



Q2 2021 Economic outlook

Almost home

The macroeconomic outlook for Q2 is overwhelmingly optimistic as consumers are expected to shake off lingering pandemic-related uncertainty and go on a services spending spree.

While we're close to coming full circle on this unprecedented economic cycle, inflation, rising interest rates and policy are all converging to challenge investors.





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All data as of March 15, 2021, unless otherwise noted.

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The economic outlook for Q2 is overwhelmingly optimistic, with consumers expected to shake off lingering pandemic-related uncertainty and go on a services spending spree. We look for a spike in inflation to complicate the interest rate outlook for investors. For markets, rising interest rates will remain a focus—it isn't just how high rates can go, but how fast. Even strong equity market fundamentals may be jolted by volatility in interest rates.

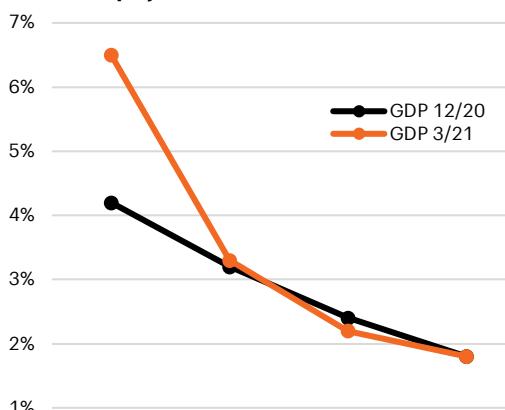
Key takeaways

- Q2 growth is expected to surge, fueled by stimulus checks and pent-up services demand.
- Monetary policy is increasingly linked to employment. We break down other metrics we will use to monitor the state of the recovery in labor markets.
- In Q2, inflation, rising interest rates and policy are converging to challenge investors.

Economic optimism is in the air

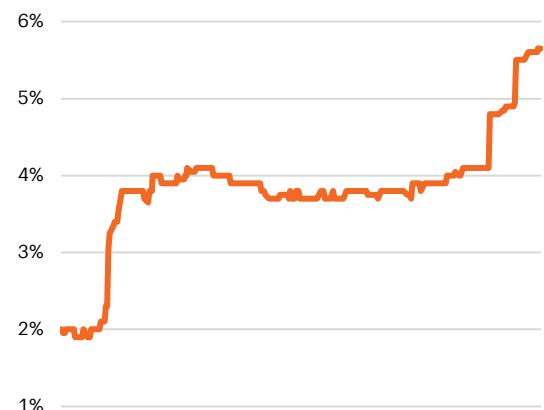
Between stimulus checks, market performance, better weather and finally getting a vaccine appointment, the optimism is palpable. The outlook for 2021 growth continues to strengthen as tailwinds and supports align to serve up a blockbuster year for growth. The Fed issued a new set of economic projections at the March 17 FOMC meeting which sharply upgraded its 2021 GDP forecast to 6.5%, up from 4.2%. This would be the strongest year of growth since 1984. The market consensus has been catching up to policymakers, and forecasts of 2022 are also moving higher, currently at 4.0%.

FOMC GDP projection



Source: Median Economic GDP Projections of the Federal Reserve Board, March 17, 2021.

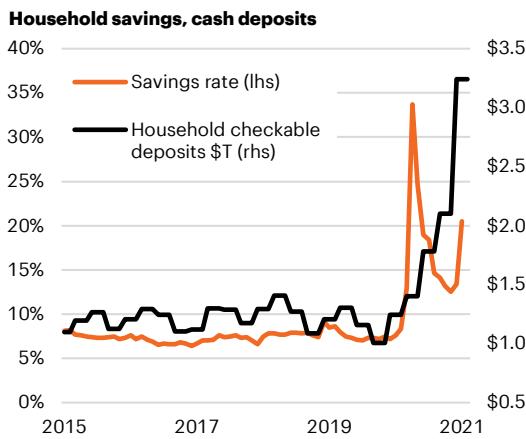
2021 GDP forecast (analyst consensus)



Source: Bloomberg consensus estimates, Bloomberg Finance, L.P., as of March 25, 2021.

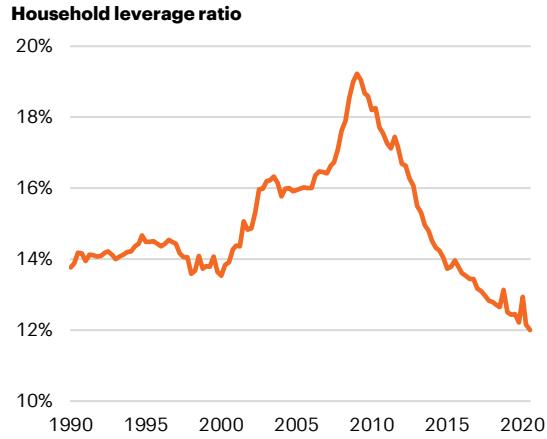
There are numerous factors driving such a strong outlook. Consumption, first and foremost, is expected to surge. Households are launching into Q2 with more cash stockpiled than at any time on record. We expect the savings rate to surge back above 30% in April in the wake of the latest round of stimulus checks from the American Rescue Plan Act (ARP). Households have used some of this windfall to pay down debt, and household leverage at the macro level is at its lowest point since the early 1980s. Another support for household spending comes from a surge in wealth creation on the back of equity prices and real estate valuation in 2020.

Macro



Source: BEA, Federal Reserve, as of March 19, 2021.

Economic outlook Q2 2021

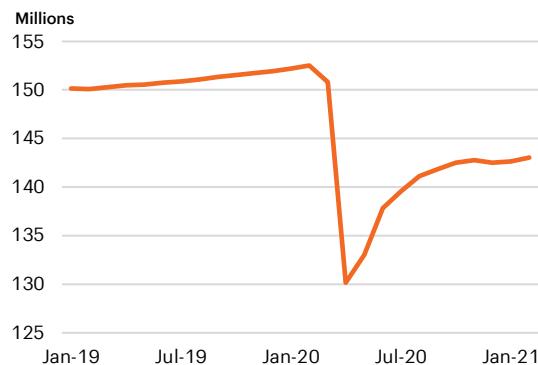


Source: Federal Reserve, as of March 19, 2021.

