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Market Perspectives **Second Quarter 2021**

Follow the money

Equity markets continued their dramatic rise this quarter propelled by a US economy awash in cash from increased savings during the lockdown and stimulus from the government. Low interest rates served as additional fuel as individuals and corporations refinanced debt. New home purchases skyrocketed as people relocated during the pandemic. These market moves are not without merit, as the Congressional Budget Office and World Bank have forecasted 2021 real GDP growth of 7.4%[1] for the U.S. and 5.6%[2] globally.

U.S. equities returned 8.2% and international equity markets returned 5.5% for the quarter.[3] Both domestic and international bond markets also had positive returns of 1.8% and 0.9% respectively.[4] Bonds typically move in the opposite direction of equities. Market watchers are somewhat puzzled by this rally. Possible explanations include fears of the Delta variant of COVID, concern about high equity valuations, inflation worries, and possible accelerated actions by the Federal Reserve.

With so much economic growth, why is unemployment still high?

To a certain extent the current incongruence between "high" unemployment, currently 5.9% and the record number of job openings can be explained by several factors. While much has been made of extended unemployment benefits disincentivizing people from returning to work, this is only part of the story. Some baby boomers accelerated retirement and many people, given time at home, reassessed their career choices and work environment. Some became less willing to spend hours commuting when remote work became an option and moved out of big cities that saw the worst of the pandemic. Parents, especially moms, needed to or chose to stay home to care for children as childcare became less available, more costly and perhaps less safe. Meanwhile, U.S. labor productivity increased 4.1% during the pandemic, the largest increase since Q1 2010,[5] reflecting technological changes that enabled teleworking and goods delivery on an unprecedented scale. It also could reflect working harder and longer to cover for absent coworkers. All this points to a labor market distortion which until it is sorted out will slow the convergence of labor supply and demand.

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[1] Congressional Budget Office, An Update to the Budget and Economic Outlook: 2021 to 2031, July 2021. https://www.cbo.gov/publication/57339

[2] World Bank, Global Economic Perspectives, June 2021.

[3] U.S. equities are represented by the total return of the Russell 3000 index and international equities are represented by the net return of the MSCI All Country World Index ex USA for the period 4/1/2021-6/30/2021. Source: Morningstar.

[4] U.S. bonds are represented by the total return of the Bloomberg Barclays U.S. Aggregate Bond index and international bonds represented by the net return of the Bloomberg Barclays Global Aggregate Bond ex US index for the period 4/1/2021-6/30/2021. Source: Morningstar.

[5] Bureau of Labor Statistics, news release, PRODUCTIVITY AND COSTS First Quarter 2021, Revised and data series ID PRS85006093.

Other Concerns Impacting Markets

The Delta and other COVID variants

There is increasing concern that the Delta variant of COVID poses a significant risk to economies trying to reopen. It is more transmissible and is spreading rapidly, especially in countries with low vaccination rates. While this is true, preliminary studies[6] have found that existing vaccines are effective against the variant and significantly reduce the need for hospitalization when contracted. The risk that is most concerning is that places such as India, which is experiencing a COVID resurgence, will spawn new variants against which the current vaccines are not effective. Another pandemic is a real concern, but its probability is harder to understand. Consequently, the ebullient sentiments being documented in recent surveys seem to be prevailing. People have cabin fever and are happy to be going to restaurants and traveling.

Elevated equity valuations

Anticipation of the reopening of economies and the influx of young investors have driven U.S. and international equity markets higher and although S&P 500 earnings have grown 19.7% year-to-date,[7] its price-to-earnings ratio (P/E) of 21.5x forward earnings is significantly above its 25-year average of 16.7. Equity markets can sustain this level of P/E multiple when interest rates are low and earnings growth is robust, both of which are true at the moment. However, high valuations may worry investors when interest rates rise quickly or earnings growth declines precipitously. Higher interest rates increase the cost of borrowing and reduce the value of future earnings. Declining earnings will increase equity valuations all else being equal.

