Market Update

15th of April 2021

Dear Investor,

Our last Market Insight was published in January 2021. This new edition should be read in conjunction with that original piece, since it contains some tweaking of our original views on the global economic recovery as well as our playbook for financial markets.

It is now **widely accepted that 2021 will mark the year of normalization for the global economy**, following the global pandemic in 2020, but this was **already factored into our framework going into the year**. As a reminder, we were modelling US / Global GDP growth of +4.5% / 5.5% year-on-year (YoY) in 2021 as published in early January. What was, however, unclear to us at that time was the economic policy approach of the new incoming US Administration with Janet Yellen as Treasury secretary and President Biden having the full support of a Democratic controlled House and Senate. We now know **systematic fiscal policy and potentially higher taxes for more inclusive economic growth will be their recipe.** At the same time, we now also have a firmer understanding of the FED's reaction function to the economic framework of this new administration. To our mind, **the key issue to gauge from here will be whether the trajectory of the ongoing US and global recovery post 2021 will be any different from the "secular stagnation" period that took hold post the great financial crisis (GFC) in 2008.** This will not only set the direction for inflation trends in the mid-term, but also influence long-term real rates in the US such that 10-year nominal Treasury yields eventually move back to 3.0+% by 2024.

The 2009 – 2020 post-GFC period was marked by a disinflationary, "low growth, low inflation" period in which the US / World economy was stuck in an unusually weak 2% / 3% trend-line growth phase, held back by headwinds from unfavorable demographics, very high debt levels and very slow productivity growth in historical context. This made the post-GFC US economic recovery the shallowest ever in history. This was also **a period during which 10-year US real rates averaged only +0.38%**, massively aiding the valuation re-rating of high FCF, high secular growth companies, in other words the Technology sector. In a low yield environment, financial markets re-branded Software companies as new long-duration bonds, albeit with growing FCF streams, and paid up their valuations such that their FCF yields continued to tighten towards long-term Treasury rates.

The other key tenant of this period was that the FED and monetary policy was the only game in town, with the FED balance sheet increasing from $0.9 trillion in 2008 to $ 7.7 trillion by early April 2021 (close to 35% of US GDP). One unfortunate by-product of this balance sheet expansion has been that income and wealth disparity in the country grew markedly as a result, leading to increasing polarization of society along of the lines of labor versus capital. This unhealthy development is clearly top of mind for all policymakers, with FED Chair Powell mentioning the "unevenness of the current recovery" as a way to justify the pushback of the rate lift-off until the economy gets to an inclusive full employment (which goes beyond just gauging the overall unemployment rate). Treasury secretary Yellen seems to have made the fighting this K-shaped recovery as the key policy hallmark of her coming tenure.

Interestingly, the FED experiment to test its boundaries in 2018 by raising FED Funds rates to 2.25% by December 2018 nearly culminated in a US recession, and the FED had to quickly pivot from its experiment. FED learned that the US economy in its current form cannot structurally handle long-term real rates of more than +1.0% anymore. The US needs a completely new approach to its economic policy making in order to avert eventually going down the same "no-growth, deflationary path" of Japan and the Eurozone. This is where Biden and Yellen come into play, in our view.

Source: Nahmani Grunder.

New Treasury secretary Janet Yellen, who is a trained labor economist, seems to believe that the only way out for the US not to follow in the footsteps of Europe and Japan is systematic fiscal policy. Systematic fiscal spending, such that the US federal government uses its own balance sheet, sometimes through deficit spending, to kick the US economic engine into a higher gear. That is how the $ 1.9 trillion COVID relief bill passed in Q1 2021, with its additional direct cash handouts to each US household in March and the extension of unemployment benefits to September 2021, is justified especially since it came only shortly after the $ 900 billion fiscal bill passed in December 2020 to fight with the effects of the pandemic. With the subsequent announcement of a proposed 8-year $ 2.25 trillion infrastructure-spending bill at the end of March, President Biden and Yellen have upped the ante one further notch under this new fiscal approach. This proposed infrastructure bill, which will still go through re-conciliation in the House and Senate, includes additional government spending for investments in infrastructure, education, work force development and fighting climate change, with the aim of making the economy more productive.

