Market Commentary

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Last Week's S&P 500 Index: +2.2%

Reflation trade

Key takeaways

- Efforts by central banks around the world to reflate their economies may be providing opportunities for investors to increase exposure to risk assets.
- Our view over the next 14 months calls for good gross domestic product (GDP) growth and a rebound in economies in many regions of the world.

There has been a lot of discussion in the financial press about what has come to be known as the "reflation trade." Keep in mind that the concepts behind this term are nothing new and the events and strategies being described are a fixture of nearly all cycles in the past. We have often referred to "early cycle" equity and fixed income market characteristics that incorporate sectors and asset classes that have tended to outperform as the economy comes to life after climbing out of a recessionary hole or a period of very sluggish growth. The idea is to latch onto these sectors and asset classes that have tended to react positively to the prospects for this newfound growth and companies that may benefit in terms of increased revenues and, soon thereafter, improving earnings.

But most of the time, economies and markets need a little help along the way to get the ball rolling in the right direction. Reflation doesn't normally just happen by accident. What typically lights the fuse and gets the process going is a combination of Federal Reserve (Fed) monetary policy and fiscal initiatives Congress puts forward and implements. Lowering interest rates to encourage borrowing and spending is the norm for the Fed. Congress usually follows by reducing tax rates or providing spending subsidies. However, reflation is especially not an on/off question in this cycle. We expect the next few months to be difficult with COVID-19. Over this time, pandemic-related trends in growth and quality may continue to favor tech, large caps and the US over int'l. But as the economy accelerates in the spring, we would be looking for a more sustained reflation – not just in the US but globally. The term "reflation," in addition to referring to an economy that is being pushed to grow, can refer to creating some level of inflation along with the growth when the absolute level of rising prices is low. Many of the biggest economies in the world have been attempting to generate inflation. Most major central banks have been printing money in an effort to flood their economies with liquidity and provide fiscal aid to consumers and businesses as they are also seeking a reflation.

Implications of reflation for various financial markets could include improving prospects for risk assets such as stocks and commodities, with gradually rising interest rates that reflect better growth and somewhat higher inflation. A steeper yield curve is also often a sign of economic reflation. Our view of the dollar calls for a modest fall in value as the perceived "safe haven" status of the U.S. currency eases as global economies reflate and improve.

The rising tide of reflation should broaden the participation in the equity market as well as provide opportunities in other assets classes tied to a recovering international economy.

Risks Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Growth** stocks tend to fluctuate more than the overall market and growth may not be realized. The growth style of investing tends to shift in and out of favor. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. Risks associated with the **Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks, especially smaller, less-seasoned companies, tend to be more volatile than the overall market.

Definitions

An index is unmanaged and not available for direct investment.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

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