EisnerAmper
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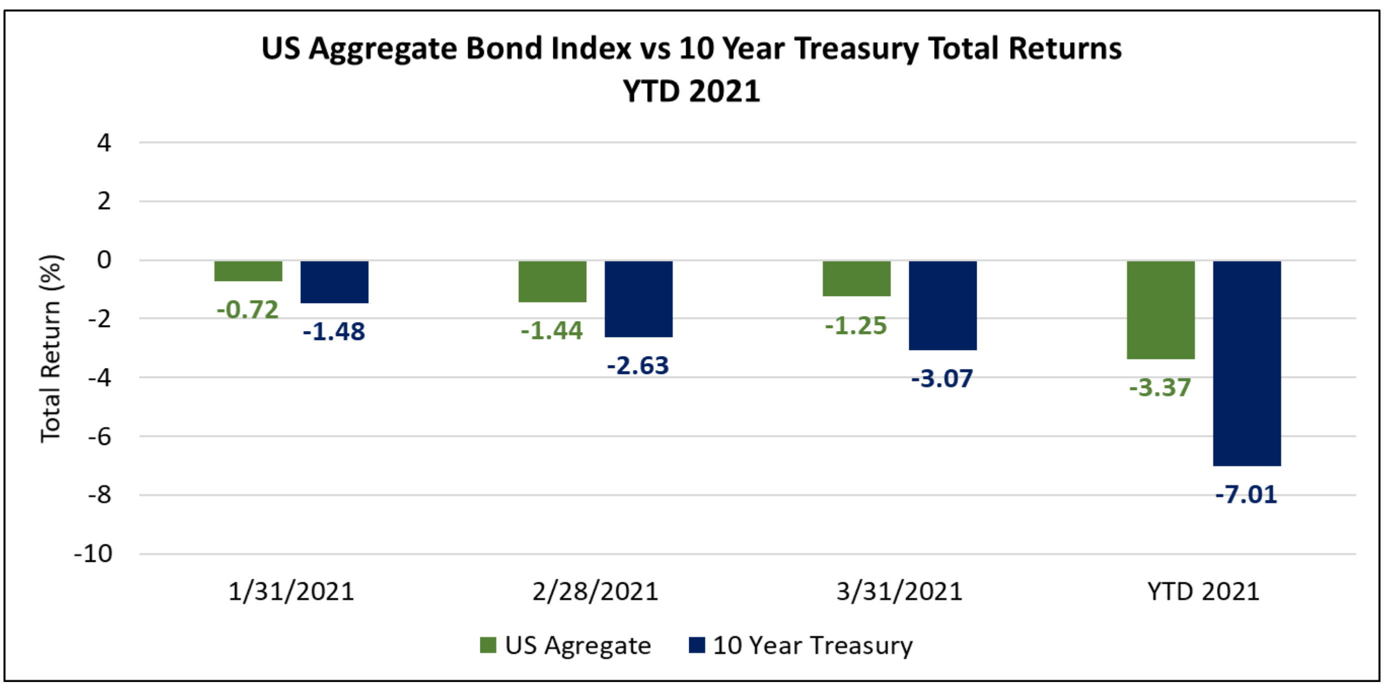
INVESTOR INSIGHTS – SECOND QUARTER 2021

The Bond Market has Losses

We have been warning about the potential of rising rates and the impact of bond returns. The total return of a bond portfolio is made up of two factors: the coupon and the appreciation or loss based on the change in coupon on a similar bond over time. The 10-Year U.S. Treasury started the year with a yield of 0.91%. What we know is that if the yield remained unchanged for 10 years, the annualized return of the bond holder would be 0.91% per year for the next 10 years. This is the calculus that had us warning the bond market because the expected future returns would be too low. How many clients could achieve their investment return needs over the next 10 years with a bond return of 0.91%? Our guess is not too many. This is implicitly what investors were doing on January 1 of this year by buying the 10-Year U.S. Treasury.

