



## **U.S. Markets Follow Fed Head to New Highs as Delta Variant Continues to Rise July 2021**

My Dear Client:

Most years the adage for the second quarter is “Sell in May and go away” – meaning reduce (sell) equities and then go off to summer vacation until Labor Day. Well, the combination of actions/inactions by the Fed chair Powell, some positive and negative economic indicators, proposed infrastructure spending and angst about the delta variant of COVID-19 pushed the Dow Jones, Standard & Poor’s 500 and NASDAQ to all-time highs.

The U.S recession officially ended in April after two consecutive quarters of positive GDP growth, even as the world continues to recover from the pandemic. Expiring public capacity restraints and expanding vaccine rollout campaigns are accelerating business activity towards pre-pandemic levels. Manufacturing and services output reached all-time highs, while the red-hot housing market saw new home sales approach levels last seen in 2006.

Around the globe, risk on markets climbed in 2Q21. U.S. equity indices set new highs as the planned fiscal spending rolled on and new spending was proposed, with the S&P 500 rising 8.6% in Q2. International equities, while lagging U.S. also ended higher as the MSCI ACWI ex-U.S. gained 5.6% for the period.

Changing course from prior quarters, Value stocks (+5.2%) underperformed Growth (+11.9%) across all asset sizes except Small, where Value slightly bested Growth. Small Cap as a whole (+4.3%) considerably trailed Large Cap (+8.55%). Some would say this shift means the value trade has ended, but the factors supporting Value and Small Cap still appear intact.

Thanks to effective jawboning by Mr. Powell and some other members of the Fed along with upwardly revised corporate earnings and avid discussions about “transitory” inflation expectations, U.S. 10-year Treasury yields reversed course from their highs of last quarter, ending June at 1.34%.

Still, not every economic statistic is favorable. Job creation was well below expectations, as 15.6 million (about 70%) of the 22.4 million jobs loss last spring have been recovered. The roughly 6.8 million still unemployed are beginning to impact the country, as worker shortages are rampant in multiple industries.

The Fed gave no immediate indication of tapering asset purchases, and a stimulus-driven demand for goods and services stress-tested the supply chain. Furthermore, inflation fears and an extremely low-yielding bond market limited choices for investors. This all means that today the



Fed is providing very high levels of liquidity and markets are still responding, so the chase for yield and riskier potentially higher-returning assets continues.

While fiscal support is undoubtedly one of the bullish cases for buying risk assets, increased government spending has begun to stir inflation fears. Five-year forward inflation expectations closed 1Q21 around their highest level since 2008. We should also keep an eye on the frequent euphoria around the newer list of non-traditional assets. Time will eventually show if their public adoption was the beginning of the end (a bubble) or the start of a multi-year stock market climb.

### Domestic equity market



The second quarter of 2021 was reminiscent of 2020 or before, with Growth style investing outperforming Value. Simply, Large and Mega Cap stocks' names did better than smaller cap names, turning last quarter on its head. Large Cap growth dominated all domestic style box categories with +11.9% for the quarter.

In a flashback to 2020, the capitalization sizes mattered for growth: the larger the size, the better the returns for the period. Large Cap broadly was up 8.6 % for the quarter, while Small Cap Growth was up the least of all style boxes, at 3.9%, during the second quarter. The inflation, Fed action and even delta variant are mentioned as influencers on U.S stocks this quarter. As I discussed last quarter, however, fervent desire by Americans to return to normalcy still appears solid. Expect investors will continue to believe earnings will grow, economic activity will continue to return to form and, while no longer cheap, smaller caps have a longer opportunity set than larger cap.

The volatility this quarter did not interrupt the markets' generally moving higher, but it did create an interesting assortment of winners within the 11 S&P sectors. We saw divergence in performance among sectors representing value and cyclical, interest and inflation sensitive and defensive stocks.

Real Estate (+13.1%), Information Technology (+11.6%), Energy (+11.1%) and Communication Services (+10.7) led the charge, all up double figures in Q2. Health Care (+8.4%), Financials (+8.4%) and Consumer Discretionary (+6.5%) all had very strong quarters, reflecting continuing consumer, housing, and retail strength plus bank loan losses were less than initially projected. Materials (+5.0%), Industrials (+4.5%) and Consumer Staples (+3.3%) were all decidedly positive during the quarter. Defensive sector Utilities (-.4%) brought up the rear as the only (barely) negative performer, which is a bit surprising since falling treasury yields could have led to investors scoop up higher-yielding utility stocks.

Many now forecast \$200 earnings per share (EPS) for the S&P 500; this implies the PE is 21.5x, 28% higher than the average trailing PE since 1978. Provided the long-term real interest rate

remains below or close to 0%, these valuations appear sustainable if supported by Fed liquidity helping drive earnings growth.

That we saw value-Energy and growth-Information Tech, along with interest/inflation sensitive-Real Estate and cyclical-Communication Services, as the leading sectors indicates a broadly rising market in Q2 and that the cross-current stories of inflation, Fed, value or growth, return to normal and end of pandemic are still being written.

### **International markets**



Both Emerging (+5.7 %) and Developed (+5.0%) International equities were solidly positive on the quarter, although once again lagging their domestic counterparts. Here the acceleration of the delta variant's proposed and implemented COVID-19 mitigation protocols, China regulatory action with its Large-Cap tech stocks and a firming dollar (USD) continue to cause International to lag its torrent pace of 2020.

Market leadership overseas was the same as domestic, with the Growth style leading Value style growth and leading Large Cap growth investing outpacing Small Cap for second quarter of 2021.

From an emerging markets perspective, China continues to rightly grab all the headlines compared with other countries, as the world's second largest and typically fast-growing economy should.

