

WHAT'S PRICED IN?

Investing is a complicated endeavor. Predicting the future is hard enough; understanding what markets have priced in is just as hard – and just as important. Nobel Laureate – and University of Chicago behavioral economics professor – Richard Thaler conducted an interesting study providing some insights on the matter. The *Financial Times* allowed him to publish a contest asking for a number from 0 to 100. The guess closest to two-thirds of the average of *all* entries was crowned winner. This clever contest forced entrants to consider all others' views – as all investors must do to outperform the broader financial market.

Three specific answers showed up most often. The “first-level thinker” gave the third most popular answer – 33. The thinking: Because the average random response is likely 50, the winning answer should be 33 (two-thirds of 50). Meanwhile, the “second-level thinker” reasoned – if all respondents are “first-level thinkers” – the winning answer should be 22 (two-thirds of 33). In fact, this was the most popular answer. But why stop there? The really “smart” contestants answered 1 (second most popular response). These entrants, Thaler concluded with humor, had “too much economics training.” Average contestants did not go that many levels deep. The winning answer was lucky number 13 (two-thirds of 20), closely approximating “third-level thinking” (fairly common across repeat experiments).

What constitutes first/second/third-level thinking in financial markets is not so straightforward – and can be very fluid, as investors respond to each other in real time. Let's give it a shot anyway.

First-level thinkers. Those answering 33 likely focus on the robust economic recovery. Global purchasing manager indices (a real-time read on the economy) have overcome last year's dip and then some. Those looking for work are starting to find it, pushing consumer confidence higher. Also, the recovery is getting a shot in the arm; literally from vaccines and figuratively from the \$1.9 trillion stimulus bill.

Second-level thinkers. Those taking the next step flag the coming inflation. But inflation risks seem transitory – and only bother investors if they bother the Federal Reserve (Fed). This has not been the case. In fact, the Fed is embracing (some) higher inflation and remaining extremely accommodative by any historical standards.

Third-level thinkers. But, finally, what's priced in? Broad equity valuations appear elevated but reasonable given (still) very low global interest rates. In fact, some areas of the financial markets – value stocks, many non-U.S. equity regions and natural resources – arguably look attractive.

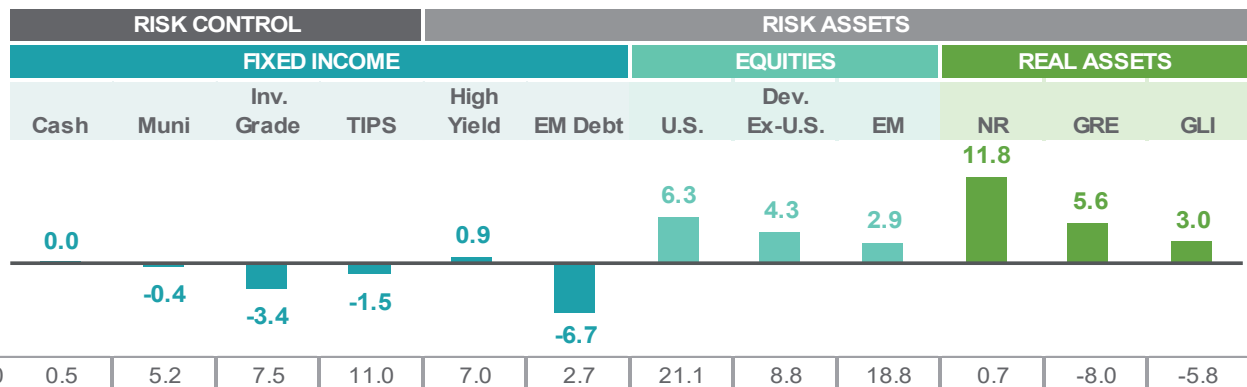
Too much economic training? Other areas of the market do look stretched. Be aware of the risks but also be careful not to dismiss their prospects entirely. Bitcoin has defied the “experts”, up 100%+; while the GameStop saga has left the “smart money” with sizable losses this year.

Conclusion: Think, but don't overthink. And, if shorting the market, be sure to remember some old advice: Markets can stay irrational longer than you can remain solvent*.

