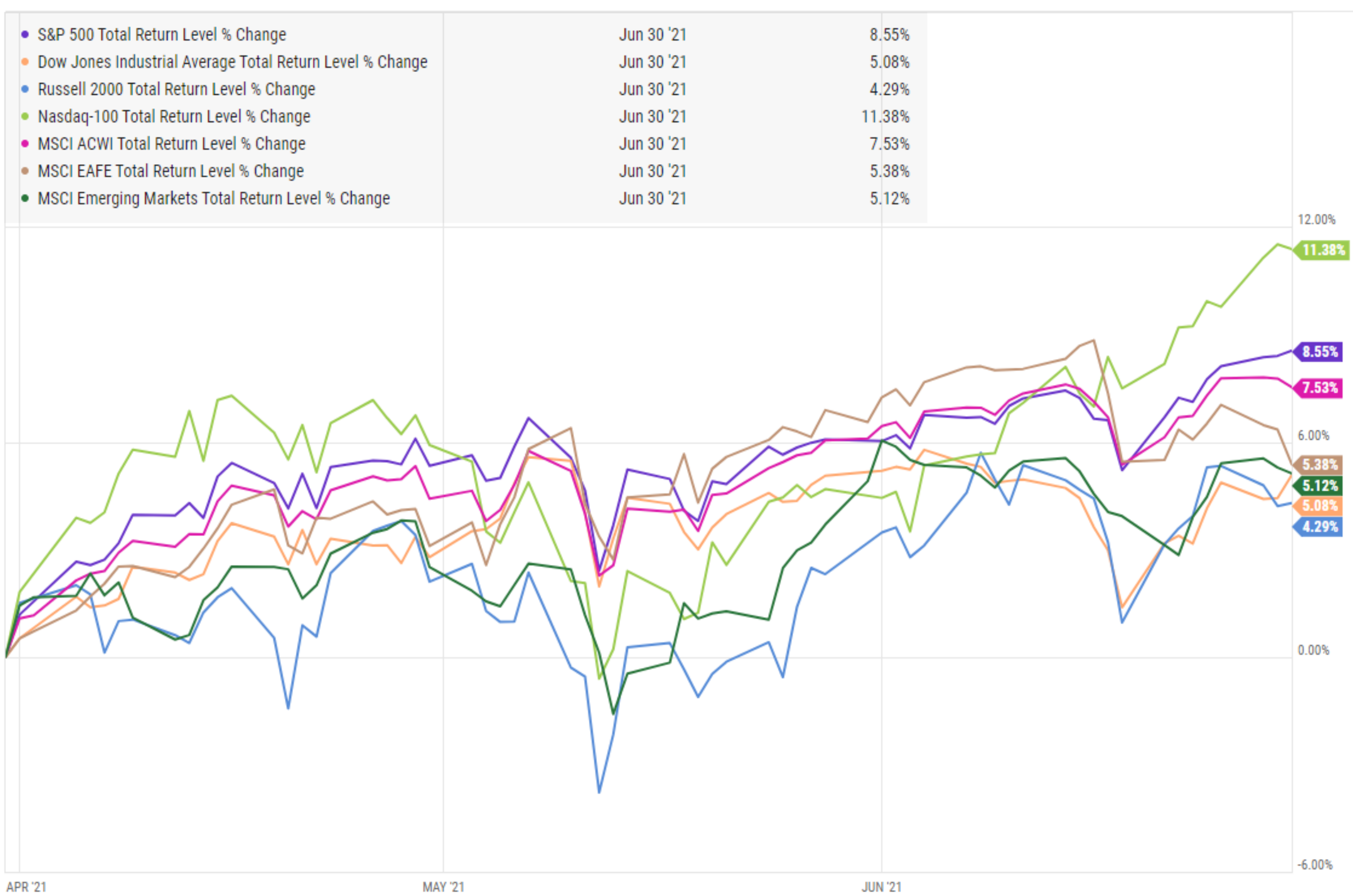
Markets

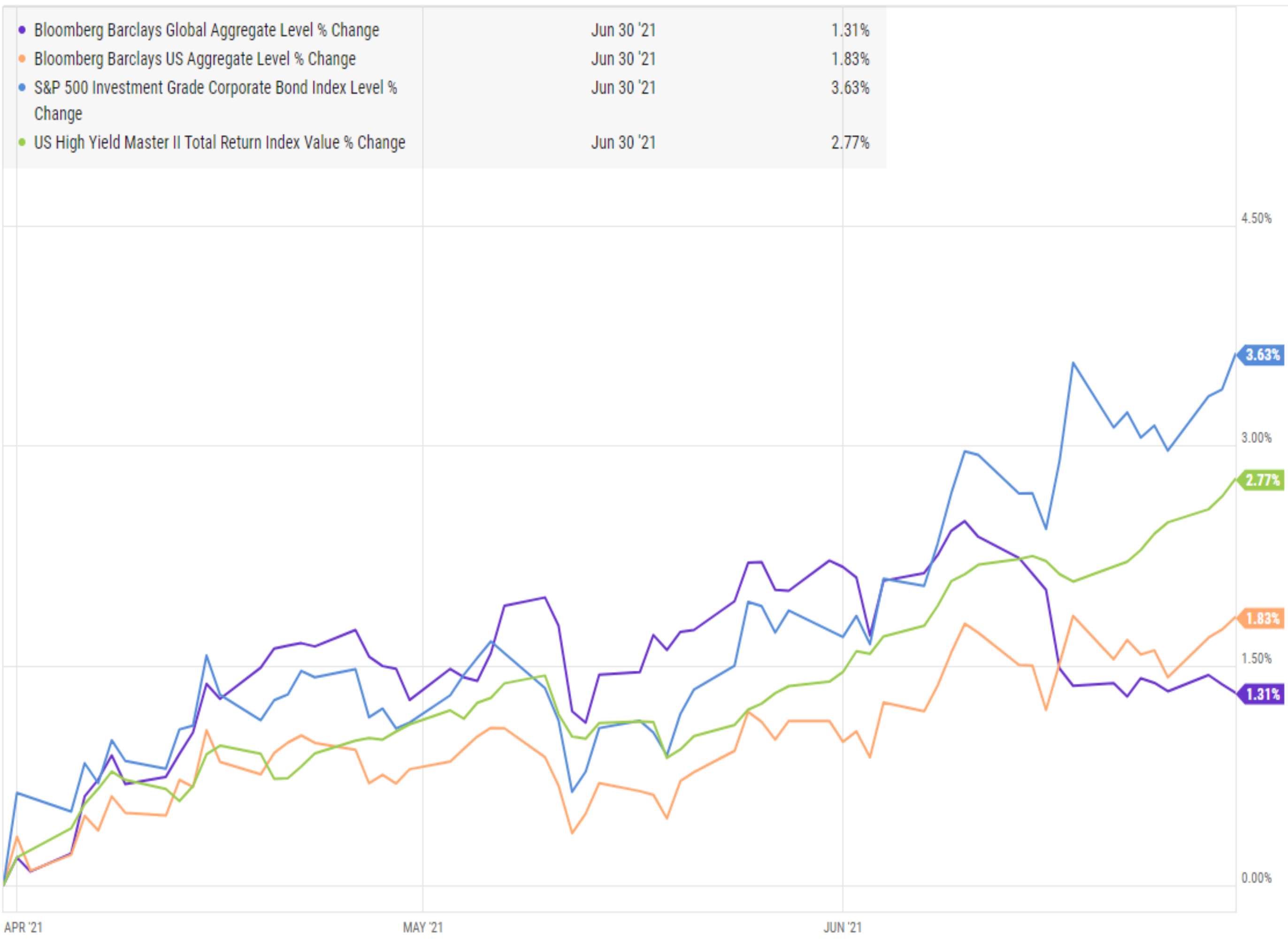
For the three months ending on June 30th, the Nasdaq 100 led by a large margin in the various broad-based indices shown below, ending the period up 11.38%, bringing the index's YTD gains to 13.34%. The next largest earner for the period was the S&P 500, which ended Q2 up 8.55%, bringing YTD gains to 15.25% and a stunning 34 record closes so far this year. Continuing with domestic indices, the Dow Jones Industrial Average ended the quarter up 5.08%, bringing YTD returns to 13.79%. Small cap equities experienced a significant cool-down during the quarter, as the Russell 2000 ended the period up 4.29% with YTD gains above all other observed indices at 17.54%. On the international side, the MSCI ACWI posted gains of 7.53% for the period, ending up 12.56% YTD. This compares with the MSCI EAFE index which finished the second quarter up 5.38% and ended the first half of the year up 9.17%. Finally, the MSCI Emerging Markets index ended the quarter up 5.12%, bringing the index's YTD gains to 7.58%.



Source: YCharts

