Market Newsletter

June 30, 2021

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EXECUTIVE SUMMARY

- Stocks, bonds and commodities rose in the second quarter. Unlike in the first quarter, growth stocks and stocks of larger companies outperformed.

- The US economy is exhibiting a V shaped recovery helped by successful vaccination programs and return to normalcy but is still not out of the woods.

- Innovation helped the US economy improve productivity during the pandemic after years of stagnation. Some of this gain in productivity may dissipate when life returns to normal, and some may remain.

- Corporate earnings are expected to have grow by a record 64% in the second quarter as compared to last year. Stocks have risen in line with expectation of higher earnings and although stocks are cheaper than they were at the beginning of the year, they are more expensive than their 25-year average.

- A successful investment plan requires taking risks that has a reasonable chance of being compensated. A diversified portfolio helps you tolerate volatility, a risk that has a reasonable chance of being compensated. A diversified portfolio also helps you stay invested in the market which contributes to long term returns.

Table 1: Market indices

(Returns include dividends)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	8.55%	15.25%	40.79%	18.67%	17.65%
S&P Mid Cap 400	3.64%	17.60%	53.24%	13.17%	14.29%
S&P Small Cap 600	4.51%	23.56%	67.40%	12.20%	15.82%
MSCI Emerging Markets	5.12%	7.58%	41.36%	11.67%	13.43%
MSCI EAFE	5.38%	9.17%	32.92%	8.33%	10.79%
Investment Grade Credit (C0A0)	3.60%	-1.06%	3.62%	7.75%	4.94%
Non-Investment Grade Credit (H0A0)	2.77%	3.70%	15.62%	7.16%	7.30%
Bloomberg Commodity Index Total Return	13.31%	21.15%	45.61%	3.91%	2.40%
Dollar Index (DXY)	-0.86%	2.78%	-5.09%	-0.73%	-0.78%
Vanguard Total Bond Market Index (VBMFX)	1.97%	-1.75%	-0.53%	5.27%	2.89%
10 Yr Rate	1.44% 06/30/2021	0.92% 12/31/2020	0.64% 06/30/2020	2.85% 06/30/2018	1.49% 06/30/2016

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg, Yahoo Finance

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 07/02/2021	Latest Release	Recent Trend	Notes
Non Farm Employment	850,000	Positive	The employment situation in the US is improving remarkably in line with a re-opening economy, as seen in the latest number. More people are looking for jobs, which ironically has led to the unemployment rate to increase to 5.9%. Wage growth was as expected allaying fears of inflation.
Weekly Claims for Unemployment Insurance	364,000	Positive	In line with a strengthening job market, initial claims continue to fall. The latest number was the lowest since the pandemic high.
ISM Manufacturing Index (over 50 indicates growth)	60.6	Positive	Manufacturing activity continues to be robust. Supply chain constraints and lack of labor affected the index as companies struggle to meet pent up demand.
ISM Non Manufacturing Index (Over 50 indicates growth)	64	Positive	The services sector is also very strong with companies struggling to meet demand.