**Quote attributed to economist John Maynard Keynes, who surprisingly never won a Nobel prize (he died in 1946, before the economics award was first handed out in 1969 – and posthumous awards are not given).*

FIRST QUARTER 2021 TOTAL RETURNS (%)

Risk taking has been rewarded; market laggards have become leaders – notably natural resources.



Source: Northern Trust Asset Management, Bloomberg. NR: Natural Resources; GRE: Global Real Estate; GLI: Global Listed Infrastructure. Indexes are gross of fees.

KEY DEVELOPMENTS

Controlling COVID

From a health perspective, there is still much to be done to address COVID-19, especially as new strains push cases higher. From an investment perspective however, the pandemic is mostly behind us. There is clear evidence that vaccines are working (see chart). And, in short order, any U.S. citizen who wants a shot can have one. European citizens must stay patient for now. But production is ramping to get the continent back on track. As the pandemic comes under control, economies are reopening – and recovering.

Controlled Inflation

The economic recovery is pushing inflation higher. But, unlike the pandemic, inflation may control itself. Inflation readings will surely rise in the next few months; but this is more driven by last year's falling prices than this year's rising prices. Because inflation is generally quoted in year-over-year (y/y) terms, last May's price nadir may be this May's y/y inflation zenith (see chart). After May, inflation numbers will likely recede; future price increases will be hard pressed to maintain the past year's recovery/stimulus-driven fast pace.

Yield Curve Control?

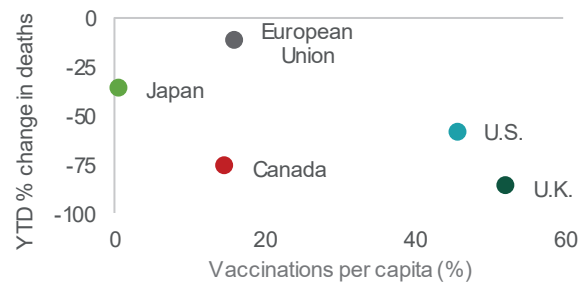
Rising inflation and the gradual return to economic normality have pushed interest rates higher. The 0.8% year-to-date increase in the 10-year U.S. Treasury yield represents a 0.5% increase in real yields and a 0.3% increase in inflation expectations (see chart). Investors don't necessarily mind higher inflation by itself; they mind central banks (over) reacting to higher inflation. On this front, the Fed has provided words of comfort. Easy money continues, while more forceful yield curve control could come if rates march much higher.

Out of Control Speculation

Equipped with stimulus checks and assisted by easy money, day traders are back. Many stocks have been targeted, but GameStop is best known (at least now). Hedge funds heavily shorted the (ostensibly) doomed retailer, only for small investors to collectively push the price higher. Those short had to cover (buy up) stated positions (pushing prices higher yet). The madness is ongoing. GameStop (a sub-\$1 billion company just last December) is now worth \$13 billion (roughly the same market value as COVID-19 vaccine maker Novavax).

