March 2, 2021

Graves-Light February ‘21 Market Commentary

Rising Rates Cause Late-Month Swoon

Market Overview:

January’s mixed tone was quickly forgotten as the markets grew increasingly confident in a robust economic recovery, both domestically and internationally. While the havoc wrought by COVID-19 has led to economic scarring which could take years to heal, the combination of historically loose fiscal and monetary policy along with a dramatic improvement in COVID-19 infection rates helped fuel the recovery for risk-assets over the course of the month. An underscoring domestic data point from the CDC revealed that vaccinations in the US have now eclipsed the number of Americans who have contracted the coronavirus since the pandemic began, an important milestone as the COVID-19 vaccines are rolled out.

As spirits became more buoyant, concerns over rising inflation quickly resurfaced, as the long dormant nemesis of fixed income instruments is once again highly topical. The chief concern is that vaccines will nurture a burst of economic growth that could fan inflationary pressure for the first time in decades. While moderate inflation is typically positive for stocks, market participants are now acutely focused on both its rate of change and trajectory. While the outcomes for rising inflation are far reaching, the knock-on effect of higher rates is already causing major headwinds for long-dated, fixed income assets.

Asset Performance:

February was a dynamic month for the markets, with the evolution of rates largely dictating relative performance within equities. For example, the S&P 500 produced total monthly gains (including dividends and price achievement) of +2.8%. However, when disaggregating by certain market factors, we saw truly diverging trends within the market’s constituents. In this case, the S&P 500 Value Index strongly outperformed the S&P 500 Growth Index, increasing +5.9% during February versus a virtually flat performance out of the S&P Growth Index, which saw particularly weak returns to round out the month.

The key impetus for this diverging trend was the considerable step-up in rates along key points of the US Treasury curve, where once again, a combination of rising inflation expectations, considerable

fiscal stimulus and an accommodative Federal Reserve (Fed) boosted medium to long-term rates. Under the Fed's current framework, short-term rates remain anchored to its supportive (or "dovish") stance. However, beyond the short end of the curve, improved expectations for the economic recovery as well as rising inflation could lead to a material rate adjustment which the bond market is currently witnessing. To this extent, the US 10-Year Treasury rate increased 37bps (remember: 1% = 100bps) during the month to 1.46%, with a similar adjustment in the US 5-Year Treasury rate which ended the month at 0.78%.

For fixed income assets, we reiterate the penalizing effect which higher rates can have on bond prices. As a rule of thumb, the higher the interest rate risk (by measure of duration), the greater the negative impact for fixed income instruments in a rising rate environment. Simplistically, for every 1% change in interest rates (positive or negative), a bond's price will change approximately 1% in the opposite direction for every year of duration. To further illustrate this point, the Bloomberg Barclays US Aggregate Index, which represents a large consortium of bonds from government to corporate securities, carries an effective duration of just over 6 years. This index declined 1.4% during the month, marking the 4th worst monthly performance observed in the last ten years as rate-exposed assets carrying high duration experienced a drubbing. Indices carrying a lower duration, such as the Bloomberg Barclays US Government Credit/Float Adjusted Index, have been comparatively resilient, albeit not immune. This particular index, with a duration of slightly under 3 years, declined 0.3% during the month.

Key US Index Returns	Jan, '21	Feb, '21
S&P 500	-1.0%	+2.8%
Nasdaq	+1.4%	+1.0%
Dow Jones Industrial Average	-2.0%	+3.4%

Relevant Fixed Income Yields	YE 2020	Feb, '21
US 10-Year Treasury Note	0.92%	1.46%
Investment Grade Corp. (C0A0)	1.8%	2.1%
High Yield Corp. (H0A0)	4.2%	4.3%

Source: Factset as of 03/01/21

Closing Thoughts:

As the economy continues to improve, we anticipate that the bond market will continue to recalibrate with bouts of rate volatility. While there were several technical factors which would have added to the erratic ascent in February, we see an improving outlook for the US economy as well as the Fed's prevailing stance to tolerate higher inflation to be the key drivers to future rate trajectory. We note that with real yields still being in negative territory, there is plenty of scope for further normalization which underpins our stance to keep interest rate exposure low. We are wary of interest rate "hiccups", which in the past have pressured stock prices, as well.

Warm regards,

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