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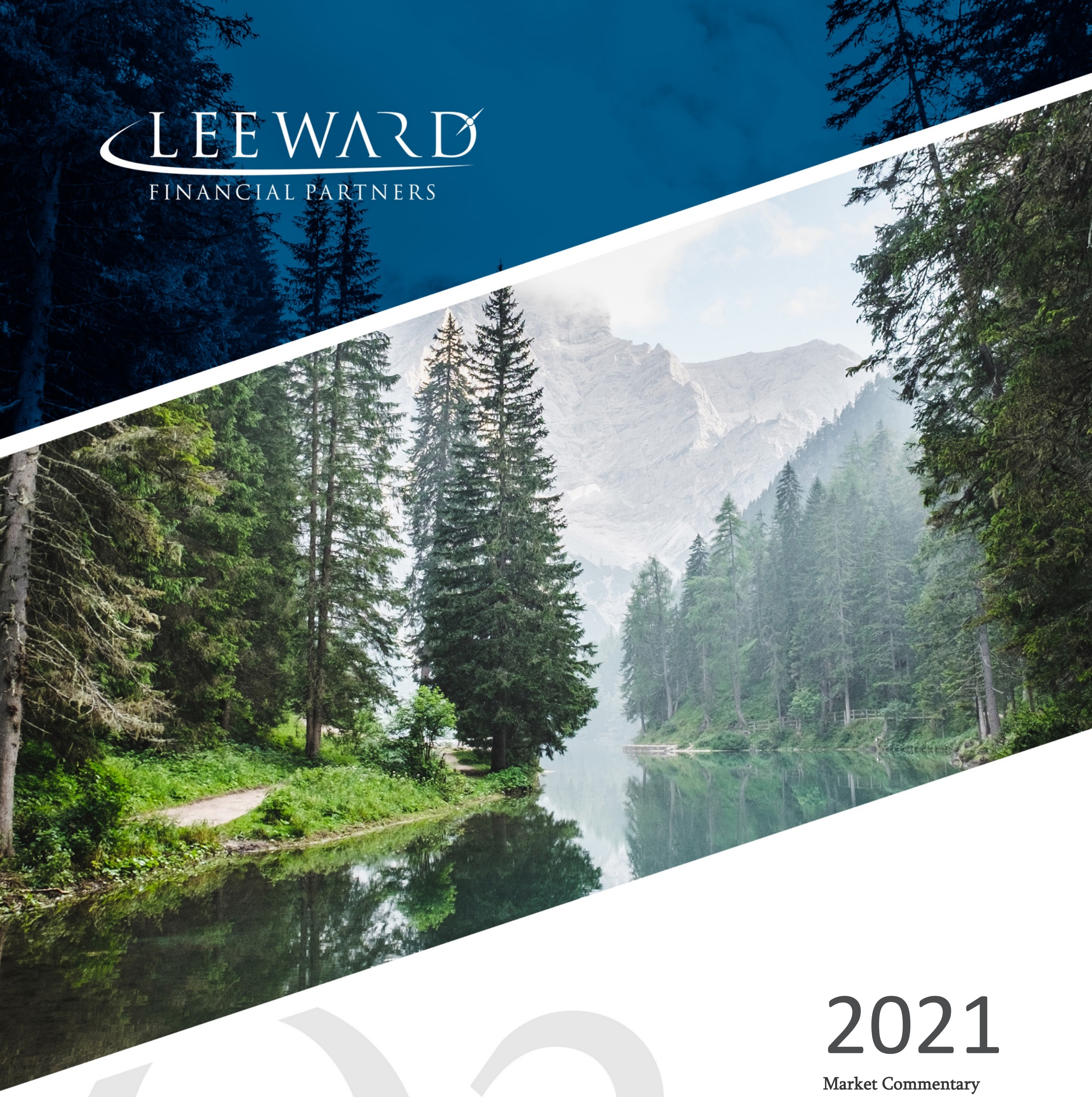

Q2

2021

Market Commentary

The U.S. economy was much stronger than expected in the second quarter. Markets reacted favorably, up almost 10%..

2Q2021 Market Commentary

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The Great Re-Opening

The U.S. economy exploded in the second quarter (2Q), driven by the fading pandemic and massive stimulus. With vaccinations topping 50% across the country, restrictions are easing, consumers are spending, and business activity is rolling. Saving rates have increased, and home values have soared. Household wealth is now up 17% since the end of 2019. 2Q GDP growth is expected to be close to 8.5% and full-year estimates are now over 7%. Reacting to the favorable landscape, equities increased in the second quarter and bonds recovered from their first quarter weakness.

Despite the robust business environment, the pandemic is stubbornly persistent. Supply chains remain constrained, inflation spikes are occurring, labor imbalances have emerged, and pressure is mounting for the Federal Reserve Bank (Fed) to reduce monetary support. Markets will need to absorb these issues in the second half of the year while concurrently digesting high asset valuations.

No doubt, 2Q was a strong quarter.

U.S. markets appreciated almost 10% in the second quarter. The S&P 500 Index was up 8.5%, and the NASDAQ Composite Index was up 9.7%. International equities were slightly behind U.S. markets, represented by the MSCI All Country World Index (ACWI), up 7.5%. Small-capitalization (small cap) companies were positive but lagged their larger-cap counterparts. The Russell 2000 Small Cap Index increased 4.3%. Bonds recovered slightly from the negative returns of the first quarter, reacting to a fall in treasury rates. The Bloomberg Barclays Aggregate Bond Index increased 1.8%, and high-yield bonds were up 2.7% for the quarter.

