Q2 2021
Investment Perspectives

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- **HIGH FIVE:** The S&P 500 advanced for the fifth consecutive month, capping five straight quarters of gains for the benchmark US index. Global stocks also fared well during the quarter, and investors have continued to bid up equities against the backdrop of ultra-supportive monetary and fiscal policies.
- **OLD HABITS DIE HARD:** On the heels of two quarters featuring rising rates and leadership from cyclical sectors, markets reverted back to their old ways with falling long-term rates and tech stocks powering indices higher. It remains to be seen whether this period is merely a pause in the cyclical recovery story or an early warning sign that results over the coming quarters may fail to match lofty investor expectations.
- **TAPER TALK AND DYNAMIC DOTS:** At its June meeting, members of the Fed began "talking about talking about" tapering the central bank's $120B of monthly asset purchases which would mark the first step on a long road toward unwinding the extraordinary measures taken in response to COVID. The Fed also revised its "dot plot"—the graph showing its interest rate forecast in future periods—to reflect a higher likelihood of rate hikes in 2022 and 2023.

Market Recap

Returns were impressive across the investment landscape in Q2 as bonds and stocks rallied in tandem. The economic reopening continued to accelerate within the US, and prospects for a broader vaccination campaign around the world during the second half of 2021 kept investor sentiment upbeat about the global recovery. For its part, the Fed continued to emphasize that it would keep financial conditions loose until labor markets have fully healed but gave early signs that the rollback of its extraordinary policy measures could begin over the coming quarters.

Beneath the surface of the broad equity market advance, investors witnessed a reversal of recent trends. Specifically, growth stocks handily outperformed value stocks during the period, and large caps outperformed small caps. This outperformance occurred despite significant progress being made toward an infrastructure bill that would lead to over $1 trillion of spending on roads, bridges, water systems, and other segments of the economy that many analysts suggested would be a boon to economically

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FIXED INCOME

	USD Total Return (%)	
Index	**Q2**	**YTD**
Barclays 1-10 Yr Muni	0.6%	0.4%
Barclays US Agg. Bond	1.8%	-1.6%
BofA/ML HY Master II	2.8%	3.7%

EQUITIES

	USD Total Return (%)	
Index	**Q2**	**YTD**
Russell 3000	8.2%	15.1%
S&P 500	8.5%	15.3%
Russell 2000	4.3%	17.5%
MSCI All Country World	7.4%	12.3%
MSCI EAFE	5.2%	8.8%
MSCI Emerging Mkts	5.0%	7.4%

Source: Bloomberg (Data as of 6/30/2021) sensitive portions of the market. The "large cap growth versus small cap value" dichotomy has come to represent the relative risk appetite of the market, with investors favoring the more predictable earnings of mega cap tech companies in Q2 relative to small cap value stocks that risk faltering if upbeat economic growth expectations fail to materialize.

The US has continued to outperform the rest of the world in 2021, buoyed by ultra-supportive fiscal and monetary conditions as well as a vaccination campaign that has rolled out faster than many other developed and emerging countries. The US market's higher weightings to growth stocks were also disproportionately beneficial during Q2 relative to the higher weightings to value sectors abroad. Chinese stocks remain an anchor on the performance of emerging markets indices as investors weigh the prospects of a broader regulatory crackdown on mega cap tech companies in addition to growing concerns about Chinese authorities restricting overseas IPOs.

Within fixed income, the benchmark 10-year Treasury rate tumbled nearly 0.3% during the quarter, ending just shy of 1.5%. The move lower for yields occurred despite higher inflation readings and upward revisions to growth estimates over coming years—typically catalysts for higher rates. In fact, at the end of the quarter, the 10-year Treasury's "real yield"—or its yield after subtracting inflation (CPI)—sat at nearly -4.0%, the lowest level since the early 1980s. Falling rates benefitted bond prices, and the Bloomberg Barclays Aggregate Bond Index rallied 1.8% in Q2. Despite the strong quarter, the Aggregate Index remains in the red for the year (-1.6%) due to the dramatic move higher for rates during the first quarter.