The bill includes **$1 trillion in spending on the construction of roads, bridges, rail lines, ports, electric vehicle charging stations, and improvements to the electricity power grid and other parts of the power sector.** In other words, a long overdue modernization push into some key tenants of the economy into which there has been a dearth of investment in the last 20 – 30 years.

We believe this **could herald a new era in which new Treasury secretary Yellen orchestrates a re-acceleration of productivity growth in the US** and thereby potentially also solving the growing wealth inequality problem in the country. Economic growth in a country simplistically is a function of population growth and productivity growth. **Higher eventual productivity growth should thus put the US economy back on a higher growth trajectory**, eradicate the need for the FED to use its own balance sheet to support asset prices, and finally allow for a better sharing of the overall economic pie between labour and capital. We would welcome such an outcome as it would result in a more balanced, sustainable and healthy long-term development of the US and global economy. We will now need to wait and see whether the US electorate and US politics will allow Yellen and the current Administration to enact ongoing fiscal policy to step kick-start the US economy out of this "low growth, low inflation" environment. First key test will be the mid-term elections in November 2022 with the control of the US Senate back up for grabs.

In the meantime, we believe the FED will continue with its FED Funds rate at zero and the $ 120bn per month QE program well into 2022, effectively keeping financial conditions as easy as possible. FED Chair Powell has stated repeatedly in recent months that the **FED will only react with a rate lift-off if inflation moves persistently and materially above tolerable levels, which we believe now is a core PCE level of 2.3%**. Despite higher US and global GDP growth forecasts, we still do not see the timing for the FED Funds rate lift-off before H2 2023. Accordingly, over the next 12 – 18 months, **we should still be in an environment of strong economic growth with gradually increasing inflationary pressures, but a patient and hands-off FED until it sees signs of full employment**. According to the FED, full employment "is a broad-based and inclusive goal" that is assessed with a "wide range of indicators" also looking at demographic-specific unemployment rates. Moreover, the unemployment rate for minority and less educated workers is still very high, reflecting the disproportionate layoffs that these groups experienced during the pandemic.

US Financial conditions index (FCI): FED will do everything to keep financial conditions easy, well into a recovery, i.e. well into 2022 in our view

Source: Bloomberg

With this new NG Market Insights edition, we are officially upgrading our US and global GDP forecasts for 2021e to +6.0% YoY and +6.2% YoY, respectively, from 4.5% and 5.5% previously. Our new global GDP forecast includes higher US and higher emerging market (EM) forecasts, slightly offset by lower assumptions for large parts of the Eurozone. Net net, we thus now expect the G-7 countries, excluding the US, to grow GDP at +5.0% in 2021e, versus +5.5% previously at the start of 2021. We are also adamant the US economy can sustain this above trend momentum into 2022 with another GDP growth of +4.2% YoY, aided the positive impact of the new fiscal stimulus. Europe has unfortunately not handled the pandemic response as well as the US and China, and is currently also being plagued by vaccine supply issues. This is only delaying the snap-back from the lockdown-related economic hit in 2020. We have had to reduce our 2021 GDP forecasts for Germany, France and Italy. Overall, the Eurozone is already mired in difficult underlying structural issues plaguing its economies. And now it is facing the unfortunate situation that its economy was hit much harder than the US and China in 2020, only to now experience a much shallower recovery out of the recession. The US economy will easily regain its pre-COVID levels by 2021, while it should be 2022 before the Eurozone does the same.

GLOBAL REAL GDP GROWTH MAP					
	2017a	2018a	2019a	2020a	2021e
USA	2.2%	2.9%	2.2%	-3.5%	6.0%
Japan	1.7%	1.1%	0.7%	-5.3%	2.8%
Germany	2.5%	1.9%	0.6%	-5.3%	3.4%
France	2.3%	1.6%	1.5%	-8.3%	5.9%
UK	1.7%	1.4%	1.3%	-9.9%	6.1%
Italy	1.5%	1.2%	0.6%	-8.9%	5.2%
Canada	3.0%	2.1%	1.5%	-5.4%	5.8%
G7-ex US	2.1%	1.5%	0.9%	-7.3%	5.0%
China	6.9%	6.7%	6.1%	2.3%	8.5%
Developed Mkts (DM)	2.3%	2.4%	1.7%	-5.3%	5.6%
Emerging Markets	4.7%	4.7%	4.2%	-2.2%	6.6%
Global GDP growth	**3.7%**	**3.7%**	**3.1%**	**-3.5%**	**6.2%**

Source: Nahmani Grunder.

