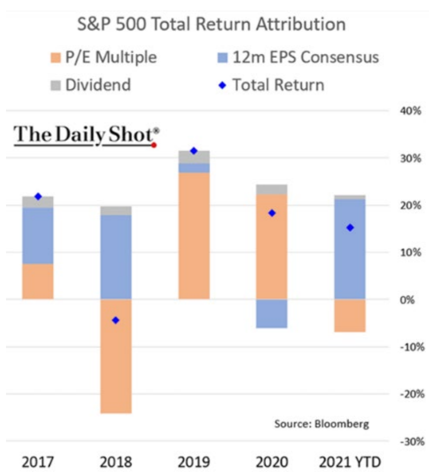
EQUITY MARKET UPDATE

As of 6/30/21 | Volume 10, Issue 6 | FFTAM.com

Stock indexes were mixed in June. Company specific news was light as we approached quarter-end. Investors continue to debate the potential for future inflation. The Fed insists that the current inflation data is "transitory" and will normalize over the next 12-18 months. However, shortages in products and labor persist. The Fed indicated the start of discussions on tapering monthly asset purchases, and the Delta variant of COVID-19 continues to spread in many countries. Those two events resulted in a large retracement in yield for the 10-year US Treasury, which aided growth stocks.

Tech Stocks Advance as Bond Yields Fall



The S&P 500 gained 2.33% in June. The index was powered by the big tech companies that jumped 6.95%. Energy was also an outperformer. Industrials, financials, and materials vastly underperformed as a drop in bond yields and concerns about the spread of COVID-19 overseas led to investor rotation within the index. Year-to-date, the S&P 500 is up 15.24%.

The Dow Jones Industrial Average increased by 0.02% last month. A lower allocation to technology, along with sharp declines in Caterpillar, Honeywell, and Boeing accounted for the underperformance versus the S&P 500. Year-to-date, the Dow is up 13.79%.

The NASDAQ was the strongest performer among the major indexes gaining 5.55%. After experiencing investor outflows for most of the year, tech stocks regained favor in June after the Fed announced discussions about tapering monthly asset purchases. Large advances in Apple, Microsoft, Amazon, Alphabet, Facebook, and NVIDIA accounted for over 55% of the gains. Despite the strong month, the NASDAQ still trails the S&P 500 and the Dow Jones Industrial Average in 2021 with a total return of 12.92%.

The best yearly results continue to come from mid and small-sized companies, although both indexes took a breather last month. The S&P 400 Mid-Cap Index declined 1.02%, while the S&P 600 Small-Cap Index gained 0.33%. Both indexes were hurt by an overallocation to economically sensitive sectors; however, the small-cap index benefitted from the 117% monthly return in AMC Entertainment as retail investors continue to chase ideas being spread on the social media platform Reddit. Thus far in 2021, mid and small-sized companies have rallied 17.59% and 23.55%, respectively.

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<u>International & Emerging Market Stocks Rally as European Economy Reopens</u>

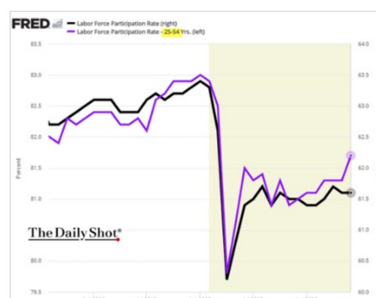
The European Union, which had lagged the US for months in vaccinations, gained additional ground in June. Over half of Europeans have received at least one shot. Restrictions are being lifted in some regions; however, worries about the Delta variant are delaying a full reopening. In June, Hong Kong banned UK flights after Prime Minister Boris Johnson announced 90% of new UK cases were from the new strain. The spread of the Delta variant also caused Israel to reinstitute the wearing of masks indoors, while Japan is considering no fans at the upcoming Olympics.

