BFS AdvisoryGroup

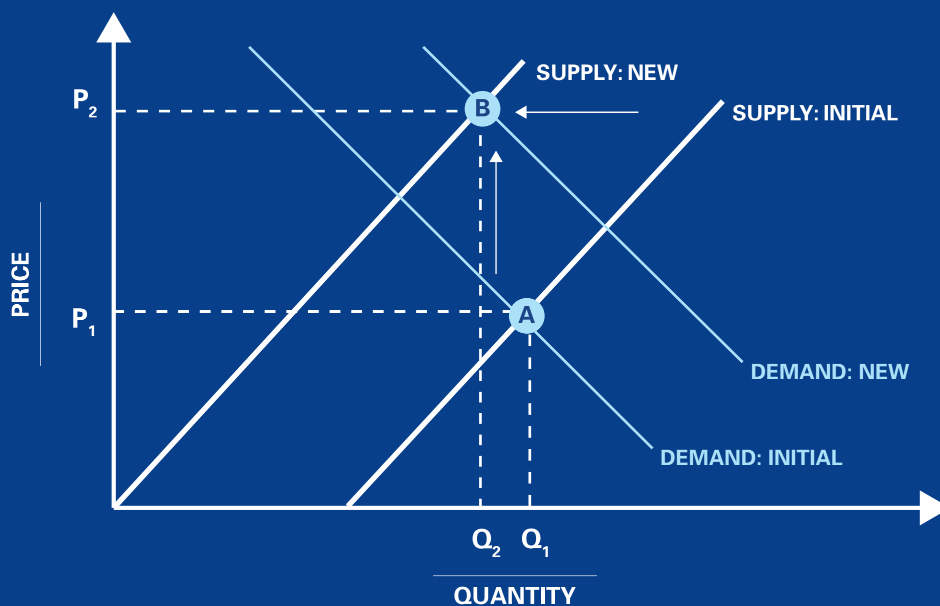
RISKS *and* OPPORTUNITIES

MARKET REPORT / SECOND QUARTER 2021

The fundamental landscape of the second quarter featured strong economic data and a friendly interest rate environment, both of which tend to be positives for financial markets. However, we also saw an increase in concern about the relationship between supply and demand that could challenge the high valuations we are seeing in many asset classes. Stories of absurd prices for goods, as well as delays in delivery times, abound these days. The result is a disconnect between what consumers want to buy and what they can buy at prices they want to pay. The question is how long will it be like this? That leads us to the theme of this edition of *Risks and Opportunities: "Econ 101 - How Supply and Demand Create Inflation."*

On that note, we will start with a quick lesson in inflation - trust us, this will make the rest of the report easier to understand. In economic theory, one of the primary models used to determine price is the relationship between supply and demand. In short, as supply shrinks, prices can go up. If demand rises, that also causes prices to go up. In a normal economy, there is an ongoing dance between supply and demand that results in prices that consumers desire to pay *(see Point A below).*

What we are seeing worldwide right now is elevated consumer demand, coupled with a supply chain that is riddled with all sorts of problems, from a labor shortage to backed up shipping channels. As you can see in the graph below, Point B is what has happened in many industries: a spike in prices. Inflation is a measure of the rate of rising prices, and will be a hot topic in the media for the next few months. While many news articles will bemoan inflation, it is inherently neutral and is generally seen as a positive sign of a healthy economy. However, some of the current price spikes are unsustainable and are therefore causing questions about how long the current rate of inflation can go on, and the effect it may have on the economy, companies, and the consumer while it is here. Even as the supply and demand curves continue to intersect at different points, the unfortunate resurgence of COVID adds another layer of uncertainty for consumers at home and around the world. We have highlighted below how these forces may push and pull on each other over the coming months.



THE GLOBAL LANDSCAPE

RISKS

- Limited access to the vaccine in some countries may delay or prevent herd immunity and allow for new variants to develop
- The supply chain has significant and varied challenges, which is limiting economic activity and creating inflation
- Vaccine concentration in developed countries may limit robust global recovery
- Inflation settles in longer term

OPPORTUNITIES

- Countries with extensive vaccine rollout and adoption are showing positive economic growth
- Potential for many more people to be vaccinated worldwide
- Broad-based coordinated fiscal and monetary support continues around the globe, with potential to create expansion through 2023
- Supply/demand forces that limit current economic activity may create longer term recovery

The theme of the K-shaped recovery from COVID marches on. Developed countries with access to high numbers of vaccine doses and the distribution capacity to vaccinate efficiently have seen a rapid economic rebound. Less developed countries, with limited capacity to vaccinate, have not. While the intense spread of COVID in India has subsided, and countries including Canada and England are beginning to relax travel bans and quarantine requirements, the current uptick in COVID may stall some of the cross-country economic activity – particularly in travel – that we are all waiting for.