The Q1 2021 corporate earnings season is now upon us, with the US Banks earnings reports due later this week. Ahead of what should prove to be another stellar earnings season, we are also increasing our EPS forecasts for the S&P 500 on the back of higher US and global GDP forecasts as detailed above. Historically, S&P 500 annual revenue growth has come with a multiplier of 2 – 3x on US GDP growth coupled with positive operating margin leverage and ongoing share buybacks adding further to overall EPS growth. We now forecast S&P 500 EPS of $ 181.8 in 2021e and $ 210.9 in 2022e, implying respective EPS growth of +26% and +16% YoY, versus $ 175.4 and $ 191.1 previously. In terms of Europe, we now expect the Dow Jones STOXX 600 (SXXP) to generate EPS growth of +39% YoY in 2021 to EUR 24.9, after falling by -31% in 2020a. SXXP EPS in 2021 will be below the 2019 level, unlike the S&P 500 whose 2021 EPS will already be +11% above 2019.

	US GDP growth	S&P 500 revenue growth	Multiplier	S&P 500 EPS	S&P 500 EPS growth
2017a	2.2%	6.9%	3.14	133.0	11.6%
2018a	2.9%	7.5%	2.59	162.9	22.5%
2019a	2.2%	4.0%	1.82	164.6	1.0%
2020a	-3.5%	-2.0%	1.75	144.6	-12.2%
2021e	6.0%	12.0%	2.0	181.8	26%
2022e	4.2%	8.4%	2.0	210.9	16%

Source: Nahmani Grunder.

The 10-year US nominal and real rates have a significant influence on the underlying valuation of many global asset classes. During 2021 so far, the 10-year Treasury rate has moved up very swiftly by around +70bps to above 1.60%, also causing an upward re-pricing in 10-year real rates from -1.08% at the end of 2020 to -0.69% as of 13 April, due to better growth expectations and some investors' fears of inflation risks. This upward re-pricing in real rates and the steeping of the US yield curve was also behind the violent sector rotation in equity markets, with the equal-weighted S&P 500 outperforming the S&P 500 by 3.6% in the year-to-date 2021 period so far. While we acknowledge that, within our new economic framework presented above, US 10-year nominal rates can continue to move higher above 2.0% with a 2-year view, we think this move will be much more gradual than what we experienced in Q1 2021. At the same time, we also believe the FED will want to keep financial conditions as easy as possible into 2022, such that it will see 10-year nominal rates of 2.0% as the pain threshold in the near-term at which point it will start to employ yield curve control, in our view. Accordingly, despite our much higher US GDP growth forecasts, we see the 10-year nominal rate between 1.50% - 2.0% over the next 12 months (versus 1.25% previously), with a core PCE inflation of 2.0% by the end of 2021 with current excessive inflation fears fading as we move into H2 2021.

