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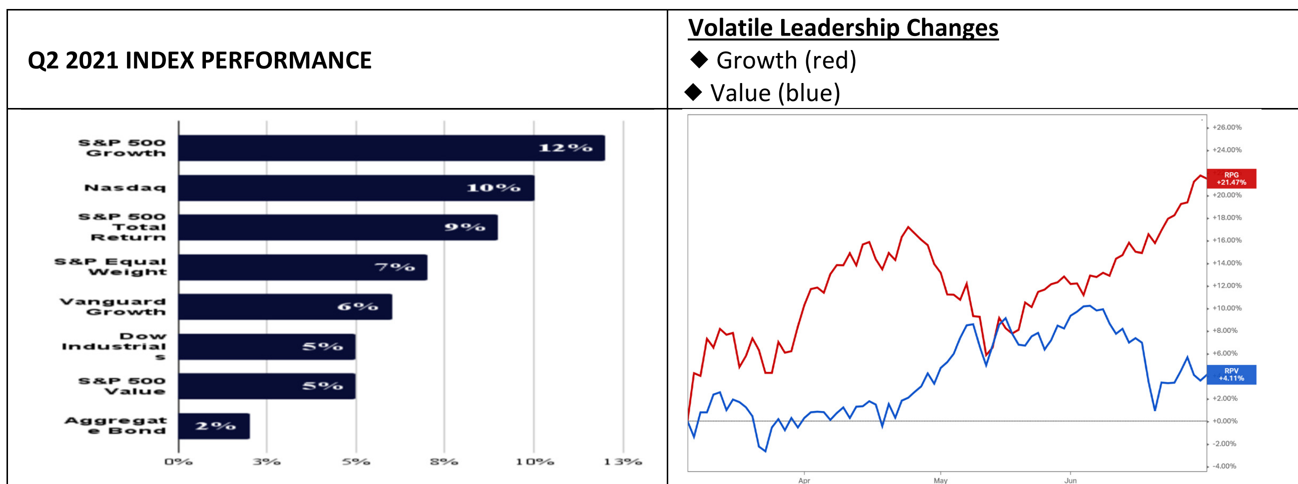
SECOND QUARTER 2021 MARKET COMMENTARY

INDEX PERFORMANCE AND ANALYSIS

Stocks rose through the second quarter to lock in gains for the first half of the year. The market is encouraged by the continuing post-COVID reopening, a generously spending Federal government, and an easy money, low interest rate Federal Reserve. Such a positive economic environment helped to propel the stock market as a whole into year two of its post-pandemic bull market. The internal dynamics of the stock market are still showing a tug-of-war between groups arguing over the business cycle and inflation. The uncertainty underlying these disputes is likely to lead to volatility heading into the latter half of the year. That being said, we are bullish on stocks going forward as pent-up demand and Americans with pent up savings emerge further from the pandemic mentality and contribute to what is shaping up to be the best year for economic growth since 1983.



INTERNAL CHURN, MARKETS RISE

There was no break in the stock market narrative from the first to the second quarter. The market rose thanks to the ongoing recovery but there remain lingering questions as to which segments should be leading markets in the years ahead.

In the first quarter we saw investors bet big on stocks that are expected to outperform in the early stages of a new business cycle. Thus, those foundational segments of the stock market—think industrials, financials, commodities, small and inexpensive stocks—outperformed everything else. But toward the end of the quarter growth and technology stocks came roaring back as investors started to question the pace and strength of the recovery (growth and tech stocks are thought better