Turning to fixed income markets, the yield on the 2-year Treasury note fluctuated within the range of 0.13-0.27% before ending the quarter just slightly below its high mark at 0.25%. The longer-dated portion of the curve reversed the steepening experienced during the first quarter as the yield on the US 10-Year began the quarter yielding its high point for the period at 1.69% before ending at its low point of 1.45%.

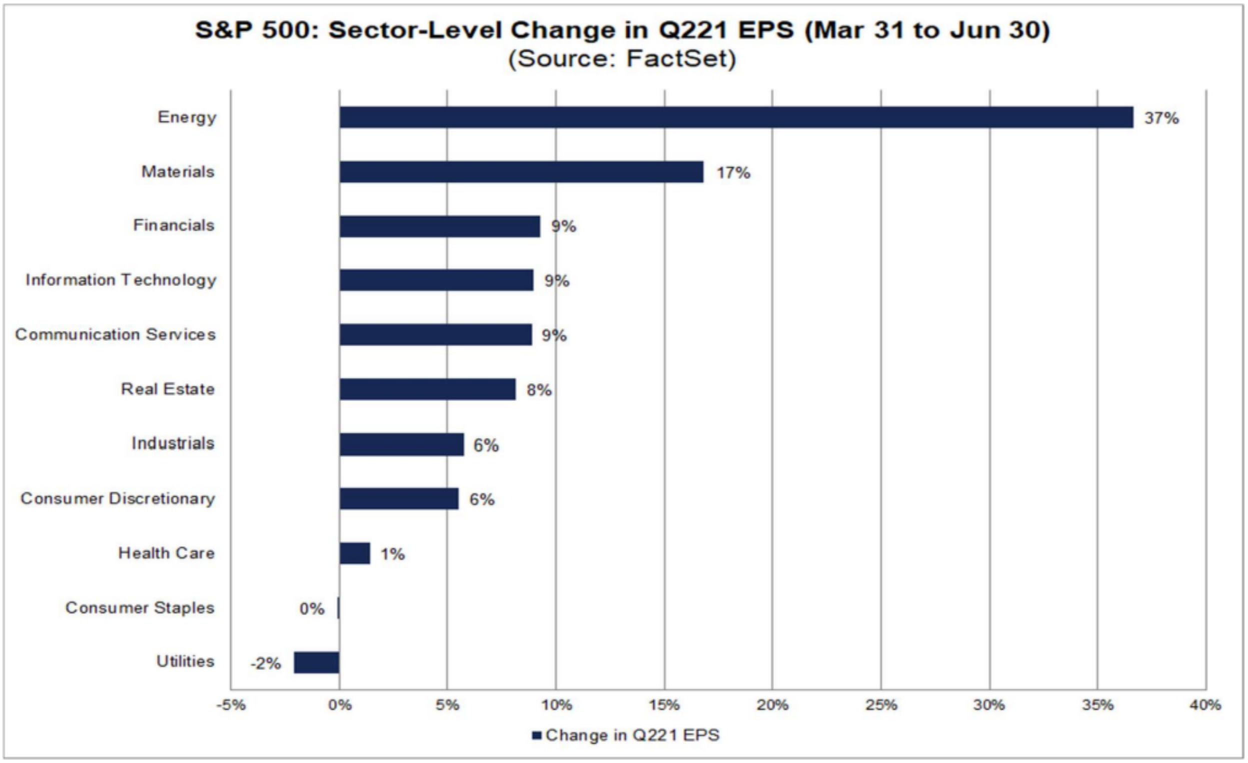
With this gradual flattening of the yield curve, fixed income markets reversed some of the losses experienced during the first quarter while the high yield segment of the market continued its gains. The Bloomberg Barclays U.S. Aggregate and Global Aggregate indices gained 1.83% and 1.31% respectively during the second quarter, shrinking their YTD losses to 1.60% and 3.21%. On the corporate side, the US High Yield Master II Total Return index posted a Q2 gain of 2.77% as compared to the S&P 500 Investment Grade Corporate Bond index ending the quarter up 3.63%. These indices finished the first half of the year up 3.70% and down 1.32% respectively.



