Q2 MARKET INSIGHTS

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Summer 2021

U.S. equity markets continued their robust recovery during the second quarter as increased vaccine distribution combined with a substantial decline in domestic COVID-19 cases led to a surge in economic growth that helped stocks rally to new highs. The S&P 500® Index posted its fifth straight quarterly gain, returning 8.55% against a backdrop of reopening momentum, central bank liquidity tailwinds, fiscal stimulus, and strong corporate profit growth. Internationally, foreign markets saw positive returns in the second quarter thanks to further declines in COVID-19 cases, rising vaccination rates, and more widespread economic reopening across the EU and UK. Emerging markets also rallied in the second quarter on hopes of a global economic recovery. For the quarter, foreign developed markets, represented by the MSCI EAFE Index, registered a solid 5.35% return, while emerging markets, represented by the MSCI Emerging Markets Index, were up 5.08%. Switching to fixed-income markets, second-quarter total returns for most bond classes were positive, a reversal from the first quarter. Despite most inflation indicators surging to multiyear highs in recent months, investors generally viewed these increases as temporary phenomena related to short-term supply-chain disruptions as a result of the recovery. In addition, reassurances from the Federal Reserve (the "Fed") that interest rates would remain near 0% for the foreseeable future compelled investors to take advantage of relatively higher bond yields. As such, the Bloomberg Barclays U.S. Aggregate Bond Index, the leading benchmark for bonds, returned 1.83% for the second quarter.

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Looking ahead to the second half of the year, our outlook for equities continues to be positive as the underlying fundamentals remain intact. For the first six months of the year the S&P 500 gained 15.2%, its second-best performance since the dotcom bubble. Since 1979, the S&P 500 has gained 10% or more during the first half of the year fourteen different times. In eleven of those instances, the index finished the second half of the year higher, averaging a 6.3% gain during those final six months. We would not be surprised if this will be the twelfth time the S&P finishes the second half of the year higher. In our opinion, easy monetary policy (including Quantitative Easing programs) from the Fed and the rest of the world's central banks will continue to act as one of the more powerful influences on the prices of financial assets. As a quick refresher, Quantitative Easing (or "QE") is when a country's central bank purchases assets from commercial banks to provide liquidity to the banking system and stabilize the economy. Here in the U.S., the Fed purchases Treasury bonds and other government guaranteed debt (like mortgage-backed securities) from banks. As a result, these banks use some of this cash to make loans, but a substantial portion of this cash is used by the banks to buy publicly traded stocks and bonds and other financial assets for their own accounts (thereby causing market values to rise). The Fed's balance sheet (which reflects how many assets it has purchased via QE) topped $8.1 trillion at the end of the quarter, up from $4.1 trillion at the start of 2020, and is on track to peak at $9 trillion by the end of 2022, providing the potential for additional gains in financial markets.

MONETARY TIGHTENING?

As the economy continues to recover, the Fed has started the process of communicating how it will begin to reduce support for the economy via "tapering," or reducing, its QE program. At some point—likely later this year—the Fed will announce QE tapering. While this may sound troublesome for equities, there is a big difference between tapering quantitative easing and outright quantitative tightening. The former is a slowing rate of increase and the latter is an actual decrease. So, while the number of securities the Fed will be purchasing every month will be lower, it will still be expanding its balance sheet and providing liquidity to markets. The last time the Fed announced it was "tapering," it triggered what was called the "Taper Tantrum" in 2013, which caused bond market volatility and interest rates to rise significantly. However, it is worth noting that the S&P 500 was up over 30% for 2013 with very little volatility (the biggest equity market drawdown that year was less than 6%). If the Fed were to announce that it was going to begin to tighten monetary policy, like it did in 2018 when it did shrink its balance sheet, then we would expect stocks to react poorly like they did in the fourth quarter of 2018, when the S&P 500 fell 13.5%. As long as the Fed does not begin to tighten monetary conditions, we believe the environment remains supportive for equities.

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RECOVERY CONTINUES, BUT MODERATION AHEAD

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Another key support for equities in the near term is record corporate profit growth. As we highlighted in our preceding quarterly update, we thought many corporations would see their earnings expand through robust revenue growth (as a result of consumers spending their stimulus checks) and increased operating leverage (due to operating cost reductions). The first-quarter earnings were extraordinary, driven by strong revenue growth and record profit margins. According to FactSet, revenues for the S&P 500 grew 10.9% in the first quarter, the most in a decade, while earnings per share ("EPS") grew 52.5%, driven by profit margins of almost 13% (again, a record high). One thing we emphasized last quarter was that analyst expectations for EPS for 2021 were likely too low. Analysts have continued to revise their EPS estimates upward for 2021, and they now expect EPS of $191, up from $176 last quarter. Moving to the second half of this year, investors will be focused on the ability of these corporations to sustain these elevated profit margins as input prices and wage pressures have begun to increase. First, we believe most of these cost pressures are due to supply-chain disruptions and will likely be short lived (or "transitory," as the Fed prefers to call them). Second, many companies have indicated they plan to pass on these cost increases to customers. If these firms are successful in their ability to pass on these costs to consumers, then we could see additional upward revisions to EPS estimates, helping valuations and further supporting equity prices.

