Where Is the Market Getting Its News?

Headlines suggest a significant disconnect between "Main Street" and "Wall Street"—a closer look at personal income and leading economic indicators reveals a different story.

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"When you add stimulus related transfer payments, personal income is set to surge to a new record high as additional fiscal stimulus takes hold in the first quarter of 2021."

Wait, the future is going to be better? What newspaper do you read?

Political turmoil. Surging COVID-19 cases. A new, more virulent strain of the coronavirus. For those of us hoping that 2021 would bring more encouraging headlines, it has been a rough start to the year. On the surface, economic-related news also seems disappointing. Labor markets cooled, manufacturing and services activity slowed, and consumer sentiment dropped.

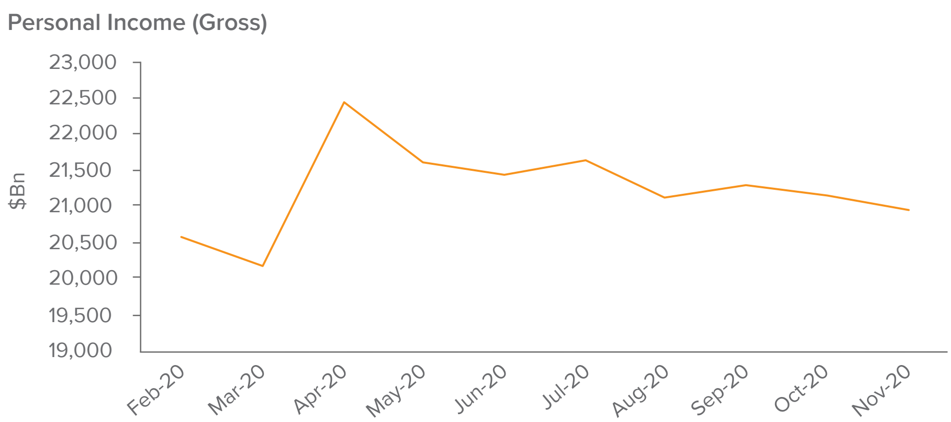
Yet, despite it all, risk assets continue to march higher. On January 6, 2021—the same day the media landscape was saturated with images of the chaos unfolding at the U.S. Capitol building–the Russell 2000 index gained ~4%. This begs the question: Where is the market getting its news?

"When you take a step back and look at the economic picture in aggregate, it's apparent that global synchronized expansion is here."

Last year, we wrote about a "K-shaped" recovery defined by uneven pressures that are creating a "two speed" recovery. Consumers on the higher end of the income bracket have largely kept their jobs and adapted to the pandemic by working from home. On the other hand, jobs in lower paying segments of the labor market like leisure, lodging and retail have been eliminated or furloughed and have yet to return. For consumers on the lower end of the income spectrum, the good news is that the fiscal response to help offset job losses has been enormous—and fiscal relief is expected to grow under a Democratically controlled government. The initial rollout of the vaccines, while slower than many had hoped, still represents a significant milestone as vaccines are the bridge that will allow the economy to fully reopen.

Despite the onslaught of negative headlines, the data is telling us that the future will be better than the present. When you take a step back and look at the economic picture in aggregate, it's apparent that global synchronized expansion is here.

Figure 1. Fiscal Relief Sets the Stage for Record-Setting Personal Income in Q121



	Feb-20	Mar-20	Apr-20	May-20	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20
Compensation (Labor Income)	11,824.6	11,483.9	10,660.5	10,962.1	11,225.8	11,399.0	11,556.4	11,656.4	11,734.6	11,784.9
Transfers Ex-Stimulus	3,211.2	3,291.4	3,561.7	3,636.8	3,668.1	3,639.0	3,592.9	3,550.8	3,503.1	3,482.3
Transfers From Stimulus	0.0	0.0	3,036.1	1,841.2	1,290.2	1,243.0	535.3	546.7	346.7	240.7

As of November 2020. Source: Bureau of Economic Analysis and Voya Investment Management. Line chart is total gross personal income and includes compensation, transfers ex-stimulus, transfer from stimulus, proprietor's income, rental income, and receipts on assets (only compensation, transfers ex-stimulus, transfer from stimulus are broken out in the table below the line chart). Total personal income is shown gross of taxes and social insurance.

Overlooked and underreported: Aggregate personal income set to reach all-time highs

The dispersion in labor income underscores the "K-shaped" disparities across economic sectors. This is particularly true within the Leisure and Hospitality sector where proxies for employment and labor income remain roughly 24% below pre-pandemic levels. However, in aggregate, labor income has made a substantial recovery and is only down ~1-2% from pre-pandemic levels.

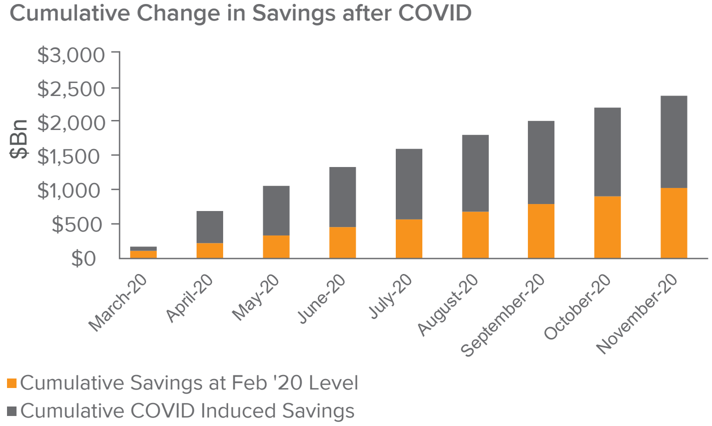
Of course, labor income is only one part of the personal income equation. When you add stimulus related transfer payments, personal income is set to surge to a new record high as additional fiscal stimulus takes hold in the first quarter of 2021 (Figure 1). At the end of 2020, fiscal stimulus in reaction to the COVID-19 pandemic already totaled 17% of GDP (Figure 2). The incoming Biden administration has already announced plans to expand this stimulus, which will provide another boost to consumers. In addition, savings rates have soared since the beginning of the pandemic (Figure 3).