Credit markets extended gains for the year as the lowest-rated segments of the market posted the strongest advances during Q2. The BofA/ML High Yield Index generated a 2.8% return during the period, bringing its YTD gains to 3.7%. With low rates continuing to dominate the fixed income landscape across the world, investors' ongoing search for yield has led to them into lower-quality issuers.

PREPARING FOR LIFTOFF

As the economy continues to heal and unemployed Americans get back to work, the Fed has started to contemplate the exit strategy from its extraordinary policies. Fed Chair Jerome Powell and other Fed members had been quick to quash any discussion of tapering or rate hikes in prior quarters, but Q2 provided the first look into Fed participants' revised thinking. Specifically, Powell referenced that he and his colleagues would begin to reconsider their asset purchase program in coming quarters, and the Fed's "dot plot" that shows each members' interest rate expectations over coming years provided a hawkish surprise—i.e., it suggested that the Fed may look to hike rates quicker than previously anticipated.

The shift to the Fed's views caught markets somewhat off guard, and short-term Treasury yields moved modestly higher as a result. Yields between roughly one and five years generally reflect the market's expectations for the Fed's interest rate policy over the respective period, but it begs the question: How much faith should investors put in forecasts of Fed actions? Recent history would suggest that the answer is "not much". The chart at the top of the following page shows the Fed Funds rate in black along with six dashed lines showing the market's expectations for the Fed Funds rate over the following three years at various points in time. For instance, the gray line at the left side of the chart suggests that, as of June 2016, market participants did not expect the Fed to hike its short-term rate beyond roughly 0.75% over the following three years. However, by 2019, the Fed had hiked rates to nearly 2.5%.

The blue dotted line on the right side of the chart reflects the current market expectations through the end of 2024. Over that period, consensus expects roughly four rate hikes and the Fed Funds rate ending at approximately 1%. This is slightly below the Fed's own forecast and suggests that the Fed may be quicker to act than previously anticipated but ultimately hike fewer times this cycle. Predicting a lower "terminal rate" would hardly be an endorsement of a high inflation regime taking hold and perhaps helps to explain some of the surprising relative performance across markets in Q2.