In Q2, vaccine distribution is expected to sprint toward widespread availability. The Biden administration expects everyone to be eligible for vaccination by May 1, lifting the final hurdle to participating in, and spending on, services. If the pent-up demand for goods is any guide, then the beleaguered spending sector can be expected to add significantly to GDP in Q2. The ability to spend on travel, restaurants and events alone could add as much as 4.0% to GDP.

This frothy growth outlook is expected to pull the unemployment rate down sharply. Improvement in the labor market has slowed but been steady, with the jobless rate at 6.2% in February. The Fed's forecast is for the unemployment rate to fall to 4.5% in 2021 and 3.9% in 2022, close to where we were pre-pandemic. But in recent speeches, Fed Chair Jerome Powell has given a lot of airtime to the idea that declaring "mission accomplished" on the employment front will take more than just a low unemployment rate. For this reason, traditional macro models that utilize output and employment gaps may be prematurely forecasting rate hikes in 2023. We dive into other ways to look at the labor market, and what we'll be watching in Q2.

Payroll employment



Source: BLS, as of March 19, 2021.

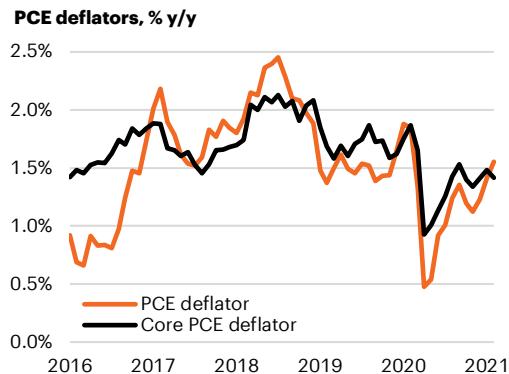
Participation rate



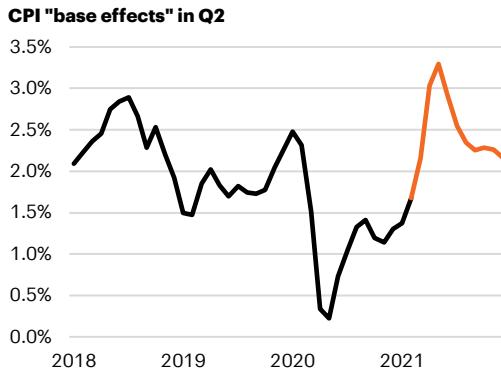
Source: BLS, as of March 15, 2021.

The inflation and reflation narrative has been critical so far in 2021, and that will continue in Q2. Importantly, the slump in inflation that happened at the height of lockdowns will work its way out of the data around May, causing a jump in inflation due to the "base effect" calculation. We think consumer price inflation could briefly rise to over 3%, the highest level in a decade, although we think this would be transitory.

Macro



Economic outlook Q2 2021

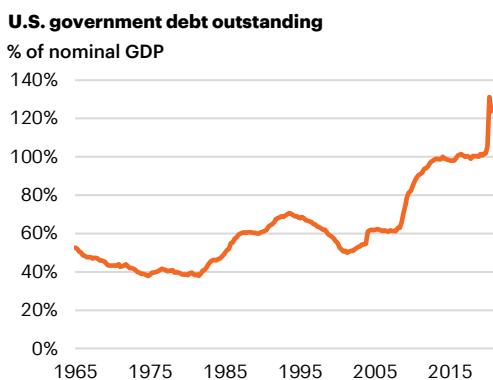
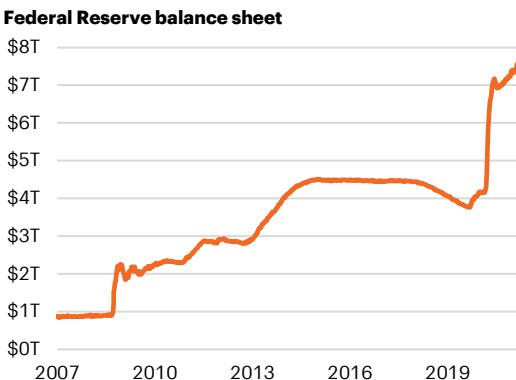


For 2021, we look for pandemic-driven price shifts to continue to muddy the picture. Business surveys are increasingly pointing to supply-side disruptions and higher commodity prices that are pushing up input prices. We have found that this typically correlates to higher energy prices but often has little pass-through to core CPI. Other factors are having a strong disinflationary impact. Owners' equivalent rent (OER), a much-maligned subindex of CPI that makes up almost a quarter of the index, works to capture the cost of shelter. The downtrend in OER alone is a powerful disinflationary pull on core CPI.

The Fed targets the PCE deflator, which is a part of the GDP calculation. The PCE deflator captures more of the economy than the CPI and tends to run about 0.25% behind its inflation data cousin. This measure has run below 2%—the Fed's inflation target—for most of the last 15 years. The Fed's framework review, which began well before COVID-19 took hold, concluded with a shift to targeting average inflation of 2%. In other words, the new policy framework gives room for inflation to remain above 2% for years before the Fed would view inflation (in and of itself) as a reason to raise rates. The policy conclusion is a dovish one, but markets may have trouble hearing the message through the conflicting inflation data picture in Q2.

Monetary and fiscal policy pivot

After a busy 2020, the Fed is clearly hoping to keep its main policy levers—the Fed funds rate and monthly asset purchases—unchanged for 2021. Fed Chair Powell and numerous Fed speakers have flooded the airwaves to impress this upon markets. In the near term, Fed rate hike expectations are sneaking into the yield curve, with markets now expecting a rate hike by early 2023; we think this may prove too early. We look at what the Fed is focusing on, what would move the needle toward a rate hike, and where the Fed may yet face a challenge to credibility both in the near and long term.



Fiscal stimulus will remain a driving force for the economy in 2021, putting policy proposals in the spotlight in Q2. So far, the fiscal response to the pandemic has dwarfed prior rescue packages by pumping approximately \$5 trillion, or 25% of GDP, into the economy over the past year. This has caused a staggering increase in the deficit, sparking a debate of whether to reframe the deficit in terms of interest expense rather than government debt outstanding.