The 10-Year started the year at 0.91% but has traded over 1.75% and ended the quarter with a yield of 1.74%, a 91% increase in yield since the beginning of the year. A 91% change in bond yield over 90-day period is dramatic. We can speculate on why this may be happening, and most of us would say the possibility of higher inflation is likely the answer. But we would argue that the reason is less important than the fact that that you can have such a dramatic move in a theoretically low volatile asset class during such a short time. So, let's look at the impact of this move on the price of the 10-Year. Chart 1 shows the rise in yields and the corresponding decline in price.

Chart 1



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Source: Morningstar Direct

The math of this decline is dramatic for bond holders. Anyone who owned the 10-Year at the beginning of the year has seen a decline of 7% over the last three months. This is exactly why we have been shortening the duration of our client's bond portfolio to minimize the exposure of interest rate movement risks and we have been focusing on good quality bonds to form the laddered portfolio. In addition, we have been using Unconstrained Managers to add alpha through the credit-side of fixed income market to further diversify the bond portfolio. The strategy protects the portfolio in rapidly changing interest rate environment, market dislocations and geopolitical uncertainties since the managers have the flexibility to adjust the sector allocation based on market and economy conditions and employ proactive defensive strategies based on macro views and sector specific risks.

What Else Do We Do?

You have to realize that you cannot use bonds like you have in the past. It will be difficult to achieve your investment return needs with bonds. The 10-Year treasury return so far this year has wiped out all the income for this year.

Our answer to what you should do is to find other low volatile investments that have similar income and the prospect of a reasonable return. We have been using a diversified ETF portfolio that we call the conservative portfolio for over 20 years. Historically, the conservative portfolio did not have an income level like bonds, but today it does, at times even higher. We have a report on it and would be happy to go over it with you. During the 20 years we have been using the strategy, our clients have achieved a reasonable return and done so with similar volatility as the Bloomberg Barclays Aggregate Bond Index. While we project the bond market will have low return over the next decade, we think this conservative portfolio will be a good complement to bonds.

But what if rates go back down?

Rates will decline at some point because economic conditions or investors' perceptions of economic conditions will change. But decline from what level? The 10-Year at today's level of 1.74%? From 2.0% From 2.5%? From 3.0%? If we knew or we could find someone who knew we would act on that, but the reality is no one knows. Our best guess is rates are much more likely to rise from here, exacerbating the problem, than they are to fall from here.

The Stock Market

The change in rates that has impacted the bond market has also impacted the stock market. We have been writing over the last few years about how a few growth stocks have driven the index returns. The rationale for these stocks

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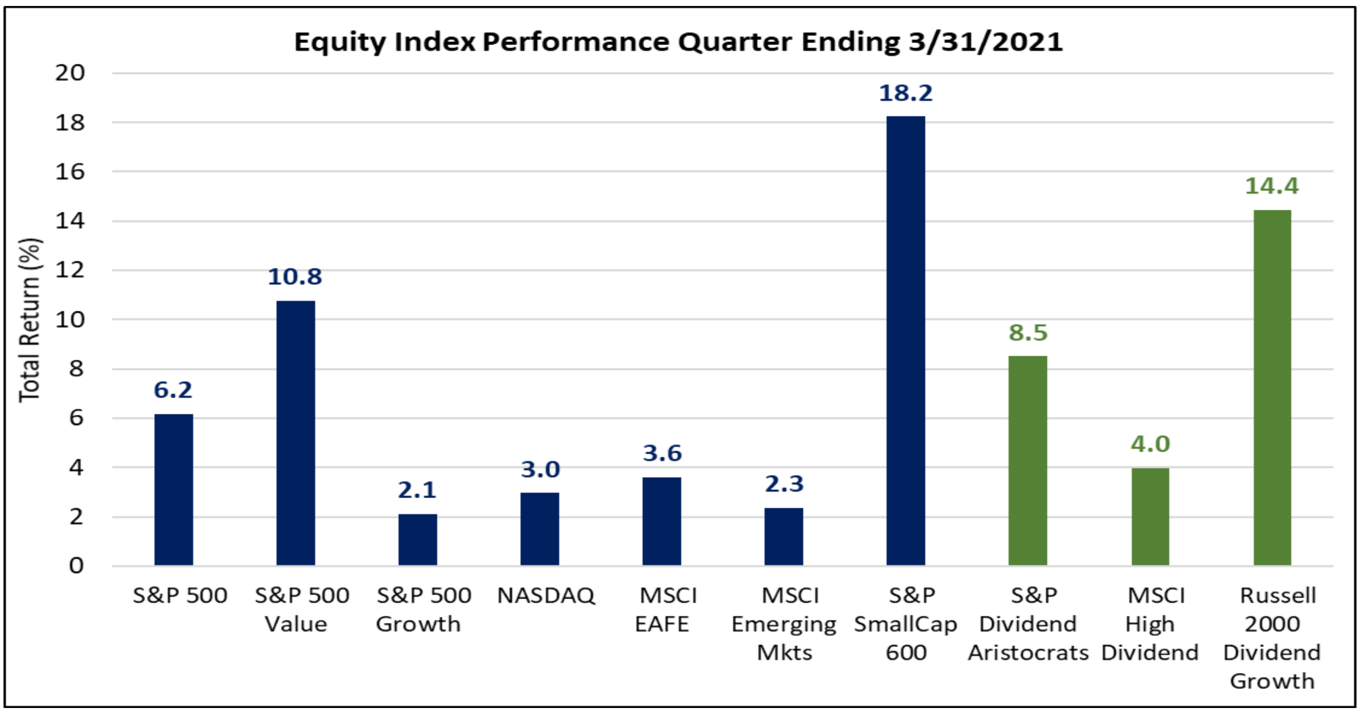
to have dramatic rises has been the low level of interest rates. The idea was that while rates are so low, P/Es can rise. So, we saw the FAANG stocks and Microsoft rise dramatically while analysts continued to suggest that high P/Es and Price to Sales were justified because interest rates were low and declining. Growth not just outperformed value, it made a discussion of investing in value seem like an idea of a former time. While rates were low, all you needed was growth.