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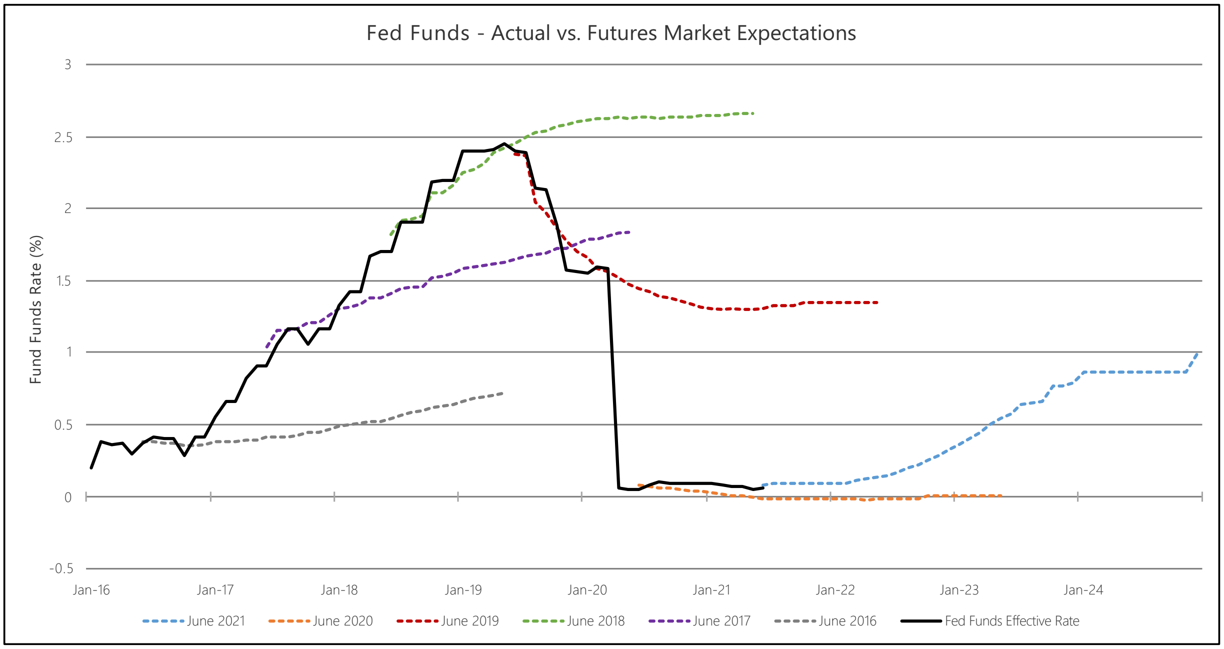
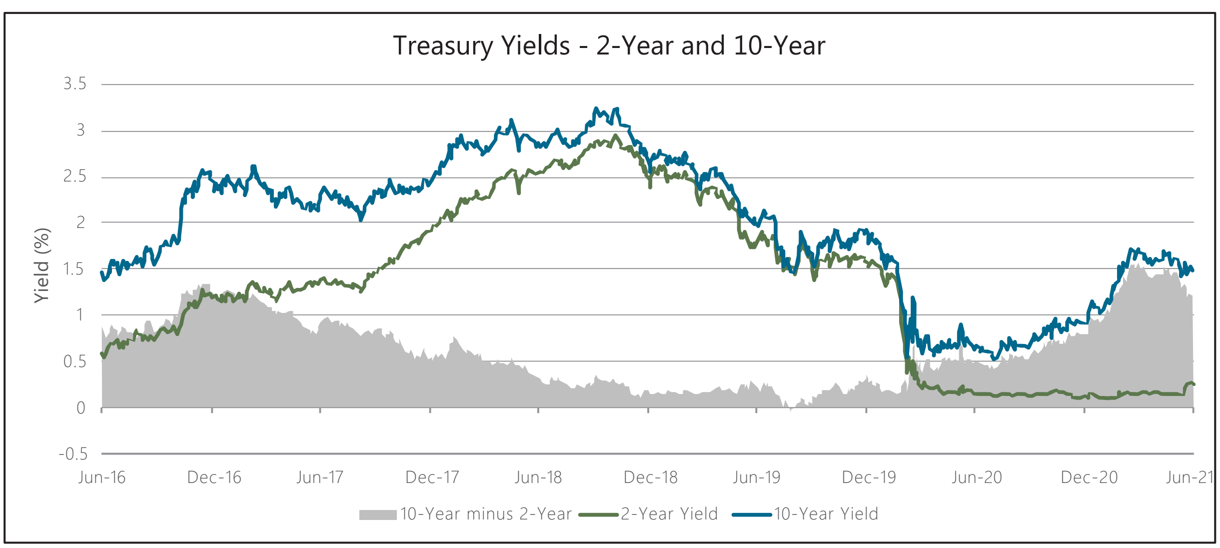


Source: Bloomberg (Data as of 6/30/2021)

HIGHER RATE HEAD FAKE

Despite upbeat corporate earnings data, upward revisions to analysts' growth estimates, higher inflation readings during the quarter, and the Fed revisions referenced in the prior section, longer-term interest rates declined during Q2. The financial markets orthodoxy would suggest that these dynamics should lead to higher long-term rates; if investors were feeling more optimistic about the trajectory for economic growth and increasingly concerned about the prospects for sustainably higher inflation, all things being equal, they should command a greater degree of compensation to own low-risk assets. Conversely, if growth is likely to underwhelm and deflationary/disinflationary forces assert themselves, investors may be willing to accept lower yields in exchange for the relative safety of high-grade bonds.