Source: yCharts

Related to the recent yield curve movements, the US Federal Reserve's most recent Federal Open Marky Committee (FOMC) meeting highlighted some significant changes to outlook and policy stance. Notably, the group released updated economic projections, which show higher domestic GDP growth and higher inflation as measured through Personal Consumption Expenditures (PCE). These projections increased 0.5% to 7.0% and 1% to 3.4% respectively from the FOMC's March 2021 median projections and included the possibility of two rate hikes by the end of 2023. Furthermore, Chair Jerome Powell took the initial step towards these eventual rate hikes as the Central Bank head finally admitted the group began "talking about talking about" tapering their fixed income security purchases ($80B/month in Treasuries and $40B/month in agency Mortgage Backed Securities per the New York Federal Reserve).

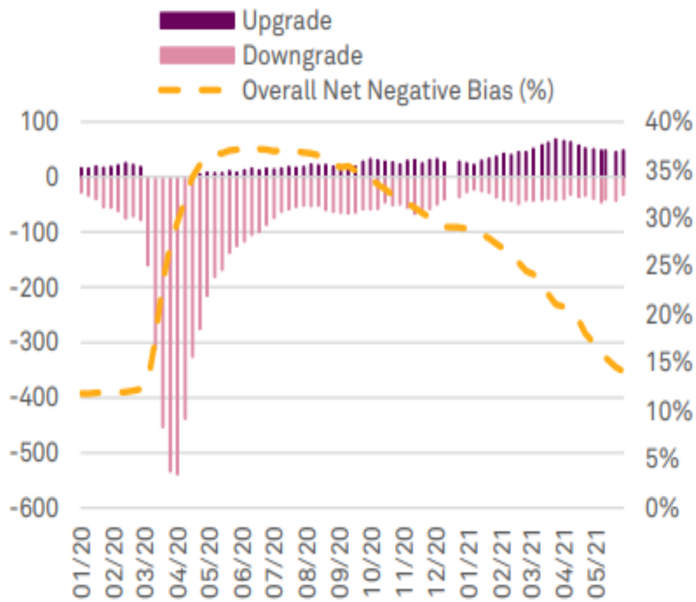
Turning briefly to earnings as the Q2 earnings season nears, it yet again looks like the current quarter's earnings continue to trend towards relative record-breaking levels. According to FactSet, as of July 2nd, estimated earnings growth rates for the S&P 500 is 63.6%, which would be the highest YoY earnings growth rate reported by the index since Q4 2009. This estimate of 63.6% compares with the previous Q2 earnings growth estimate of 52.1% reported in March of this year, as 9 sectors experienced upwards revisions to EPS estimates while economic activity has come back faster and stronger than previously anticipated. While positive earnings growth is a bullish indicator for future economic and market activity, the positive trend comes, in our opinion, at the cost of an increasingly overvalued equity market. Specifically, FactSet estimates the forward 12-month Price-to-Earnings (P/E) ratio currently stands at 21.4, which is above both the 5-year average (18.1) and 10-year average (16.1).



Finishing our market segment with positive developments in the credit space, we highlight important takeaways from a recently released S&P Global Ratings report. On a broad level, forward looking indicators point to what we see as rapidly improving credit trends due to the following drivers: rebounding economies, vaccination progress, ample liquidity, and a strong appetite for risk even at the weakest end of the credit spectrum. These trends have led to such metrics as the global corporate net negative outlook bias – a measure of future downgrade risk – to decline from the high of 37% reached last year to the pre-pandemic levels of 14%. Reflecting this, there have been three times as many upgrades as downgrades this year, with companies in the 'B' and 'CCC' categories accounting for a majority of the upgrades. While certainly good news, it is important to note that these upgrades remain a fraction of total 2020 downgrades triggered by the pandemic and collapse in oil prices. An equally-as-important caveat to these positive credit developments is that roughly 40% of speculative grade corporates in the US and more than 30% in Europe are rated B- and lower. This concentration of high-yield risky debt leaves some borrowers vulnerable to credit deterioration and defaults if income recovers more slowly than expected, especially if costs of debt start to rise.