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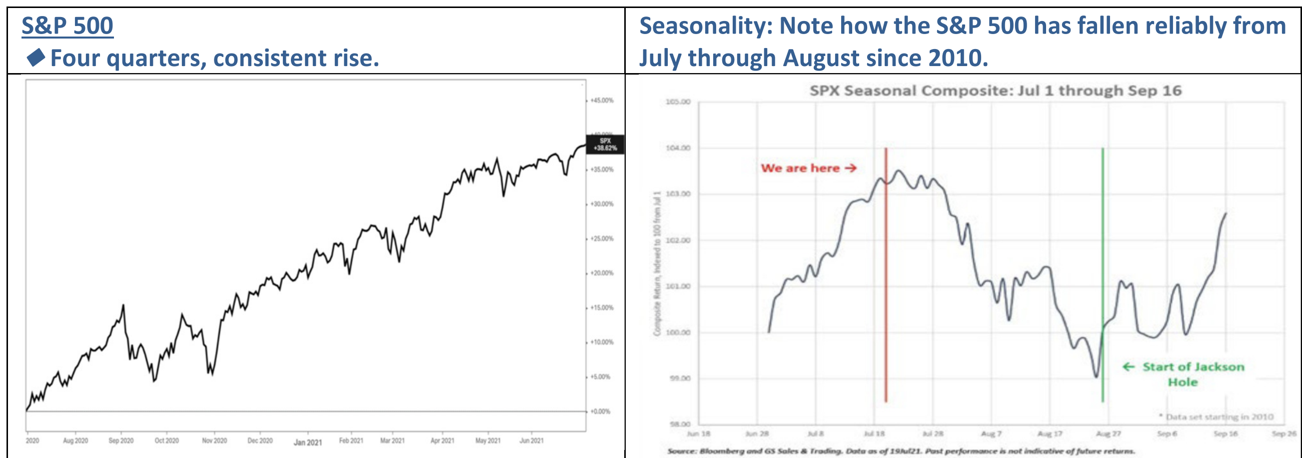
able to weather slow growth/low inflation environments). This battle between the early business cycle camp and the more skeptical camp was a constant feature of the first half. Note the chart below that shows this shifting leadership. This chart measures performance from March 8th when growth stocks started to outperform value stocks.

As of this writing, growth maintains the upper hand and has done so going on two months straight. We do not anticipate this battle to declare a victor any time -soon because much of the back-and-forth is due to the market's sensitivity to monthly economic data releases. Such sensitivity—based ultimately on the market's most hated condition, uncertainty—helps to explain these intermittent shifts and why there has been no consistent leadership.



Consistency can be found in the upward movement of the stock market taken as a whole. The arrival of the COVID vaccines late last year meant an end not only to the government-imposed lockdowns, but also to self-imposed individual lockdowns owing to fear of the virus. Reopening means spending, it means profits, and it means growth. The stock market rose on this simple logic. As explained, internal market leadership has been erratic but overall, the bull market continues to charge forward. Measuring from the bottom (March 23, 2020), we are now three months going on four months into this bull market's second year.

What is exceptional about this recovery is its steady endurance. The chart above denoting quarterly performance makes this point especially clear. Aside from some volatility last September (nearly a-10% correction), the steepest drop so far this year has been just -4% from peak to trough.

Ironically, this low volatility rise is one reason, among others outlined below, to be concerned about market turbulence in the months ahead. The S&P 500 averages a -14% drop each year and even young bull markets average a -10% drop in their march higher. Add to this the market's tendency toward seasonality, that is to say its habit of rising and falling at certain points in a calendar year (see chart below), and we have reason to believe that there will be a correction before the end of the year.