This calculus played out in a textbook fashion during Q1 but saw a swift reversal in Q2. One way to view this relationship and provide some historical context is by comparing the 10-year Treasury yield to the 2-year Treasury yield—as depicted on the chart below. As previously discussed, the 2-year yield (green line) is heavily influenced by Fed policy and currently sits slightly above 0% thanks to the Fed's accommodative stance. The declining 10-



Source: Bloomberg (Data as of 6/30/2021)

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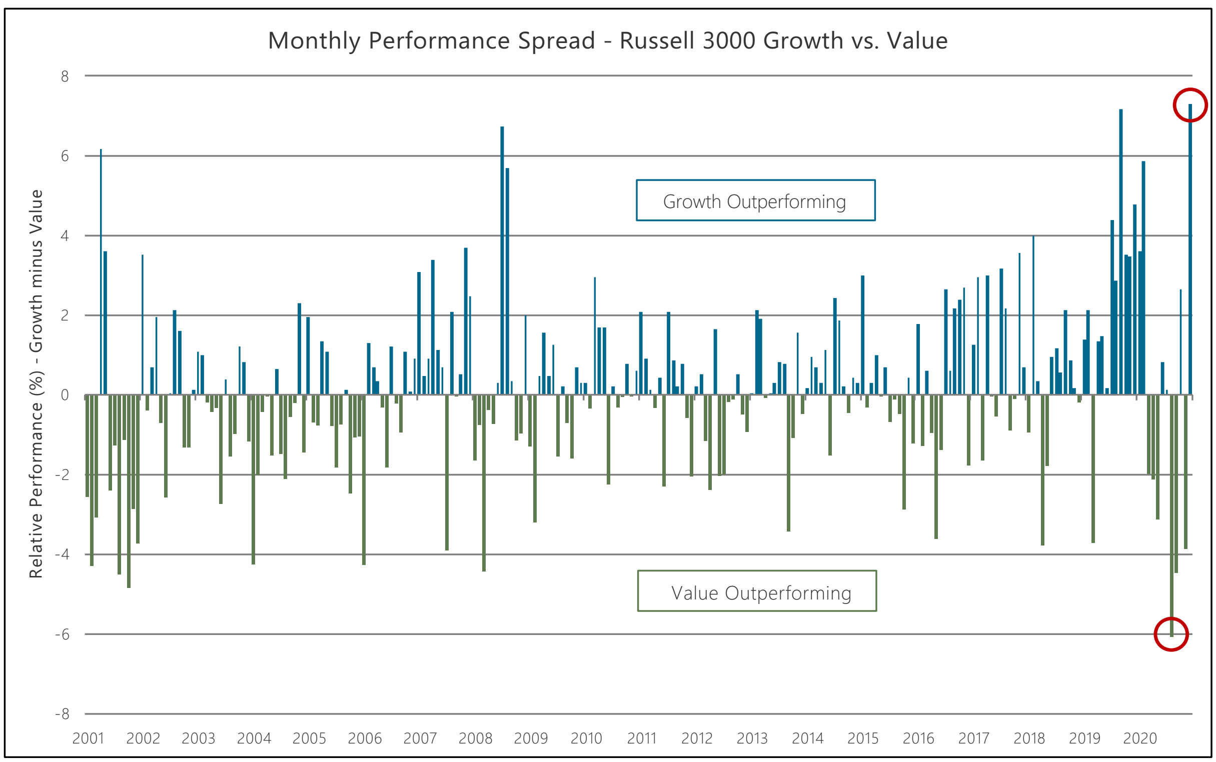
year rate (blue line) has narrowed the difference between the two, represented by the gray bars. While it is very early in the process, a meaningful degree of narrowing between the 10-year and 2-year rates, or "flattening" of the yield curve, could be viewed as an ominous sign—particularly if short-term rates are moving upward and converging with long-term rates.

Perhaps the COVID delta variant has some market participants skittish, or maybe this is simply a technical phenomenon driven by imbalances within investor positioning. In any event, fears of the nascent recovery being short-circuited must be respected. The good news? In the recovery phases after the last four recessions, there has been a comparable period of modest yield curve flattening before the recovery resumed. While the last 18 months have been full of extraordinary developments, investors would welcome confirmation of a more ordinary expansion.

DON'T CALL IT A COMEBACK

After a strong run from cyclical segments of the market since Q3 2020—namely, value and small cap indices with higher exposures to economically sensitive sectors like energy, materials, and industrials—the second quarter concluded with growth stocks—particularly mega cap tech names—reasserting themselves as market leaders. The chart below plots the monthly performance of US growth stocks relative to value stocks—as measured by the Russell 3000—over the last 20 years. Incredibly, the best one month reading for both growth and value outperformance has come in 2021; growth beat value by 7.3% in June after value beat growth by 6.1% in April.