If the world were still hunkering down like last year, this may not cause significant issues. However, we are a global community, and the US relies on international trade partners to provide supplies for the goods we consume. Even if developed countries in North America and Europe have vaccination rates over 50%, if emerging markets are well under that rate, the coronavirus can continue to cause problems in the global economy for the foreseeable future. The real unknown is how the variants will continue to evolve, when they will show up in various countries, to what degree, and what effect that will have. The pandemic is already causing labor shortages, which - along with natural disasters, shortages in raw materials, and shipping delays - have snarled the global supply chain. We anticipate that the supply and demand forces will continue to shift more significantly than normal for the coming 12-18 months at least.

The overall environment of low interest rates and continued fiscal spending is supportive for global economic growth through next year. According to the International Monetary Fund (IMF), "the global economy is projected to grow 6% in 2021 and 4.9% in 2022." This forecast is based on a reduced expectation of growth in emerging countries, but a higher growth outlook for developed countries.

We continue to have a pro-risk view, which means that we are positioned for maximum exposure to the stock market as determined by risk level in our portfolios. We therefore have the lowest level of exposure to bonds, and continue to be positioned conservatively in our bond allocation. We trimmed our overweight in US equities vs international, based on our belief that the international markets are on the precipice of an economic recovery like the US has seen in 2021.

INTERESTING NOTE:
Vaccination has proven highly effective at preventing symptomatic infections from the new Delta strain of Covid-19, and more importantly, at preventing hospitalization (97% of patients hospitalized due to Covid-19 are unvaccinated). While about 125,000 fully vaccinated Americans have tested positive for Covid-19, that number represents only 0.08% of the 165 million fully vaccinated.

THE US LANDSCAPE

RISKS	OPPORTUNITIES
• Vaccine distribution thus far is not wide enough to produce herd immunity, which may create pockets of restrained economic activity • Inflation is spiking in certain parts of the economy, and may become sustained • Employment market is tight, which may create wage inflation • The supply chain has many challenges, especially when coupled with American consumerism • Valuations are high in the real estate, stock, and bond markets	• As more Americans get vaccinated, more Americans can return to work and spending • Consumer demand is high, and can persist as the supply chain issues get worked out • Savings levels remain high, which will allow for future spending • Bank and business balance sheets are healthy • Interest rates are very low and will remain low, making borrowing less expensive • The bipartisan infrastructure deal is advancing through Congress

The economic story at home is similar to the global economic growth story: we have a very accommodating environment that allows for substantial growth through the end of 2022 at least. The American consumer ups the ante a notch, providing high demand, immediacy in buying decisions, and a willingness to spend our cash. According to Barron's, "Personal consumption expenditures were up 18.9% in May from a year ago...The consumer is in good shape. The housing market is strong, and manufacturing is doing well."

The current question is how long this positive momentum can persist. The US Bureau of Economic Analysis (BEA) reports that US Gross Domestic Product increased by an annualized rate of 6.5% in the second quarter. Not surprisingly, the Cleveland Fed's Probability of Recession in 1 Year is less than 6%. Even with this as our backdrop, we should expect that our recovery is going to be bumpy, and that temporary setbacks are part of the process. What is more likely at this point is that the massive increase in new savings will propel consumers to continue buying for at least 1-3 years. This can be a boon for goods and services, as well as the housing market. Despite the massive run-up in prices over the last year, the demand for new homes remains high, and supply remains low, setting up a strong multi-year housing cycle.

While the Fed remains committed to keeping interest rates low for now, they can't ignore inflation. There is no indication that the Fed will raise rates in the next 2-3 quarters, but they may need to update their timeline to increase rates if inflation appears to be "settling in." The Fed's real job is to keep our economy growing, which means encouraging an environment that is sustainable. Many of the current spikes in inflation which have been in the news all year are expected to be transitory. The most obvious example is lumber, which had an unsustainable rise in price earlier this year, only to tumble in July under the pressure of increased supply and (slightly) decreased demand.

The most interesting story right now is the labor market. Employees have had time to consider what they want out of their lives and therefore their jobs. Employers are being forced to provide incentives from higher wages to bonuses and other perks just to get employees to return to work. Still, we are seeing both high levels of jobs available and people seeking jobs, as there is a significant disconnect between what employers want employees to do, and what employees want to do. Wage growth is "sticky" – meaning it is hard to reverse. This will be a key component in the Fed's thinking.

When the Fed decides to increase rates, it will be because the longer term trends indicate that it is the right thing to do to keep our economy growing. Perhaps the US vaccination rate will increase to a level that we will no longer have COVID constraining the economy, which would allow the economy to truly heal and strengthen. Or maybe the forces of supply and demand can't control prices, and inflation really settles in. Whatever the case, the Fed will raise rates with an eye towards continuing the current expansion, not stifling it.

