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Quarterly Update & Economic Commentary—June 30, 2021

Quarter in Review

The broad market, represented here by the S&P 500, notched another positive quarter during the second quarter of 2021. This is the fifth straight quarter of positive returns, following the 20% drop during the first quarter of 2020 which coincided with the onset of COVID-19 and global lockdowns. There was a second quarter resurgence from the large cap growth category; the S&P 500 Growth Index returned 11.93% for the quarter, while the S&P 500 returned 8.55% and the S&P 500 Value returned 4.99%. Domestic mid-cap and small-cap stocks also had positive quarters but underperformed the S&P 500. The S&P MidCap 400 returned 3.54% and the S&P SmallCap 600 returned 4.51%. The top performing US sector during the quarter was the real estate sector which returned 13.09%, followed by: Information Technology returning 11.56%, Energy returning 11.30% and Communication Services returning 10.72%. Only one sector posted negative performance for the quarter, Utilities, which lost 0.41%. Other laggards were: Consumer Staples, 3.83%, and Industrials, 4.48%. International stock markets also had a strong quarter. The developed index, MSCI EAFE NR, did slightly better than the emerging market index, MSCI EM NR. The EAFE index returned 5.17% and the EM index returned 5.05%, both indices benefited from a weakening US dollar during the quarter.

The interest rate yield curve flattened slightly during the quarter as 2-year US Treasury yields rose, but both the 10-year and 30-year Treasury yields fell. While interest rates stabilized during the quarter, yields remain at much higher levels than where they were at the start of the year—but still low from a historical perspective. The 2-year rate has more than doubled (from .12% to .25%), the 10-year is higher by 52 basis points and the 30-year is higher by 42 basis points. As a result of the stabilization and falling of intermediate and longer-term rates, the Barclays Aggregate Bond Index had a good quarter, returning 1.83% but remains negative by 1.60% year-to-date. The Barclays US Corporate High Yield Index, which is made up of bonds with a lower credit quality, had a solid quarter, returning 2.74% and is now positive by 3.62% for the year.

With the growing threat of inflation, many commodities are seeing price increase. Natural Gas was a particular standout during the quarter, returning 39.95% and is positive by 43.76% year-to-date. Oil prices have also continued to soar this year and it is being felt at the pump by the majority of Americans. Crude Oil prices rose 24.19% during the second quarter bringing the year-to-date gains to 51.42%. Many of the metals are also seeing price increases, but the largest year-to-date increase has been seen in copper. Copper prices have increased by 6.62% during the quarter and are now up by 20.73% year-to-date. Other metals' performance for the quarter were: Nickel 13.47%, Silver 6.77%, Gold 3.26% and Platinum -9.95%. Lumber prices have been another commodity that has caught some price momentum. Prices have moved from around $495 per thousand board feet up to a high of $1,670 in mid-May, a move of almost 230%. Since the May peak, prices have fallen by over 50% to around $710 per thousand board feet. In June, lumber prices fell by over 40%, its worst month on record since 1978.

The economy and the stock market continued a robust recovery, much faster and stronger than most had predicted. Much of the recovery has been a result of people getting vaccinated and restrictions being lifted. As of the end of the second quarter, about 47% of the population has been fully vaccinated and 57% of individuals over 18 years old have been vaccinated. In response to the decline in COVID cases, a product of the increasing vaccination rates, many venues are being opened, savings rates are higher and household net worth has increased. With limited opportunities to travel and attend live events, coupled with having more money to spend, consumer spending has been hot. While this spending and activity spree has been a positive development for the economy, individuals and businesses, the increase in demand for goods and services is pushing prices higher. In addition to the demand increase, there has been a labor shortage, causing employers to either limit services or pay higher wages, cost increases which often are being passed on to consumers. In addition, there remain supply chain disruptions from the unique environment created by the pandemic.

Inflation has been the major topic of the year so far, and not only among Fed officials, corporate executives, and stock market commentators, but it has also been one of the most searched topics on Google. Inflation is typically a sign of an overheating economy—too much money chasing too few goods. When the economy begins to overheat, the Fed steps in and raises interest rates to disincentivize borrowing and spending, thus promoting saving. Inflation indicators have been confirming the broad inflation concerns. The 12-month change for the headline consumer price index (CPI) for May was 5%, but if you exclude food and energy the percentage increase was only 3.8%. The headline increase was the largest 12-month increase since the 5.4% increase during the period ending August 2008. Inflation is often specific to the person or the household. There were major spikes in energy, used cars and truck rentals. Housing prices have also been on the climb but are not included in the CPI number. The Case-Shiller Index for U.S. home prices gained 13.2% in March and 14.6% in April. These increases are extraordinary. The housing market is hot but causes of this can be attributable to low inventory levels and supply line disruptions. Home sales have been falling in recent weeks, attributable to the supply and rising costs; housing starts are also slipping because of backlog of demand, labor shortages and disruptions in getting materials.