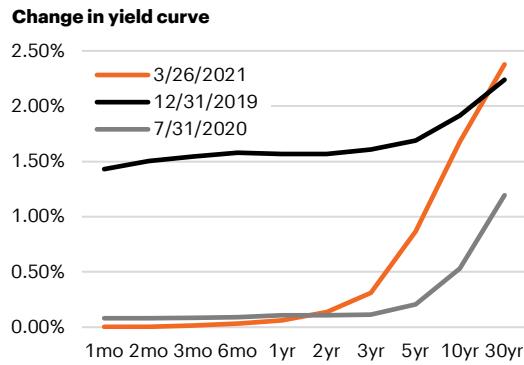
Looking ahead, households may need to be weaned off popular and generous programs like the stimulus checks and supplemental unemployment insurance. To make our economic recovery self-sustaining, the economy now needs business investment and infrastructure to be more active in driving growth. The Biden administration is in the process of rolling out plans for its next big policy priority, with a price tag of \$2 trillion–\$3 trillion, which includes traditional infrastructure, green energy and focused investment like 5G telecommunications. Through Q2, we will be watching closely to see how this next round of spending develops.

Equity and fixed income markets navigate rising yields

Rising interest rates have been the macro-market event of Q1. Supercharged growth, the renormalizing of inflation expectations, and further massive fiscal stimulus have all combined to accelerate the rise in yields. Despite the rosy economic backdrop, however, rising interest rates are often uncomfortable for markets.



Source: Bloomberg Finance, L.P., as of March 26, 2021.

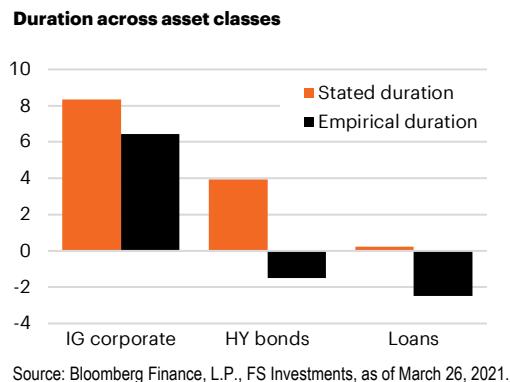
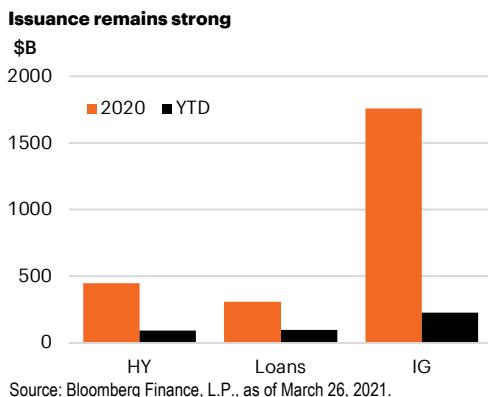


Source: Bloomberg Finance, L.P., as of March 26, 2021.

Over the coming quarter, there are factors that support yields moving higher still: Surging growth (particularly in Q2), inflation that could surprise to the upside, and Treasury auctions that will be offering record amounts of debt to fund our deficit. But we also note the natural barriers to higher rates that materialize as yields near the 2.0%–2.5% range. Our expectation is that yields could readily continue their upward trajectory to and beyond 2%, but much beyond that could see more resistance.

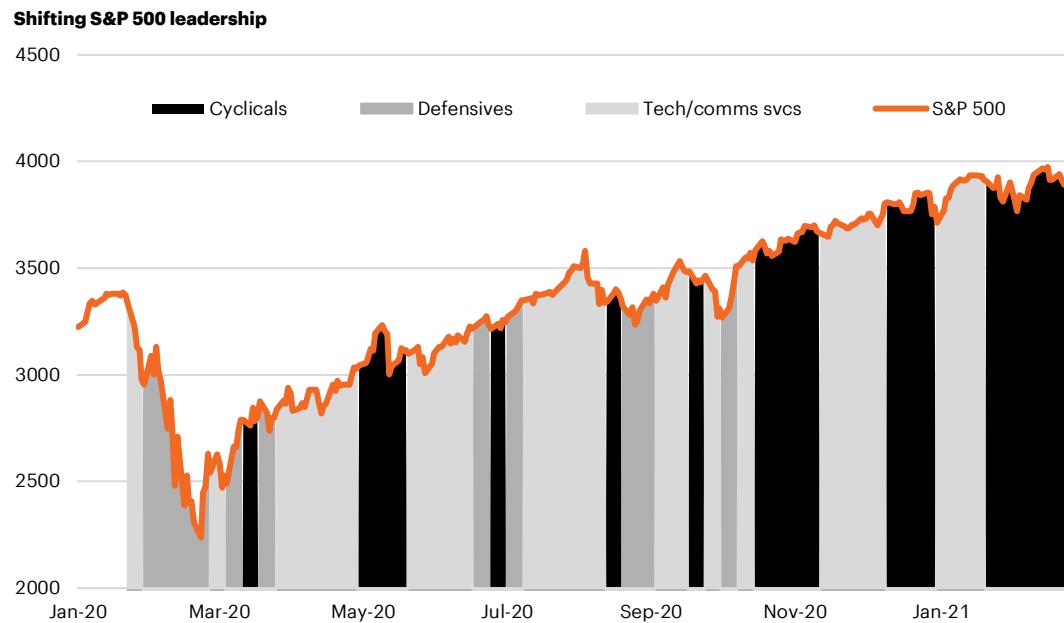
For markets, rising yields have important implications. Traditional fixed income struggled for much of the first quarter amid the unrelenting climb in long-term rates; the downside of duration has become increasingly apparent this year. The Barclays Agg is down over -3% as of March 25, eroding nearly two years' worth of yield in just the last few weeks. Within core fixed income, rates giveth and rates taketh away.

These benchmark rate spikes have sent ripple effects across financial markets, including in other fixed rate products like high yield bonds. History tells us, however, that credit should come out relatively unscathed. Investment grade debt carries a longer maturity, which aligns with poor performance periods of rising rates. High yield, however, is more impacted by the macro environment and individual company fundamentals and tends to be more duration-agnostic over the medium term.



