Keeping Up with Financial Markets

February 16, 2021

In case you have not noticed, the stock market is off to great start so far in 2021. If it were not for a little hiccup at the end of January due to the volatility triggered by the practice known as short selling, gains would have been straight up. One difference within this rally is the performance of large company stocks versus small company stocks. Through the end of last week, the S&P 500 has rallied 4.9% but the Russell 2000 small cap index has risen 16%. Up until the election last year, the small cap index was lagging the big cap universe severely. Ever since the election, the comparison has been reversed. This fact is one example of why diversification among various indices reduces volatility compared to owning just one asset class. Just to give you a glaring example of how wide the disparity can be over short time periods, over the past year, the well-known Dow Jones Industrial Average rose 8.9% while the broader NASDAQ index rose 46.2%.

Fixed income market returns are beginning to show the effects of low interest rates. The year-to-date return on the 10-year Treasury bond is minus 2%. If rates remain low for the balance of 2021 or rise slightly, the real return on these long-term government bonds could continue to be negative.

An important factor in assessing the reasons for the continuing rally in stocks in the face of Covid-19 is the role the federal government is playing to ensure that the economy recovers as soon as possible. Both the Federal Reserve and the Administration have been pumping trillions of dollars into the economy by buying securities and spending through various distributions of money such as the Payroll Protection Program. Another $1.9 trillion program is in process and should add additional support to the economy when those funds are distributed. Given this aid and the Fed's commitment to keep interest rates low, we see no economic reason for the stock market to do anything but rise during the balance of 2021 as that money is likely to find a way into the stock market.

Of course, the media is warning investors about the inflationary implications of big budget deficits and low interest rates. We do not think that inflation is just around the corner. Such fears were prevalent back in 2008-2009 when the government bailed out the mortgage industry, but inflation did not follow. As far as we can see, there is no such thing as too much demand across the economy to permanently drive prices higher. There are some pressures on lumber prices due to the boom in housing and some commodities are rising in price, but those events are wealth transfers from one sector of the economy to another.

One indicator to follow is employment and the unemployment level. Once the economy is operating at full potential, unemployment could fall to record lows and the demand for labor across the economy could be a contributor to rising inflation. If that measure of economic strength does not overheat, then the equity markets should remain on an upward trend.