At the sector level, the recovery-oriented winners from the start of the year gave way to higher growth sectors. The top-performing areas in 2Q were Energy (11.3%), Technology (11.6%), and Real Estate (13.1%). The bottom-performing sectors were Industrials (4.5%), Consumer Staples (3.8%), and Utilities (-.4%). Changes in sector leadership signal a narrowing of the market similar to the environment in late 2019 and early 2020. Presently, valuation metrics remain stretched even as price-to-earnings ratios have come down slightly. The S&P 500 is currently trading at 21.5x forward earnings, somewhat less than the index's 22.5x multiple at the beginning of the year, but still above its 15x historical average.

Economic data points continue to improve.

At the beginning of 2020, there was uneasiness around vaccine distribution, and the pace of re-opening was unclear. That uncertainty has passed. Both business activity and consumer spending are now increasing faster than expected, and the economy is surging.
Initial jobless claims are at post-pandemic lows. June's reading of 360,000 is down drastically from the 6.1M reading at the pandemic's peak. Manufacturing data points are booming as well. The Purchasing Managers Index (PMI) is impressive at 61.2% (a reading above 50% is considered positive). Up 24%, retail sales moved higher in the quarter, confirming strong consumer demand. Home prices continue to rise, with the Case-Shiller Home Price Index up 14.7% year-over-year.

One wrinkle to appear from these economic metrics is the emergence of supply shortages. Global supply chains have been caught flat-footed during the re-opening, causing stock-outs and pricing spikes. These imbalances will take time to unwind and could lead to inflation-related risks and employment disruptions.

The inflation debate – sticky or temporary?

In March, the Consumer Price Index (CPI) – a measure of the average change in prices – rose 2.7%, twice its long-term average. By June, the CPI had doubled again, up to 5.4%, the most significant CPI increase in 30 years. The Producer Price Index (PPI) – another measure of price increases – followed the same trend increasing 7.3%, that index's largest move since 2014. These data points signal a notable increase in inflation. Part of this uptick is normal, a common phenomenon experienced during recoveries that ultimately unwinds. Other price increases could be more sustained and present risk. If inflation is persistent and unchecked, prices will spiral, purchasing power will plummet, and the U.S. dollar will devalue. This event would be damaging for both the markets and the U.S. economy. For now, this is not a significant risk. It is unclear how much of the recent rise in inflation is short-term and how much will be permanent, but expectations are for most current inflationary pressures to be shorter and decrease over time.

Markets, for their part, currently reflect the view that inflationary increases are transitory. The Fed believes that while some prices are "sticky," there is not enough of a permanent boost to fuel a long-term shift in inflation. We tend to agree. Certain areas of the economy – energy, new and used vehicles, building materials, semiconductors, transportation services, for example – are experiencing temporary price spikes. Much of the price appreciation is due to pandemic-related shortages. Other areas are experiencing more lasting price increases. Home prices, for example, should continue to hold their gains due to limited supply and relative affordability. Wages should permanently climb as well. How long inflation lasts remains a crucial question. For now, we are expecting above-normal inflationary readings through the end of the year.

More "work" to be done in the labor market.

People are getting back to work. The unemployment rate is dropping and on pace to reach pre-pandemic levels by early 2022. Underlying the jobs recovery is a structural change in the labor force. The pandemic has spurred geographic migration, shifting preferences of remote work, and rising retirement rates. Presently, over 7 million people remain out of work, and another 3.5 million have dropped out of the workforce entirely. Yet job openings have soared, with over 9 million positions advertised and unfilled.
It will take time to resolve the labor supply-demand mismatch. Hiring processes do not evolve overnight. Most people who remain out of work should re-enter the labor force over the next twelve months, incentivized by higher wages and reduced unemployment benefits. Additionally, wage rate increases should be relatively permanent and help support full employment.

Aside from inflation and labor imbalances, the next area of focus for investors will be tax policy's impact on earnings. Higher taxes for both individuals and corporations may pressure growth and slow earnings. We anticipate this issue will become more critical when clarity is reached on how extensive tax increases might be, most likely a fourth-quarter event.

Overweight equities at the expense of bonds.

We remain underweight fixed income in client portfolios as risk-adjusted returns remain materially higher for stocks than bonds. The problem for bonds is two-fold. First, the low level of interest rates makes yields unattractive. Second, fixed income is pressured when rates rise as bond appreciation is inversely correlated with interest rate changes (rising rates hurt bond values).

Our current view is interest rates will creep higher over the next several quarters. We anticipate becoming more constructive on fixed income once this occurs, and there are signs interest rates may start to plateau. Until then, our under-weight fixed income positioning remains focused on higher quality short-duration investments, which act as a capital preservation tool in more conservative client portfolios.

In equities, we have started to unwind our position in economic-recovery companies, replacing those holdings with long-term secular growth investments. We are adding real estate exposure through Real Estate Investment Trusts (REITS), an asset class we largely avoided in 2020 but now find to be more attractive. We are modestly increasing positions in small capitalization companies but believe much of the small-cap momentum is essentially over for now.

An excellent start to the year.

The first half of the year was pleasantly surprising. The U.S. has re-opened more successfully than expected. This has allowed for some much-needed normalization. Ironically, the pace of recovery has created its own set of challenges. Economic data will continue to be favorable but distorted by the easy comparisons caused by the pandemic. Inflation will be in focus, feeding expectations the Fed will have to begin acknowledging a tighter monetary policy. Employment will continue to recover but will ultimately bear the scars of the pandemic, looking different than before.

We will navigate these issues in the second half of the year, balancing the economy, policy, and earnings growth. There may be some headline risk due to recent market appreciation, but without any new information, we view any market reversals as healthy consolidations versus market downturns. The economy will remain strong and support further growth.

Please feel free to contact us with questions or comments.

We wish you an enjoyable and healthy summer.

Sincerely,

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