APRIL 27, 2021

On the Radar

FAQS ON THE MARKETS AND ECONOMY

How does the U.S. recovery outlook compare to the rest of the world?

Boosted by a strengthening U.S. outlook, the global economy this year appears set to record its strongest pace of growth since 1973. However, prospects vary regionally and by economies according to success in responding to the pandemic.

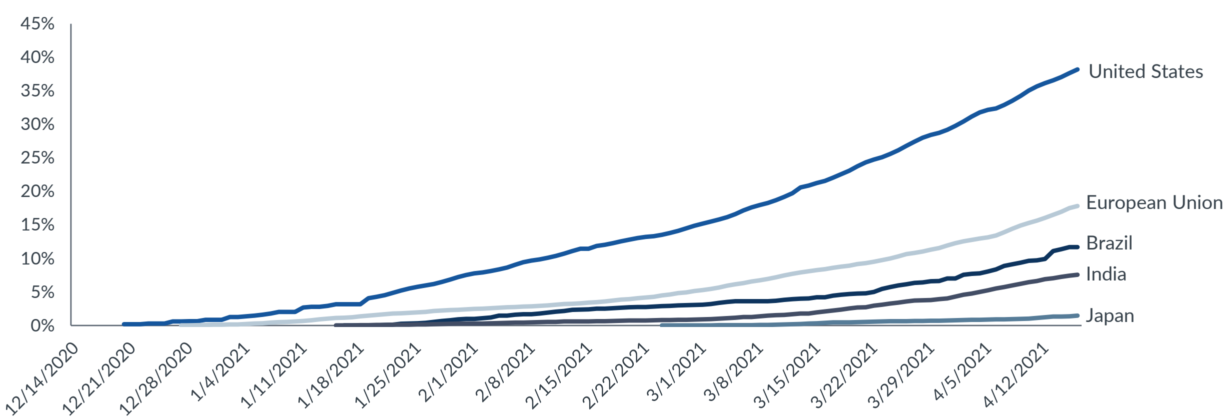
While the latest data shows that the U.S. recovery is gaining momentum through a combination of fiscal stimulus and relaxation of restrictions, vaccine setbacks and worsening virus outbreaks will likely delay recoveries in many other parts of the world.

Europe, for example, continues to face significant supply challenges with its vaccine rollout. Just 21% of its population has received at least one vaccine dose so far, compared with 42% in the U.S. Euro area Q1 GDP is now expected to have declined slightly to around 6% below its pre-pandemic level, and with most governments extending restriction measures, a meaningful pickup in activity is unlikely until the third quarter.

A number of emerging market economies, particularly in Latin America and Africa, are also expected to lag behind as they struggle to acquire enough vaccine doses. However, China and the broader emerging East Asia should still be strong performers this year thanks to improving global demand and policy support, which will remain loose for some time to come.

CNR's portfolio exposure continues to reflect these divergent outlooks, with overweights to U.S. and EM Asia equities and significant underweights to the euro areas and other developed markets.

% of Population With At Least One Dose



Source: Our World in Data.

KEY QUESTIONS

With the strengthening economy, when will the Fed begin to reduce its monetary stimulus?

It seems like shopping malls are packed. Are Americans out spending their stimulus checks?

Should equity investors be concerned about inflation?

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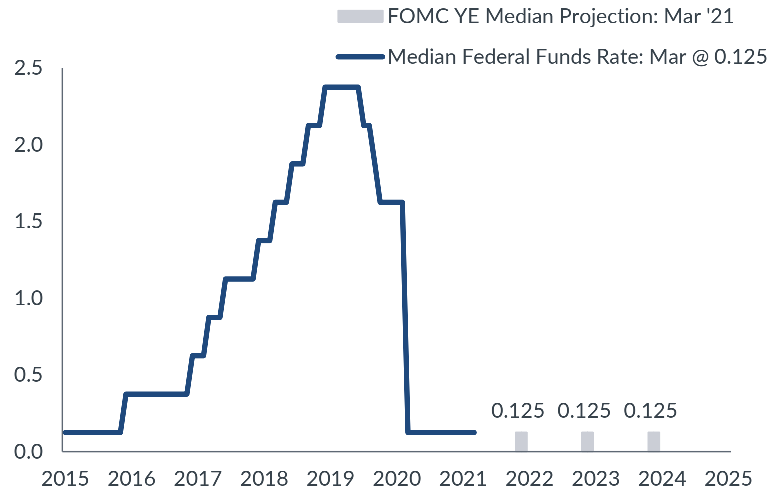
The Fed has committed to keeping the federal funds rate at the near-zero level until the beginning of 2024. It wants to ensure that economic growth is sustainable, and it would like the inflation rate to move slightly above its target level of 2%. For the past 10 years, it has averaged just 1.6%.