	Latest Release	Recent Trend	Notes
Consumer Prices (Month over month change)	0.6%	Negative	The consumer price index rose significantly raising fears of runaway inflation. Year over year, prices were up 5%, the highest level since 2008. As of now, it seems inflation is transitory and is likely to subside when the pent up demand in the economy normalizes
Producer Prices (Month over month change)	0.8%	Negative	Like consumer prices, producer prices shot up recently. Prices were up 6.6% over the last one year.
Retail Sales (Month over month change)	-1.3%	Positive	Retail sales dipped in May as consumers cut spending on items such as autos and furniture and shifted to spending on goods and services associated with going out. The drop in May comes after an unusually strong January and March.
Consumer Confidence (Conference Board)	127.3	Positive	Consumer confidence has improved every month last four months. The level of the consumer confidence index is now at the highest level since the onset of the pandemic in March 2020
Durable Goods Orders (Month over month change)	2.3%	Positive	Durable goods rose in May despite supply chain bottlenecks, driven by orders for aircrafts. Core capital goods excluding defense and aircraft fell, but an increase in shipments used to calculate the GDP indicates the economy is on solid footing.
Industrial Production (Month over month change)	0.8%	Positive	Industrial production rose for the third straight month. Supply chain constraints and shortages affected industrial activity.
Capacity Utilization	75.2%	Positive	As the economy rebounds, industries are making use of more of their capacity. Not surprisingly, there is still slack in the economy.
Housing Starts	1.572MM	Positive	Housing starts continues to increase reflecting a strong housing market. There is a shortage of houses in the US, but high lumber prices and material shortages have hampered construction activity.
Home Prices (Case-Shiller 20 city Index- Month over Month)	1.6%	Positive	Low interest rates and a shortage of homes for sale have led to an increase in home prices in the US. Over the last year, prices have increased by 14.9%.
GDP (Real, Annualized)	6.4% (Q1 2021)	Positive	The US GDP is expected to grow by the highest rate in over 7 decades this year.

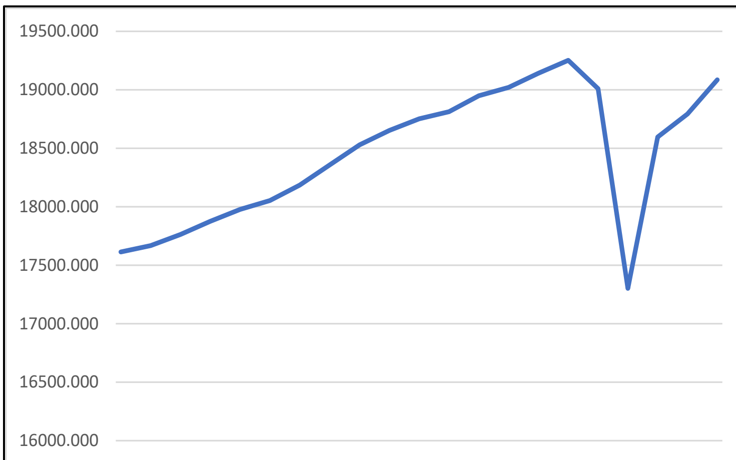
Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ism.ws, www.nahb.org

Global stocks rose in the second quarter as successful vaccination programs and a re-opening economy led to healthy economic activity. Unlike the first quarter, stocks of larger, faster growing companies (Growth stocks) outperformed smaller and slower growing companies (Value stocks). Also, unlike the first quarter, bonds rose as fears of runaway inflation were allayed, primarily by the US Federal Reserve (The Fed), which believes the recent spike in inflation is transitory. (Unexpected inflation hurts bond prices). A strong demand combined with material shortages led commodity prices to increase sharply.

As seen in Table 2, the US economy is growing at a healthy rate. Thanks to stimulus checks, unemployment benefits, a rising stock market and consumers that had limited options to spend, there was a lot of pent-up demand which was released when the economy started to re-open. The debate about the shape of the recovery has subsided as it now seems, this recovery will be a 'V shaped' recovery (Fig 1). The US economy is expected to grow by the highest rate in over seven decades this year, and if that happens, the US Gross Domestic Product (The total output of the US economy) will exceed the pre-pandemic level by the end of 2021.

