Sitting in limbo, waiting for the pandemic to end

By Michael A. Tyler, CFA
Chief Investment Officer,
Eastern Bank Wealth Management

A year into the pandemic, Americans are stuck in an uncomfortable suspended animation: Our quotidian lives are hamstrung at every turn by restrictions intended to curb the pandemic, yet we still yearn to move more freely again soon. Investors, too, must live with this tension. On the one hand, we look at the landscape around us and see signs of pain manifest everywhere: entire industries still effectively shut down; small businesses facing existential threats; office space abandoned in major cities; corporate earnings under severe pressure; more than 10 million lost jobs not yet recovered.

On the other hand, markets are anticipatory in nature. Investors look to the near future and see an America in which millions are vaccinated and herd immunity is nigh. They see Americans eager to greet one another in person at their local restaurant; siblings and cousins jetting across the country for long-delayed family reunions; entrepreneurs discovering new uses for retail storefronts; and new jobs opening everywhere. The most optimistic investors even see Fenway Park packed with fans for a Mets-Red Sox World Series.

For most of the past year, the visionaries have held the upper hand in the markets. Prices soared, stretching historical valuation measures to what some bears call bubble territory. One definition of a market bull could be “an investor who expects the best and is occasionally disappointed,” and it seems reasonable to expect a few disappointments on the road to full-post-pandemic recovery. Perhaps one or more of the vaccines will have some nasty long-term side effects; perhaps distribution logistics will prove to be frustratingly difficult to untangle; perhaps new mutations will resist the current vaccine crop.

Or, more worryingly, perhaps Americans have permanently changed their habits and prefer eating at home and watching movies on their own big-screen TVs instead of at the multiplex; perhaps they prefer a one-hour Zoom visit with Uncle Eddie and his bratty children rather than three uninterrupted days with that meshuggeneh family.

We can’t presume to know what the future holds. For now, as Jimmy Cliff wisely understood about these in-between times, we abide the tension: I can’t say what life will show me / But I know what I’ve seen / Sitting here in limbo / Waiting for the tide to flow.

Drivers, start your engines

By Timothy Garvey, CFA
Investment Officer,
Eastern Bank Wealth Management

A year after the pandemic began, American consumers are still feeling its pain. With much of the country still living in lockdown conditions, consumer spending remains notably below prepandemic levels — especially in service industries like dining, hospitality, leisure, recreation, and travel. Spending in these sectors has fallen by about 35% to 60%. In order for the economy to extend its recovery, consumers must have the means and the willingness to start spending again.

Government packages can help for awhile, but the biggest stimulus will be widespread vaccine distribution. Once enough people have been inoculated, we think individuals will start becoming more comfortable going out and spending money. And once individuals start spending money on “high-touch” services, more jobs will be created. Unfortunately, accomplishing this will be challenging. The vaccine rollout process could last several more months, which likely means more stimulus measures will be required. It’s also possible that some consumer behavior may be permanently changed; it remains uncertain how many jobs lost during the pandemic will be recovered, and how many will be gone forever due to changing consumer interests.

Despite the challenges, we believe the process will ultimately be successful. The vaccines have been effective up to this point, and eventually the distribution process will be completed. The rate at which consumers are saving has increased sharply over the past year, providing individuals with the means to spend once given the opportunity. We think consumers will resume their spending habits, stimulating economic growth and reviving more and more jobs, which in turn, will result in more and more spending. We can see the road to economic recovery; we are just waiting for the green flag. Drivers, start your engines.

CHANGE IN CONSUMER SPENDING BY CATEGORY

After their stunning comeback and double-digit returns last year, stock prices are clearly elevated. Traditional valuation measures suggest that prices are expensive relative to earnings, dividends, and other metrics. Skeptical investors may well ask what — if anything — can lead the equity markets forward through 2021.

Several factors give us cause for optimism. Low interest rates and an improvement in corporate profits are two primary reasons for continued upside. The current interest rate environment may persist for some time, boosting the present-day value of future earnings and resulting in equities offering more appeal than fixed income securities. Equities provide both current income in the form of dividends and the opportunity to participate in the long-term growth of the economy and corporate profits. Even in the short term, more fiscal stimulus — perhaps including a much-needed infrastructure bill — can lead to improved corporate profits.

Equity markets for some years have been led by growth-oriented stocks, especially in the technology sector. Although we expect prospects for long-term growth to continue for these companies, a vaccine-led recovery should result in the resurgence of battered industries in the financial, consumer discretionary, industrial, and energy sectors. Many companies in these sectors have posted depressed earnings due to the pandemic; we think they will participate in a rebound as the vaccine is rolled out. As people begin to spend money in these areas again, growing re-employment can jump-start sustained corporate profit growth across the entire economy.

For many years, small-cap equities underperformed their large-cap peers, but that changed abruptly last December. The overall profit picture for this group is improving, and valuations have trailed those of large-cap equities. Many investors consider small-cap equities to be excellent early-cycle investments in that they tend to perform best when the economy is beginning to recover from a recession.

COVID-19 vaccine rollout should make 2021 a year of recovery on Main Street and throughout the economy. Although the equity markets anticipated renewed vigor last year, we think the combination of accommodative central banks, improved economic recovery, and a corporate profit rebound in industries especially hurt by the pandemic can drive the equity market further upward.

2020 was a great year for the debt markets as Treasury yields plunged to historic lows. The Bloomberg intermediate government and intermediate credit indices returned 5.73% and 7.08% respectively. Those returns are unlikely to be duplicated in 2021, as we expect Treasury yields to move higher (thereby pushing prices lower) as the economy begins to rebound during the second half of the year. The upside in yields, however, may be limited as the Federal Reserve has said it plans to keep the federal funds rate near zero until 2023 and it will continue to purchase $80 billion of Treasuries per month.

As the Fed suppresses yields, investors are being forced to look for income in places other than U.S. Treasuries and investment grade corporate bonds. Despite the rally in lower-quality debt since the equity market bottomed in March 2020, we still expect more gains. Debt markets are flush with liquidity, and companies are pushing out their maturity structures while locking in record-low yields. In this environment, we think that high yield, floating rate, and preferred securities should continue to perform very well. As the 10-year Treasury note yields just over 1% and about $17.5 trillion of securities offer a negative yield (mostly in developed Europe), the 4% percent yield an investor can receive from lower quality securities is difficult to ignore. To get exposure to such securities, we purchase actively managed ETFs and mutual funds.