Welcome to reality! Nothing goes up forever and the rationalizations about why a concentrated number of stocks drive markets historically has always ended very painfully. This time will be no different, no matter what you think of Apple and Amazon.

Chart 3 shows the returns for Q1 of the various equity indices.

Chart 3



Source: Morningstar Direct

As you can see, value and dividend strategies outperformed growth, and we would add, “Finally”! The absolute returns are quite high. If the S&P 500 is up 6.2% every quarter this year, the total return for the year would be 27.2%. If our portfolio, which was up 7.7% for the quarter, continued that exact return for the next three quarters, our accounts would be up 34.5% for the year. While it unlikely this will happen, it is nice to have a good quarter.

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The Fed and several investment banks are projecting high GDP growth for the year, over 6%. This could very well happen as we recover from the pandemic. Whether 6% or 7% is the right number remains to be seen, but our economy is recovering, and we have people getting vaccines at a high rate. That should allow all of us to return to restaurants, the theater and sporting events as well as get back on airplanes and take trips. Everyone is excited about returning to normal, even knowing normal will likely not be exactly what it was before the pandemic.

The question is what will happen to equity prices in this environment over the remainder of the year? Is 6% or 7% GDP growth already priced into stock valuations? We think the economy will do well, and in addition it is highly likely we will have a significant infrastructure bill passed reasonably soon which will further move our economy forward. If that does happen, unemployment will be reduced, and our economy will get a boost. So, not only do we think this year will see attractive GDP growth of 6% or so, next year will likely be high as well. Likely next year is not 6%, but it will also not be the 2% we have seen in recent years. So, expect a good year in the stock market.

The important data point to determine returns will be the level of interest rates. If rates rise gradually and the 10-Year stays below 2.5%, we would expect stocks prices to do well. We would also expect our dividend strategies to outperform growth. The higher rates go, the better the environment is for dividends and value to outperform growth.

The other important data point to remember is that stock prices do not rise in a linear fashion. Every quarter this year will likely not be positive, and do not be surprised if growth has a quarter outperforming dividend strategies. But it is reasonable to expect attractive returns this calendar year.

April 2021

As always, information provided should be considered based on your personal needs to accomplish your goals. At EisnerAmper, we will be happy to discuss with you any questions and how these principals can be applied to meeting your financial plan. Feel free to contact Marc Scudillo, Managing Partner of EisnerAmper Wealth Management & Corporate Benefits, LLC; 908-429-0025 or email at mscudillo@eawmcb.com.

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