Second-Quarter 2021
American Portfolios Quarterly Market Commentary

by Chief Investment Officer Clifford T. Walsh, CFA

THE U.S. EQUITY markets had another strong showing in the second quarter of 2021 with the S&P 500 up 8.6%. Midcap returns were strong as well, up 7.5%, while Smallcap trailed in 2Q, but were still up 4% and 2%-plus ahead of the S&P 500 for the first half of the year. REITs and energy were large standouts, both up more than 10% in the quarter. International equity markets—both developed and emerging—continue to trail as vaccination efforts and, ultimately, the reopening of commerce has lagged the U.S.

Bonds were mixed in 2Q with U.S. high yield the only positive asset class (up 3.6%) among the major global classes. The U.S. Aggregate and Global Aggregate Bond Indices were down 1.6% and 3.2%, respectively.

INFLATION

There was no topic discussed more in the financial markets in the second quarter than inflation and the Federal Reserve's (the Fed) likely response. In May, we saw the largest jump in inflation since 2008 as the CPI increased again, spiking to 5% over the past year. Many investors focused on the government stimulus, the oversized budget figures and the infrastructure package as drivers of potential runaway inflation, but we do not believe that any of these are the real drivers behind the numbers we've been seeing on the inflation front. Instead, the rise in inflation is coming from the combination of the economic shutdown, inventory reductions, out-of-whack pricing comparisons and temporary supply/demand imbalances as the economy reopens.

A deeper dive into the components of the CPI illustrates our view. A global chip shortage—another result of the economic shutdown—has driven used car prices up 30% because new car production has been constrained by the shortage of this key component. This is an example of a supply shock that will work itself out as production comes back online; this is hardly a long-term driver of higher prices, but it manifested as such in the May 2021 data.

Gasoline prices were up 56% in May, year over year, highlighting not only supply constraints as the economy reopens, but the ridiculous nature of comparing any pricing data to a period when 70% of the economy was shut down. Oil price futures literally went negative in the midst of the pandemic panic. One must consider the deflationary period we are comparing these recent numbers against. Not to mention, many prices across the economy are still below 2019 levels. Airline prices are up 24%, but still below prices prior to the pandemic. This spike drives the CPI higher, but we ask, is that really inflation or is it the result of wacky comparisons of prices in an industry group that was virtually nonexistent in May of 2020? The same can be said for car and truck rentals, which were up 110% in May. One has to question whether or not these large moves are not only likely to continue at their current rates to maintain current

inflation rates, but even if they will hold these pricing levels as supply comes back online. Prices are filling gaps from the economic shutdown. They are not breaking out higher because of any other reason. As such, we believe that the spike in inflation is transitory and has likely peaked. The breakeven on five-year TIPS has dropped from 2.72 in mid-May to 2.49 at the end of June. We expect this will continue to drop and that all of the hyperinflation rhetoric will fade.

THE FED

What does it mean if inflation has peaked? It means the Fed's recent "hawkish" move on the dot plot—forecasting interest hikes as early as the end of 2022—is likely not going to prove to be accurate. To review, after signaling at the March Federal Open Market Committee (FOMC) meeting that rate hikes would be on hold until 2024, the Fed reversed course on the heels of the May CPI data, indicating an expectation of two rate hikes by the end of 2023. As of this writing, 13 of the 18 officials expect at least one rate hike by the end of 2023, with 11 officials seeing two hikes by the end of that year. Fed Chairman Jerome Powell signaled his vote for one hike by the end of 2022.

The Fed's reversal spooked the markets, at least temporarily, putting downward pressure on equity prices. However, bond shorts were seemingly caught by the most surprise, spurring a significant rally in long-dated U.S. Treasuries.

Overall, we think the Fed is a long way away from raising rates. We do not expect to see any hikes during the next 18 months, at least. We've already made the case for inflation returning to normal levels. Unemployment rates are still well above levels that should cause concern at the Fed, although job gains could come rapidly as unemployment insurance runs out. Still, we expect it to take some time before the job market returns to normal and creates conditions for lasting wage gains.

THE FED FALLOUT

If the Fed doesn't raise rates and inflation will normalize, is it all systems go for equity prices? Before assuming that all is clear for equity prices to move higher or that long-duration bonds will sell off, we note that much more likely than interest rate hikes will be balance sheet tapering. The massive spike in the overnight Reverse Repurchase Agreement (RRP) market could be the start of ongoing tapering. It is something to watch closely as it drains liquidity from the financial markets, not to mention can create imbalances, which increase the risk of counterparty mishaps. Furthermore, current equity valuations are also likely to provide a ceiling for prices.

It has always been our view that balance sheet tapering would come before rate hikes, and it will take significant time to do so. We expect more clarity on the Fed's tapering plans in August following the annual Jackson Hole policy retreat.