Equity market fundamentals, in some sense, bring us full circle to where we began our Q2 outlook: optimism. The consensus projects S&P 500 revenue to rise over 9% in 2021, 7% higher than the 2019 level. EPS is expected to surge 21%, also comfortably outpacing pre-COVID performance.

For equities, the rise in long-term interest rates was also a key narrative of Q1. The Fed's vow to keep rates low, plus an outlook for a supercharged economic recovery, has led to a steeper yield curve, a recipe for outperformance of value over growth. This is what we've seen; the large-cap FANG+ stocks have barely moved off late-August levels, which coincides with the inflection point for interest rates. More broadly, we expect earnings to continue to beat expectations in Q2 as surging revenues and operating leverage create a sort of perfect storm.



Consumption: Services spending spree

Key takeaways

- Awash with savings and cash, consumers are expected to power growth in Q2.
- Services spending has lagged and is expected to surge given pent-up demand.
- Wealth accumulation jumped in 2020 and is yet another support to spending.

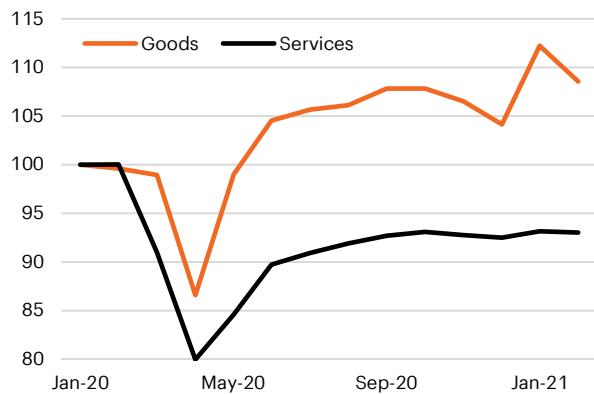
U.S. households collectively will kick off Q2 with more savings than at any time in living memory. Expectations that this windfall will be spent quickly as vaccines and warmer weather open up remaining areas of the economy have caused GDP estimates to roar higher. Aside from fiscal stimulus, wealth gains add further fuel to consumption forecasts.

Fiscal stimulus payments to households, in addition to augmented unemployment insurance, have caused savings to rise sharply. Each successive round of stimulus checks has pushed the savings rate up, and in March, we expect it to surge to over 30% again as the latest round of \$400 billion is disbursed. Households have so far used this bonanza to pay down debt, augment savings and spend.

And spend they have. Consumers have spent largely on what they can, namely goods, which have more than recovered from the Q2 2020 slump. In 2019, 36% of household spending was on goods. But pandemic-related restrictions caused large swaths of the services sector to be unavailable, pushing the share of goods spending to 40% from March 2020 to February 2021.

Goods vs. services spending

Indexed to Jan. 2020 = 100



Source: BEA, FS Investments, as of March 26, 2021.

The surge in consumption expected in the second half of 2021 is largely built upon estimates that services will follow the same trajectory as goods. If demand races back after a year of restrictions on restaurants, travel and events, it could add significantly to GDP.

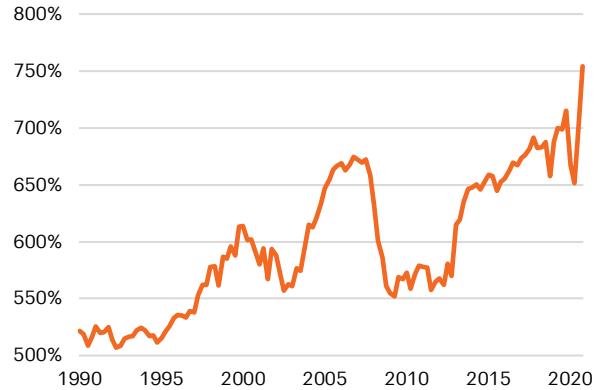
Wealth accumulation has also been phenomenal and is an additional tailwind to spending. Household net worth climbed \$12 trillion in 2020 to over 750% of personal disposable income, driven by significant equity and real estate valuation gains. Opinions vary as to how much of this added wealth will translate into spending—and GDP—in the coming year. As of Q4 2020, the wealthiest 10% of households account for 64.4% of total household net worth, and the top 1% hold 53.1% of equity wealth.¹ This concentration of wealth gains in a small number of households may limit broader “wealth effect” spending in 2021.

But the real good news is that household leverage levels remain low and consumer balance sheets are healthy in the early stages of this expansion, something that will power spending through the last lingering uncertainty of the pandemic.

How sustainable is this consumption boost beyond 2021? Looking ahead, fiscal stimulus should start to pivot away from checks in the mail and toward policies which encourage investment, hiring and infrastructure. This is what will be required to make our economic expansion sustainable and resilient beyond 2021.

Household net worth

% disposable income



Source: Flow of funds, FS Investments, as of March 26, 2021.

¹ Distributional Financial Accounts, Federal Reserve, March 12, 2021.

Employment: More than just one number

Key takeaways

- The unemployment rate is expected to plunge on the heels of strong growth.
- We look beyond the headline jobless number to the participation rate and underemployment to gauge labor market recovery.
- The falling participation of prime age women is one example of the long-run impact of the pandemic on our economy.

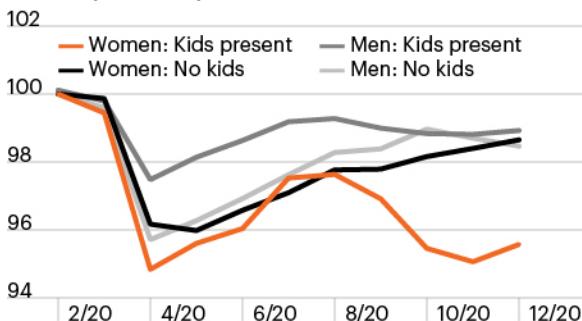
Surging growth is expected to pull down the unemployment rate quickly. Like the broader economy, the labor market recovery from the depths of the 2020 downturn has been faster than expected. And yet, it remains incomplete. As of February, the unemployment rate was 6.9% and 6.7 million people were unemployed compared to a year ago. In addition, 4.4 million people have dropped out of the labor force. How fast these jobs and workers can be recovered in Q2 will be critical. It requires digging deeper than the headline unemployment rate.

