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OP-ED: Federal Reserve underpins the equity market

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2021 began with a slow start. Seemingly it was not a good time for investing. Between January 1 and March 1, the market dropped 1.01 percent as the pandemic stretched on. In this column, I warned against short-term investing and encouraged investors to pay attention to the Federal Reserve and government fiscal spending policies. The Fed said it wanted low interest rates and the central government wanted a large stimulus package. A few months later, the Fed has had its way with interest rates and the government has its stimulus package. As a stream of economic data and corporate profits turned positive, the U.S. equity market experienced strong gains for the first quarter of 2021.

With 99 percent of companies in the S&P index reporting positive earnings and a decline in new COVID-19 cases, the market powered upward. The passage of a $1.9 trillion fiscal relief bill and the Fed's assurance of a near-zero interest rate policy, coupled with continuance of the monthly bond purchase program, spurred the market on.

Concern about inflation expressed by the Federal Reserve chairman caused investors to rotate out of economically sensitive stocks and out of high-growth companies. Still, equities closed near their highs as the quarter came to a close.

Fear began to rise that inflation would take hold if the market recovered too much. Ten-year Treasury yields rose sharply, with stocks falling just as sharply. Things began to look grim for the equity market, but just as quickly, the market reversed course and began to recover. The result has been a solid start to the year with the S&P broad market index up 9.19 percent through April 5. Notably strong have been the aptly named "reopening stocks," as the virus appears to have loosened its stranglehold on the economy. The Dow Jones Industrial Average, reflecting a rotation from technology into more established value stocks, has topped the S&P and Nasdaq for now.

The jobs market reflected the largest gains since the onset of the pandemic. The U.S. reportedly added 916,000 jobs in the last month, the most since August and twice as many as February. Unemployment fell to 6 percent, its lowest level since the coronavirus took hold. Nearly 350,000 people rejoined the labor force. However, if the new virus cases turn into a surge in hospitalizations, they could cause the economy to slow. There is no way to predict the path of the virus. A lot depends upon personal behavior.

The Federal Reserve Bank of Atlanta, which tracks economic data in real time, reported a real rate of GDP growth in the first quarter of 4.75 percent. A jump in manufacturing activity, as measured by the Institute for Supply Management (ISM), reached a three-year high, and the Services PMI registered its biggest expansion since July 2014.

The consumer appears to be in good shape with net worth at all-time highs. Retail sales increased 5.3 percent in February. Homebuying continues to be strong with historically low mortgage rates. The unemployment rate has come down, but jobless claims have remained stubbornly high and wages slightly lower.

Still, optimism for continued economic expansion remains high. The Federal Reserve, in its revised 2021 outlook, expects the economy to expand by 6.5 percent this year – a substantial upward revision of its previous estimate of 4.2 percent. Also, the Fed forecasts that the unemployment rate will decline to 4.5 percent by year end, with inflation at a modest 2.2 percent: a Goldilocks economy.

Growth forecasts for the rest of the world economies remain subdued with the exception of China, which recorded a jump of 16.9 percent in industrial output from January to February and retail sales soaring 33.8 percent. (Chinese economic numbers are historically unreliable).

What to do now as an investor? In the past we have recommended full investment in a well-diversified portfolio. Is it time to change that mantra? With the Fed promising low rates through 2022 and the central government committed to stimulus, including a large infrastructure package, it seems that our recommendation still has merit.

If the market forces the Fed's hand by moving rates up, we could be on the wrong side of the trade. Thus far, the supply of money rotating into bond funds in search of stability and some semblance of guaranteed yield has kept yields low. We still like our strategy.

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