Inflation fears

For many investors inflation has not been a risk that they have encountered in a meaningful way. The U.S. has not seen inflation above 6% in over 30 years and the average inflation rate since 1991 has been a little more than 2%. So, headline inflation hitting 5% in May, the highest since August 2008,[8] spooked some investors. A rapid increase in inflation usually pushes equity markets lower because corporate earnings and profit margins get squeezed. However, many economists and the Federal Reserve believe this is a transitory phenomenon due to the extraordinary spike in economic activity as vaccination rates rise and pent-up demand is released.

One significant contributor to inflation is wage growth, particularly at lower income levels. Wages tend be sticky, meaning they persist and represent a more permanent increase in the cost of services and goods. So, the most recent Bureau of Labor Statistics data showing wage growth of 4.6%[9] has also provided pause for some investors because we have not seen this amount of wage growth since 1983. However, this wage growth is a positive in the sense that it helps slow down the growing disparity of income and wealth. Other factors such as housing price increases, supply chain bottlenecks and record levels of savings are also contributing to inflation worries. Nevertheless, some of these factors are temporary, such as the supply chain issues and high level of savings. One

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[6] Effectiveness of COVID-19 vaccines against variants of concern, Canada, July 3, 2021. https://www.medrxiv.org/content/10.1101/2021.06.28.21259420v1.full.pdf and COVID-19 vaccine surveillance report Week 27, Public health England. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1000512/Vaccine_surveillance_report_-_week_27.pdf

[7] Source: JP Morgan Guide to the Markets, page 7.

[8] Bureau of Labor Statistics, Consumer Price Index, May 2021.

[9] Source: Bureau of Labor Statistics, Series ID CES0500000008, Annualized wage growth 6/2019-6/2021.

can also take solace in the fact that we are now most likely experiencing peak economic growth in the U.S. with Europe to follow shortly.

Where is the Fed heading?

Many eyes are on the Fed because it continues to buy bonds, providing liquidity in the bond market and is keeping short-term interest rates low. The questions of the day are 1) when will the Fed reduce its bond purchases (tapering) and 2) when will it raise the Fed funds rate? Fed Chairman Powell has been consistent in his message that rates will remain low until full employment is achieved and inflation averages 2%.[10] How the transition to higher interest rates and reduced bond purchases is telegraphed will in large part determine the reaction of both equity and bond markets. Markets usually react negatively to Fed moves it does not expect. So far, the Fed has done a good job setting expectations.

Choppy seas ahead

In summary, stimulative monetary and fiscal policies as well as ongoing COVID vaccination efforts have propelled stock markets to new heights, making equities expensive relative to historical averages. The pandemic has also created winners and losers in the equity markets, a boon for active management. In the near term, we expect:

- Outsized earnings growth will help equities grow into their high valuations and high equity prices to be supported by low interest rates.
- The Fed to keep interest rates low until there is evidence of sustained full employment and to reduce its bond buying as economic indicators normalize.
- Economies overseas to reopen and experience peak economic growth later than the U.S. that may create opportunities in international equity markets which, on a relative basis, are cheaper than the U.S.

Feelings of elation as economies reopen, cash is deployed and stocks surge higher, coupled with heightened concerns about inflation, equity valuations, low yields, Fed actions, and possible virus resurgence is a recipe for increased market volatility. Market sentiment will be pushed and pulled more dramatically as news related to these concerns comes out. Though this is an uncomfortable place to be in, it is an opportune time for active investment managers to take advantage of mispriced equities and bonds around the world.

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[10] Barron's, July 14, 2021. Powell Repeats View of Transitory Inflation, but Sharpens Focus on Expectations. https://www.barrons.com/articles/fed-chief-jerome-powell-testifies-to-congress-today-and-tomorrow-what-to-watch-51626265499