HIGHTOWER
Westchester

Market Commentary Q2 2021

Looking back on the markets throughout the first half of 2021, it is important to understand both where we are now and where we came from. As we all know, the stock market tends to be a forward-looking indicator, and it has been just that as prices have reflected an economic recovery well before it occurred. To put it into context, over the last year, domestic large cap stocks are up over 40%, small cap stocks over 60%, developed international are up over 30%, and emerging markets have risen by over 40%.[1] We are also witnessing a significant rebound in Gross Domestic Product ("GDP"), solid jobs growth, and record corporate earnings expectations. It is hard to fight the strength of the fundamental factors, and the U.S Federal Reserve ("Fed") right now.

Underneath the hood we are seeing market participants continue to favor U.S. and European companies as year-to-date returns in these markets are all in the double digits. With rising vaccination rates and falling infections, it appears the tide is starting to turn against the horrid virus that upended all our lives. Meanwhile, investor confidence is being lifted by the elevated levels of cash that are being supplied by central banks and governments. This, in turn, has lifted the share prices of not only companies, but of homes, cryptocurrencies, and a host of other consumer items.

With that said, stocks closed out the first half of the year at record highs. The S&P 500 has soared almost 16% this year.[1] That qualifies itself in the top 15 first halves in the history of markets and from a technical perspective the rebound is now longer and more potent than the 2009 rally in terms of duration and magnitude.[1]

Growth stocks outperformed their value counterparts through June 30. Government bond yields saw a different performance as the U.S. 10-year yield fell (meaning prices rose). Corporate bonds outperformed government bonds and commodities gained with energy again being the strongest component.

The Fed rate-setting meeting brought no change to policy, but its projections indicated that interest rate rises could come in 2023 or earlier. This seemed to wrong-foot some market participants, though subsequent comments by Fed officials sought to allay any worries over tightening monetary policy too quickly.

In late June President Joe Biden also secured a deal on an infrastructure package worth about $1 trillion to upgrade roads, bridges, and broadband networks over the next eight years. The agreement fell short of the $2.3 trillion infrastructure spending plan announced in March and did not address the social safety-net spending proposed in April.

The usual technology giants made strong gains over the quarter. By sector, energy, IT, communication services and real estate were amongst the strongest areas of the market. Utilities and consumer staples lagged.

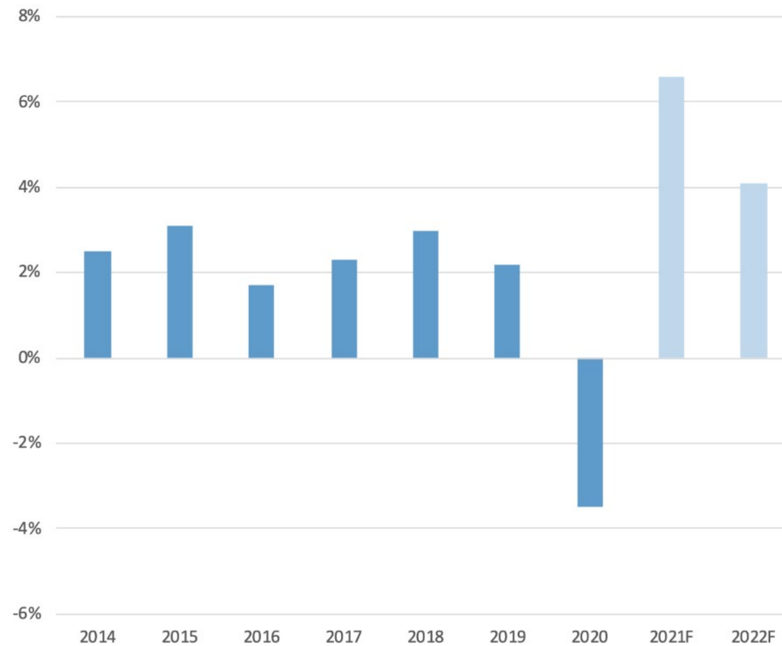
Leading US Indices (Total Return)	1Q'20	2Q'20	3Q'20	4Q'20	2020	1Q'21	2Q'21 (sorted)	YTD
S&P/Citigroup Growth	-14.5%	26.2%	11.8%	10.7%	33.5%	2.1%	11.9%	14.3%
Nasdaq	-14.0%	30.9%	11.2%	15.6%	44.9%	3.0%	9.7%	12.9%
S&P 100 Mega-Cap	-17.2%	20.8%	9.8%	10.7%	21.5%	5.1%	9.4%	15.0%
S&P 500 Total Return	**-19.6%**	**20.5%**	**8.9%**	**12.1%**	**18.4%**	**6.2%**	**8.5%**	**15.3%**
Dow Jones Wilshire 5000	-21.2%	22.1%	9.0%	14.4%	20.0%	5.8%	8.1%	14.3%
S&P/Citigroup Value	-25.3%	13.1%	4.8%	14.5%	1.4%	10.8%	5.0%	16.3%
S&P 600 Small-Cap	-32.6%	21.9%	3.2%	31.3%	11.3%	18.2%	4.5%	23.6%
Russell 2000	-30.6%	25.4%	4.9%	31.4%	20.0%	12.7%	4.3%	17.5%
S&P 400 Mid-Cap	-29.7%	24.1%	4.8%	24.4%	13.7%	13.5%	3.6%	17.6%