The European economy continues to strengthen despite the COVID concerns. Data from Google showed mobility levels in Europe now exceed the US even though the Eurozone has more business restrictions. PMI data showed a strong recovery in the UK service sector, while Eurozone Manufacturing PMI hit its highest level in 21 years. As the European economy reopens, inflation is running ahead of the ECB's target, but price hikes are limited to areas sensitive to reopening such as oil and raw materials. After hitting a record high in May, European stocks declined in June. The MSCI EAFE Index fell 1.40%. Year-to-date, the index is up 9.21%.

The MSCI Emerging Markets Index gained 1.34% in June even though Chinese economic activity slowed. Industrial output increased 8.8% year-over-year, while retail sales expanded by 12.4%. Finally, Chinese fixed asset investment grew by 15.4% year-over-year. All three data points decelerated from the previous month's readings. Finally, the Chinese government continued its crack down on the use of crypto currencies and ordered large tech companies to provide the government with user data on certain platforms. Year-to-date, emerging markets remain the weakest performer gaining only 7.43%.

<u>Delta Variant of COVID-19 Spreads Worldwide</u>

The Delta variant strain of COVID-19 that originated in India has begun to spread with increasing speed. Scientists say the mutation is more transmissible than COVID-19. Infections are rising in many parts of the world, especially in regions where vaccination rates are low. As mentioned above, many countries are beginning to take precautions against the illness. The Delta variant so far does not appear to be more virulent than previous mutations. Both Johnson & Johnson and Moderna have announced their vaccines provide strong coverage against the virus. All approved COVID-19 vaccines continue to show great efficacy against all strains of COVID-19, and there is ample supply available for Americans who have yet to be vaccinated.



<u>US Reopening Remains on Track, Labor and Product Shortages Persist, Fed Hints at Tapering</u>

Economic data showed further improvement in June. Non-farm payrolls increased by 850,000 jobs. This was the biggest gain in 10 months as vaccination rates continue to rise, the economy reopens further, and states sunset enhanced unemployment benefits. Leisure and hospitality accounted for the most jobs; however, that industry remains woefully understaffed despite lifting wages 10.45% from pre-pandemic levels. Hourly pay for all private sector workers is up 3.6% year-over-year. There are still 6.8 million fewer jobs than pre-COVID. Labor force participation remains flat, but data shows improvement among prime aged workers (25-54 years old). As the economy reopens, employers are learning that many of their older aged employees are electing to retire rather than rejoin the workforce. According to the Dallas Fed, more than 2.6 million people have retired between February 2020 and April of this year. That is 1.5 million more retirements than under normal conditions.

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Retail sales remained strong as consumers continue to spend their stimulus checks. As the economy reopens more widely, spending is shifting towards services over goods with large increases seen in recreation and restaurant dining. The brisk pace of consumer spending is leading to critically low inventory levels in many products. ISM Manufacturing PMI data showed further expansion with strong activity in new orders; however, the backlog time to get the finished products is lengthening as factories are having difficulty hiring new employees. The ISM Services PMI data showed similar results.

The shortage of workers and products resulted in PPI and CPI data running hotter than consensus estimates. This placed outsized attention on the Fed meeting. The FOMC left monetary policy unchanged; however, the dot plots implied two rate hikes in 2023. The Fed also raised their forecasts for GDP growth and PCE inflation. The post-meeting statement dropped the language that it is "too early" to discuss tapering. During the press conference, Chairman Powell said a detailed tapering plan could be announced at an upcoming meeting. He reiterated that the Fed would give advance notice to the market before implementing the plan and stressed the timing would be dependent on job growth in the next several months. Finally, he repeated that the Fed believes the above average inflation data is transitory and will return to normalized levels once more people have spent their stimulus checks and return to the workforce.

Tech Stock Rally Expands Market PE as Interest Rates Fall

Currently, the S&P 500 trades at 22.74x 2021 EPS estimates. This is far better than the 30.62x trailing earnings reading, and it shows how rapidly corporate profitability has improved. As we approach earnings season, analysts have lifted their profit estimates. Currently, Wall Street is looking for 2nd quarter 2021 earnings growth of 63.6% on a year-over-year basis. If that comes to fruition, it will mark the highest year-over-year growth rate since the 4th quarter of 2009.

