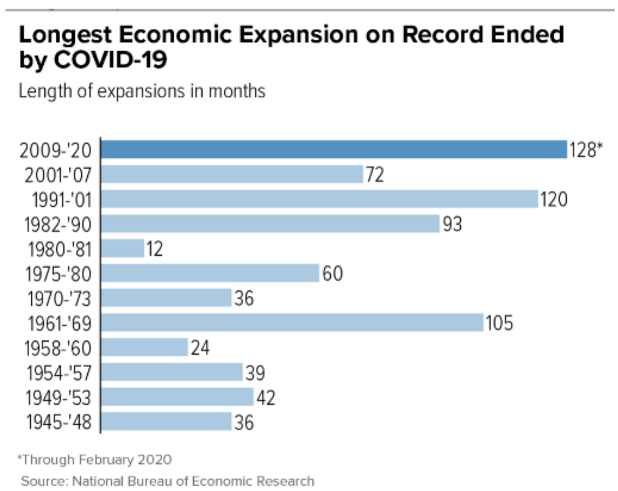
Alley Company Quarterly Letter
Getting Back on Track

April 15, 2021

Heading into 2020, the U.S. economy was on an historic run. The economic expansion that started in 2009 was entering its 127th month, making it the longest business cycle on record. Unemployment, inflation, and interest rates were all at favorably low levels and supportive of durable economic growth.

The COVID-19 pandemic came out of left field and abruptly derailed the economy, throwing it and other countries around the world into recession. Thankfully, the U.S. banking system was in sound financial condition – the exact opposite of the Global Financial Crisis of 2008/2009 – and thus was able to support the functioning of the economy and financial markets. This, combined with bold action by the Federal Reserve and U.S. government, stabilized the economy in just a matter of months.



Now, as we look forward to getting back on track with the next economic expansion, there are a number of positive factors at play:

- The consumer is in the best financial shape in recent history.
- Innovation is plentiful and significant secular advances are occurring.
- Monetary and fiscal stimulus has been substantial and a multi-year infrastructure bill could be in the offing.
- Interest rates remain very low by historical standards with inflation most likely contained.

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The Consumer

Consumer spending represents nearly 70% of GDP in the U.S., making it a key ingredient for a recovery. By most accounts, the consumer looks to be in strong shape:

- Household debt as a percentage of disposable income is at its lowest level in over 40 years.
- The personal savings rate is approximately 14% (twice the rate of savings in recent years) providing dry powder for future consumption.
- While unemployment is relatively high at over 6% currently, it should drop as the economy reopens.

The largest risk to vibrant consumer activity in the near term is if new COVID variants emerge that require a step backwards to ensure containment.

Innovation

Significant technological innovation is reshaping and advancing our economy. Renewable energy, e.g. solar and wind, is augmenting the primary energy sources that power public utilities. Electric vehicles are reducing carbon emissions and reliance upon fossil fuels. 5G is increasing data speeds substantially and allowing for more applications/devices to be connected to the internet. And, as illustrated by the incredible work of scientists developing COVID-19 vaccines in less than a year, significant advancements are happening within the healthcare industry.

Monetary and Fiscal Policy

The Fed's response to the COVID-19 recession has been swift and accommodative. Furthermore, their recent policy shift to allow inflation to run higher than the 2% target before hiking interest rates has sent a strong message to markets that the Fed, with a keen eye on slack in the labor market, does not want to impede this economic recovery.

In terms of fiscal response, a total of $5 trillion has been extended to individuals, families, and businesses to help bridge the gap in lost economic activity in 2020. In addition, a long awaited infrastructure bill appears to be gaining steam and this too would strengthen the economic recovery and likely extend it.

Interest Rates and Inflation

Our "lower for longer" thesis on interest rates remains in place. The yield on the ten-year U.S. Treasury bond bottomed this past summer at 0.50% and currently stands at approximately 1.70%. At these levels, interest rates are *very supportive* of overall economic activity and there is still ample room for rates to increase before impacting a recovery.

Central to any discussion of interest rates is inflation expectations on both a short- and long-term basis. In the short term, inflation may tick higher than normal driven by the reopening of the economy, brisk consumer activity, and a restocking of the global supply chain. On a longer-term basis, the disinflationary forces of globalization and technology are alive and well. Both forces are likely to continue to moderate long-term inflation trends benefiting consumers with stable pricing for goods and services.

A moderate rise in interest rates from here is a reasonable base case. A clear risk would be an unexpected and substantial rise in rates in the near term, however this seems unlikely for a few reasons:

- The bond market is global in nature and with rates in other countries typically below 1% and in some countries (Germany and France) *negative*, a gravitational force exists limiting a decoupling from other markets.
- Many parts of the world are still battling deflationary pressures, which weighs on interest rates.
- Significant changes in interest rates typically take time to unfold over many years, if not decades.

From an investment perspective, rising interest rates do portend potentially negative total returns for bond portfolios in the near term, but they also afford investors the opportunity to reinvest at higher yields as bonds mature. Relative to bonds, stocks continue to look attractive with an "earnings yield" of 4.6%[1] compared to the yield on the ten-year U.S. Treasury bond of 1.7%. History shows that stocks generally perform well when rates are rising from a low level and are being driven higher by strong economic growth which is presently the case.

The U.S. economy is indeed getting back on track. While S&P 500 earnings dropped by 14% in 2020, they are estimated to rebound by over 25% in 2021. The stock market, through its forward-looking lens, is discounting some portion of the aforementioned underlying positive factors, and therefore, as we always say, "a 10% correction is around any corner" as events unfold. That said, this economic expansion looks to have solid underpinnings and is capable of picking up from the last cycle and producing durable economic growth.

[1] Earnings yield is calculated by taking the inverse of the price-to-earnings ratio. In this case, at March 31st, 2021 the S&P 500 was trading at 21.88x forward earnings which equates to an earnings yield of 4.57%.