Chart 1

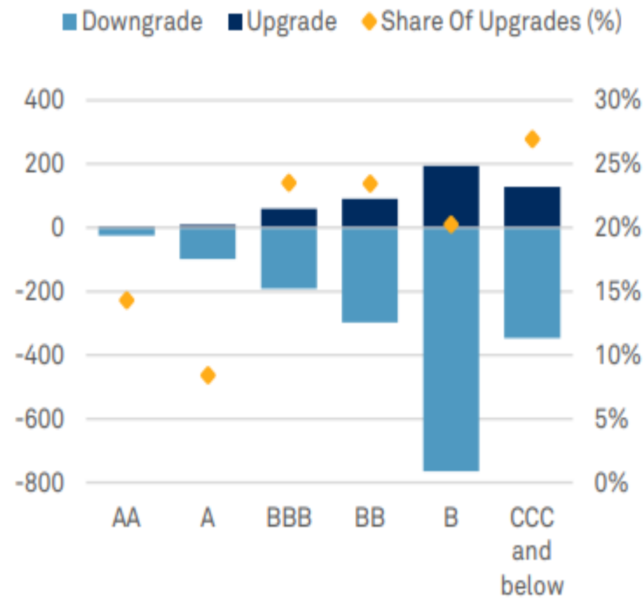
Positive Rating Actions Peaked In April But Remain Strong



Rating actions as of June 7, 2021. Downgrades and upgrades are trailing four-week. Net negative bias is calculated by subtracting the positive bias from the negative bias. Overall net bias (%) excludes sovereigns. Source: S&P Global Ratings.

Chart 2

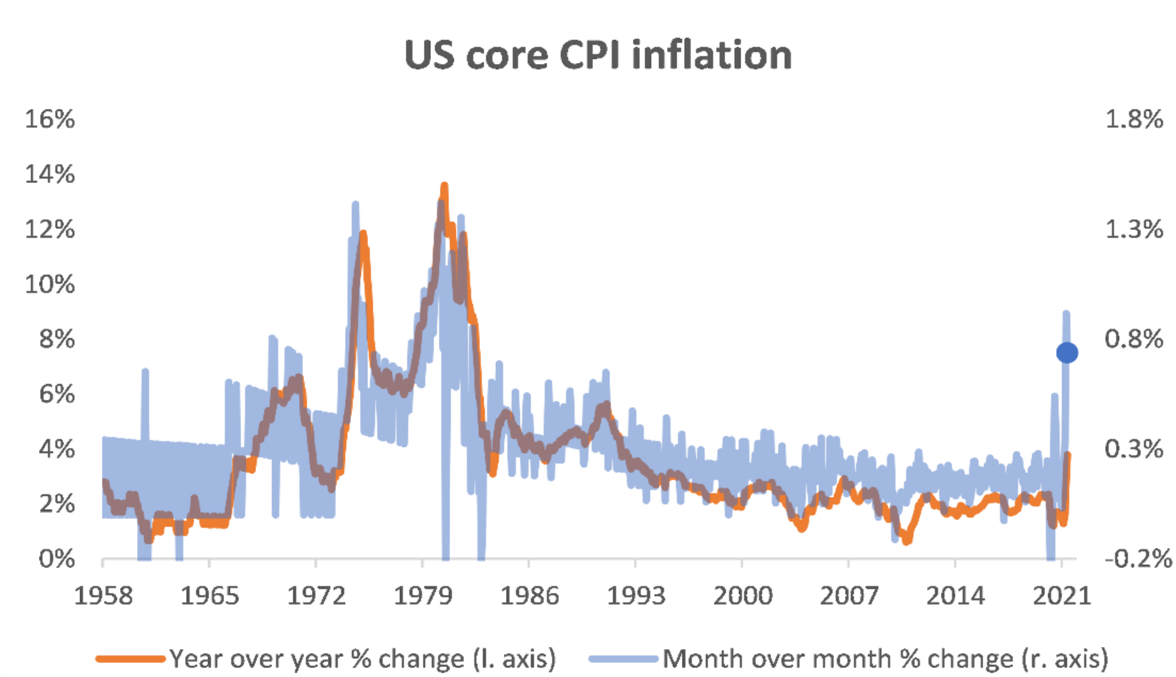
Rating Actions By Rating Category



Rating Actions are from Jan. 31, 2020 to June 7, 2021. Source: S&P Global Ratings.

US Economy

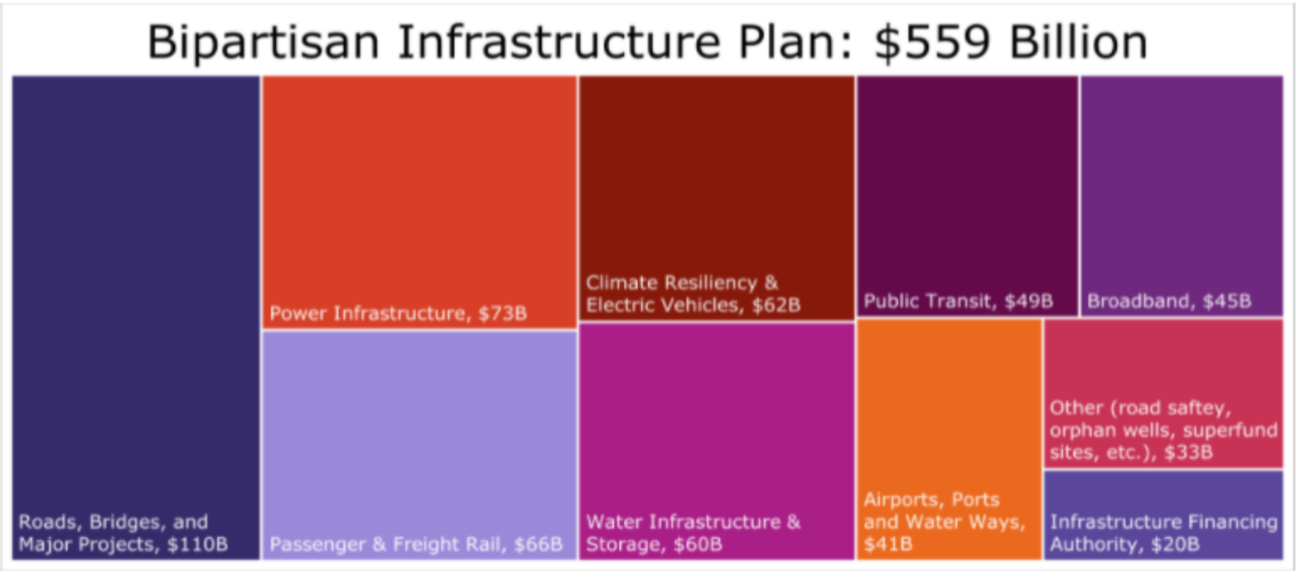
It would be impossible to discuss the domestic economy without first paying credence to what seems to be at the forefront of every market participant's (and news organization's) mind – inflation. The main question to consider when discussing the inflationary pressures in the domestic and global economy is a simple one to ask, but a complicated one to answer: Are these recent increases transitory or are they a sign of a longer-lasting elevation to asset prices and wages? To help answer this, we look to Russell Investment's Q3 update to their 2021 Global Market Outlook. In the report, while their analysts note that recent inflation readings from April through June were some of the strongest numbers seen since the early 1980's, they also note that 80% of the observed inflation was driven by transitory items. Specifically, the US was experiencing significant increases in used car prices resulting from the global semiconductor shortage, as well as in categories such as airfares and hotel prices, which are recovering from depressed levels as the economy normalizes.