The participation rate is an increasingly important statistic that connects employment to GDP. It captures the share of the working age population in the labor force (either working or unemployed vs. those no longer seeking work). The participation rate slumped from 63.4% at the start of 2020 to a low of 60.2% in April. In the past six months, recovery has been tepid and the participation rate has slipped again, to 61.4%.

A part of this story is continued school closures and the impact it has on prime age women with children

Parents and gender gaps in labor market outcomes

LFP rate (Feb. = 100)



Source: "Parents in a Pandemic Labor Market," Federal Reserve Bank of San Francisco working paper, Lofton, Olivia et al., February 2021.

2 "Prime age workers" are considered to be 25–54 years old.

3 This reflects median prime women earnings in 2019, and applies past 60/40 investment returns over the past 35 years.

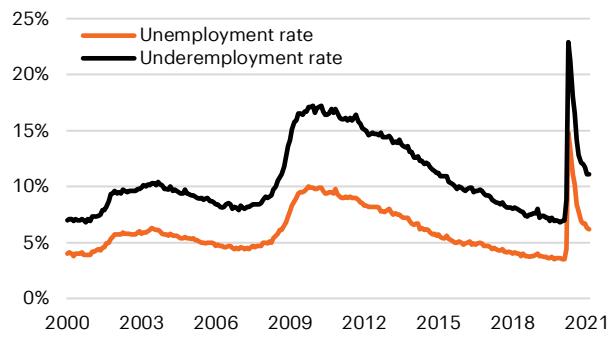
in the household. Many families have been impacted by the need to care for loved ones, a burden that is by no means only carried by women as many men have also adjusted work schedules and obligations. But other groups have seen labor force participation recover more robustly, with the glaring exception of women with children aged 17 or less in the home.

The fall in employment of prime age workers² has long-run implications. In this category, productivity and income tend to be higher. Taking the median income for prime age women, we estimate a two-year absence from the workforce could cost \$96,000 in lost wages and \$122,700 in lost retirement savings.³

This is just one example of the uneven impact the pandemic has had on the labor force. The unemployment rate of college-educated workers has improved steadily to 3.8%, but for less well-educated workers progress has stalled at a much higher rate. The underemployment rate is at 11.1%, meaning that many workers would rather be full-time or employed at a higher level in line with their skills. A recent BLS paper highlighted that in the labor market, a K-shaped recovery is still very much apparent as workers with the lowest average wages "had the steepest decline in employment and are still the furthest from recovery."⁴

Fed Chair Powell recently made clear that any possible removal of support for the economy will hinge on broad improvement in the labor market. While the U-3 unemployment rate makes for an easy headline, the full employment picture will likely remain more complicated in Q2.

U-3 and U-6 unemployment rates



Source: BLS, as of March 15, 2021.

4 "The K-Shaped Recovery: Examining the Diverging Fortunes of Workers in the Recovery from the COVID-19 Pandemic using Business and Household Survey Microdata," BLS working paper, Dalton, Michael et al., February 2021.

Inflation: Here comes the spike

Key takeaways

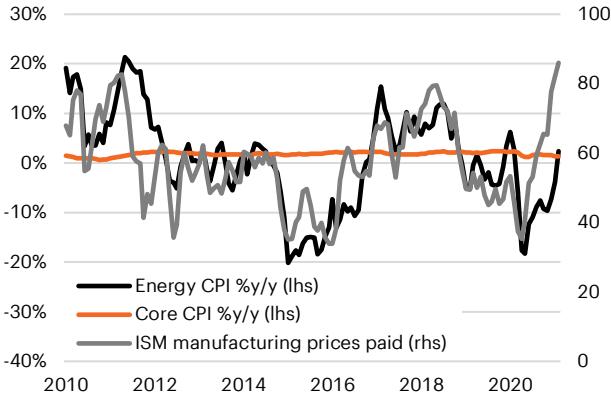
- We look for inflation to spike in Q2 as “base effects” work through the annual calculation.
- The pandemic continues to muddy the inflation outlook with both inflationary and disinflationary pressures.
- Fluctuations in inflation data could cause interest rates volatility.

Inflation lives at the intersection of growth, Fed policy, interest rates and financial markets, putting it at the top of concerns for investors as forecasts change rapidly. In Q2, we are expecting a spike in inflation, but beyond that, the inflation outlook gets muddier. Growth significantly above potential plus supply-side price increases have raised concern about rising inflation. But large pockets of disinflation are also occurring, making it hard to decipher the path later in 2021.

Get ready for an inflation spike. In Q2 last year, as our economy ground to a halt, inflation decelerated sharply from 2.5% at the start of 2020 to 0.1% in May. With this economic slowdown came a broad deflationary pulse, including some spectacular declines in select areas. In May 2020, for example, hotel prices fell -17.3% y/y, energy prices fell -18.3% y/y, and airline tickets plunged -28.8%.⁵ This “base effect” will work its way out of the annual calculation over the coming months and could cause consumer price inflation to spike over 3.0%, the highest in a decade.

Outside of base effects, the pandemic continues to influence inflation. Higher commodity prices have

Energy prices, surveys and CPI



Source: Macrobond, as of March 15, 2021.

⁵ These subindexes have relatively small weightings and together make up only 7.6% of total CPI as of February 2021.

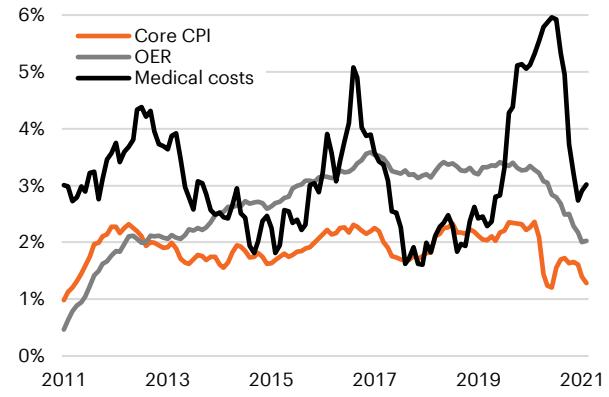
made news so far in 2021, and purchasing managers' surveys show that price indexes have surged higher, sparking fears of a broader inflationary upsurge. But history tells us that while prices-paid surveys are highly correlated to energy prices, they don't often feed through to core inflation. This time around, we expect this supply side-driven spike in input prices to be transitory and to not extend into next year.