Indulge me this quarter as I focus on the Developed side, in particular, by mentioning a name that dominated headlines from 2016-18 and now is barely discussed: Brexit. From June 23, 2016, to June 23, 2021, the MSCI All-Country World Index rose 80.65%, yet the MSCI UK Index is only up 8.13% (based on price returns). The underperformance here is strikingly significant and seems to reinforce the doubts many raised about the lack of positive benefits to the deal.

Further:

- Britain's international trade has declined 14% since 2018, while total world trade declined a about 8% during the same period.
- London has been slowly losing its status as the financial capital of Europe, with banks continuing to shift employees to other European cities.
- Britain has been facing labor shortages similar to what we are seeing here in the U.S., without the ability of EU workers to enter the country and fill jobs.

While it's too early to call Brexit a disaster, it clearly is not a triumph and is absolutely self-inflicted. Advocates now point to proposed pro-growth policies that will improve and grow investment and of course lower taxes. Still, I wonder if you have an aging country with declining/negative birth rates and you encourage the people with growing birthrates and consumption to leave while aggressively limiting/discouraging others like them to join your country... Won't you become Japan, which has been in a sideways-at-best spiral since the 1990s?

## **Bond markets**



The broad U.S. bond market, measured by the Bloomberg Barclays Agg Index, rose 1.8% in 2Q21 as rising rates paused with the acceptance by many of the phrase of the quarter: “transitory inflation.” The shift in expectations led to a dramatic move upward for fixed-income markets: Long-duration and

high-quality debt soared. The Bloomberg Barclays US Government Bond Long Index was up 6.43%. To put that in perspective, in 2Q21 it performed as well or better than five of the 11 S&P 500 sectors during a quarter where the S&P 500 touched an all-time high.

All areas across the fixed income landscape were positive, with inflation interest rate-sensitive bonds leading the way. Behind the Long bond this quarter came U.S. TIPS (+3.25%), followed by the High Yield Corporate bond index (+2.7%). As one would expect with the upward move and leadership of these areas in the bond market, Short-term world and U.S. government bonds were basically flat for the second quarter.

The downward move in rates had some market participants like Scott Miner, CIO of Guggenheim, and Cathy Woods of ARK Investments fame talking about a coming deflationary environment. With Mr. Miner opined in a recent call with investors that the Fed is now squarely in a box of their own creation where interest rates must stay low because a) when they talk of raising or do raise them, a market tantrum meltdown occurs; and b) the federal government is on track to hit a new record high debt-to-GDP ratio by the end of fiscal 2021, even higher than in the aftermath of World War II. So, the massive debt level means the Fed will never reduce its balance sheet or raise interest rates because the U.S. government simply can't afford it.

The final size of the traditional infrastructure bill, along with the proposed human infrastructure spending and the monthly tax credit benefit, will have a huge say in the magnitude of debt and deficits in the US. The fascinating tug-of-war I previously talked about is getting closer.

In particular, a sharp rise in inflation could result in higher interest rates and higher taxes and ultimately set the stage for an economic relapse. With surging labor demand and a higher cost of

low-wage labor due to enhanced unemployment benefits, employers have had to raise wages to lure people back to work. This is critically important for the Federal Reserve, as higher wages could lead to inflation that is less “transitory” than the Fed currently expects. Of course, the question is, can or will they raise rates to check inflation?

## **A Look Ahead**



The U.S. economy demonstrated historic growth in the first half of 2021. While expectations remain strong, the economic impact of the U.S. vaccination and reopening campaigns have largely been met, suggesting that peak growth is likely in 2Q21 or this summer.

During the second quarter of 2021, it seemed that every economic data point or comment from a Federal Reserve official resulted in a meaningful move in interest rates and, thus, sector rotations. These rotations coincided with constantly changing investor perceptions on whether inflation might be sticky or transitory.

Despite the risk of a rising interest rate environment, we are still in an historically low-yield environment. Value investing doesn’t need inflation to work, yet if inflation is not transitory, historically higher inflationary periods were a good backdrop for value.

The Fed seems to determine to continue to force a move from bonds to stocks over the coming quarters. The market has basically gone straight up for 15 months; a correction would appear overdue, and the longer we wait the more powerful it should be.

*There’s an old saying: When the Fed is not worried about inflation, the market should be worried.*

My portfolio recommendations, consistent with those of the past year, offer further adjustments to enhance your asset allocations. Maintain a risk-balanced focus, multi-asset class approach and evaluate opportunities and be ready to invest when larger short-term declines occur. Consider:

- Maintaining overall equity allocation to portfolio targets and below maximum range;
- Raising cash from Large Cap growth stocks and private U.S. equity distributions for increasing investments in Emerging and International stocks;
- Increasing allocations to Small Cap and Mid Cap;
- Underweighting overall fixed-income portfolio allocations and maintaining diverse high-quality bond portfolios paired with proven opportunistic credit strategies for yield;
- Seeking niche, opportunistic and secondary illiquid private investments, including VC and Co-Investment;





- Real Estate opportunities in private and public space (logistics, warehouses, data centers, etc.), along with Infrastructure; and
- Continuing prior asset allocation adjustments in public equities, further rebalancing – and when assets aren't cheap, cash inside your portfolio is still a good idea.

We will maintain disciplined, pragmatic approaches and patience to strategically deploy capital, riding the Fed's wave without reaching for extra risk to your portfolio to meet our long-term objectives and goals.

Lastly, many investors' interest in the "E" for environment ( "S" for social and "G" for governance) of ESG continues to grow. Please know that this has and always will be a deep part of our firm's DNA that we can happily talk about at length.

It is a pleasure to serve you, and I look forward to continuing our work together. Stay safe and healthy.

Appreciatively,  
*Walid L. Petiri*

Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board, Guggenheim Investments.