-US	(6.45%)	(6.45%)

### US 10 Year Treasury Yield



Source: Bloomberg

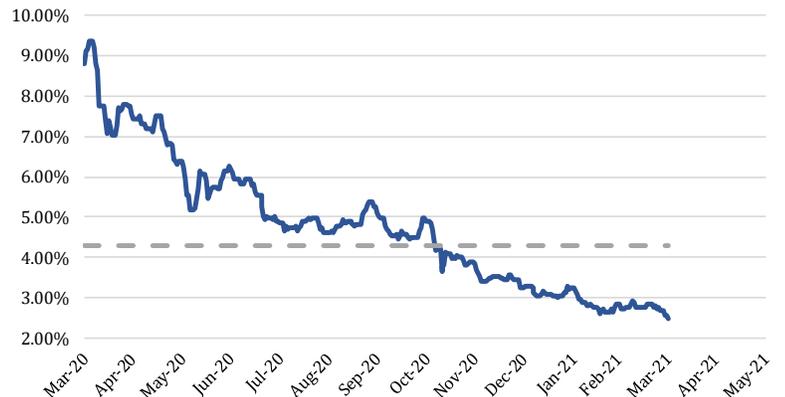
### Treasury Yield Curve (Previous Month End)



Source: Bloomberg

### Corporate High Yield - 10 Year Treasury Spread

Historical 10yr Avg Spread: 4.29% Current Spread: 2.49%



Source: Bloomberg



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### **Performance Disclosures**

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

### **Citations**

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