THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – MARCH 2021

U.S. Markets and Economy

The U.S. stock market was strong in March. The venerable Dow Jones Industrial Average cracked the 33,000 barrier, and the large-cap S&P 500 index closed in on the 4,000 level (breaking it on April 1). The Nasdaq Composite index was the weakest of the major averages, for a change, as it was pulled down by declines in some of the mega-cap tech stocks, such as Apple. The bull market that began in late March 2020 is now one year old, and most indexes have risen almost 100% in that one year.

A booming stock market is considered one of the better leading indicators of the economy, and it has certainly been right on the money this time: the U.S. economy, which last year surged in the third quarter (after a horrendous second quarter) and continued to grow in the fourth quarter, is now poised to expand at an accelerating rate in 2021. The March monthly employment report, issued on April 2, showed a dramatic increase of more than 900,000 jobs, following a February increase of more than 400,000. The unemployment rate has now dropped to 6.0%. Many economists believe that real GDP growth could reach 5%–6% in 2021, which would mean substantial further growth in employment, a significant further decline in unemployment, and a sharp recovery in corporate profits. The economy may have appreciable room to grow, as Treasury Secretary Yellen and Fed Chairman Powell have both argued that the 6% unemployment rate understates the number of Americans without jobs who want to work. Some of the strongest evidence for their position is that the labor market is still missing about eight million jobs compared to the month before the pandemic began.

This argument about the “true” level of the unemployment rate is much more than a sterile academic debate, as some well-known economists are afraid the amount of fiscal and monetary stimulus already in the pipeline will be enough to reignite inflation: businesses will be scrambling to fill openings, wages will begin rising more quickly, and firms will pass along those increases in labor costs in the form of higher prices. This is the standard scenario when the economy is “running hot” (producing at or above its potential), which is similar to the red line on your tachometer: you can run the economic engine above the red line for a bit, but then it leads to overheating, which is not good for engines or the economy. But if Yellen and Powell are right, we are nowhere near that point. Additionally, the Fed remembers that it began raising interest rates and reversing quantitative easing (QE) in 2016–2018 in anticipation of just this scenario, and inflation never did pick up even to 2%, the Fed's target rate of economy-wide price increase. This time the Fed is determined not to slay the inflation monster until it actually sees it in the data. Chairman Powell has also said that he would tolerate 3% inflation for a while just so that inflation *on average* would be 2%, which is the Fed's new long-term goal. So the Fed has not wavered from its zero short-term interest rate regime, and it has maintained its QE of $120 billion per month in purchases of long-term securities. Wall Street, of course, loves all this.

But Wall Street also loves Joe Biden's fiscal policy. With $2 trillion in new stimulus now in effect, this spending gusher will encourage more spending by Americans and thus lead to even more increases in jobs, wages, and business profits. Biden has also proposed another $2 trillion in infrastructure spending, which will help repair America's roads, bridges, ports, airports, water and electricity distribution networks, levees, and canals and will help bring the country's Internet up to high speed everywhere. This spending, if enacted, will pay substantial dividends by increasing America's productivity, which means the economic pie can grow even faster without setting off rapid inflation.

The icing on this two-layer cake of expansionary policy is progress against the coronavirus. Vaccine production and distribution have improved (many states are now willing to jab anyone over the age of 16), and vaccines appear to be highly protective in real-world conditions. Daily shots are very close to the three million level, and vaccine hesitancy is dropping. Although there has been a worrying increase in new cases in recent weeks, there is still a good chance that the pace of vaccinations could push this infection rate back down, because the virus has fewer targets to infect. This progress thus means that Americans can begin to travel again, go to restaurants and the movies, attend sporting events, and so on, providing a further boost to economic activity.

While the stock market does love all this, the bond market has cast a jaundiced eye on the proceedings: long-term interest rates have continued to creep up with the benchmark 10-year Treasury yield reaching 1.75%, compared to about 0.6% a year ago. This has also pushed up mortgage rates from historic lows. But if we subtract inflation from the nominal interest rate, the 10-year real yield is barely above zero. This is still highly expansionary.

World Markets and Economy

Euphoria in the U.S. has not spread to Europe, which is mired in economic and virus gloom. France is back in lockdown, Germany is headed in that direction, and the vaccine rollout has been botched in many countries. Even worse, AstraZeneca vaccine distribution has been halted—at least partially—in a number of European countries over worries that this vaccine may, in rare cases, trigger blood clots. Europe has also not mustered the fiscal thrust of the U.S., as fiscal policy is still mostly made at the country level. The European economy is not showing much strength under these conditions. In March, the broad-based STOXX Europe 600 index gained more than 4%, but the index is still only 50% above its March 2020 low—about half of the U.S. market's gain over that same time period. British stocks had an even smaller gain, even though England has done a better job of vaccinating its citizens. The British economy is being held back by the continuing and costly effort to escape from the European Union and the spread of a highly contagious variant of the virus. Economic growth was probably negative in Britain in the first quarter, and this kept the gain in the FTSE All-Share index to about 3% for March.

In Asia, trouble looms. North Korea has launched ballistic missiles as a way to get the new Biden administration's attention. Rising tensions on the Korean peninsula, coupled with further intensification of the economic cold war between the U.S. and China, adds uncertainty to the outlook for most Asian economies and stock markets. However, Japan's economy has been growing strongly, supported by expansionary fiscal and monetary policy, although the Summer Olympics will likely not provide much help: there will be no foreign visitors because of the pandemic, and there is still the possibility that the Games will not be held, as they could trigger a virus super-spreader event. Japan's Nikkei 225 index gained less than 1% in March.

Outlook

The economic recovery is moving into high gear, with the Fed and fiscal policy pressing on the accelerator. Stocks have led the way forward, but investors cannot expect the rally to continue at its current pace. If it did, the Dow would be at 250,000 in 2024. Although a more moderate pace for the advance would be welcome, there are elements of speculative euphoria among market participants that could lead to sharp corrections after bad news on any front. GameStop stock is again trading at $190, bitcoin broke $60,000, and a digital NFT sold for more than $60 million. Long-term investors, however, will avoid all these fads and bubbles and stick with the tried and true: hold a diversified, well-managed portfolio of good-quality stocks of companies with real earnings, dividends, and growth potential.