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**Investment Institute**


**Weekly perspective on current market sentiment** **December 16, 2020**

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Last week's S&P 500 Index: -1.0%

# A good thing

## Key takeaways

- Some investors fear that higher interest rates and inflation will be headwinds for equity prices over the coming year.
- In our opinion, modestly higher interest rates and inflation reflect an improving economy and outlook.

If you think about the beginning of a typical economic cycle and how interest rates, inflation, and stocks have usually acted in that environment, investors may be able to get a better feel for what may lie ahead over the course of 2021. While the initial stages of this cycle can be considered anything but typical, there are a number of projections we have made that would sync with past cycles and how various asset classes have often behaved when exiting a slow economic growth period or recession. Although one could make a rational argument that "this time is different," it still helps to understand how markets have usually acted as brighter skies begin to appear on the horizon (or are anticipated to appear). And as referenced in our 2021 Outlook report, our expectations certainly call for the skies to clear further over the coming 12 months.

Interest rates and inflation have been huge topics of discussion in the financial media since the pandemic pushed our Federal Reserve (Fed) to dramatically lower interest rates and Congress to implement more than $2 trillion in fiscal stimulus to help support the economy and spending. Fortunately, the recession, while deep, was very short lived by historical standards (two quarters) and the economy has bounced back and shown resilience as the unemployment rate has dropped from nearly 15% to back below 7% as of the November reading.

Some pundits have been looking for a meaningful rise in inflation and higher interest rates with the result being headwinds for the stock market over the coming year. We disagree. While we do expect only modest rises in interest rates and inflation, we do not look for these factors to negatively affect the stock market. And that makes sense to us. Think of it this way: In the wake of a recession, an improving economy with rising employment and increasing demand from confident consumers most often has been reflected by somewhat higher interest rates and inflation. The stock market, at least in the early stages of recovery, has historically looked at higher rates and higher inflation as indications that demand and the economy are improving. In other words, it has taken gradual increases in rates and inflation as positive signs.

That is where our analysis leads us as we look through the end of next year. We look for the yield on the 10-year Treasury note to end 2021 in the 1.0% to 1.5% range. This is only modestly higher than current levels. We believe Fed buying and global demand should help keep longer-term rates contained. As far as the stock market is concerned, the midpoint of our year-end S&P 500 Index target range is 3,900. That represents an approximate 7% return from current levels, excluding dividends.

Modestly higher interest rates and inflation, in our opinion, are reflections of an improving economy and should be considered good things by equity market investors.

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