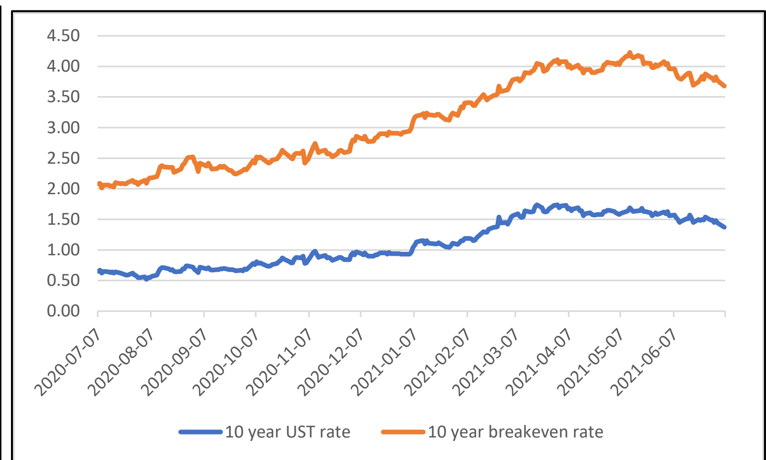
The pandemic has led to low inventories and supply chain bottlenecks causing inflation to spike up to multi year highs as producers scramble to meet the pent-up demand. The Federal Reserve believes the spike in inflation is transitory and has said it will not raise interest rates until 2023 (The Fed usually raises interest rates to curtail inflation). The bond market, which usually sniffs out inflation much earlier than anyone, seems to agree with the Fed. The 10-year US treasury rate, has dropped from a recent high to settle at 1.37% and the 10-year breakeven rate (The bond market's expectation of future inflation) has been declining in the last few months to settle at 2.31% (Fig 2)

Fig 1: US Real GDP 2016-2021 ($ Billions)



Source: St Louis Federal Reserve, Sarsi

Fig 2: 10 year US treasury and 10 year breakeven rates

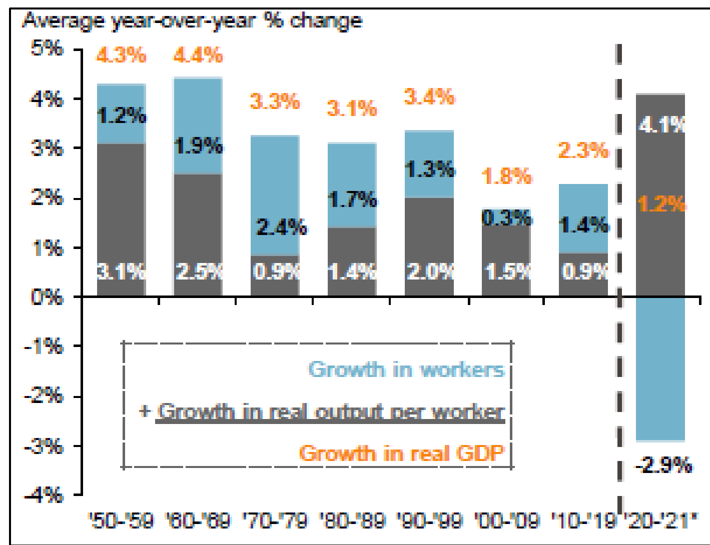


Source: St Louis Federal Reserve, Sarsi

One of the effects of the pandemic on the US economy is that it pulled forward many technological advances as firms and consumers worked around widespread disruptions. This caused the US productivity to rise significantly after years of stagnation (Fig 3). While some of this increase in productivity may dissipate as we return to a normal life, some of the innovations and efficiencies may remain, which augurs well for future economic growth.

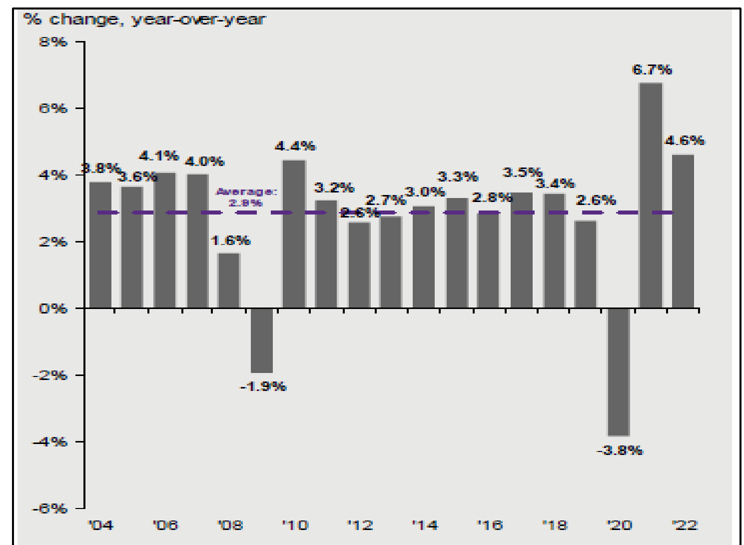
Despite several tailwinds to US economic growth, it is still not out of the woods. Although the number of jobs is growing and the unemployment rate has fallen to 5.9%, about 7.5 million workers that were employed before the pandemic are still out of work, as many as during the depths of the financial crisis. There are millions of workers who have stopped looking for jobs and if you include them in the calculation, the unemployment rate is 8.6%. While vaccination programs have progressed successfully, there are new variants of the virus that could hamper normal life. As of now, the existing vaccines are thought to be effective against known new variants.