OER makes up 24.3% of the Consumer Price Index. During the pandemic, the dramatic deceleration in this measure dragged CPI down, raising questions given rising home prices.

OER is meant to capture the monthly cost of shelter. In reality, purchasing a home serves two purposes: investment (which is a stock not captured in monthly household costs) and the commodity of shelter. OER is therefore often based on rental prices, which have suffered a double whammy during the pandemic. Low interest rates have caused more renters to buy homes (causing rents to fall) while other renters have moved out of expensive urban centers to cheaper cities, substituting expensive rent for cheaper rent.

Inflation for 2021 could be volatile as both disinflationary and inflationary forces caused by the pandemic play out. Beyond 2021, the long-run trend has been disinflation, with inflation on a slow but steady grind lower. This has caused inflation expectations to erode in tandem, with important implications for interest rates.

Key categories weigh on CPI



Source: BLS, March 26, 2021.

Fed policy: Credibility concerns from two sides

Key takeaways

- The Fed has signaled it expects to maintain zero rates and asset purchases at current levels this year.
- Markets, however, are testing Fed credibility by sneaking in a rate hike as early as 2023.
- In coming years, the Fed may yet struggle to impact long-run inflation expectations.

The Fed is clearly hoping to leave its two main policy levers—the Fed funds rate and asset purchases—untouched in 2021. Fed Chair Powell and numerous Fed speakers have been flooding the airwaves to assure markets that the Fed is not expecting to raise rates for quite some time and, in fact, sees the pace of current monthly asset purchases lasting through this year, if not longer. The Fed may yet experience some challenges to its credibility both in the near and long term.

The surge in growth forecasts and rising interest rates have caused a Fed rate hike to start sneaking into market expectations. At the start of Q2, markets are seeing a rate hike by mid-2023—hardly a heroic forecast, but one that may yet prove too early. At recent press conferences, Powell has been clear that the economy still has a long way to go toward fully healing from the economic dislocation of the pandemic. In particular, the Fed is focused on the labor market. The quarterly economic projections include an optimistic drop in the unemployment rate, but the Fed has noted other measures it would like to see improved, including labor force participation, an

improvement in underemployment, and improving the quality of jobs across education and incomes.

The question of whether the Fed will tolerate rising yields is important. So far, Powell has taken the line that the rising 10-year Treasury reflects an optimistic growth outlook. The move has been noteworthy, but real interest rates are still negative and financial conditions have remained exceptionally accommodative.

Beyond the pandemic and 2021, there is a looming threat to the Fed's credibility. The Fed's long-run goal of well-anchored inflation has become unmoored. Over the past two decades, disinflation has taken root, and while the Fed targets inflation of 2%, long-run inflation expectations have fallen well below that.

The Fed has created a new measure to capture a varying range of long-run inflation expectations, which come in the form of market-determined rates, professional forecasts and surveys. The result is an index of common inflation expectations, which we expect to continue to be a reference for Fed policy reviews. Well before the pandemic, for the past six years, this measure had remained below 2%.

To regain long-run credibility that inflation at 2% cannot just be attained but maintained will be no small feat. It took years of chronic undershooting of inflation before long-run expectations adjusted down, and the data shows that short-term moves in inflation have little impact on long-run expectations.

Financial Conditions Index



Source: Goldman Sachs U.S. Financial Conditions Index, Bloomberg Finance, L.P., as of March 26, 2021.

Index of common inflation expectations



Source: Federal Reserve, as of March 15, 2021.

Fiscal policy: A big policy pivot

Key takeaways

- Fiscal stimulus has added \$5 trillion, or 25% of GDP, to the economy over the past year.
- A skyrocketing deficit has shifted the discussion to interest expense.
- The details of the next massive spending package will be key as policy needs to pivot from “mailbox money” to infrastructure and investment.

The fiscal stimulus response to the pandemic has pumped approximately \$5 trillion into the economy over the past year, or about 25% of GDP. Flush consumer savings, resilient economic data and surging growth forecasts are largely a direct result of this historic stimulus. With that, of course, has come a massive deficit.

In the face of a growing mountain of government debt, there have been attempts by some administration officials and economists to reframe the discussion against the backdrop of interest expense. With interest rates near historic lows, the argument goes, we can significantly grow the deficit while having little impact on the year-to-year cost of servicing the debt to fund it.

In the short term, the “now is not the time to worry about the deficit” attitude has merit given low borrowing costs and the challenges our economy still faces. But with growth expected to be so far above trend and what is clearly a path toward higher interest rates, the risk posed by a possible inflationary episode becomes more serious. This is not our base case, but the vulnerability posed by higher inflation has grown.

Federal net interest expense



Source: Office of Management & Budget, as of March 25, 2021.

The need for a policy pivot is growing. Over the three separate stimulus packages since last March, the government has sent over \$835 billion in stimulus checks to households. This “mailbox money” is understandably popular. But as the labor market strengthens further, households need to be weaned off these direct payments. Similarly, supplemental unemployment benefits have totaled over \$600 billion. To make our recovery self-sustaining, the economy now needs business investment to be more active in driving growth.

Businesses have bolstered their balance sheets over the past year by stockpiling nearly \$1.2 trillion in cash last year. Businesses are typically cautious in the early stages of an expansion and hiring often remains sluggish even after a recession has ended. This could recur, particularly given lingering pandemic-related uncertainty. But a policy pivot could help with this.

The Biden administration is in the process of rolling out plans for its next big policy priority. After passing the \$1.9 trillion ARP, the administration quickly shifted toward passing a robust infrastructure package, with the price tag sitting somewhere between \$2 trillion–\$3 trillion. While specific details have not been divulged, the plan would likely include monies for traditional infrastructure, such as roads, bridges and airports, as well as green energy-focused investment and 5G telecommunications. Unlike the ARP, which was focused on getting money to households as quickly as possible to boost demand, an infrastructure bill would look to boost business investment and longer-term productivity.