Source: Bloomberg (Data as of 6/30/2021)

Recent performance has left market participants wondering if the growth comeback in Q2 was simply the resumption of a longer-term trend. The link to interest rates cannot be ignored; as rates declined in Q2, growth stocks were well bid. This is consistent with the majority of the post-financial crisis period that saw value stocks underperform alongside lower longer-term rates. The implications are twofold: One, in an environment where investors expect inflation to be tame and growth to be scarce, there is likely going to be higher demand for companies that can demonstrate outsized growth prospects. Two, using lower rates in a present value calculation leads to a higher value. For growth stocks that derive a significant portion of their worth from cash

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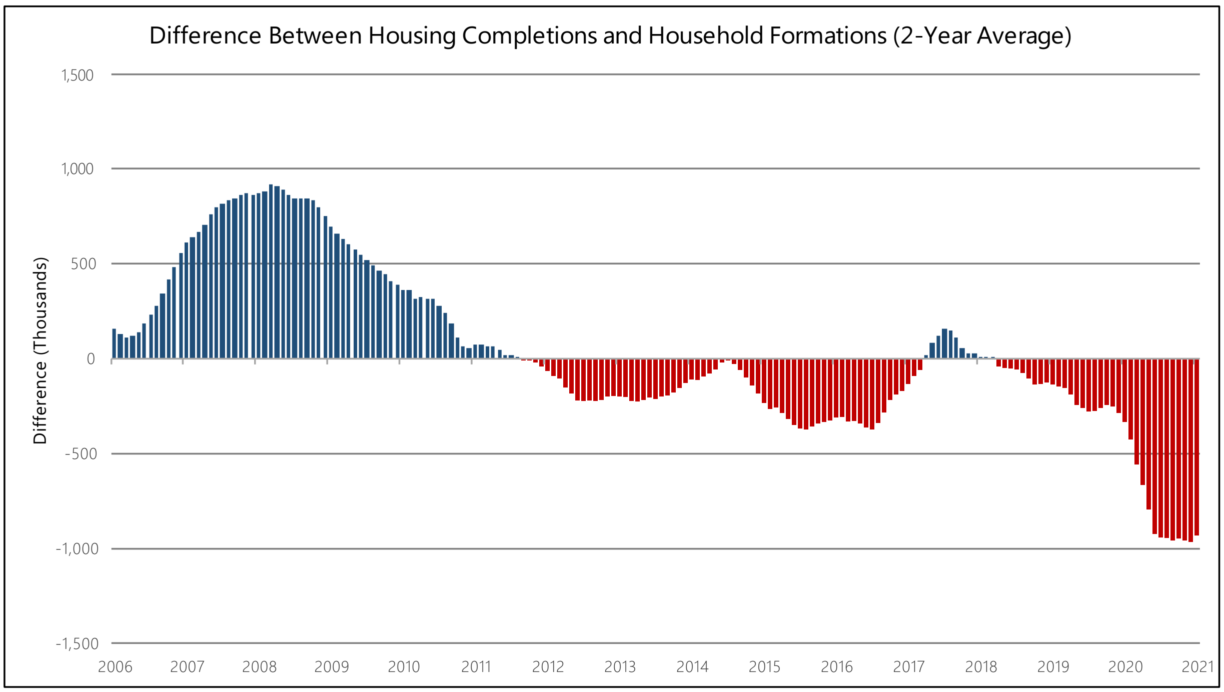
flows many years into the future, lower rates should lead to higher valuations. Through that prism, as rates go, so goes growth versus value.

RED HOT REAL ESTATE

The real estate market has continued to make headlines in 2021 thanks to soaring home prices. According to the most recent S&P Case-Shiller Composite Index data, a national average of residential real estate prices was up nearly 15% in April relative to the same period last year, and anecdotes abound of homes selling above their listing price. The combination of low mortgage rates and relatively strong consumer balance sheets (thanks to multiple rounds of stimulus) has put homebuyers in a strong position despite elevated unemployment.

