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2ND QUARTER 2021

Market Commentary

The only function of economic forecasting is to make astrology look respectable – John Kenneth Galbraith

The economic recovery continued to gain momentum and drive equity values higher. The S&P 500 returned 8.5% during the second quarter, bringing the year-to-date return to 15.2%. Small cap US stocks lagged the S&P 500 during the quarter, remained ahead of the S&P 500 year-to-date. Non-US stocks underperformed so far this year, with the MSCI EAFE Index, which represents developed markets, returning 8.8%. The 10.1% return of Europe was diluted by the flat performance of Japan. The MSCI Emerging Market Index returned 7.4% which masked a wide dispersion among individual countries. China, which accounted for over 40% of the index, returned 2.2%. India and Brazil both returned over 10% while Indonesia declined by 12%.

Across large and small cap US stocks, nearly 80% now trade above their pre-COVID high. Among non-US stocks this number is only slightly lower, around 70%. These ratios compare favorably to more normal periods for equity markets. Consensus expectations of earnings for major indexes over the next twelve months are comfortably above pre-COVID levels.

With the pandemic largely under control in developed countries, focus has shifted to emerging markets where the new, more virulent mutations of the virus threaten populations that have been slow to receive vaccines. While India's COVID outbreak has waned from its peaks, a slow vaccine rollout – less than 5% of the population is fully vaccinated – means the disease continues to spread. Brazil has vaccinated 13% of its population and continues to see over 1500 deaths per day. Indonesia has entered a critical stage, with hospitalizations outstripping medical resources. South African new cases in early July surpassed the peak of the last surge in January. Less than 1% of the South African population is fully vaccinated.

While growth stocks outperformed in several markets during the second quarter, value remains ahead of growth for 2021 in all major markets. This outperformance primarily stems from the fact that the value indexes possess larger weightings in the cyclical industries most levered to the post-COVID recovery. The broad economic resurgence provides a runway for the earnings of value stocks to outgrow growth stocks. Growth stocks tend to outperform later in an economic cycle where the cyclical tailwinds are weakest. During the early stages of a recovery, where cyclical businesses such as travel, materials or financials experience a large increase in demand, is where value typically performs best. The issue then comes down to how long these cyclical tailwinds will last for value stocks. Importantly, value is not 'owed' outperformance to make up for its past decade of record underperformance. However, with valuations of growth stocks near historical highs and the prospect of broad economic growth distributing profit growth outside of a few quasi-monopolistic technology companies, the case for value investing appears stronger today than it has for the past several years.

While bonds posted positive returns during the second quarter, year-to-date fixed income returns generally remained negative. Inflation-protected Treasury bonds (TIPS) and lower rated credits remained positive for the year. Inflation over the twelve months ending May 31 reached 5%, a number last seen in June 2008. During that period, inflation came from a doubling of crude oil prices to an all-time high of $140/bbl and it quickly receded after oil prices collapsed during the Global Financial Crisis. Prior to that, 5% inflation was seen last in 1990 when crude prices likewise doubled after the Iraqi invasion of Kuwait. Yields below 2% provide little compensation for investors relative to these inflation rates.

The high yield corporate bond market perhaps illustrates COVID-related volatility better than any other asset class. At one point in March 2020, nearly 2000 bonds traded at distressed levels (defined as over a ten percentage point spread over Treasuries). Today, fewer bonds trade at distressed levels than before COVID. Yields on junk bonds now are 3.7%. If the riskiest CCC-rated issues are excluded, the high yield market now offers investors a yield of only 3.4%. Since 1983, credit losses from defaults within the high yield market averaged 2.4% per year. These losses are unevenly distributed, with average annual losses under 1.5% during periods of economic growth, then spiking to 6-7% during recessions. Putting these numbers together – junk bonds, under a rosy annualized credit loss scenario of 1.5%, offer a total expected return today of approximately 2.2%. Given that high yield bond funds charge fees of around 0.5%, the net return to investors in junk bonds today falls to around 1.7% - only 0.2% above the yield of the investment-grade Bloomberg Barclays Aggregate Index and below the 2.0% yield of investment-grade corporate bonds.

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Successful long term investing depends upon identifying favorable risk and reward combinations. However, in recent years the markets continued to reward thoughtless risk-taking. At some point, which is impossible to time, this speculative period will end and overly exposed investors will suffer large losses. Attention to business quality and financial strength continue to translate to better performance. Portfolios need to be balanced to handle a wide variety of risks, as what seems obvious today may turn out to be completely wrong in the future. Investors should continue to focus on the long term, reserving near term liquidity needs in high quality fixed income. However, with bonds offering a certain loss of purchasing power, overly conservative portfolios can result in suboptimal long-term results. We continue to review your portfolio relative to its goals and objectives to ensure a proper allocation between safe liquidity and risk assets.

- Stephen C. Browne, CFA
Chief Investment Officer
Chief Compliance Officer

Smart Investing Webinar:
Tuesday, July 20, 2021 at 11:30 Central on Zoom

We invite you to join Steve Browne, CFA, CIO and Alison Moss, CEO, for our Smart Investing Webinar.

Successful long term investing depends upon identifying favorable risk and reward combinations. We will discuss the dynamics of 2021 that are driving the markets as well as looming tax law changes that may impact portfolio planning.

Link to join the webinar:

https://us02web.zoom.us/j/82618953825?pwd=Skc2V0x4WUV6MFd1OURacE1DaTVRZz09

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