Of course, the ability for such a large package to pass is in doubt. There are two pathways to passage in Congress: Democrats either must get at least 10 Senate Republicans to vote for the bill, or pass the bill via the reconciliation process, as they did with the ARP. That process carries its own issues, including a rule that the bill cannot increase the federal deficit beyond 10 years—which such a long term-focused bill almost certainly would do. Infrastructure is overwhelmingly popular with the public, so we do expect another round of fiscal stimulus to get done, though the size and scope remains highly uncertain.

Interest rates: How high and how fast?

Key takeaways

- Rising rates reflect growth optimism and yet can be uncomfortable for markets.
- Markets have been surprised by the speed of rising rates, even though rates remain historically low and real rates are negative.
- We expect rates to continue to rise in Q2, but above 2% some headwinds may materialize.

Rising interest rates have been the macro-market event of Q1. Treasury yields bottomed in early August and steadily gained for the rest of 2020. In Q1 2021, robust GDP forecasts also helped inflation expectations correct and interest rates to begin to renormalize. Despite the rosy economic backdrop, however, rising interest rates are often uncomfortable for markets. The 10-year started 2021 at 0.92% and rose as high as 1.72%. In Q2, markets need to consider not only how high interest rates can go, but how fast.

We need to keep the discussion of higher rates in context because yields are still near historic lows. The 10-year Treasury is still below pre-COVID levels, and real yields, in our calculation, are -60 bps.

Looking ahead, there are factors pushing yields both up and down. Sustained faster economic growth far above our underlying potential, particularly into 2022 and beyond, could be a powerful catalyst for higher rates. Related to supercharged growth is the risk of inflation, which could push up long-run inflation expectations. That's not our base case, but even a temporary surge in inflation could cause volatility in the Treasury market.

Finally, the size of Treasury auctions has jumped with the need to fund our skyrocketing deficit.

Real rates bear close watching



Source: Bloomberg Finance, L.P., as of March 18, 2021.

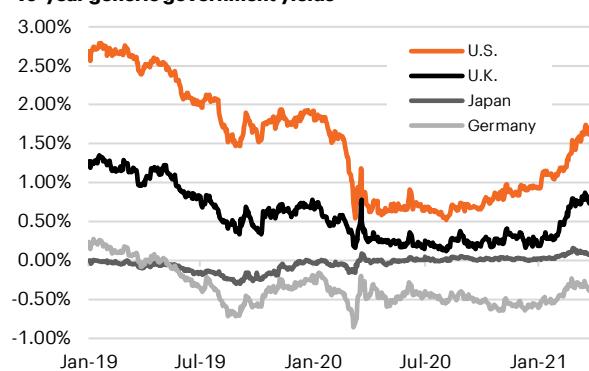
For half a century, global markets have readily absorbed U.S. government debt. But a recent poor showing in a 7-year auction raised the question: Has the marketplace finally reached a saturation point? These supply dynamics could be another factor causing yields to rise.

There are also pressures that could slow the ascent of U.S. yields. The U.S. still has the highest-yielding government debt in the developed world. With long-term sovereign debt in Europe and Japan still carrying negative or near-zero yields, U.S. debt yielding more than 2% starts to look attractive as a global investment. Above 2% also competes with S&P 500 dividend yields. Finally, long-run demographic trends should still put downward pressure on yields, as they have since the 1990s.

For many, the big question in Q1 as yields surged higher was "why now?" The short answer is Fed Chair Powell. Over several speeches, Powell surprised markets by saying the Fed would not intervene in the move higher, despite a slew of other policies still aimed at supporting the economy. He noted that higher interest rates were a direct result of economic optimism.

The question for the Fed may come down to whether they can truly have their cake and eat it, too. In Q1, bouts of sharply higher interest rates corresponded to poor equity market performance. We are not in "taper tantrum" territory, but some form of that dynamic may still emerge. The Fed may yet feel the need to control rising long-term rates that risk becoming a headwind to economic growth or, worse, destabilizing broader equity markets.

10-year generic government yields



Source: Macrobond, Bloomberg Finance, L.P., as of March 26, 2021.

Credit markets: What rates giveth, rates taketh away

Key takeaways

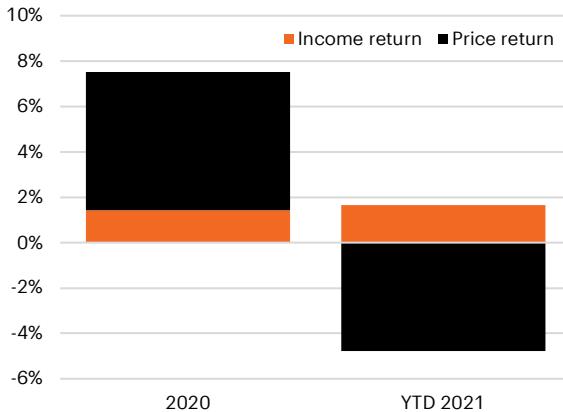
- Rising yields have hit core fixed income particularly hard.
- Both IG and HY issuance have been strong, pointing to well-capitalized businesses.
- High yield has fared better, however, and is historically agnostic to duration in the medium term.

Core fixed income struggled for much of the first quarter amid the relatively unrelenting upward climb in long-term interest rates. After another strong showing for bonds in 2020, the downside of duration has become increasingly apparent this year. The Barclays Agg is down over -3% as of March 25, eroding nearly two years' worth of yield in just the last few weeks. Within core fixed income, rates giveth and rates taketh away.

In another dramatic reversal, fixed income has been driving much of the year-to-date volatility in equity markets. Sharp interest rate spikes have caused coincident declines in equities, especially large-cap growth stocks, as valuations need to be reevaluated. As yields rise, bond prices fall, meaning fixed income and equities have also become increasingly correlated.

Going forward, we would not be surprised to see this interest rate volatility continue. Inflation data in the second quarter could certainly send mixed signals; we expect to see a temporary spike due to base effects after last year's largely deflationary

Mirror image: Barclays Agg return contribution



Source: Bloomberg Barclays U.S. Aggregate Bond Index, as of March 26, 2021.