Figure 2. U.S. Fiscal Stimulus Has Been Enormous—With More on the Way

Date	Major Stimulus Bills / Measures	Size ($bn)	% of 2019 GDP
3/6/2020	Coronavirus Preparedness and Response Supplemental Appropriations Act	$8.3	0.0%
3/18/2020	Families First Coronavirus Response Act (FFCRA)	$100	0.5%
3/27/2020	Coronavirus Aid, Relief, and Economic Security Act (CARES)	$2,200	10.3%
4/24/2020	Paycheck Protection Program and Health Care Enhancement Act	$484	2.3%
8/8/2020	FEMA Lost Wages Assistance Program Executive Order	$44	0.2%
12/27/2020	Consolidated Appropriations Act, 2021	$900	4.2%
Total		$3,736.3	17.4%
Spring 2021	Biden Stimulus Plan	$500 - $1,500	2.3 - 7.0%

As of January 18, 2021. Source: BofA Global Resarch, Bureau of Economic Analysis.

Figure 3. Saving Rates Soar: Dry Powder for Consumers When the Economy Fully Reopens



As of November 2020. Source: Bureau of Economic Analysis and Voya Investment Management.

Against this backdrop, consumers, supported by excess savings, robust net worth and additional fiscal aid, will drive a recovery in discretionary spending, leading to a full re-engagement of the service sector. The recovery in services spending coupled with resilience in goods demand will usher in an extended period of synchronized above trend global growth.

While the amount of fiscal support has been enormous, the response from central banks has also been extraordinary. In our last issue, we explored the Fed's adjusted approach to its longer-run inflation goal of 2%, as the Fed is now seeking to achieve inflation that averages 2% over time. The Fed's new approach is a game changer for risk assets, and it will likely result in longer periods of accommodation than might otherwise be expected during economic recovery phases.

One underappreciated aspect of the accommodative monetary and fiscal policy is that it will take time to fully filter through the economy, providing support beyond just 2021. The housing market has also been quite strong, benefiting from lower interest rates. Lockdowns artificially depressed housing sales in 2Q20 despite the drop in interest rates. Housing has now recovered and is making up for lost ground. While the year-over-year growth rate in housing should peak and begin to level off, housing sales should remain elevated. Strength in housing also bodes well for future retail sales as homeowners buy goods for their new or renovated homes.

What are the risks?

Given rapid money growth and expectations for above trend growth in 2021, inflation is rising to the top of investors' concerns. However, we believe inflation will prove to be a cyclical phenomenon, not a structural risk. The return of service demand will create localized but less globally transmissible pockets of inflation. Historically, headline inflation has transmitted to core inflation, but the lead time has been roughly 18 months. This suggests that a sustainable lift in core inflation is more likely to come into play in 2022 or 2023.

Another risk to monitor is the growing deficits around the world, which are providing the world with a cyclical bounce in the near term. Over the long run, however, this massive increase in debt could be a suppressant to growth as any eventual increase in interest rates will increase debt servicing costs and either crowd out other initiatives or require higher taxes. While we believe higher growth and inflation could allow countries to grow into their debt levels, catalysts for inflation will not be found in monetary policy driven by central bankers, but instead in sound fiscal policy and global economic policies targeted towards sustainable global growth.

Finally, we recognize the market seems to be very aligned on the near-term positive direction of risk assets. This one-way sentiment opens the door for unexpected volatility. The vaccine news is overwhelmingly positive and, we believe, ultimately the vaccine will succeed. However, the potential for episodic market stresses, whether connected to the vaccine or other global factors, should not be overlooked.

Positioning portfolios for the cyclical bounce

Heading into 2021, the market backdrop for risk assets is extraordinarily positive. In equities, we think the improving medium-term fundamental economic backdrop outweighs any near-term technical weakness. Estimates of U.S. corporate earnings growth for 2021 appear to substantially undershoot, particularly in the back half of the year, when we anticipate pent up demand will be unleashed as consumer spending speeds up and ailing services sectors are restored to health. We recognize most valuation measures that compare broad market stock prices to earnings, cash flows or sales look historically expensive. Yet, when adjusted for interest rates, we think stocks have more room to run. Against this backdrop, we continue to favor U.S. small cap and emerging market equities, which stand to benefit from economic progression. In addition, investors can look for pockets of attractive valuation within the equity markets that might also serve as a hedge against rising inflation. In our last issue we highlighted empirical evidence showing that value stocks have outperformed when real rates are off their lows and inflation is expected to pick up.

In fixed income, cyclical sectors across securitized credit, corporate credit and emerging market debt are relatively attractive. We believe that a rebound in economic growth, fostered by a duality of fiscal and central bank support, will push spreads uncomfortably tight in 2021. However, the heavy use of economic stabilizers creates fragility to shocks and will leave investors exposed to increasingly asymmetric risk profiles. Security selection, which is always important, has become absolutely critical as the dispersion between "winning" and "losing" investments within sectors will remain extremely wide. Diversification, tail risk hedging and careful analysis of cyclical versus structural factors are necessary to mitigate downside risks and prepare portfolios for the income-starved world we face ahead.

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