In addition to low short-term interest rates, the Fed has been buying $120 billion in bonds each month to help keep intermediate and longer-term interest rates low.

When the Fed is ready to ease up on the monetary stimulus, the first move will be to reduce the amount of bonds it purchases each month. This is something the Fed will ease into, as it does not want to shock the markets.

This summer, we expect the Fed to talk about its thinking in regard to reducing the bond buying. In the autumn, it will talk about reducing the bond buying. Then in the winter, if the economy is still performing well, the Fed may set a schedule to reduce its bond buying.

Federal Funds Rate & FOMC Projections (%)



Source: Federal Reserve as of March 2021.

It seems like shopping malls are packed. Are Americans out spending their stimulus checks?

Americans are going out and shopping. Retail sales surged 9.8% in March alone. To put that in perspective, the long-term average annual increase in retail sales before the pandemic was 4.3%.

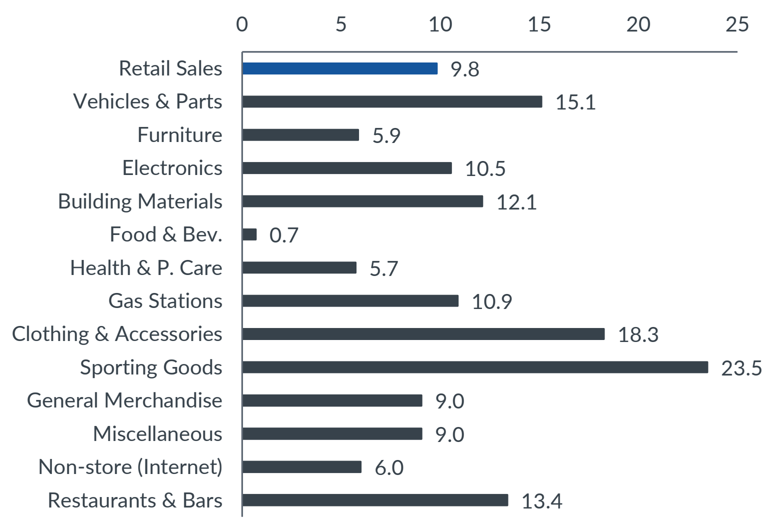
Americans were armed with the recent $1,400 stimulus check and the residual of the $600 January stimulus check. Combine that with the loosening of restrictions and the easing of virus fears due to the vaccine rollout, and the shopping malls were full.

All significant categories increased (chart). Unsurprisingly, spending shifted away from grocery stores to restaurants.

The demand for many goods is outpacing supply. Producers are trying to increase supply, but they are being forced to deal with many bottlenecks in the supply chain. That is putting some upward pressure on prices, but that is temporary. Once the supply–demand imbalance is corrected, prices are expected to retreat.

Retail Sales - Sector Performance

March 2021, m-o-m, % change



Source: U.S. Census Bureau as of March 2021.

Should equity investors be concerned about inflation?

Rising inflation should not be disregarded as a risk for investors. Too much can spell trouble for equities if it results in tighter real monetary policy or slower growth. Still, current market jitters look overblown to us and are unlikely to prove a long-term headwind for stock prices.

