Legacy Trust

Investment Perspectives

Rates, Inflation, and Asset Valuations

What should investors do now?

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Key Takeaways

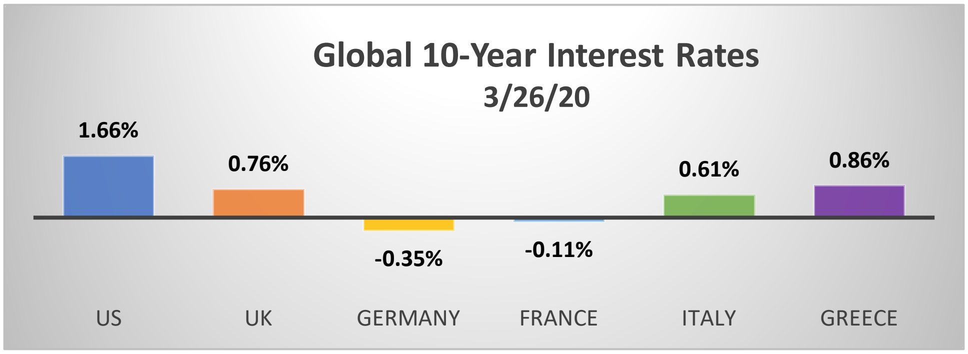
- Interest rates rose rapidly from February through mid-March, leading to year-to-date price losses in the bond market
- The improving economy and accommodative Federal Reserve have reinvigorated expectations for higher inflation
- Rising inflation is likely to occur in 2021 on the post-pandemic recovery but we expect it to be transitory
- The impact of higher rates on asset valuations has investors shifting favor from momentum to cyclical stocks, leaving many of the most popular investments in recent years lagging behind

After years of a falling rate environment, the recent rise in interest rates has renewed investor concerns over the potential for higher inflation and its implications for stock valuations. A properly allocated investment portfolio with active management is key to navigating periods of market transitions such as this one.

Rates

Much has been made recently of the sharp rise in yields. Since last summer, the yield on the 10 Year Treasury has gone from 0.56% to a recent high of 1.72%. While the move had been orderly early on, matching rising expectations of an economic recovery, we saw a sharp move higher throughout February and into mid-March. Over that time, we saw rates rise more than 60 basis points (one basis point = .01%). I will forgive you if you are wondering why a 1% move in interest rate warrants discussion. More on that later.

It is not the level of interest rates that caught the attention of investors; rates are still very low by historical standards. In fact, as you can see in the chart below, rates around the world are extremely low. Even countries like Greece, which has teetered on the brink of insolvency, has extremely low rates.



It was the speed at which the move happened. Bond investors are used to slow and steady. Anything that deviates from that pace is usually cause for concern. But it is not just the bond market that took notice. Low rates have been a driving force behind the rise in all asset prices from stocks, to housing, to collectibles of all types. Any sense that a change in the current environment may be underway results in a quick reaction across the spectrum, with financial assets first to adjust.

What is the impetus behind the recent move? Further signs that global economies are on a path toward recovery from the Covid-19 pandemic explains most of the move. The efforts put forth by the Federal Reserve and other central banks around the world last year to blunt the economic impact from the pandemic will at some point be reversed. A recovering economy does not need trillions of dollars of bond purchases, or short-term rates pegged at zero. Today's 10-Year yield is about where it was in the fall of 2019.

Other factors are also at play. Rising inflation expectations is one, along with a fresh supply of new Treasuries that will be needed to pay for the $5.6 trillion in stimulus packages that have already been passed and the potential for additional spending plans by the Biden administration. Both have the potential to send rates even higher. Too much supply and not enough demand will always cause prices to fall. Economics 101 told us as much. Falling bond prices result in higher yields.

Inflation

The following chart from the Federal Reserve Bank of St. Louis illustrates what the market's inflation expectations are for the next 5 years. At 2.50%, it's above average – but not extreme.

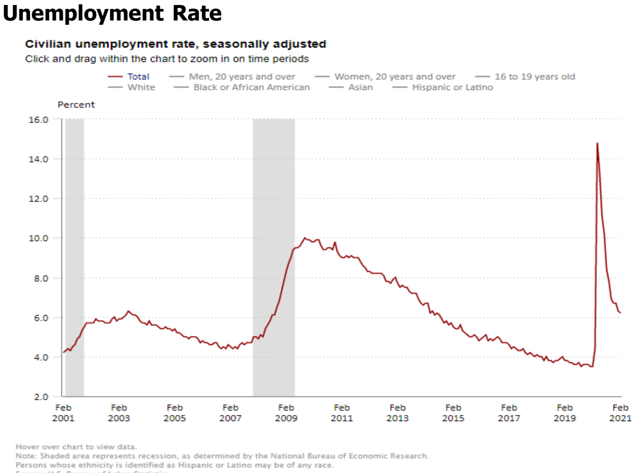
5-Year Breakeven Inflation Rate

Since last spring, inflation expectations have been steadily rising, pausing only briefly last fall as Covid cases were spiking. Since news broke in November of the development of a successful vaccine, we have seen the trend resume. However, that only explains about 30bps of the rise. And while expectations are now higher than we have seen in the past few years, they are far from being problematic.

