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Investment Institute

Weekly perspective on current market sentiment January 6, 2021

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Last Week's S&P 500 Index: +1.4%

Happy New Year

Key takeaways

- We look for modestly higher interest rates and inflation this year.
- This should be reflective of an improved economy with increasing demand for goods and services.

Last week we looked ahead to the New Year and discussed our positive outlook for equities. The bottom line is, from current levels, the S&P 500 offers an approximate 6% upside to the midpoint of our year-end 2021 target range. Throw in a couple of percent for the index's dividend yield and it adds up to an attractive return potential in our opinion. We like equities.

But what about the fixed income and real assets investment classes? Those are the issues we will briefly cover in this week's commentary as we believe properly allocated portfolios should contain exposure to both. From a fixed income view, our projections call for modest increases in interest rates and inflation. However, some investors become nervous when they hear the word "higher" or "increase" when associated with either interest rates or inflation, but one needs to consider the context.

At least in the early portions of a recession, interest rates and inflation have typically been lower than they were during the previous economic expansion and reflect slower growth or contraction and less demand for goods and services relative to supply (Econ 101). But early in a new economic cycle, post-recession, increases in both interest rates and inflation (or inflation expectations) are a reflection of anticipated or resulting improvements in economic activity from increased demand for goods and services. For now, with interest rates still low and the recovery broadening out, we favor fixed income sectors such as high yield, preferreds and credit. Keep in mind that real assets like commodities may also benefit from improved demand for goods and higher inflation.

And that is precisely what we view the case to be as this year plays out. A better economy this year will likely help push interest rates higher. For example, we see the yield on the 10-year Treasury note trading in the 1% to 1.5% range at year-end, only modestly higher than the current yield. We also see inflation, as measured by the Consumer Price Index (CPI), rising from approximately 1% last year toward 2% this year. We currently rate commodities as favorable and expect to continue to see the prices of oil along with raw material inputs such as copper and aluminum supported by increasing demand as the global economy continues to recover. We also like gold at current levels and believe this precious metal can trade up into the $2,100 to $2,200 range by year-end. A modestly lower dollar, low-to-negative real (inflation adjusted) interest rates globally, and central bank money printing efforts should all help gold.

All in all, modestly higher interest rates, inflation, and commodity prices could bring a smile to the faces of investors as they would be a reflection of the improving economy that we believe lies ahead as we look out over the next 12 months. Happy New Year to you and yours.

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