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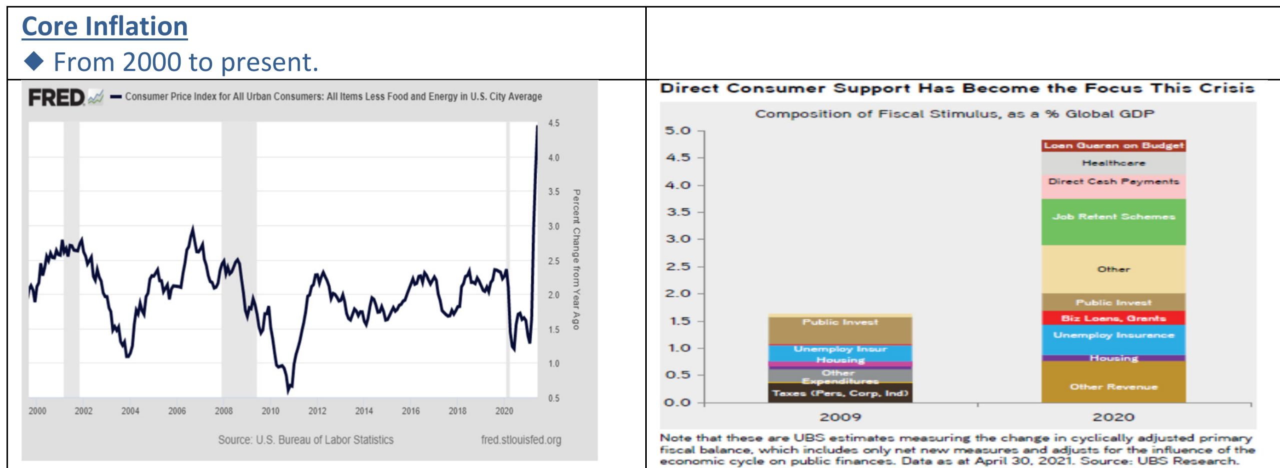
Inflation Considered

The overwhelming economic condition influencing markets this year is inflation. Following three decades of conspicuous absence, inflation is here. Prices increased 5.4% in June from where they were a year ago. This is the highest monthly reading since 2008 when inflation spiked due to astronomical oil prices during the Great Financial Crisis. If we strip out volatile energy and food prices—because they tend to move independently of other prices—then June's "core" inflation increase was the biggest in thirty years.



The reasons for higher inflation are many. To cite the most prominent: the pandemic shutdown interrupted the supply chain; pent up demand following the shutdown exacerbated supply chain bottlenecks; government spending in the trillions including direct payments to citizens; and a central bank newly willing to allow inflation to run hotter than normal for an indeterminate period of time.

No one denies that inflation is here. We all can attest to higher prices at retail and grocery stores and at restaurants. The big question looming over investors is whether or not this recent bout of inflation is temporary. Those arguing that these higher prices will be short lived—notably the Federal Reserve and the Biden administration—maintain that the majority of price pressures are the lingering aftereffects of the shutdown. They claim that shocking data points can be attributed to either (1) "base effects" (i.e., measuring annual performance from the depths of 2020's shutdown provides only heavily skewed numbers), or (2) singular circumstances unique to the shutdown that will be resolved with the passing of time. As to the latter, supply chain bottlenecks will resolve, they state, as the economy opens up further and the initial burst of demand is quenched. The single biggest contributor to June's stunning inflation reading, this side is quick to point out, was the price of used cars. Used car prices appreciated an unprecedented 45% in June from a year earlier thanks to an unexpected computer chip shortage and rental car companies replenishing their fleets. The effects of these one-off occurrences will inevitably fade, as will the base effects, and prices will stabilize later this year going into next.

On the other hand, the sustained inflation group argues that even after accounting for the base effects and the shutdown disruptions, higher prices are going to stick around. Their reasoning is twofold: first, there is a hyperabundance of money and a super accommodative central bank; and second, inflation is hard to tame once it establishes a hold on prices and on consumer/producer