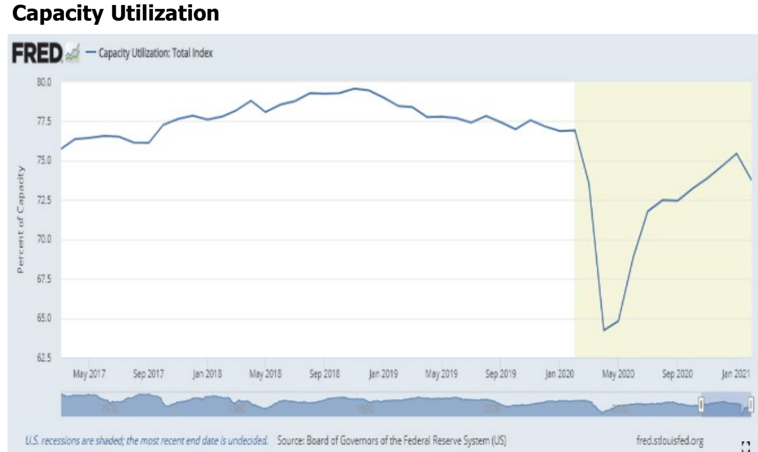
The market fears the Federal Reserve is falling behind the curve when it comes to maintaining price stability. Investors argue that keeping rates too low for too long coupled with on-going asset purchases will lead to runaway inflation and ultimately the need for a sharp increase in rates to keep inflation in check. While expectations may be rising, history has shown that expectations tend to overshoot actual inflation in the near term.

While we too expect inflation to rise in 2021, our view differs in that we believe it is likely to be transitory and mostly reflective of the disinflation experienced in 2020 as a result of the lockdowns and travel restrictions brought on by the pandemic. As the economy continues to heal, its reasonable to expect inflation to trend higher as pent-up demand is satisfied in the near term. However, there are still significant output gaps, like unemployment and factory capacity utilization, that will keep inflation in check. Another limiting factor, often overlooked, is the aging of the US population. People tend to accumulate more assets and spend less as they get older, which in turn leads to lower demand for goods and services and lower inflation.

Unemployment Rate



Capacity Utilization



Valuations

In the past few months, there have been renewed discussions around asset bubbles and extreme valuations. We made the argument a year ago that valuations would likely rise during the year as asset prices anticipated the recovery, which is exactly what happened. As earnings continue to recover, valuations will return to normal levels. But what is normal at any point in time depends in part on the prevailing level of interest rates.

Interest rates and asset valuations always move in opposite directions. This is due to the discounting mechanism of interest rates. When rates are high, future earnings, cash flow, and underlying value are lower. When rates are low, those same streams of future income and value are worth more. Below we illustrate how two different levels of interest rates affect the current value of a company.

Example

Value of Company XYZ in 2026:	$20B	Value of Company XYZ in 2026:	$20B
Risk Free Rate:	3%	Risk Free Rate:	1%
Value of Company XYZ in 2021:	$17.25B	Value of Company XYZ in 2021:	$19.03B

In a lower interest rate environment, the current value of a company can be worth considerably more and therefore support a higher valuation, but if rates begin to rise, those valuations will need to come down. In some cases, substantially. But it is important to remember that interest rates are not the only reason for changes in valuations. There are often offsetting forces at work such as future growth rates and investor sentiment.

But markets have taken notice of the shift in rates. So far in 2021, we have seen a resurgence in dividend paying stock performance (more cash paid to investors upfront versus growth in the future). The iShares Select Dividend ETF is already up 18.6% for the year. On the other hand, high growth companies with little or no profit have struggled of late. The ARK Innovation ETF (high growth stocks with little current earnings) is down 8.3%. Most of the difference in performance has occurred in the last month, just as rates began to rise.

The same can be seen in the bond market. Longer dated bonds (high duration or sensitivity to changes in interest rates) have been underperforming shorter dated issues (low duration). Better to get your principal back sooner than later if rates are set to go higher. It gives investors an opportunity to reinvest at something greater than say 1%.

What are investors to do when both stocks and bonds are expensive and there is no money to be made on cash? A properly allocated investment portfolio with active management is the best bet at handling market transitions. In the last year we have transitioned from a slow and steady growth economy to one that sent 20M people to the unemployment line, all while stocks and bonds reached new highs. We are now transitioning to an economy that is going to grow at a much faster rate than most of today's investment professionals have ever seen, probably faster than at any time since the early 1980's. This will cause inflation to rise (temporarily), rates to move higher (temporarily) and cyclical stocks to outperform (for a while).

The problem for most multi-asset portfolios is that unlike years past, bonds offer little to nothing in the way of downside protection. The near zero interest rate environment has removed any of the insurance against losses that bonds had typically provided. As we have already seen this year, a mere 1% move up in long-term interest rates has resulted in significantly negative returns with the iShares Aggregate Bond ETF down 3.2% for year, dropping 2.5% in the past six weeks.

Legacy's View

The benefit of experience is that you gain perspective. There is a huge advantage that comes from being able to look at a situation in the right context. It is true, inflation over time will lead to higher rates and all else being equal, higher rates mean lower valuations and consequently lower returns. The key to knowing whether you should make changes to your portfolio can only come from asking one question…Why?

Why is inflation rising? Why have rates suddenly moved higher and will they continue? Why have some sectors of the market flourished while others struggle? Why is my portfolio allocated this way, and should it be?

At Legacy Trust our clients have answers to these questions and more because we take the time to explain to them our views of the markets and the economy. Much like the owner of a business, our clients understand the importance of their income statement, balance sheet and cash flows and when making decisions on each one is appropriate.

Here are a few things to keep in mind. When rates are rising for the right reason, there is less reason for concern. Healthy levels of inflation are good for the economy and should be expected after periods of low or disinflation. Valuations may be pressured from rising further, but there are plenty of companies whose stocks trade at attractive valuations and are likely to be bigger beneficiaries of the economic recovery coming during the next 12-18 months than they have been in the past. Bonds can become as expensive at stocks and do not offer the same protection many investors have come to know, but there are other sources of income out there if you need it.

If you are not sure your portfolio is in the right place or are not sure where the markets and economy are headed, we are here to help. We would love to have a conversation with you about the things on your mind and offer some answers.