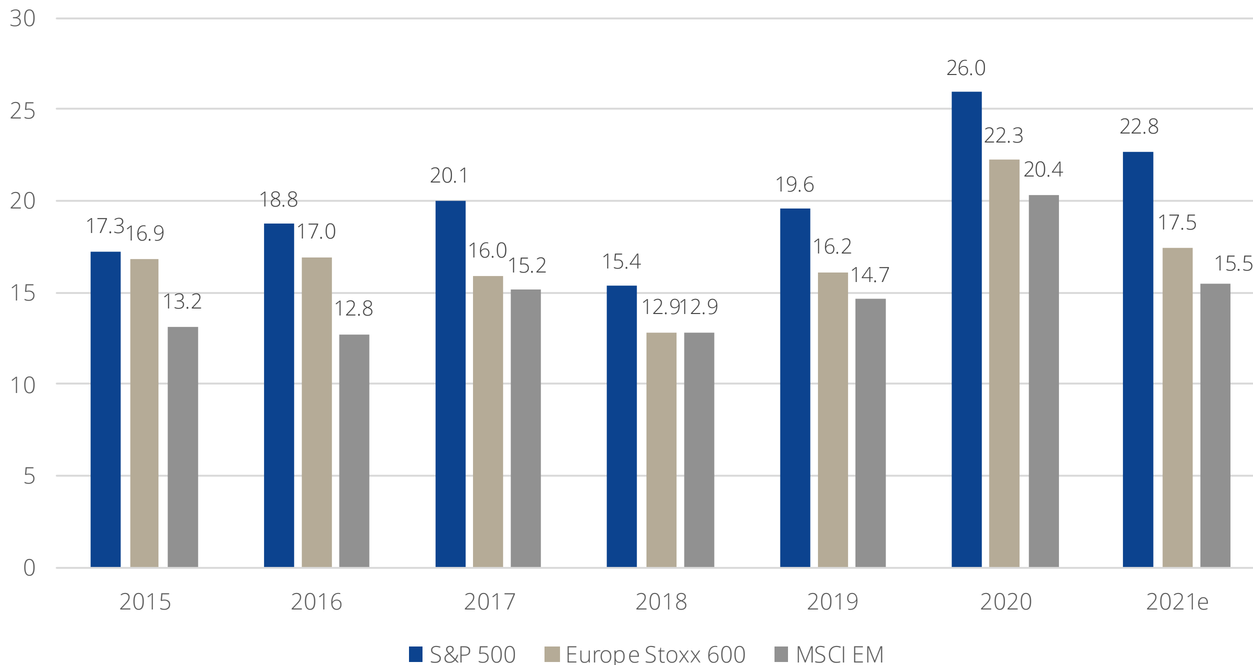
Based on our overall global macro framework and our new S&P 500 EPS forecasts, we are also **increasing our S&P 500 price target by mid-2022e from 4,180 to 4,250**. In summary, this new target uses a EPS 2022e forecast of $ 210.9, as well as a mid-2022e 10-year Treasury rate assumption of 1.75% and an equity risk premium of 3.20% yielding a target P/E multiple of 20.2x (versus a target multiple of 22x earlier and a historical average of 18.2x between 2015a – 2019a). So, net net, our higher S&P 500 price target is based on a higher EPS estimate, slightly offset by a lower target P/E multiple (due to higher 10-year rate assumption). **At this stage of the cycle and given existing valuation levels, we continue to prefer global equities and commodities over Credit. Within global equities, we hold our positive towards US and EM/Chinese equities**, while at the same time, we acknowledge that it is possible European equities, given their cyclical tilt with a wealth of Energy and Commodities, as well as Industrials stocks, will keep pace with the former in 2021e. As you see below, on a P/E 2021e basis, SXXP is currently trading at a 23% discount to the S&P 500, which does not make it attractive enough on a relative basis to change our regional preferences, especially as one starts to look into 2022e.

S&P 500 scenario analysis, mid-2022e

10-year nominal	P/E 2022e*	S&P 500
1.25%	22.5	4,745
1.50%	21.3	4,492
1.75%	20.2	4,260
2.00%	19.2	4,049
2.25%	18.3	3,859

Source: Nahmani Grunder.

* Assumes an equity risk premium of 3.2% in 2022e, versus an average of 3.8% between 2011 - 2019 and 2.9% at end-2020a



Source: Nahmani Grunder estimates (as of 13 April 2021)

The **biggest risk to our overall case is a lasting, and not just transitory, inflation overshoot**, which we will keep on our radar. As long as the core PCE inflation rate remains below 2.2% - 2.3% during 2022 (versus our end-2021 forecast of 2.0%), our current framework and positive bias to Equities and Commodities will hold true. The easy money has already been made since the February/March 2020 crash, but we think there are still a wealth of stock level opportunities in our view, and hence stock picking and proper portfolio construction should continue to help us generate good 5% - 10% return over the next 12 months. On the important issue of portfolio construction, we will continue to **employ a balanced barbell approach for global equities** with a group of cheaper structural growth stocks also within the Technology sector overlaid with some underappreciated stocks in the Energy, Commodities and Financial Services sectors that do not reflect the strong recovery we expect. At the same time, investors should also bear in mind that the new found tension between the FED's roadmap and the market's own pricing of the rates outlook is here to stay and will create a more volatile market backdrop in 2021 with higher probability of corrections, similar to what we experienced in the latter parts of February 2021. As long as any possible inflation overshoot in 2021 remains transitory due to base effects, we believe these corrections will be fertile buying opportunities.

The Nahmani Grunder Investment Team

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