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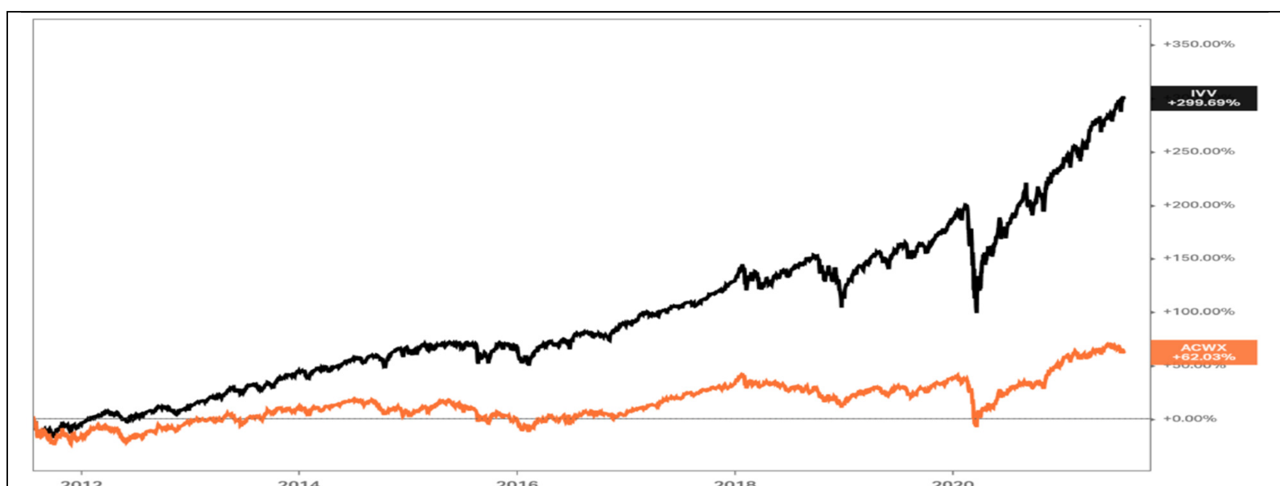
psychology. The Federal government got a taste for spending trillions of dollars during the pandemic and has had a hard time letting go of such awesome power. Much of this stimulus spending went directly to consumers who have managed to sock away $2.5 trillion in savings.

Also, state and local governments have yet to even spend $480 billion of their COVID aid package. The Federal Reserve is still in emergency bond-buying mode even though the pandemic recession lasted only two months and growth for the second quarter is expected to top 7%. The Fed is still buying $80 billion in Treasury bonds and $40 billion in mortgage bonds every month (despite a red hot, historic housing market). Finally, we know that as consumers start to accept higher prices for goods and services—as they become accustomed to the “inflation mindset”—the producers, the price-makers, will have little or no incentive to lower them later on. Once inflation reaches a certain point, this side states, it will display a ratcheting effect where it climbs suddenly but is then hard to reverse.

As we head into the third and fourth quarters, we will be getting a clearer picture of the inflation situation. We tend to agree that higher prices in many areas are going to be longer lasting but that this does not spell disaster for investors. The great inflation debate will continue to cause internal market shifts and its persisting uncertainty will lead to stock market volatility. However, given the ongoing reopening and an expanding economy, we believe there is broad opportunity for domestic stocks to climb higher notwithstanding sustained higher prices in certain areas.

Looking Ahead

This is why we are optimistic about the rest of the year. The unprecedented economic shutdown resulted in just a two-month recession, the shortest recession on record. The stock market recovered from its bear market bottom in record time and clocked its best bull market recovery since the Great Depression. These quick comebacks are testaments to the strength and durability of America’s economy and securities markets. Our markets are home to freedom and innovation and the following chart makes clear investors’ preferences for both over any alternative.



More immediately, as we look ahead, the uncertainty behind the market’s second half headwinds is not likely to resolve any time soon. Inflation, prospects for growth, government spending, and the Fed tapering their easy money policies all have the potential to disrupt this bull market. We think the

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best approach for investors when confronting a fragile market is to focus on current price behavior. Our tactical approach, informed by proprietary portfolio management software, does exactly this. It monitors only price movement as it attempts to filter out emotion-driven noise caused by whatever piece of news is dominating headlines each day. With this tactical approach we are better able to confront volatility's inevitable arrival and navigate through the market's internal leadership changes.

Performance Disclaimer

No investment strategy or methodology can guarantee profits or protect against losses. Investment risk is inherent in every individual portfolio and no computer model or modeling program used or relied upon in making investment choices for a portfolio can eliminate risk.

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