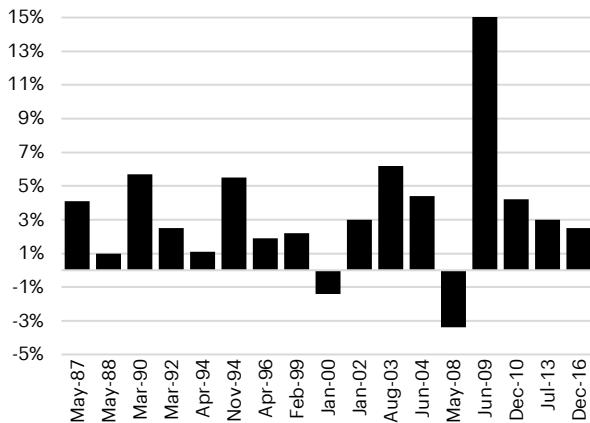
environment, which could send rates up once again. Today's record duration on many core fixed income products leaves many bond investors particularly exposed to volatility in this portion of their portfolio.

These rate spikes have sent ripple effects across financial markets, including in other fixed rate products like high yield bonds. History tells us, however, that credit should come out relatively unscathed. High yield bonds saw some price erosion in late February and March, declining roughly -1% from February 15 to March 15 alongside a greater drop for equities. This decline is unsurprising given their historical correlation of roughly 0.65. Going forward, however, we expect high yield to regain its footing. In the 17 periods during which 5-year Treasury rates increased more than 70 bps, 3-month forward returns for both high yield bonds have been negative only twice.

High yield bonds are more impacted by the macro environment and individual company fundamentals. Because rising rates often accompany periods of economic growth and optimism, and therefore less risk, the spread or compensation demanded by credit investors declines, leading to price gains.

We expect the relationship between high yield bonds and interest rates to normalize in the coming weeks, and we maintain our conviction that high yield remains an attractive investment for those looking to minimize duration risk.

3-month forward high yield bond returns following 5-year Treasury rate increase of 70+ bps



Source: J.P. Morgan.

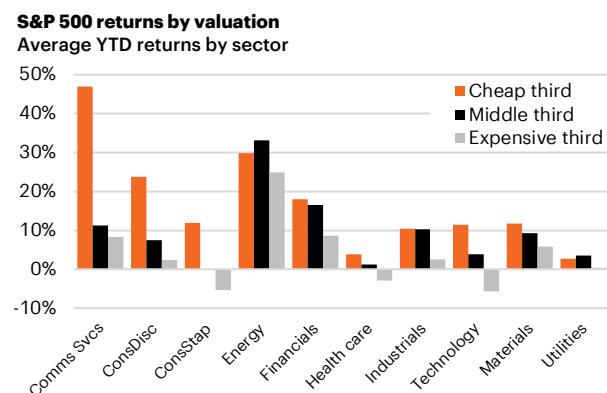
Equity markets: Rising rates a speed bump, not a brick wall

Key takeaways

- Rising interest rates sparked volatility in equity markets in Q1.
- The macro backdrop favors continued outperformance of value over growth.
- We expect earnings to continue to beat expectations on the back of strong revenues and operating leverage.

U.S. markets continued their ascent in Q1, though an ongoing shift in market leadership reintroduced higher volatility. The S&P 500 has climbed 5.8% YTD, with energy, capital goods, banks and airlines among the top-performing sectors.⁶ Valuations, while now well above pre-COVID levels at a forward P/E ratio of 21.5, have not moved materially since June, meaning gains continue to be driven largely by upgrades to earnings estimates.⁶ Rising yields have not only capped valuations, but they have driven a broad rotation toward cyclical and value stocks.

For equities, a key narrative of Q1 was also rising long-term rates. The Fed's vow to keep short-term rates low caused equity markets to price in a supercharged economic recovery and an uptick in inflation. A steeper yield curve and strong growth are the recipe for an outperformance of value over growth stocks, and that's what we've seen year to date. Even when we control for sector, the cheapest stocks on a P/E basis outperformed more expensive ones across the board.



Source: Bloomberg Finance, L.P., FS Investments, as of March 25, 2021.
Note: Cheap/expensive based on forward 12-month blended P/E ratio.

6 Bloomberg Finance, L.P., as of March 26, 2021.

The brunt of rising yields has been borne most severely by the high-valuation, high-growth areas of the market, many of which reside in the technology sector. The Russell 2000 Growth Index has recently shown a -0.46 correlation with moves in the 10-year Treasury rate, the lowest level on record.⁶

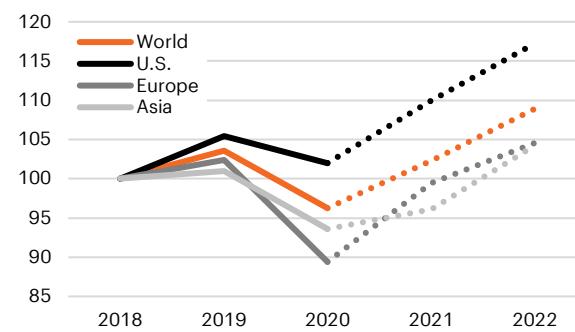
The large-cap FANG+ stocks have also shown a significant negative correlation with rates. Our index of the Big 6 tech stocks has barely moved off late-August levels, which coincides with the inflection point for interest rates. Since then, the index has lagged the Nasdaq 100 by 5.2% and the S&P 500 by 12.4%.⁶ Of course, each of these stocks remains well above pre-COVID levels thanks to their impressive rallies in 2020. However, given stellar fundamentals and recent underperformance against both high-growth and value stocks, we may see the FANGs show their teeth again before long.

Revenue and earnings estimates for 2021 continue to be revised higher as the outlook for economic growth in the U.S. brightens. S&P 500 EPS surged past its 2019 levels in Q4 2020, earlier than analysts expected. We expect earnings to continue to beat expectations in Q2 as surging revenues and operating leverage create a sort of perfect storm.

From a global standpoint, the U.S. leads in both strong growth and vaccination distribution, presenting investors with a quandary. In theory, a robust global recovery should favor value-oriented European and emerging markets; however, fundamentals in the U.S. look much better right now.

U.S. expected to lead on fundamentals

Revenue/share, actual and estimates (2018 = 100)



Source: Bloomberg Finance, L.P., FS Investments, as of March 28, 2021.
Note: Indexes are S&P 500, STOXX 600, MSCI World, MSCI Asia.