S&P 500 Sectors (Total Return)	1Q'20	2Q'20	3Q'20	4Q'20	2020	1Q'21	2Q'21 (sorted)	YTD
Real Estate	-19.2%	13.2%	1.9%	4.9%	-2.2%	9.0%	13.1%	23.3%
Technology	-11.9%	30.5%	12.0%	11.8%	43.9%	2.0%	11.6%	13.8%
Energy	-50.5%	30.5%	-19.7%	27.8%	-33.7%	30.9%	11.3%	45.6%
Communication Services	-17.0%	20.0%	8.9%	13.8%	23.6%	8.1%	10.7%	19.7%
S&P 500 Total Return	**-19.6%**	**20.5%**	**8.9%**	**12.1%**	**18.4%**	**6.2%**	**8.5%**	**15.3%**
Health Care	-12.7%	13.6%	5.9%	8.0%	13.4%	3.2%	8.4%	11.9%
Financials	-31.9%	12.2%	4.4%	23.2%	-1.7%	16.0%	8.4%	25.7%
Discretionary	-19.3%	32.9%	15.1%	8.0%	33.3%	3.1%	6.9%	10.3%
Materials	-26.1%	26.0%	13.3%	14.5%	20.7%	9.1%	5.0%	14.5%
Industrials	-27.0%	17.0%	12.5%	15.7%	11.1%	11.4%	4.5%	16.4%
Staples	-12.7%	8.1%	10.4%	6.4%	10.7%	1.1%	3.8%	5.0%
Utilities	-13.5%	2.7%	6.1%	6.5%	0.5%	2.8%	-0.4%	2.4%

US Yields	1Q'20	2Q'20	3Q'20	4Q'20	1Q'21	2Q'21	Q/Q Chg (bps)	Y/Y Chg (bps)
Fed Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0	0
3-Month T-Bill	0.07	0.14	0.09	0.08	0.01	0.05	4	-9
2-Year Note	0.23	0.16	0.13	0.11	0.11	0.25	14	9
5-Year Note	0.38	0.29	0.26	0.31	0.74	0.69	-5	40
10-Year Bond	0.70	0.65	0.66	0.87	1.70	1.40	-30	75
30-Year Bond	1.35	1.41	1.45	1.64	2.42	2.07	-36	66

Source – Strategas Securities, LLC

U.S. GDP growth in the first quarter finished over 6% while second-quarter growth will likely come in over 10%! For the year, U.S. GDP is expected to grow more than 6.5% and more than 4% in 2022 (see chart below), a run-rate significantly above the 2-3% range we have seen since 2014.



With that said, the strength of market performance often comes with questions about the future. The primary point of concern over the last few weeks/months has been inflation. There is little doubt that inflation exists because of recovery-influenced demand and continued constraints on supply chains. Breaks in supply chains were always going to be part of the reopening story though. For more than a generation, global businesses have honed their manufacturing and supporting supply chains to such a degree that any disruption in the network would impact businesses.

Certain pockets of extreme price increases (think lumber) have been used as talking points for whether inflation is overheated and if the U.S. Federal Reserve needs to change course to control rising prices. Prior to the pandemic, contracts on lumber traded in the $400 range per thousand board feet. During the shutdown in March of 2020, prices fell roughly 35% to $264. As reopening took hold, prices rocketed higher, eventually topping out at almost $1,700 (see chart below).2 As we write this, prices are retreating. Highlighting the adage that the cure for high prices is high prices, the rise in lumber prices resulted in a change in consumer behavior as buyers postponed purchases.