The inflation experienced thus far in the above-mentioned categories is not the kind of inflation that is likely to persist year after year, the analysts assert, pointing to the fact that sectors such as travel and accommodations are still running well below pre-COVID trends. The report indicates it will take until mid-2022 for the US economy to recover lost output from lockdowns (and longer for other economies), broad based inflation pressures are unlikely until then. Looking forward, the financial group expects the Fed to commence tapering in 2022, with the second half of 2023 being the likely timing for the first interest rate hike.

From our team's perspective, while we do acknowledge that certain parts of the transitory argument are valid and rates are responding to such assertions, we are cautious to universally accept it. We continue to monitor more "sticky" portions of inflation calculations, such as wage growth and rent expense – both of which have been on the rise – as we believe these buckets are much less likely to decrease after experiencing price increases.

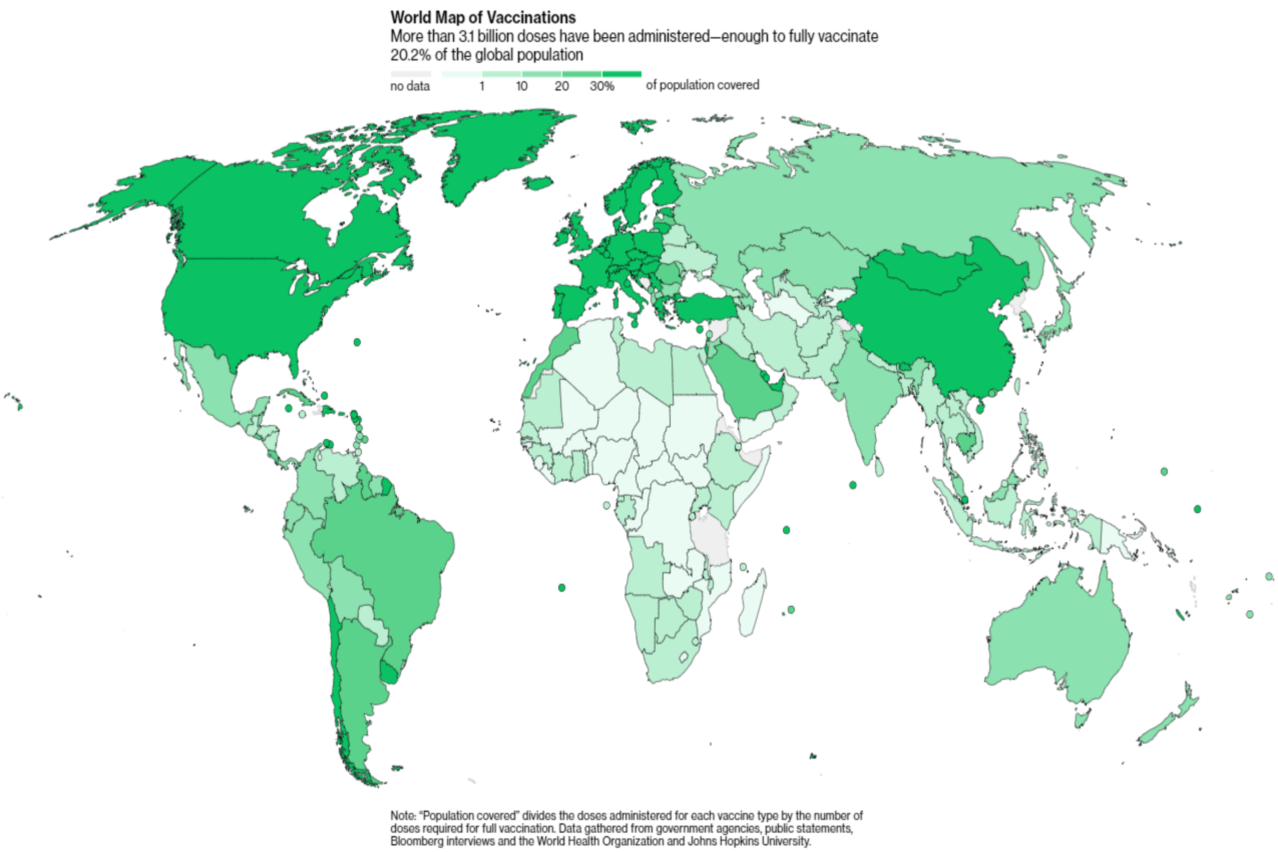
On the policy side of the economy, the Biden administration continued negotiations with bipartisan members of Congress during the quarter and appear to have reached a deal regarding the American Jobs Plan (AJP). The original $2.25 trillion spending proposal rolled out at the end of the previous quarter received a steep price and scope cut, as the two sides took the "physical" infrastructure portions of the AJP (which totaled nearly $1 trillion) and cut that figure in half. The new plan consists of $559 billion of new spending over a period of five to eight years that is paid for through various sources and policy changes. Critically, the bipartisan agreement does not include the proposed corporate income tax increases mentioned in the original draft.