Despite the improved earnings, stock valuations remain pricey. If you fast forward to the 2022 and 2023 profit forecasts, the index trades at 20.37x and 18.46x, respectively. All these valuations are well above the historical median of 16.64x, and they do not consider President Biden's proposed tax increases.

The above average valuations can be justified by the enormous amount of liquidity in the system. Extremely accommodative financial conditions, along with the drop in 10-year US Treasury yields from 1.77% to 1.32%, are providing fuel to the stock market rally. The recent decline in interest rates has been a boon to the pricey tech stocks. Given the tech sector's large weight in the S&P 500, the rally has pushed the market's PE ratio even higher.

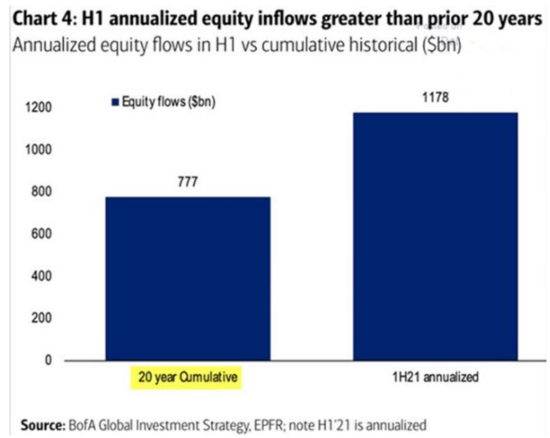
All these indicators signal the market has baked-in much of the upcoming improvements for the economy; therefore, stocks are vulnerable to further consolidation or pullbacks in the next few months, especially as we enter the seasonally weak 3rd quarter. We expect volatility to remain high as the economy transitions from the early to the middle stages of the business cycle.

Our Outlook & Strategy

For several months, I have written that elevated risk taking and preference for the most economically sensitive stocks is coming at the expense of companies with strong balance sheets. That trend reversed itself in June as interest rates fell following the Fed meeting. A rotation towards quality resulted in monthly outperformance for our portfolios.

When examining stocks as a whole, risk appetites remain large. During the first half of 2021, stocks have seen inflows of almost $1.2 trillion. That is an enormous amount of money. To put it in perspective, the inflows in the first half of 2021 far exceed the inflows of the previous 20 years combined!

As I stated above, much of this has to do with excess liquidity created by the Fed and stimulus programs from the government. With money being plentiful, it must find a home somewhere. Banks are flush with deposits and are net buyers of bonds as the lending environment remains tepid. We are also seeing a narrowing of credit spreads to all-time low levels in both investment-grade and junk bonds as the economy recovers. With negative real yields (the rate on a bond minus the inflation rate), stocks are finding little competition, which is pushing equity valuations higher.



This tells me the yield on the 10-year US Treasury has become the most important price indicator in the world. The correlation of bonds and stocks are increasing; therefore, providing less diversification benefits than the past. The excess liquidity is inflating all assets to levels that have historically indicated below average forward one-year and five-year returns. This means volatility will likely remain high, and it makes inflation readings very important to watch.

The effects of COVID-19 have created a new "normal" for investors to consider. We have accelerated the time frame on the use and adoption of mobile technologies for education, shopping, entertainment, doctor visits, etc. We have also adapted to a non-centralized workforce. We have seen from the past two administrations that the United States wants to encourage domestic manufacturing of semiconductors, medical equipment, and other items deemed to be of national security importance. Finally, the rush to develop a vaccine has brought many new healthcare related technologies to marketplace. When considering all of these items collectively, the Fed is likely correct that total inflation will prove to be transitory as productivity rises from these technological innovations; however, a misallocation of workers and skillsets increases the likelihood that certain pockets of the economy will see above average inflation for many years.

As we evaluate our roster of holdings across our equity styles, we remain highly selective about which companies to own. We are constantly searching for companies that will benefit from long-term secular trends that can produce top-line revenue growth and sustainable cash flows. This naturally leads to overweight positions in technology and healthcare. These stocks are negatively impacted when interest rates rise, so we have been boosting our holdings in energy and financials to offset this risk should inflation readings remain hot for longer than expected.