Using data from the US Census Bureau and Bloomberg, we can look at the longer-term trends of the housing stock in the US relative to the number of new households being formed—a proxy for the growth of the overall homebuyer pool. The chart below shows this relationship over time, with blue bars representing more homes being built than households being formed and vice versa for red bars. Said differently, blue bars represent new supply exceeding demand and red bars suggest that demand is outstripping new supply.



Source: Bloomberg (Data as of 6/30/2021)

It will come as no surprise that the mid-2000s period saw a dramatic oversupply in the housing market, culminating with the bursting mortgage bubble in 2008. What may be unexpected is the degree that the US housing market has been undersupplied since that time—particularly in recent years as the Millennial generation hits its peak household formation years. COVID may have accelerated the trend toward single-family homeownership, but the fundamental case for higher home prices has been building for years. ●

As Good as It Gets?

With the S&P 500 up nearly 100% from its March 2020 lows, a key question confronting investors is how much longer the run of nearly uninterrupted gains can continue. Frequent readers will recall our penchant for viewing markets in terms of rates of change and considering data readouts relative to expectations as opposed to simply looking at absolute levels. Viewed through that lens, growth and earnings are likely to be strong in absolute terms, but if the market has already incorporated those assumptions into prices and there is a diminishing potential for upside surprises, perhaps the near-term risks tilt more toward disappointment.

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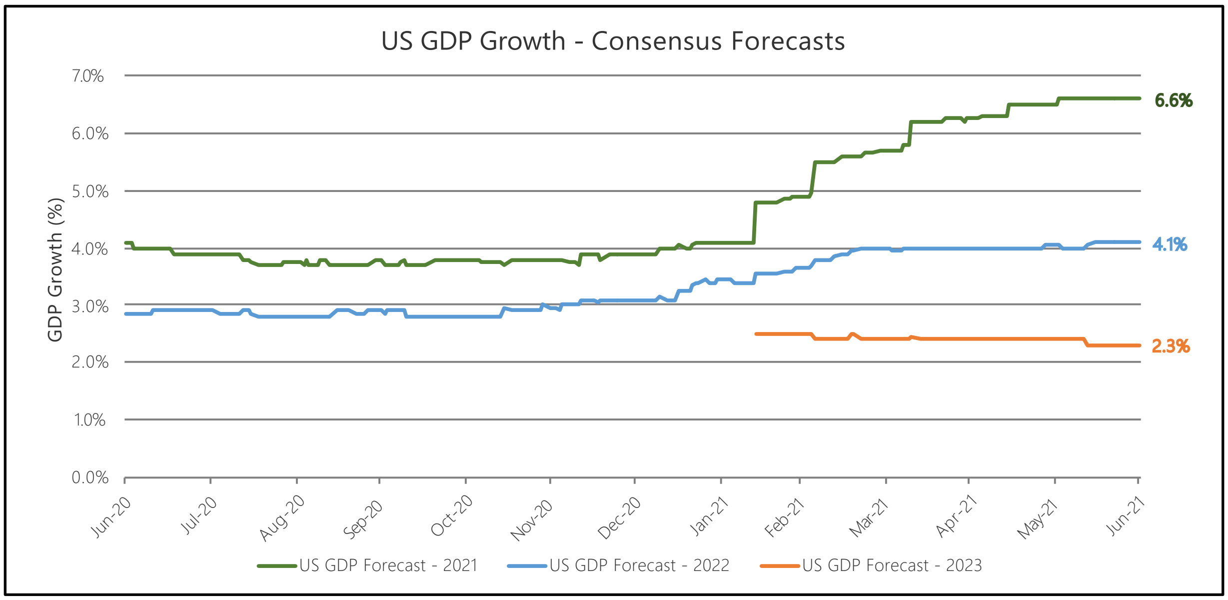
We can examine this phenomenon further using two examples. The first, depicted on the chart below, shows economists' consensus forecasts for US GDP growth over the next three years, per data gathered by Bloomberg. The green line shows the 2021 expectations, and one can easily observe that the rate of change earlier in the year was significantly positive—i.e., economists became increasingly sanguine about the US recovery and boosted their economic growth assumptions by nearly 3% over a six-month period. Alongside 2021's upward revisions, economists gradually upped their 2022 estimates (blue line), albeit at a more muted pace. These revisions—and company-specific earnings expectations that have been bumped higher as a result—helped underpin the stock market rally. But, perhaps the most interesting line to watch going forward is the orange one, representing the 2023 US GDP forecast. Since data collection began in earnest around the beginning of the year, expectations for 2023 have actually declined modestly—even as near-term estimates have jumped higher. Perhaps economists see the US stimulus "sugar high" wearing off over the next 18 months.



