THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – FEBRUARY 2021

U.S. Markets and Economy

The U.S. stock market gained enough in February to wipe out January's small losses. While the large cap S&P 500 index, the Dow Jones Industrial Average, and NASDAQ Composite index all made small gains, mid-cap and small-cap stocks were much stronger, with the S&P 600 small-cap index up more than 7% for the month and more than 14% for the year thus far. This relative outperformance partly reflects the market-moving impact of many social media-driven small investors who have bid up the prices of speculative stocks like GameStop, which, after falling 90% from its high, rallied back above $100. While this is certainly a bubble that will pop yet again, the overall stock market is struggling to come to terms with rising interest rates as the pace of economic activity accelerates.

Although the Federal Open Market Committee (FOMC) has repeatedly stated it will keep short-term rates at almost zero, the Fed does not control the long end of the maturity spectrum. The Fed is still buying $120 billion per month in longer-term securities, but February nonetheless witnessed a steady rise in long rates: the yield on the benchmark U.S. Treasury 10-year bond rose to almost 1.5% by month's end. For comparison, this yield was below 0.6% at the depths of the pandemic sell-off last March. Yet this yield is still historically low and near zero in real terms (correcting for inflation).

The paradox is that the rise in rates reflects the success of expansionary monetary policy and stimulative fiscal policy, which, combined with good progress on vaccination, is setting up the economy for a year of strong growth. By the end of 2021, millions more of the jobs lost in the pandemic will have been recreated, unemployment will be further reduced from its February level of 6.2%, and corporate profits will be recovering strongly from the 2020 disaster. Of course it can be argued that some of this good news was already reflected in stock prices, which often tend to lead movements in the real economy by three to six months. It is also true that the massive outperformance in 2020 of the mega-cap tech stocks, like Apple and Google, leaves a lot of room for a catch-up phase by the rest of the market.

World Markets and Economy

The STOXX Europe 600 index managed a small gain for February as its movements almost exactly followed the U.S. market. Europe is still lagging the U.S. in economic growth as well as vaccination rates. Within Europe, the FTSE All-Share index managed a small gain for the month as the British government continued to struggle with both Brexit and new variants of the virus. The good news is that the U.S. has erased tariffs against some British exporters, which will help improve trade relations and economic activity for both countries. In Italy, the new technocratic government of Mario Draghi may have restored economic confidence. Italian stocks, as measured by the FTSE Italia All-Share index, rallied more than 5% for the month, and the Italian government sold 10-year bonds at a very low interest rate.

In Asia, the economic and political competition between China and the U.S. continues to intensify. China’s human rights record is poor and getting worse—in Hong Kong in particular—and China continues to apply pressure on Taiwan, which the U.S. is pledged to defend. China has also aggressively challenged India, another nuclear power. Rising tensions in Asia could affect stock markets all over the world. But in February, Chinese stocks shrugged off these worries and rose slightly. The Shanghai SE Composite index is now at its highest levels in more than five years. In Japan, the Nikkei 225 index rose nearly 5% in February and during the month touched the 30,000 level—the highest it has been in 30 years. The good news driving stocks was that Japan’s economy grew strongly in the final quarter of 2020, with GDP up at an annual rate of more than 12%. This growth was driven by both exports and consumer spending. There will most likely be a pullback in the first quarter of the year, as Japan has struggled with new variants of the coronavirus that have been spreading rapidly.

Outlook

Progress on vaccinations in the U.S. is accelerating, with a current count of more than two million shots administered per day. The Biden administration projects that all American adults can be vaccinated by the end of the summer. With production of Johnson & Johnson’s one-and-done vaccine ramping up (with help from Merck), the vaccine picture is even brighter. As we have said before, America cannot fully recover until the virus is conquered. It is true that the good news on vaccines is countered a bit by the continued emergence of new mutations of the coronavirus, which may be more transmissible and could reduce the effectiveness of current vaccines. The long-term result may be that we get annual booster shots for the virus along with our annual flu shots, which would still be a very positive outcome for everyone, including stock investors.

As the economic recovery gains speed, corporate profits will recover sharply from the 2020 decline. While long-term interest rates are ticking up, recent increases are not nearly enough to derail the economic recovery or bull market for stocks that began in late March 2020. But the pattern of short-yet-sharp selloffs may continue: Wall Street traders reflexively sell whenever rates rise, running for the exits upon any bit of bad news on vaccinations or mutations. Long-term investors, however, have always been richly rewarded for taking the long view, which, for stocks, is up.

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