Fig 3: Productivity has surged during the pandemic.



Source: JP Morgan

Fig 4: Global Real GDP Growth



Source: JP Morgan

Around the world, the pace of economic recovery has varied widely, as countries are at varying stages of fighting the pandemic. Some countries in Asia, such as India, have seen increasing infections in recent months. However, vaccination programs are trending higher, and economies are recovering, and GDP growth is expected to be strong (Fig 4).

Corporate earnings are expected to have grown significantly in the second quarter of 2021. Like in the first quarter, analysts increased their estimate for corporate earnings by a record level and they expect earnings to have grown by 64% as compared to last year, according to Factset. Stock prices rose along with expected earnings and forward price earnings ratio (A measure of how cheap or expensive stocks are) is currently about 22 times as compared to a 25-year average of 17 times. Year to date, the performance of the index was driven solely by an increase in earnings as the price earnings multiple fell i.e., stocks became cheaper.

Risk in investments

For an investment plan to succeed it is important to understand the concept of risk and how it impacts your investments. According to the Merriam Webster dictionary, risk is defined as *the possibility of loss or injury*. We take risks in almost every activity and seem to understand that we must reduce risks, take acceptable risks, and avoid unacceptable risks. For example, driving involves risks and we minimize it by following traffic rules and wearing seat belts even if it slows us down or requires extra effort. Driving at an extremely high speed involves taking unacceptable risk, and we chose not to take that risk even if it saves us considerable time. When it comes to investing, people sometimes misunderstand the concept of risk and what is acceptable and what is not.

Although it has a negative connotation, risk is not bad per se. In fact, taking no risk is the biggest risk. If you deposit all your money in a bank account, which currently yields near 0% interest rate, you are losing money after adjusting for inflation. To do better, you must take risks that have a reasonable possibility of being compensated, such as investing in stocks and bonds that offer higher potential returns. The risks you must avoid are those that will not be compensated such as the risks that could lead to a permanent loss of capital. For example, speculating in an investment you do not understand, or ill-timed investments can lead to permanent loss of capital. Buying meme stocks in the hopes of making a quick buck is a speculative activity that can lead to a permanent loss of capital. Buying a perfectly good investment can lead to a permanent loss of capital if it is not timed properly. For example, if you have money for an objective in the future

and you invest it in a good investment but need to sell it when its value is down to satisfy your objective, you will convert a temporary loss to a permanent loss. This is why, investing in line with your time horizon is important.

One kind of risk that could be compensated when taken appropriately is volatility of investments (i.e the market's gyrations). In fact, all else being equal, the higher the volatility the higher the expected return of an investment. For example, stocks are more volatile than bonds but have a higher expected return. By diversifying the portfolio, you can take volatility risks and reduce the possibility of permanent loss of capital. Diversification is called the only free lunch in investing- because you can reduce risks without a commensurate reduction in expected return. When a well-diversified, well-constructed portfolio, decreases in value, such as during a recession, you can confidently 'ride the volatility' and stay invested. One of the most important factors that contributes to investment success is time in the market, so staying invested leads to a higher long-term return.