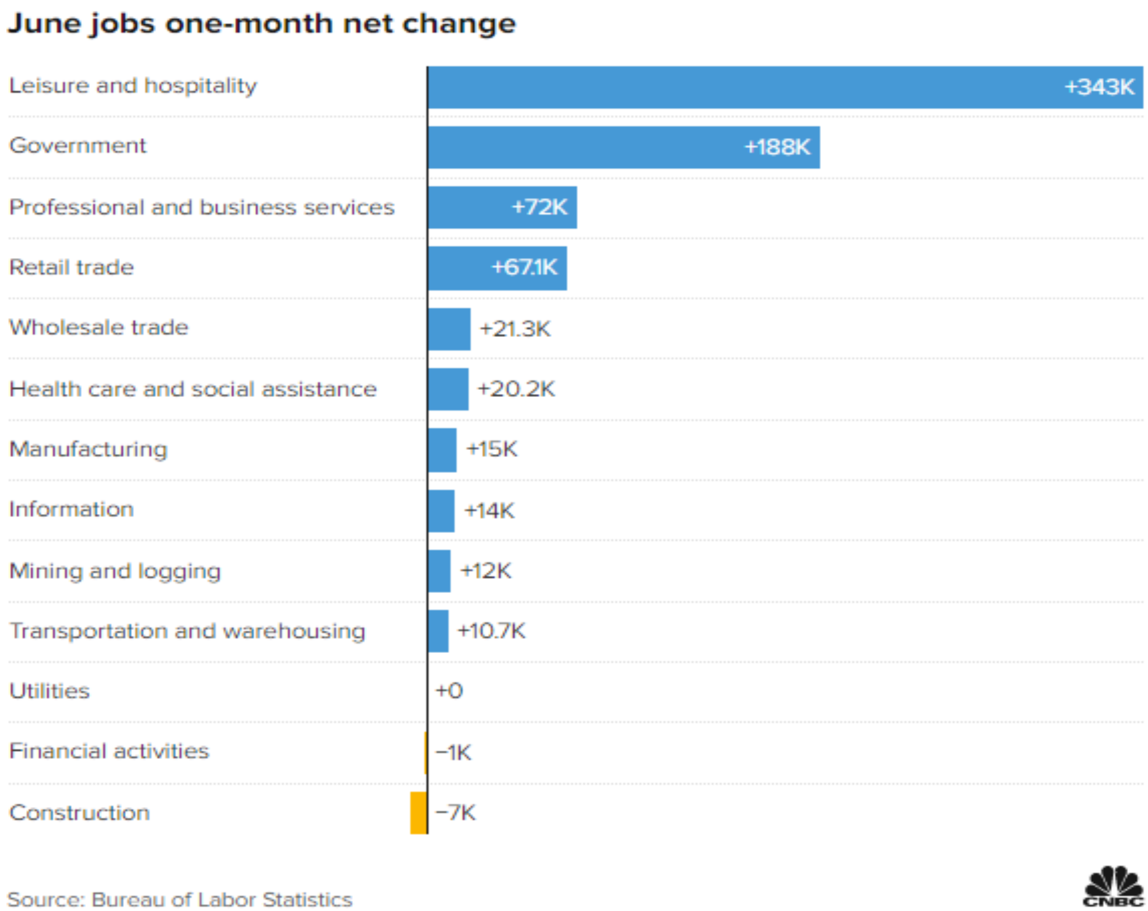
Source: U.S. Senate Memo, Committee for a Responsible Federal Budget and Wells Fargo Securities

An important aspect to note on the proposed changes to the AJP is that while the plan would authorize $559 billion in new spending, the total cost of the package would be closer to $1 trillion as it would also reauthorize spending that is already occurring. Specifically, the proposal calls for the reauthorization of a 2015 bill known as the Fixing America's Surface Transportation Act (FAST Act). This bill's rapidly approaching expiration, which authorized $305 billion in infrastructure spending over the fiscal years 2016-2020 is a leading driver behind the current administrations push to pass the AJP.

Turning to the battle against COVID-19, according to Bloomberg as of July 1st more than 3.1 billion vaccine doses have been administered across 180 countries. This rate of roughly 41.9 million doses a day globally, in comparison dwarfs the rate reported at the end of the first quarter of the year, which was around 15.3 million. In contast, domestic vaccination rates have fallen significantly since Q1, as the US has administered 328 million doses thus far; a Q2 rate of 1.12 million doses per day is less than half of the Q1 rate of 2.83 million doses. While enough doses have been administered to fully vaccinate 20.2% of the global population, countries and regions with the highest incomes are getting vaccinated more than 30 times faster than those with the lowest. Stemming from the uptick in global vaccination rates and declining domestic rates, Bloomberg estimates that it will take another year to achieve a high level of global immunity, while in the US it will take just 4 more months. This compares to estimates given at the end of Q1, which put high levels of global immunity years into the future and domestic levels 4 months, meaning there has been a relative standstill in US progress in the vaccination campaign.