Lastly, fiscal policy risk was on the forefront of many investors' minds as the prospect for higher tax rates and a greater regulatory burden seemed imminent with the newly elected Biden Administration and Democratic Congress. Yet, those risks also diminished over the quarter as the fairly even political split in both the House and the Senate has reduced the likelihood of meaningful legislation being passed, particularly on the tax front.

The U.S. economy remains on track for a strong recovery. As the economy fully reopens and consumer confidence continues to rise, consumer spending is expected to keep driving the recovery forward. These outlays will be underpinned by a strengthening labor market and a large pool of savings derived from three rounds of fiscal stimulus checks dispersed over the past year. Furthermore, a new wave of monthly government checks to families with children,

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worth more than $100 billion, launched on July 15. This program should further strengthen spending in the second half of the year. Analysts expect 2021 to be a blockbuster year for economic growth, with GDP expected to grow 6.6%. This would be the highest rate of growth since 1984. The high-water mark for growth this year, however, is likely already behind us. U.S. GDP growth is expected to be 10% in the second quarter, but in the second half of 2021 and throughout 2022, the pace of growth will likely decelerate. Please note that this should not be construed as a pessimistic outlook, as analysts currently expect GDP to grow at a 3.8% annual rate in 2022. This is well above the 2.3% average annual growth rate the U.S. experienced between the end of the Global Financial Crisis and the beginning of the pandemic. However, in the second half of 2022, we expect the tailwinds from the current recovery to subside and growth rates to revert to prepandemic levels.

FINDING ATTRACTIVE OPPORTUNITIES

We believe investors are beginning to discount the prospects of lower growth rates, which is why bonds rallied toward the end of the quarter and more growth-oriented sectors of the equity market began to outperform (remember, market prices reflect investors’ future expectations of economic activity). Given this backdrop, we believe equity exposure should be focused on the companies that combine above-average revenue and earnings growth prospects with attractive valuation metrics. Three quantifiable metrics are high on our list: free cash flow, return on equity (“ROE”), and low leverage. Free cash flow is the measure of cash a company generates on an annual basis after it pays its capital expenditures to maintain and grow its operations. For example, if you run a manufacturing company that is in the process of building a new production facility to expand the number of products you offer, free cash flow is the amount of cash you have left from your earnings after you pay the cost of the new facility, plus any maintenance costs on your current facilities. Not only does free cash flow represent cash that is available to be returned to shareholders via dividends and buybacks, but it also is an important indicator of a company’s financial health, including its ability to make accretive acquisitions. ROE is the income a company generates, minus taxes and expenses, divided by the firm’s equity—the difference between total assets and total liabilities. Stated as a percentage, a high ROE relative to peers indicates that a company is making good use of its assets to generate profits. Stocks with higher ROEs have historically outperformed those with lower ROEs. The chart on the following page shows the performance of the companies in the S&P 500 ranked by ROE over the past five years. As you can see, companies that make the top 20% ranking in ROE have had the best returns. Low levels of leverage (or debt) are also very important. While debt is not necessarily a bad thing, particularly if it is taken on to invest in projects that generate higher returns than the rate of interest paid on the debt, companies with above-average leverage ratios tend to have more earnings volatility (as a result of higher interest expenses). This can be especially dangerous in a low-growth environment as the risk of default or bankruptcy may rise.

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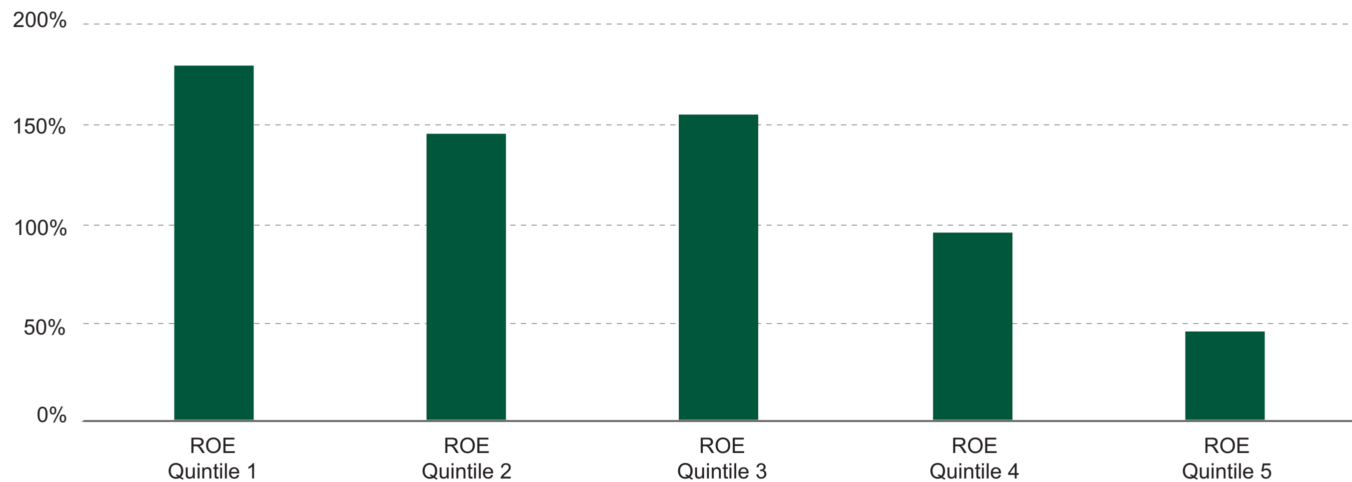
Not all attributes come in the form of ratios or financial metrics. In a slow-growth environment, we believe the concept of a “wide moat,” or durable competitive advantage, is especially important. Wide moats can come from having a strong brand, a patented product, or superior knowledge, given advanced research and development. Firms with wide moats may also engender high barriers to competition, potentially via specialized manufacturing capabilities, difficult-to-replicate distribution networks, and economies of scale. A large internet retailer with an extensive global distribution network that would take many years and billions of dollars to copy would fit this model, as would a social media company with an installed base of more than 3 billion users that can provide customers with the best returns for each advertising dollar spent. Pricing power—the ability to raise prices on goods and services without lowering demand—is another desirable trait. Cell tower companies, which operate in markets where the choice of service providers is limited, usually score well on this front.