With inflation being one of the Federal Reserve's mandates, the attention to the Fed has been high. Despite the rising inflation concerns, the Federal Reserve in their June Federal Open Market Committee (FOMC) voted to leave rates unchanged at 0%-0.25% and its bond-buying program to be unchanged. The committee did change its guidance expecting its next rate hike in 2023 as opposed to 2024. During Chair Powell's news conference, he announced it was time to retire the previous wording "too early to talk about talking about" slowing the pace of the Fed's $120 Billion monthly asset-purchase program. The Fed's policy continues to be accommodative, and its policy is consistent with an emergency program which is no longer the case. The Fed believes inflation is transitory and should begin to subside during the second half of the year and into 2022.

The Fed conducted stress tests on US banks and the results were positive with all 23 lenders easily passing. The results will open the door up for these banks to increase dividends and share buybacks, a positive for the banking sector. Following the announcement, Morgan Stanley announced it would double its dividend and buy up to $12 billion of its stock through June 2022, JPMorgan boosted its dividend by 11%, Bank of America increased its by 17%, and Goldman Sachs is boosting its dividend by 60%.

The U.S. economy continues to show signs of a robust recovery. The first quarter GDP final revision stayed at 6.4% and the second quarter estimates are calling for GDP to grow by over 8% in the second quarter. The unemployment rate continues to fall and is now at 5.8%. While this rate is still elevated from the pre-crisis levels of sub 4% the high unemployment rate is not a result of job shortages. Many businesses are citing labor shortages, with the causes being attributed to the enhanced unemployment insurance that is expected to expire in September, continued health concerns, and child care responsibilities while many kids are on summer break. The Job Openings and Labor Turnover Summary (JOLTS) report announced in early June that there were 9.3 million job openings in the US. Consumer confidence rose 7.3 points to 127.3, the highest level since February 2020. With savings rates elevated, many consumers may not be motivated to work right now, but consumers are in good financial shape. Bank of America reported that transaction volumes on customers' credit and debit cards and over Zelle payment network has grown by 20% so far this year, compared to this point in 2019.

To add fuel to the fire, the White House and a group of bipartisan Senators announced a tentative infrastructure agreement. The infrastructure plan is worth around $1.2 trillion, well below the $2.3 trillion initially proposed. The new agreement includes around $580 billion in new spending. The new agreement focuses on railways, broadband internet expansion, water infrastructure and public transit, and includes an agreement of no new individual taxes. The bill will be paid for by stricter IRS enforcement.

First quarter earnings announced throughout the second quarter came in strong, as you would expect given the better than expected economic conditions. The S&P 500 reported growth in earnings of 52%, the highest year-over-year growth since the first quarter of 2010. 86% of S&P 500 companies exceeded earnings per share (EPS) estimates, the highest percentage since FactSet began tracking the metric in 2008. With such strong results during the first quarter, second quarter expectations are on the rise which contributed to the robust stock market. As we end the second quarter, 103 S&P 500 companies have issued guidance, which is above the five-year average. Of these 103 companies, 37 issued negative EPS guidance and 66 issued positive guidance. From FactSet, the number of companies issuing positive guidance is well above the five-year average and the number issuing negative guidance is well below the five-year average.

International markets had a good quarter but were overshadowed by the strong performance of the S&P 500. The dollar weakened compared to many foreign currencies during the quarter which provided a small boost to performance for US investors. Many European countries continue to grapple with the coronavirus and economic restrictions. European countries still have low vaccination rates and concerns are growing that the emerging delta variant could cause another wave of coronavirus to spread through Europe. Even in the U.K. where vaccination rates are higher, restrictions are still in place but are expected to end in July. Some fear the restrictions may need to be extended because of the more transmissible delta variant.

A Look at the Numbers

Name	Total Return 2nd Quarter (%)	Total Ret YTD (%)
DJ Industrial Average TR USD	5.08	13.79
S&P 500 TR USD	8.55	15.25
S&P MidCap 400 TR	3.64	17.59
S&P SmallCap 600 TR USD	4.51	23.56
NASDAQ Composite TR USD	9.68	12.92
MSCI EAFE NR USD	5.17	8.83
BBgBarc US Agg Bond TR USD	1.83	-1.60
Wilshire US REIT TR USD	12.84	22.78
IA SBBI US 30 Day TBill TR USD	0.00	0.02
**As of June 30, 2021*		

A Brief Forecast

With such a strong start to the year and economic readings looking positive heading into the second half of the year, many investors and Wall Street analysts are feeling confident about the second half. There will be several topics to keep an eye on throughout the rest of the year.

