Investment Newsletter

Second Quarter 2021

The U.S. and international equity markets performed strongly during the quarter, making new all-time highs. For the quarter, the S&P 500 Index gained +8.44% and the MSCI All-Country World ex-U.S. Index gained +5.48%. Moreover, the S&P 500 Index posted its second-best first-half gain (+15.00%) since the dot-com bubble, and its fifth straight quarterly gain. This stellar performance was driven by continued monetary and fiscal policy stimulus, accelerating vaccination rates, lower new COVID-19 infections, economy reopening momentum, and outsized corporate earnings surprises.

Fixed income performance was also positive for the quarter. The Bloomberg-Barclays Intermediate Government/Credit Index increased +0.98%, and the Bloomberg-Barclays (1-5 year) Municipal Bond Index increased +0.30%. Rising interest rate pressures eased as long-term inflation expectations declined and the Federal Reserve continued its Quantitative Easing (QE) program. Interest rates over four years in maturity declined, while rates under four years rose slightly as expectations for the Federal Reserve to raise interest rates shifted to 2022 from 2023. Despite increased new issuance, corporate bonds - particularly lower rated bonds - outperformed as investors continued to search for yield in an extremely low-yield environment.

Municipal bonds continued to outperform taxable bonds, reflecting strong demand from individual investors seeking tax-free investments. Demand for tax-exempt income has been extraordinarily high due to the likelihood of higher income taxes for high net worth individuals. This demand is expected to continue to outstrip new issue supply over the next quarter, providing a solid underpinning to the municipal bond sector.

The uneven recovery in the labor market will likely reinforce the Federal Reserve's accommodative policy with the continued purchasing of U.S. Treasuries and mortgage-backed securities until early next year, unless the economy and labor market post significant progress. We continue to expect to see higher interest rates as the recovery unfolds. For this reason, we are maintaining short durations in our clients' portfolios and opportunistically purchasing longer maturities as attractively priced bonds become available.

On the policy front, the Federal Reserve has committed $6.4 trillion in monetary stimulus, of which $3.3 trillion (52%) has been disbursed, and Congress has enacted $6.8 trillion of stimulus, of which $5.1 trillion (75%) has been disbursed (Committee for a Responsible Federal Budget).

On vaccination rates, 47.6% of all Americans (157.9 million) have been fully vaccinated (CDC), and 11.7% of all people globally (902.4 million) have been fully vaccinated (Johns Hopkins).

Despite the emergence of the Delta variant, which has caused a recent rise in new infections in the U.S. and the U.K., new daily infections globally have been reduced by half to 443K since the peak of 906K on April 28 (Johns Hopkins).

On reopening momentum, two of the largest states – California and New York – both recently eliminated nearly all remaining restrictions on businesses and social gatherings on June 15. Moreover, with more people returning to physical offices and schools in the fall, the economy should continue to strengthen into the second half of the year.

With the economy fully reopening against a backdrop of accommodative fiscal and monetary policy to support future growth, here is an update on the key unanswered questions for investors going forward that we posed last quarter:

a) **Will economic and corporate earnings growth come in much better than forecasted, justifying the stock market's high valuation?** So far, the answer is 'yes.' Since last quarter, the consensus estimate for S&P 500 Index earnings growth in 2021 has increased over 11%-points to +36.1% from +24.7%, and the consensus estimate for U.S. real GDP growth for 2021 has increased to +6.5% from +5.8% (FactSet).

b) **What will future normalized economic and corporate earnings growth look like once government stimulus measures have largely been exhausted and consumed?** No one knows, but we are closer to finding out as fiscal stimulus peaked in March when consumers received $445 billion of direct payments. Since then, payments have decelerated. Moreover, fiscal policy stimulus equated to 10.4% and 11.4% of U.S. GDP in fiscal 2020 and 2021, respectively, but is forecasted to be just 2.3% of U.S. GDP in fiscal 2022. This amounts to a $1.8 trillion deceleration from 2021 to 2022 without new stimulus (Strategas).

c) **Will the economic recovery become self-sustaining, or will it require a perpetual stream of government stimulus and bailouts?** Four key events to watch: 1) the expiration of the CDC's national residential tenant eviction moratorium on July 31 (CDC intends this to be the final extension of the moratorium), 2) the expiration of federal unemployment benefits on September 6, 3) the expiration of the suspension of all federal student loan payments on September 30, and 4) the potential passage of a $6-$7 trillion spending bill by the Senate.

d) **When will the froth and excessive speculation and risk-taking in the stock market end?** Meme stocks, Dogecoin/cryptocurrencies, penny stocks, WallStreetBets, SPACs and digital art are all worrisome signs that the concept of risk has been greatly diminished or ignored. While no one knows when it will end, Bloomberg Businessweek recently published a magazine cover on June 14, 2021 with the title "Why is Everyone Making Money But You?" that was eerily similar to the Barron's magazine cover published near the height of the dot-com mania on September 20, 1999 with the title "Are You Rich Yet?"

e) **Will inflation materialize and catalyze higher interest rates?** So far, inflation is heating up but interest rates have fallen - a sign that the bond market agrees with the Federal Reserve's assessment of near-term inflation being "transitory" based on tough comparisons with last year when the pandemic ravaged the economy, and on temporary supply chain disruptions (e.g., lumber and semiconductors). Even if some inflation is not transitory, that is not necessarily a bad thing, especially given years of inflation coming in below the Federal Reserve's 2% target. A zero interest rate policy that produces negative real rates is not a healthy sign of a growing economy, and the stock market has proven historically it can still perform well when interest rates are low and rising.

f) **How much of the new Administration's regulatory, tax and spending programs can actually get enacted, and what will their effects be on the economy?** So far, the new Administration's agenda has had a tougher time being enacted than expected because of a lack of a solid Democrat Party majority in the Senate. Consequently, some of its original proposals have already been scaled back. For example, it recently proposed a minimum corporate tax rate of 15% in lieu of its original proposal to raise the corporate tax rate to 28.0% from 21.0%. In addition, its $2.3 trillion infrastructure plan has been reduced to $1.2 trillion and still has not passed the Senate. Even if the Administration's entire fiscal agenda were enacted, the incremental economic impact would be small at just 0.5% and 0.9% of U.S. GDP in fiscal 2022 and 2023, respectively (Strategas).

g) **Are we experiencing peak economic growth, peak corporate earnings growth, and peak government stimulus?** So far, the answer is 'yes.' All three of those metrics are forecasted to peak this year and decelerate going forward. In fact, the first two metrics are forecasted to peak when the second quarter is reported in a few weeks. Despite reaching this inflection point, growth should still be very healthy next year. In fact, the consensus estimates for real GDP growth and S&P 500 Index earnings growth in 2022 are +4.0% and +11.4%, respectively (FactSet). Moreover, we continue to find and invest in innovative, growing companies.

With the S&P 500 Index at an all-time high and its valuation expensive at 21.6x price to earnings vs. its all-time peak of 24.3x in 2000 (FactSet), many client portfolios have developed outsized individual stock position sizes. We are committed to strategically reducing these outsized positions in order to prudently rebalance client portfolios. As such, clients should expect a higher level than normal of capital gains to be realized this year, especially given the possibility that the government will increase what have been historically low tax rates on capital gains.

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