INTERESTING NOTE:
Real estate plays an important role in portfolios – not only as a diversifier, but as a hedge against inflation. Under improving economic conditions, and with higher prices across the economy, landlords and property operators generally have the ability to raise rents. Many long-term leases for office, industrial, and retail properties contain built-in increases that are tied directly to inflation. As demand recovers, and rents and occupancy rise, so too do property income and asset appreciation, which drive returns for investors.

US BOND MARKET & THE FED

RISKS	OPPORTUNITIES
• Interest rates could spike in the market, in response to inflation, which may cause more volatility in bond prices • Speculation about the Fed changing course may disrupt the bond market • Inflation decreases “real returns”	• The Fed is committed to keeping interest rates low for the near- to mid-term • The municipal bond market is seeing increased demand due to expected increases in taxes • Corporations and municipalities have high levels of cash and are well-positioned, lowering the risk of default • The yield curve is healthy

The Fed’s impact on the bond market will be significant over the coming months and years. While growth is good for the economy, it can cause a rapid increase in inflation, as noted above. High inflation has historically been controlled by the Fed increasing interest rates. The current Fed stance is to let inflation run above 2% if the economy is still growing, but this is a new paradigm. In a vote of confidence for the economy, the Fed announced in July that it will likely start to reverse its bond-buying program in January and is targeting increased rates no sooner than 2023. However, even speculation that rates may increase sooner than expected can cause the bond market to move around. This type of market particularly calls for diversification in bond portfolios.

Municipal bonds are showing resilience this year, especially after receiving COVID related support over the past year. According to JP Morgan, “the American Rescue Plan alone has an approximate $650B in municipal related support.” Concerns over rising taxes also attract high income investors to this sector of the bond market. These investors use the tax-free income that most municipal bonds provide as a key tax strategy.

INTERESTING NOTE:
US interest rates are among the highest in the developed world, which is helping to attract considerable foreign investment. The current 10-year yields are as follows: US 1.47%; Japan 0.05%; Germany -0.21%; Switzerland -0.25%.

US EQUITY MARKET

RISKS	OPPORTUNITIES
• Certain industries may see a drop in profits if inflation persists or settles in • If demand is driven by a COVID recovery, low vaccination rates may stall the consumer demand many companies need. • Anticipation of higher corporate taxes • Possible increase in interest rates	• Continued spending by the government, consumers, and businesses • Corporate earnings are robust • Persistently high consumer demand • Low interest rates are expected to continue, keeping borrowing costs down • Potential infrastructure spend by the government

The US stock market continued to be buoyant in the second quarter, pushed up by strong corporate earnings. While the broad market returns have been solid, the trends have shifted significantly over the past year. In 2020 we saw the Covid Beneficiary theme (growth, technology, e-Commerce), followed by the Re-Opening theme (value, cyclicals, travel, energy) at the top of the year. Now there appears to be an opportunity for both growth and value to complement each other as we move towards consumers both spending and being cautious as needed due to COVID. With so many unknowns, especially in the supply chain, investors would be wise to seek high quality companies, as opposed to riskier options.

Despite so many positives for US companies, many are asking when we will see a sell-off. As usual, the answer is that no one knows, but it is part of normal and expected stock market activity. Even minor sell-offs haven't lasted long this year since there is so much cash on the sidelines that gets put to work in the market dips. US stock investors who have been rewarded with above average returns over the past year should also expect more normalized rates of return going forward.

INTERESTING NOTE:
Trading of cryptocurrency continues to be a topic of interest in the media and to adventurous investors. This chart shows the incredible Bitcoin price increase, followed by a substantial drop in May. It dropped 52.84% from its high, wiping out trillions of dollars in single days. Only investors with very high risk tolerance can handle swings this big.

OUR FINAL THOUGHTS

While we are troubled by the current escalation in COVID cases, we continue to look beyond this immediate surge to the likely outlook for economies and financial markets around the world over the long-term. It's clear that COVID will leave a lasting change, in obvious places like the workplace and pharmaceuticals, and possibly in less obvious places like consumer preferences and behavioral finance. We find that to be fascinating.

Every day for investors presents risks and opportunities. The whole world has a heightened awareness of risk right now, and there is work to be done to get back to a place where we have a "normal" amount of supply to meet consumer demand. We should expect it to take time, and we should expect some surprises throughout the recovery. We should also expect to be invigorated by the opportunities – new businesses, new markets, new products – that develop along the way.

We appreciate the confidence and trust that you place in us, and we are dedicated to helping you pursue your long-term goals. If you have any questions about our views on the markets, or about your portfolio, please contact us. We're here for you.

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August 13, 2021