S&P 500 Stocks with High ROE Have Outperformed



Source: FactSet

BALANCING ACT

As investors navigate a lower-growth environment, we expect interest rates to stay below their historical average. While some of the recent headline inflation data is likely short lived (again, due to supply-chain disruptions), the consequences of the unconventional monetary and fiscal policies utilized to offset the impacts of COVID-19 could have longer-term implications for inflation. In our preceding quarterly update, we highlighted in great detail how we believe these long-term inflationary pressures, the U.S. economy's inability to handle higher interest rates (due to outstanding debt), and possible solutions from the Fed to contend with these factors could have consequences for fixed income and may negatively impact an investor's ability to maintain their purchasing power. While we believe fixed income does offer diversification and correlation benefits relative to equities and still serves an important role in a client's portfolio, an allocation to real assets, such as bitcoin and other alternative assets (where appropriate), could help protect an investor's purchasing power. Assets such as these not only may help protect the risks associated with higher inflation, but also can offer uncorrelated exposure to traditional asset classes and tend to reduce overall portfolio volatility.

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IN CLOSING

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In summary, the strong gains of the second quarter and the first half of 2021 reflected continued government support for the economy combined with a material improvement in the domestic pandemic situation. As we start the second half of 2021, we expect financial markets to continue to benefit from accommodative monetary and fiscal policy. The coming year is shaping up to be one of deceleration, which, again, is not meant to be a pessimistic forecast. Corporate earnings and GDP are still expected to grow, however deceleration can be uncomfortable for markets. As such, we expect volatility to increase in the months ahead. In addition, new variants of COVID-19 that may render vaccines less effective could lead to increased levels of market volatility. Yet, while many risks remain in the markets and the economy (as they always do), it is important to remember that a well-executed and diversified financial plan that is focused on the long term can overcome bouts of even intense volatility, like we have seen over the past eighteen months. This is why we remain committed to working with you to establish a personal investment allocation appropriate for your financial position, risk tolerance, and investment timeline.

We thank you for your ongoing confidence and trust. Please rest assured that our entire team will remain dedicated to helping you successfully navigate the financial markets.

Have a great summer!

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Definitions:

S&P 500® Index is a registered trademark of Standard & Poor's Financial Services LLC, a division of S&P Global ("S&P"). S&P 500 Index is an unmanaged index used as a measurement of change in U.S. equity markets. Performance numbers for the index are total return with dividends reinvested in the index.

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The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets (Europe, Australasia, Far East), excluding the US & Canada. The MSCI EAFE Index is an equity index which captures large and mid-cap representation across Developed Markets countries around the world, excluding the US and Canada. With 913 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Indices are not managed and do not incur fees or expenses. Performance numbers for the index are total return with dividends reinvested in the index.

The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (EM) countries*. With 838 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Performance numbers for the index are total return with dividends reinvested in the index.

The Bloomberg Barclays US Aggregate Bond Index provides a measure of the total return performance of the U.S. dollar denominated investment grade bond market, which includes investment grade government bonds, investment grade corporate bonds, mortgage pass through securities, commercial mortgage backed securities and asset backed securities that are publicly for sale in the United States.

Gross domestic product (GDP) is calculated by the Bureau of Economic Analysis that serves as a measure of total market value of the goods and services produced (output) in the U.S. GDP is the sum of consumer spending, investments made by industry, the excess of Exports over Imports and Government Spending.

Quantitative easing (QE) is defined as large scale purchases of securities, typically fixed income, by a monetary authority such as the Federal Reserve. In theory, the result is an increase in demand for those securities, putting upward pressure on their prices and pushing yields down. Quantitative easing allows a monetary authority the ability to influence longer duration securities, while traditional monetary tools can only directly influence shorter duration securities.