Market Review & Outlook

July 2021

At the close of 2021's first half, it's difficult to portray the ongoing recovery from last year's COVID-induced recession as anything less than exceptionally robust. For the most part, the major headline stock indices in the US continue to trade at or near all-time highs. The most widely followed US benchmark, the S&P 500, finished the last trading day of the quarter at a new all-time high, up 15.25% year to date. The benchmark index has gained more than 10% during the year's first half only 26 times since 1928. Following those 26 occurrences, the index posted positive returns in the second half of the year 77% of the time. For its part, the technology-heavy Nasdaq Composite finished the last trading day of the quarter only 0.17% off the all-time high it set one day earlier. To accompany the strong returns, US stocks have also exhibited remarkably low volatility, with the S&P 500's worst drawdown being only 4% YTD. So far, 2021 is the least volatile year since 2017 and one of the least volatile over the past 25 years. For a closer look at how various asset classes performed in recent periods, please refer to the table above.

Index	June 2020	2nd Qtr. Perfomance	One Year Performance	Description (what the index is comprised of)
S&P 500	2.33%	8.55%	40.79%	Large cap stocks
DJ Industrial Average	0.02%	5.08%	36.34%	Large cap stocks
NASDAQ Composite	5.55%	9.68%	45.23%	Large & mid cap tech stocks
Russell 1000 Growth	6.27%	11.93%	42.50%	Large cap growth stocks
Russell 1000 Value	-1.15%	5.21%	43.68%	Large cap value stocks
Russell 2000 Growth	4.69%	3.92%	51.36%	Small cap growth stocks
Russell 2000 Value	-0.61%	4.56%	73.28%	Small cap value stocks
MSCI EAFE	-1.13%	5.17%	32.35%	International stocks
MSCI EM	0.17%	5.05%	40.90%	Emerging markets stocks
S&P US HighYield Co.Bd	1.40%	2.95%	14.74%	High Yield Bonds
Bloomberg Barclays US Aggregate Bond Index	0.70%	1.83%	-0.33%	Primarily U.S. Government Bonds

Despite the resiliency of stocks, there has been some divergence in recent trends if you look beyond the headline indices. While value stocks outperformed growth stocks handily during Q4 of 2020 and Q1 of 2021, they began to lag on a relative basis this past quarter, especially the last month of the quarter. This is reflected by the more value-oriented Dow Jones Industrial Average last hitting an all-time high on May 7. Even so, the Dow sat less than 1% off its all-time high at the end of June. Small cap stocks had similarly outperformed large stocks with a huge run that began last fall, but which stalled out in mid-March, with the Russell 2000 last hitting an all-time high on March 15 and underperforming the S&P 500 since then. Still, the index sat only 2.1% below its peak as of June 30. Likewise, overseas stocks were exhibiting some outperformance over domestic stocks at the end of last year, but that has mostly faded, with notable exceptions such as various European markets.

Treasury rates bottomed out last summer, and as the economy began to re-open in the last half of 2020, growth began to accelerate into the last few months of the year. Concurrently, the price of many commodities, including oil, began a rapid ascent as we ticked over into 2021. This, along with rising home and auto prices, stoked inflation fears and contributed to a sharp rise in interest rates to start the year, with the yield on the 10-Year Treasury reaching 1.75% at the end of March, up from 0.52% last August. The result was that bondholders, especially in rate sensitive bonds, got bruised, with the benchmark bond index losing more than 3.3% during the first quarter.

While Treasury yields remained at elevated levels compared to a year earlier, they trended mildly lower throughout the quarter as the June FOMC meeting approached. Over a year ago, Fed chair Jerome Powell quipped that the Fed isn't "thinking about thinking about raising rates" during the pandemic. The Fed has maintained this easy money stance, stating as recently as its late April meeting its intention to keep short rates at zero through the end of 2023. Moreover, it is continuing to purchase $120 billion/month of Treasury and government agency bonds in the open market.

The official Federal Open Market Committee (FOMC) statement released on June 16 is essentially the same as previous statements. One noteworthy change is that FOMC members project that the federal funds rate will be raised to an average of 0.6% in 2023, up from an average of about 0.1% currently. While noting that inflation has risen, the FOMC still attributes this largely to "transitory factors," and states again that it will "maintain an accommodative stance of monetary policy" as long as "inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent."