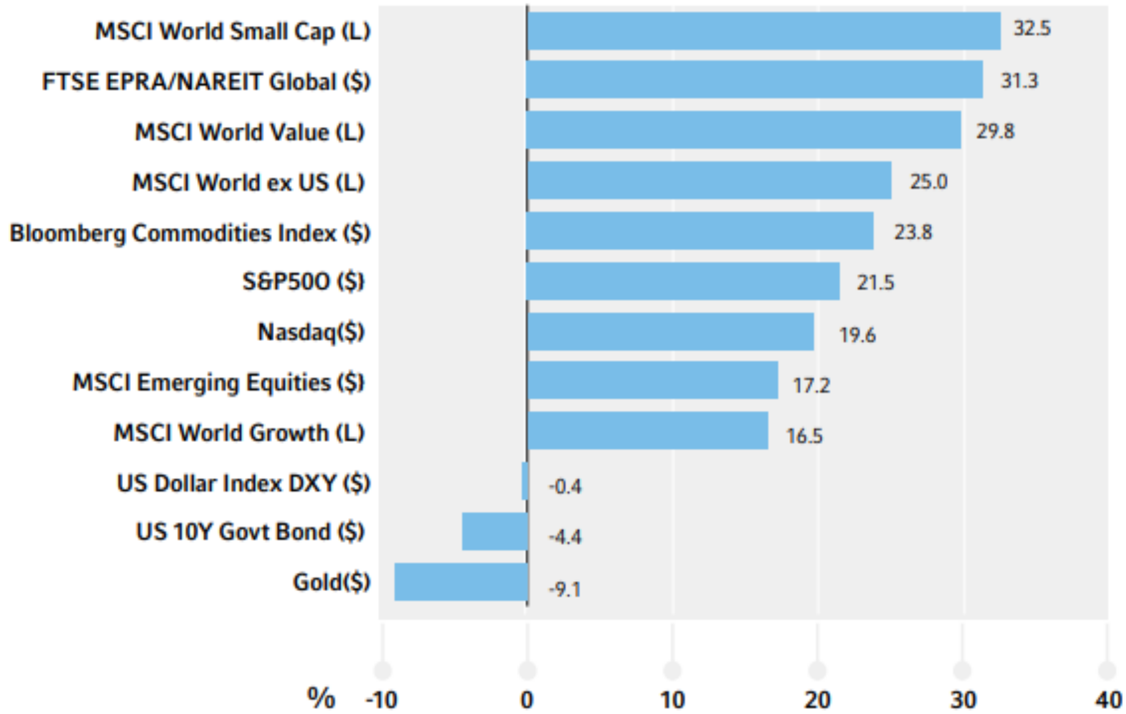
In the labor market, the US economy finished the first half of the year with a significant push towards labor market gains, though the unemployment rate experienced little change. In total during the second quarter, nearly 1.7 million jobs were added, with more than half of those gains occurring during the final month of the quarter. The unemployment rate fell by 0.10% during the period, down to 5.9% - a considerable improvement to the June 2020 unemployment rate of 11.1%. Most of the job gains were concentrated in leisure and hospitality, while finance and construction lost jobs during the month of June. Nearly 200,000 of these job gains were experienced in the long-term unemployed segment of the population, an increasingly important metric to watch as these jobs are widely seen as the most difficult to add back into the economy following business closures or shutdowns. This progress brought the long-term unemployed proportion of total unemployment down from 43% at the beginning of the quarter to 42% at the end of June, a positive development for the economy.



International Economy

Ending our quarterly recap with the international economy, we turn back to the report from Russell Investments which conducted an equity analysis into what they call the "Reopening Trade" – which can be dated from November 6th, 2020, when Pfizer announced the first successful COVID-19 vaccine. Since then, they note, the best performing asset classes have been small cap and non-US equities, global REITs, commodities, and the value factor.

Asset performance since the COVID-19 vaccine announcement



Source: Refinitiv Datastream, as of June 17, 2021; performance since November 6, 2020. (L) implies local currency. *Indexes are unmanaged and cannot be invested in directly.*