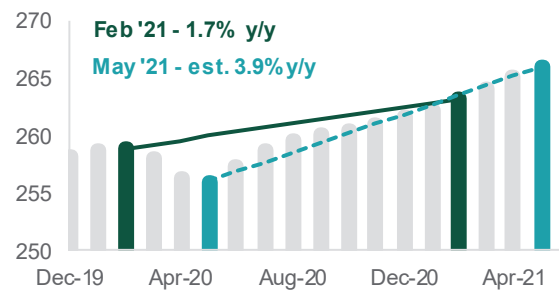
VACCINE EFFECTIVENESS

MORTALITIES AND VACCINATIONS



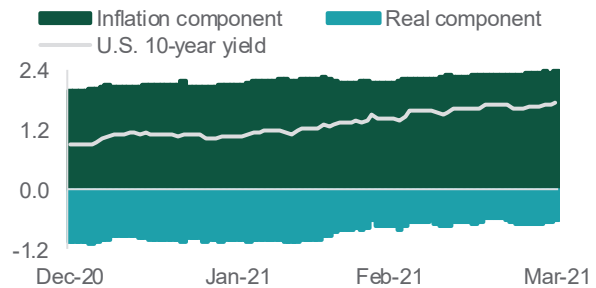
YEAR-OVER-YEAR INFLATION COMPARISONS

CONSUMER PRICE INDEX LEVEL



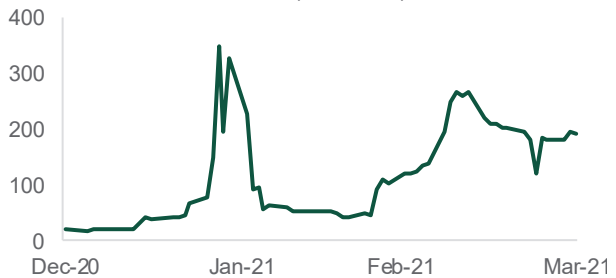
10-YEAR TREASURY YIELD DECOMPOSITION

U.S. 10-YEAR TREASURY YIELD (%)



THE SPECULATION POSTER CHILD

GAMESTOP SHARE PRICE (\$/ SHARE)



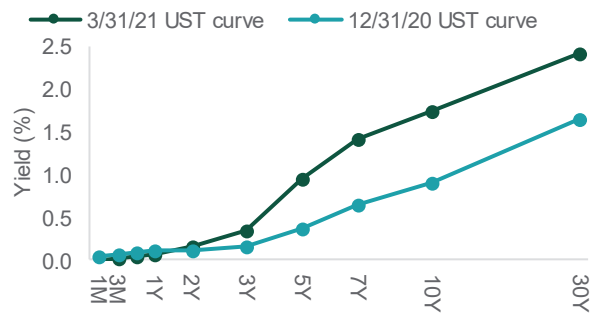
Source: Northern Trust Asset Management, Bloomberg. YTD = year-to-date. Chart 2: data through 2/28/2021, May '21 is NT estimate. Data as of 3/31/2021 for all other charts.

MARKET REVIEW

Interest Rates

The Fed made no major policy changes as it stressed the difficulty of realizing persistently higher inflation. Investors challenged the Fed's ability to maintain ultra-accommodative policy against a backdrop of rapidly improving economic activity boosted by huge stimulus. This Fed-investor dichotomy led to a steeper U.S. yield curve with shorter-maturity yields holding firm while investors pushed longer-dated yields above pre-virus levels. Government bond yields faced upward pressure globally, but real yields are still stimulative overall.

U.S. TREASURY YIELD CURVE



Credit Markets

The improving economic growth trajectory pushed up future corporate earnings expectations. As is often the case, this led to some spread tightening. Investment grade and high yield spreads fell 6 and 50 basis points, respectively. Vaccine-led normalizing economic activity and bolstered corporate liquidity helped by added fiscal stimulus slowed corporate defaults. Rising interest rates and less room for spread compression – spreads are near all-time lows – weighed on returns in credit-sensitive securities, but fundamentals remain strong.

CREDIT SPREADS



Equities

The 4.7% global equities return masks a big rotation into stocks likely to benefit from economic reopening, such as value and cyclicals, and out of pandemic winners. U.S. equities led the major regions with a 6.3% gain driven by leading vaccinations. Despite Europe's ongoing virus troubles, developed markets outside the U.S. benefited from cyclical exposure and rose 4.3%. Overall, rising interest rates and inflation concerns weighed on equity returns, but inoculation, economic reopening and stimulus tailwinds proved powerful.

REGIONAL EQUITY INDICES



Real Assets

Natural resources returned 11.8%, outperforming global equities for the second straight quarter. After years of underperformance, revived returns stem from improved energy fundamentals and increasing appreciation of the industrial metals that will be necessary to support green energy initiatives. Rising interest rates weighed on global real estate (GRE) and global listed infrastructure (GLI). Still, GRE outpaced global equities as property sector valuations hit hardest by the virus improved, while GLI was buoyed by cyclical exposure.