Source: Bloomberg (Data as of 6/30/2021)

The second example looks at analysts' estimates for S&P 500 earnings growth on a year-over-year basis. On the following page, the green line demonstrates how these expectations have evolved over the last 25 years. Generally speaking, the best near-term opportunities have come after growth expectations drop significantly (see: 1998, 2001, 2008, 2020) then rebound higher off a low base—emphasizing that the "rate of change" (i.e., are things getting better or worse?) is often more important than the absolute level, particularly at extremes. The current reading is at a 25-year high, so it is fair to ask how much higher the bounce from the 2020 lows can go.

To be clear, there is nothing about these metrics that would suggest imminent trouble for markets. The ongoing fiscal and monetary largesse may make these types of contrarian indicators less relevant than ever before. However, history would suggest that investors should stay vigilant at the extremes—monitoring forecasts for downside revisions and keeping return expectations in check going forward. ●

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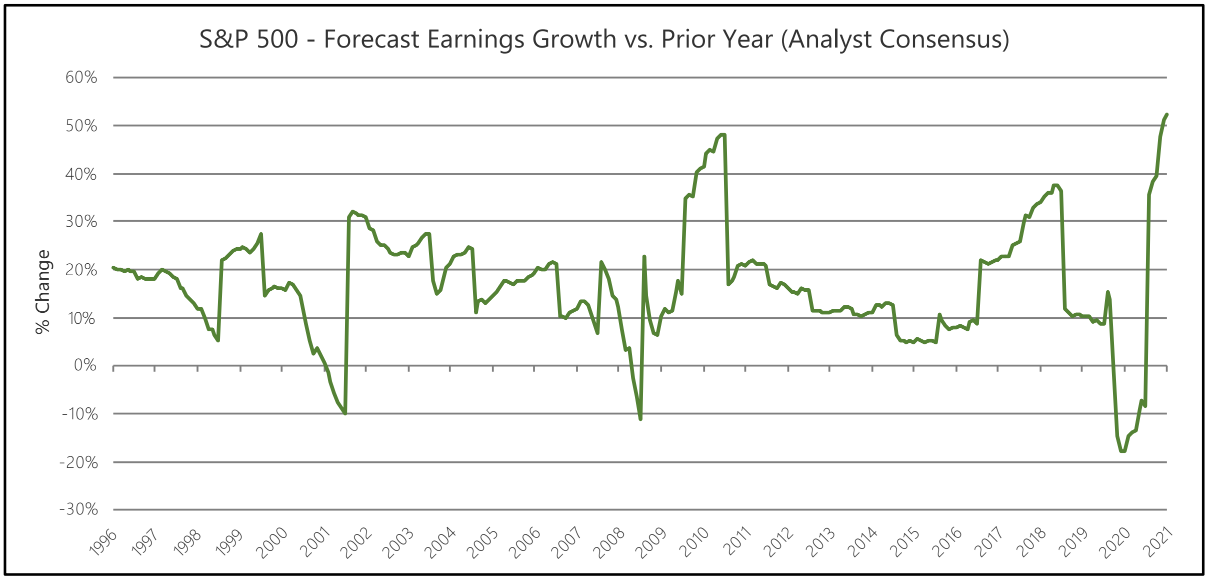
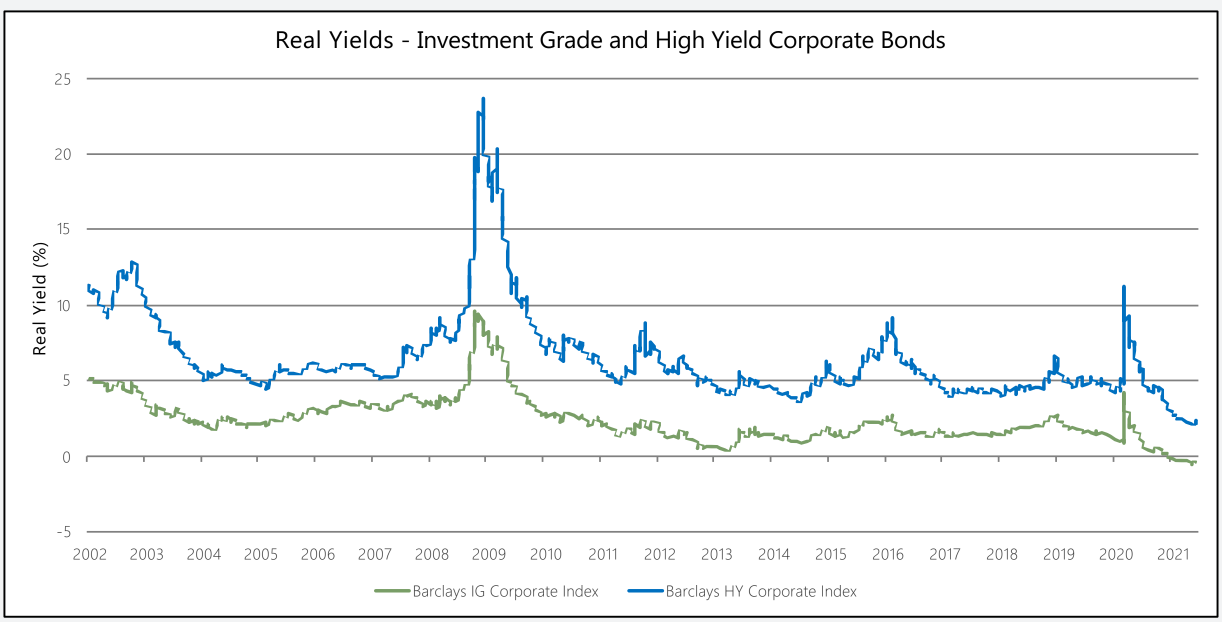