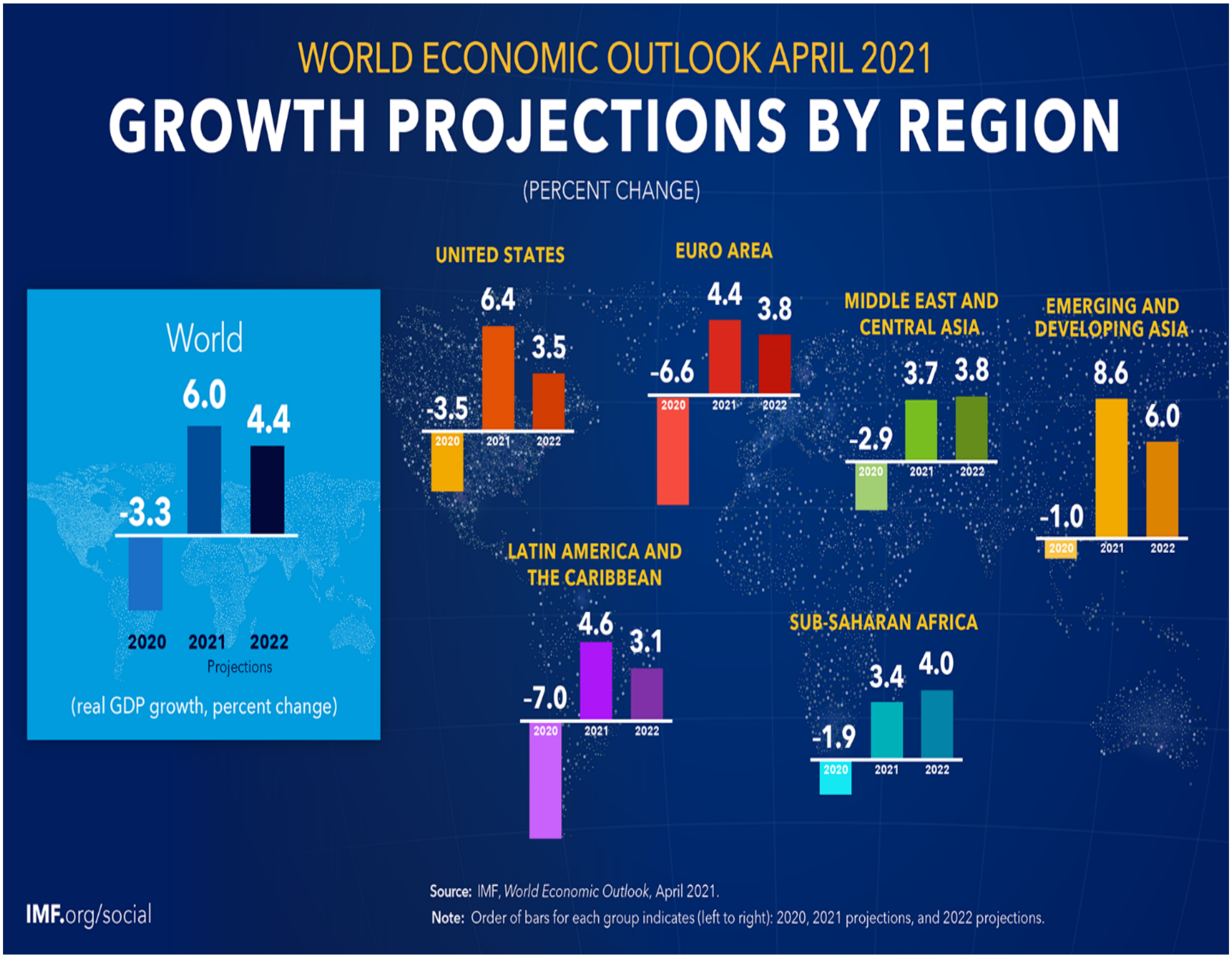
Going back to what we touched on earlier in this summary, two key factors mean that this recent trend is unlikely to end soon. Firstly, cyclical stocks which comprise the value factor are reporting stronger earnings upgrades than tech-heavy growth stocks. Secondly, the value factor is still cheap compared to growth, as shown by the elevated 12-month P/E ratio on the tech-heavy S&P 500. This dynamic should foreseeably help non-US equity markets outperform the US market, as the rest of the world is overweight to cyclical value stocks relative to the US, which has a higher weighting to tech. Lastly, the US dollar's forecasted weakening will further support the performance of non-US markets, especially emerging markets. While the US dollar index has traded generally sideways since the vaccine announcement, as investors price in Fed tightening expectations and global economic recovery becomes more entrenched, analysts project a depreciation of the USD on a relative basis.

Taking a step back, we have generally read the same three arguments supporting international & value over domestic & growth from various Wall Street participants for quite some time. While the arguments seemingly have more credibility and are spoken louder today than previously, our team's stance is still a cautious one. The recently added exposure to developed European and Asian markets will serve as a barometer for this argument as the team continues to discuss optimum allocation to our global multi-asset portfolio allocations. From our top-down view, the trend of growth beating value has been a long-term trend, so if it is reversing then, one would expect the trend to also last for the long-term. Considering this, we do not feel overly pressured to "catch the train" and are happy with our current allocative breakdown regarding growth vs value and international vs domestic as we gradually adjust our exposure.

Highlighting important economic updates from a regional standpoint also outlined in the Russell report, we look first towards the Eurozone/UK. There, as the vaccine rollout has gathered pace and a more sustained reopening of economies is on track for the second half of this year, the regions post-lockdown recovery is likely to be extremely strong. Europe and the UK's exposure to financials and cyclically sensitive sectors give them the potential to outperform the post-vaccine phase of the recovery as economic activity picks up in combination with yield curves in the global region steepen.

In Japan, where recovery has been constrained by localized outbreaks that have led to renewed lockdowns of metro-areas, economic recovery is expected through the back half of the year, boosted by strong global capex and the return to services activity in the country. The Russell team went on to forecast low rates to remain in place for some time, with the Bank of Japan maintaining its yield-curve program and inflation expectations remaining depressed. A caveat to these projections is that there is a possibility for further fiscal stimulus in the lead-up to the lower house of parliament elections, which need to be held prior to October 22nd.

For the emerging markets, a report from the International Monetary Fund (IMF) suggests there is still a long road to go before pre-pandemic levels of activity are reached. Vaccine procurement data suggests that effective protection for most of the population will not be attained in 2021, meaning lockdowns and containment measures may be needed more frequently throughout 2021-2022. While this will affect each individual economy differently, emerging market economies over-reliance on tourism-based sectors foreshadows tough times still ahead for a majority of the developing world. While the IMF revised GDP projections for emerging and developing Asia up slightly, mainly due to China, projections for the Middle East, Central Asia, Latin America, and sub-Saharan Africa remained largely unchanged from previous projections.


WORLD ECONOMIC OUTLOOK APRIL 2021
GROWTH PROJECTIONS BY REGION
(PERCENT CHANGE)
World
-3.3
6.0
4.4
2020
2021
2022
Projections
(real GDP growth, percent change)
UNITED STATES
-3.5
6.4
3.5
EURO AREA
-6.6
4.4
3.8
MIDDLE EAST AND CENTRAL ASIA
-2.9
3.7
3.8
EMERGING AND DEVELOPING ASIA
-1.0
8.6
6.0
LATIN AMERICA AND THE CARIBBEAN
-7.0
4.6
3.1
SUB-SAHARAN AFRICA
-1.9
3.4
4.0
Source: IMF, World Economic Outlook, April 2021.
Note: Order of bars for each group indicates (left to right): 2020, 2021 projections, and 2022 projections.
IMF.org/social

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