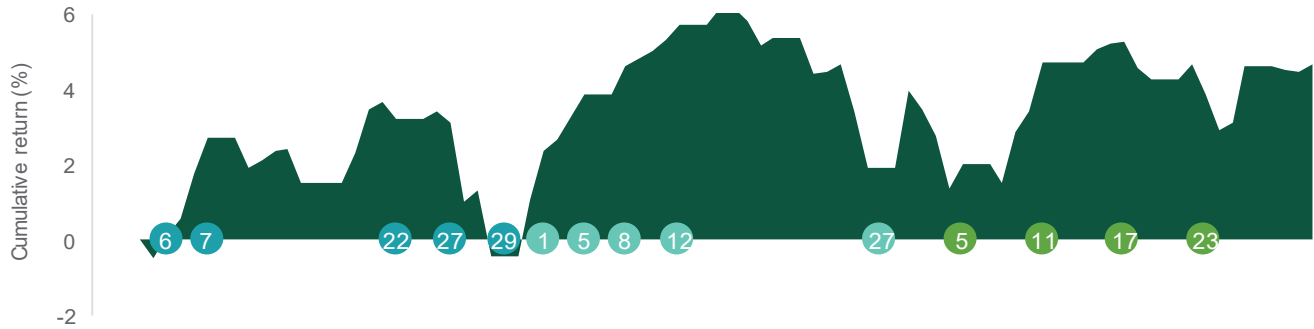
REAL ASSET INDICES



Source: Northern Trust Asset Management, Bloomberg. Returns in U.S. dollar terms. UST = U.S. Treasury. Indexes are gross of fees.

MARKET EVENTS

■ 1Q 2021 global equity total return: 4.7%



JANUARY	FEBRUARY	MARCH
<p>6 Democrats win control of U.S. Senate after the Georgia Senate run-off.</p>	<p>1 The number of American vaccine recipients exceeds the number of Americans who have tested positive for the virus.</p>	<p>5 Accelerating vaccinations and decelerating hospitalizations contribute to a better-than-expected February jobs report.</p>
<p>7 NYSE delists three Chinese telecommunications stocks to comply with an executive order from the Trump administration.</p>	<p>5 Congress passes a budget blueprint for a reconciliation bill, opening the door for more COVID-19 relief (a bill is later signed on March 11).</p>	<p>11 President Biden signs \$1.9 trillion virus relief bill which includes stimulus payments, state and local aid and extended unemployment benefits.</p>
<p>22 President Biden signs executive orders to boost COVID-19 aid and expand worker protections.</p>	<p>8 OPEC+ supply restraints and renewed demand drive oil prices higher, eventually settling above \$60/barrel for the duration of the quarter.</p>	<p>11 The European Central Bank declares intent to expand asset purchases in the next quarter to stabilize real bond yields.</p>
<p>27 GameStop (GME) rises 135% on the back of "short squeeze" trades attributed to retail buying.</p>	<p>12 CBOE Volatility Index reaches lowest level since pandemic started as the U.S. inches closer to a stimulus package.</p>	<p>17 The Federal Reserve upgrades 2021 growth forecast and reiterates accommodative policy.</p>
<p>29 Johnson & Johnson (JNJ) reports 66% global efficacy for its single-dose vaccine.</p>	<p>27 The U.S. Food and Drug Administration issues Emergency Use Authorization for Johnson & Johnson's (JNJ) COVID-19 vaccine.</p>	<p>23 A container ship stuck in the Suez Canal blocks passage to roughly 10% of worldwide shipping traffic.</p>

Indexes used: Bloomberg Barclays (BBC) 1-3 Month UST (Cash); BBC Municipal (Muni); BBC Aggregate (Inv. Grade); BBC TIPS (TIPS); BBC High Yield 2% Capped (High Yield); JP Morgan GBI-EM Global Diversified (Em. Markets Fixed Income); MSCI U.S. Equities IMI (U.S. Equities); MSCI World ex-U.S. IMI (Dev. ex-U.S. Equities); MSCI Emerging Market Equities IMI (Em. Markets Equities); S&P Global Natural Resources (Natural Resources); MSCI ACWI IMI Core Real Estate (Global Real Estate); S&P Global Infrastructure (Global Listed Infrastructure).

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