TOLLS AND TAXES

During the second quarter, there was significant geopolitical activity in D.C. and abroad, most importantly in U.S. infrastructure and global taxes. With respect to infrastructure, a deal was struck that would finance a range of construction and infrastructure programs, including the largest investment in public transportation in U.S. history—including repairs to roads and bridges—and the expansion of broadband internet service, among other areas. The deal still has to be passed by Congress, a sizable hurdle despite the handshake agreement in place. Democrats appear to be tying their votes to the American Families Plan, which has very little support from Republicans. While a boost to economic growth is likely should the bill pass, given the long lead time of such projects, we would not expect to see any meaningful economic expansion until 2023.

As far as taxes are concerned, G7 finance ministers agreed to pursue a global minimum tax rate of at least 15% and to allow market countries to tax up to 20% of the excess profits—above a 10% margin—of around 100 large, high-profit companies. The G7 deal likely would mean higher overall tax bills for many of the biggest tech companies, with more of the payments potentially going to countries in Europe and less to the U.S. Counteracting this somewhat would be the removal of digital-services taxes that have been applied to big tech companies in the past couple of years in several European countries.

The G7 deal could expand to include the larger G20 group of nations, followed by the Organization for Economic Co-operation and Development (OECD), a group of mainly wealthy nations that has led tax negotiations for quite some time. This is potentially pretty significant; given that the top five stocks make up roughly 20% of the S&P 500, this could knock off up to 5% of market value for some at current valuations.

We will continue to watch as the details come into focus and lobbyists weigh in. The U.K. is already pushing for financial services firms to be exempt. And right now, this deal wouldn't include Amazon because they don't earn that 10% margin overall. However, we could see a push for business segmentation to tax profitable parts of the business individually, meaning Amazon's web services will be taxed regardless of whether or not retail sales turns a profit. This would make it more difficult for companies to avoid the tax. Without segmentation, I would expect businesses to rejigger their operations to offset profits against loss-making units to remain under the 10% threshold.

A lot still needs to be done for this to happen, but it is worth keeping an eye on as it could put downward pressure on after-tax earnings and valuation multiples.

THE U.S. DOLLAR, COMMODITIES AND OVERSEAS MARKETS

The U.S. dollar, which has been languishing for years, is starting to show some life. It recently formed a triple bottom and broke above its 200-day moving average on the heels of the last Fed meeting. We think the breakout could run higher in the short term, which would put pressure on oil prices. However, we don’t think it will be a runaway breakout, but the move higher is significant from a technical and psychological standpoint. This could be a potential headwind for oil prices, one of the few commodities that have held its recent gains.

While we expect the broader commodity complex to continue to retreat as the economy reopens and the speculative frenzy wanes, we are not convinced the U.S. dollar will have a lasting negative impact on commodities and overseas markets as the reason for the breakout appears to be the expectation for interest rate hikes occurring sooner rather than later—a premise we do not agree with. However, with a solid bottom seemingly in place, we don't believe it will be a boon to beneficiaries of a weak dollar either.

PUTTING IT ALL TOGETHER

Given that inflation has likely hit its peak for this cycle and economic growth is starting to normalize and, perhaps even, fade in the fourth quarter of 2021 and into 2022 following the removal of government unemployment support, we no longer recommend a tilt to value over growth equities. We think growth has the potential to lead, at least until long-duration bonds bottom, but the segment's outperformance could continue beyond that depending on how scarce or abundant growth is at that time.

As we look forward to the next 18 months, we foresee a roller-coaster ride of economic activity fueled by ebbs and flows of government stimulus and spending. We are not overly concerned about mutating COVID-19 variants at this point, so the economy should continue to normalize. However, with already-high valuation multiples, near-zero interest rates and more volatile earnings streams given the government dependence, we question how much more equity prices can rally—especially considering the possibility of Fed balance sheet tapering—if it hasn't already begun with the recent jump in the RRP market.

As such, we continue to believe that one's investment focus should become increasingly thematic and more selective than in the past because the equity markets, and financial assets in general, have become extended. Broader asset prices don't reflect the mid- to long-term economic outlook because the financial markets have been boosted by unprecedented fiscal and monetary policy stimulus, requiring nimbler and more focused asset allocation down to the industry and stock levels. While valuation is not a reliable timing tool, current levels suggest limited long-term gain potential based on history.

We also look to fade inflation, considering how much bad news is factored in for bonds: massive inflation chatter, huge recent increases in commodity prices, record money supply growth, double-digit GDP growth, infrastructure stimulus and wage increases. Long-duration bonds continue to look attractive here for capital appreciation potential.

We'll see how this all plays out in the coming months. We suggest examining the June and July CPI components as they are released, as well as the Fed's comments coming out of its August policy meeting for hints about its tapering plans—both of which are likely to be outsized drivers of the financial markets in the back half of the year.

QUESTIONS AND COMMENTS

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