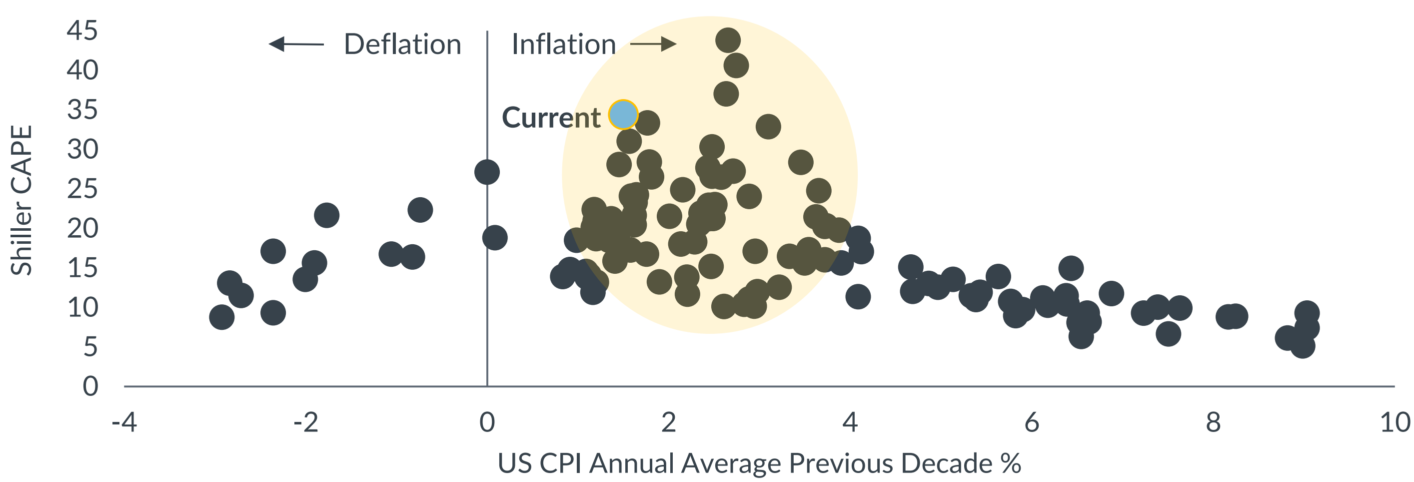
Going forward, the question is not whether inflation pressures will firm but whether the pickup will be persistent or temporary. We suspect it will be more of the latter. Inflation is currently gaining momentum due to "base effects" from pandemic-depressed prices last year, as well as temporary supply–demand imbalances from the reopening of economic activity. However, given the extent of the COVID-19 crisis, the economy will continue to operate below its full potential even as it grows strongly this year.

A number of factors that have conspired to keep inflation low over the past decade should also help contain a rise in the coming months. Many of these disinflationary forces – globalization, demographics, technology adoption, etc. – are structural in nature, and a sharp recovery from the COVID-19 crisis will not change this.

Historically, equity markets have done well despite rising inflation, especially when emerging from low levels. That's because companies can pass on higher costs to customers and preserve profits. In fact, a bit of inflation greases the wheels of commerce and tends to be associated with a healthy economy and growing corporate earnings. With that in mind, it should come as no surprise that Shiller's cyclically adjusted price earnings ratio for the S&P 500 has tended to be highest when inflation has been modest and positive.

Despite all this, inflation concerns are likely to remain in the near term, and investors should brace for potential headline-driven spikes in volatility. While a sharply improving corporate profit outlook supports further gains ahead, a lot of good news has been priced in to the current rally, and even small catalysts can extend a period of market consolidation.

Shiller's CAPE & U.S. CPI Inflation (1900-2021)



Source: St. Louis Fed, Robert Shiller Online Database.

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Index Definitions

S&P 500 Index (S&P500) is a stock market index that tracks the 500 most widely held stocks on the New York Stock Exchange or NASDAQ. It seeks to represent the entire stock market by reflecting the risk and return of all large-cap companies.

The ISM Non-Manufacturing Index is an economic index based on surveys of more than 400 non-manufacturing (or services) firms' purchasing and supply executives.

The CAPE ratio is a valuation measure that uses real earnings per share (EPS) over a 10-year period to smooth out fluctuations in corporate profits that occur over different periods of a business cycle.

The CPI measures the average change in prices over time that consumers pay for a basket of goods and services, commonly known as inflation.