In recent months, the Bureau of Labor Statistics has reported monthly and year over year inflation figures higher than any seen in the US since the Great Financial Crisis and in some cases going back to the 1990's or even early 80's. For example, the May Consumer Price Index rose 5% year/year while the "core" inflation (ex-food & energy) rose 3.8% year/year. The headline number was the highest since August 2008 and core inflation highest since May 1992.

It's true inflation rates were low during the spring of 2020 as the price of many things was depressed because of the shutdowns. Therefore, it's not unreasonable to expect at least a few months of distortion in the numbers when comparing to the COVID depressed levels of a year earlier. In addition, the shutdowns did cause significant disruption of global supply chains, and to the extent supply remains constrained as demand snaps back with re-opening, this will continue to put upward pressure on prices.

With the mid-June Fed statement, the markets seemingly took the Fed's assurances about "transitory" inflation at face value, and on June 17-18, many cyclical stocks and other reflation/inflation plays that had been working so well since November sold off sharply. Other Fed officials have hinted at possible tapering of bond purchases or rate hikes on an earlier timetable than set forth in official announcements. The overall Fed posture has worked to keep mild downward pressure on rates, with the yield on the 10-Year Treasury trading as low as 1.44% in the past several weeks.

In the Financial Times this week, ex-PIMCO CEO Mohamed El-Erian worried about the mainstream "Goldilocks" outlook for markets of not-too-hot, not-too-cold conditions, something he believes rests on a "consensus based on three core hypotheses: durable high global growth, transitory inflation, and ever-friendly central banks." The danger is if inflation proves not to be "transitory," this would eventually threaten the oth-er 2 parts of the thesis that support the current market tranquility. While he is not the only notable analyst to question the Fed narrative, it should be stated that there are very few voices out there predicting chronic 1970's style inflation.

While the market rebound since March 23, 2020 continues to surprise with its strength, analysts can point to fundamental reasons for the historic rally. Earlier this week, JP Morgan noted that since the onset of the pandemic, earnings have surprised to the upside by a significant margin, and that many analysts' models grossly underestimated the strength and pace of the economic recovery, leading to earnings projections that were overly pessimistic. With the 2Q21 earnings season approaching, the bank believes earnings will come in well above current estimates but likely slow as we approach 2022.

This makes sense, as much of the recent strength in the data is simply a function of easy comparisons to COVID-depressed levels of earnings and economic activity. Indeed, the Citigroup Economic Surprise Index, which measures the degree to which the economic data is either beating or missing economists' forecasts, has been trending downward in recent months and briefly went negative in May. As it's not an absolute measure of growth, it isn't a huge deal, but it does mean that after more than a year of economists consistently underestimating the strength and durability of the economic recovery, they've now caught up to reality.

Given the government-imposed global economic shutdown we went through, forecasting the subsequent recovery is impossible given its uneven nature. There is nothing remotely close as a historical analog. For instance, in the context of the economy still being down 6.76 million jobs from pre-pandemic levels, job growth has been disappointing the past couple of months. However, job growth could surprise to the upside over the coming months as COVID-related extended unemployment benefits come to an end in many states. Overall economic growth should continue to be strong for several quarters, but as things continue to normalize, it's likely the economy in the US will trend towards some pre-pandemic level of growth in the annualized 2-2.5% range. Future trend growth may even be lower than that because of all the increased aggregate debt that has been taken on.

Certainly, there is risk in the market – risk always exists in the market – and investor complacency seems elevated based on sentiment indicators. The COVID delta variant, a more contagious and dangerous strain of the virus, does pose risk to the re-opening of the economy, both here and abroad, with the daily new case count rising 10% in the US just over the past week. With a slowdown in the rate of change of improving earnings and economic data, a correction in stocks or months of trading sideways would likely be healthy for stocks, unless that was also coupled with a continued spike in the inflation data.

Of course, we must make the obligatory mention of historically elevated stock valuations. As noted in past missives, there are only a couple of other instances in stock market history where valuations rivaled what we see in the current market – 1929 prior to the Great Crash and in late 1999-early 2000 directly preceding a painful, technology-led bear market that did not really recover until the spring of 2003.

With historical amounts of stimulus, a deep sell-off in risky assets seems unlikely, but investor psychology can change and it's important to know your own investment comfort level and how you might react given various market outcomes.

If you have a general administrative question about your account, please contact our customer service at 800-535-4253 option 1. If you need investment advice, please contact your firm's designated consultant or me. You can reach me at extension 1178 (510-740-4178) or at advisors@wespac.net. We would be happy to schedule a call or Zoom meeting to discuss your portfolio.net. John Williams, Manager of Advisory Services – WESPAC