The inflation topic which was discussed above, and closely followed through the first half of the year, will be a major economic indicator to be monitored. A connected but separate topic will be the Fed's ongoing guidance. The Fed has been expressing its view that the hot inflation readings seen earlier this year are transitory, being driven by labor shortages, pent up demand, and supply chain disruptions. The enhanced unemployment benefits are set to expire in September, which is expected to bring back some workers and many schools are planning for a normal school year this year which can alleviate some childcare issues. We are already seeing a shift in the way that some consumers are spending, moving from less goods to more entertainment spending. This may help lessen the demand for low inventory products. Regarding the supply chains, some of the issues are expected to last for years, but other areas can be eased within a shorter timeframe. If these trends play out inflation could stabilize, giving the Fed room to be patient with tightening monetary policy. The precipitous drop in lumber prices in June is being pointed to as an example of the transitory nature of some of the inflation concerns.

The path towards the Fed's first post-pandemic rate hike is expected to be long and transparent. The Fed's next move will be to start talking about a potential tapering of the $120 billion monthly asset purchases. The Fed will be sure to give the markets plenty of warning. The first taper could take place later this year, but is more expected during the first quarter of 2022. The Fed will ease out of the purchases, expected to reduce around $20-$30 billion per quarter, which could fully end asset purchases at the end of 2022. The next step in tightening monetary policy will be a rate hike. Based on this track the Fed will not start hiking rates until 2023, with most analysts expecting late 2023. From an investment standpoint, if the Fed follows this path, the economy will continue to look strong. If the economy begins to slow, the Fed will not continue to tighten. The caveat being if inflation is not transitory, and the Fed is tightening to get inflation under control. In normal environments the first-rate hike is a positive sign for stocks. Recent JPMorgan research showed that the market returned 18% over the following twelve-months after the Fed first hiked rates and 28% over the following twenty-four months. It is typically not the first-rate hike to be concerned with, but the fourth or fifth rate hike. In summary, the Fed's tightening may cause some short-term volatility, but historically the Fed beginning to tighten is a positive sign for the markets.

The other obvious risk to the continued bullishness on Wall Street would be virus-related. So much of the strong first half is attributed to the robust recovery but if the virus begins to spread, especially among the unvaccinated, travel and economic restrictions may be reinstated. The US has done a great job rolling out the vaccine relative to other parts of the world, but there is still a large portion of the population who is not vaccinated, and anybody not vaccinated by now may choose not to get the shot. Additionally, the global vaccination rate is not that high, which can result in continued transmission and mutation of the disease. Fortunately, most of the vaccines administered here in the US have been effective in protecting against variants. With such an abundance of vaccines available in the US, it is unlikely to see shutdowns and restrictions being reissued to protect people choosing not to get vaccinated, unless the virus begins to attack children. The other potential risk would be if a variant proves to be resistant against the vaccines, this could cause another shutdown; this does not appear likely at this time but it is a risk.

Washington often plays a role in areas to watch. With the labor shortages causing issues for many small businesses over the last several months, the enhanced unemployment benefit is often cited as a main reason for the shortage. This government subsidy is expected to expire in September, barring any further action from the federal government. We expect the unemployment readings to continue to decline as long as the unemployment stimulus expires. As of the writing of this commentary, President Biden is in the middle of a roadshow promoting the bipartisan infrastructure bill that was tentatively agreed upon during the second quarter. If the proposal is passed, the additional spending and agreement to not raise individual taxes would be a good development for the markets. The US has also led a push for a global minimum tax rate of 15% which, as of

Federal government. We expect the unemployment readings to continue to decline as long as the unemployment stimulus expires. As of the writing of this commentary, President Biden is in the middle of a roadshow promoting the bipartisan infrastructure bill that was tentatively agreed upon during the second quarter. If the proposal is passed, the additional spending and agreement to not raise individual taxes would be a good development for the markets. The US has also led a push for a global minimum tax rate of 15% which, as of this writing, had garnered support of 130 countries worldwide. The President is still pushing to raise the US corporate tax rate to 28% but it is unknown if the proposal could gain support. Republicans are adamantly against it and some Democrats are weary of the increase; if the corporate tax is increased it may not go all the way to 28%.

Broadly speaking, international markets have trailed the US markets, as defined by the S&P 500. In fact, over the last decade, the EAFE Index and Emerging Markets Index, only outperformed the S&P 500 in two calendar years, 2012 and 2017. The opportunity overseas does look attractive from a valuation perspective; perhaps the low valuations are warranted due to structural economic challenges, or maybe it presents an opportunity. With the US being ahead on the recovery, relative to much of the rest of the world and having provided a blueprint from a fiscal and monetary standpoint to follow, we may be approaching some investment opportunities overseas as the rest of the world begins too catch-up. Over the last decade the strengthening US dollar has been a headwind for US investors investing internationally, but should real rates remain low in the US along with ballooning deficits, the dollar could enter a weakening cycle.

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