Source: Bloomberg (Data as of 6/30/2021)

Chart of the Quarter

With the Fed continuing to buy over $100 billion of assets per month, investors would be excused for assuming that market conditions are still somewhere between perilous and tenuous. The Fed's company line is that the asset purchase program is supporting its goals of full employment and 2% inflation, and while there is clearly some level of interconnectivity between capital markets and those two aims, it is increasingly difficult to argue that the cost of capital for corporates, municipalities, homeowners, etc. is an issue. In fact, some areas of markets are beginning to show signs that the ultra-accommodative measures may be going too far.

The Q2 Chart of the Quarter (below) explores the idea that Fed interventionism in capital markets may be hitting its useful limit. Specifically, the chart shows real yields—or yields minus inflation—for the US investment grade (green) and high yield (blue) corporate bond indices over the last 20 years. In this case, we are using the



Source: Bloomberg (Data as of 6/30/2021)

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5-year breakeven rate—the market's best guess at what inflation will average over the following five years—as our measure for inflation. As you can see, investment grade corporate bond yields have actually moved into negative territory in recent months, and the high yield segment of the market is not far behind. Plotting real yields using current inflation levels (CPI) would push junk bond yields below zero as well.

In the aftermath of the global financial crisis, the idea of "risk-free returns" from the Treasury market was turned on its head, and market commentators began talking about "return-free risk". With paltry yields and the looming threat of inflation, investors had to extend out the risk spectrum in order to generate a modest rate of return. That pressure is even more acute now; not only are Treasury bonds offering negative real yields, but safer areas of the credit market also fail to keep up with the rate of inflation. Investors must extend into lower-quality issues to generate positive real returns and necessarily accept the higher default risk that comes along with it.

Financial markets have a history of being irrational for longer stretches of time than most reasonable investors could conceive, and this has the look of another head-scratching distortion. Canny fixed income investors will find a way to navigate this environment through credit selection and idiosyncratic opportunities, but a broad, passive approach may be a recipe for disappointment. The mantra might be "Don't fight the Fed", but sometimes it pays to push back. ●

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