EXHIBIT C: U.S. LUMBER PRICES

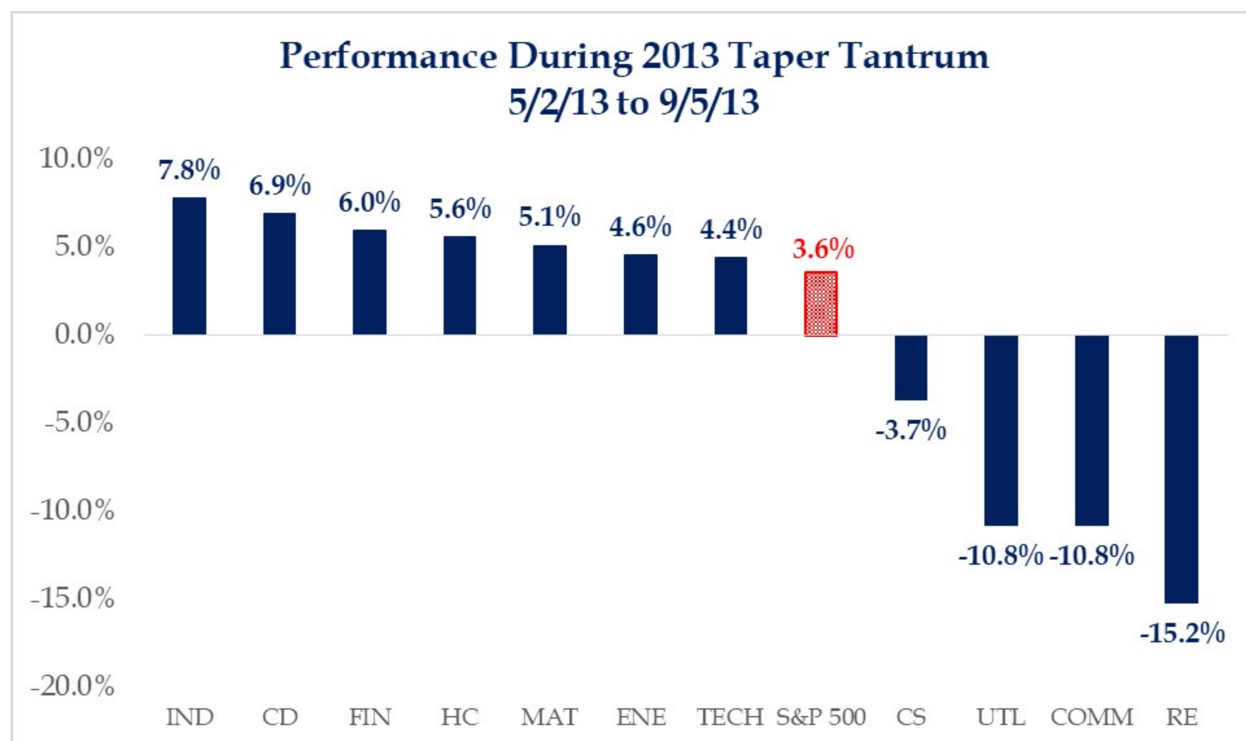
Source: Bloomberg, Fiduciary Trust Company. Lumber is LB1 Generic Contract. Contract specifies 110,000 board feet. Data as of June 28, 2021.

Bottom line is the composition of inflation likely remains more important than the year-over-year numbers as they will not be as drastic as we enter the second half of the year. Still, after three month-over-month surges in a row, it's clear that the so called "experts" are having a difficult time understanding whether this is transitory or not. Something we are keeping a close eye on.

Despite the Fed's best efforts to reassure us that they are still committed to its new average flexible inflation targeting framework, the market isn't buying it. We think the Fed has not abandoned its new framework and we would expect Fed leadership to communicate as much. However, market perceptions may be influenced also by outside sources such as the media. If these perceptions don't change, there could be sustained implications for the relative performance of the market.

We think it is important to look back at the 2013 taper tantrum, a time that describes the surge in U.S. Treasury yields, resulting from the Fed's announcement of future tapering of its policy of quantitative easing. From a sector standpoint, the industrial sector, followed by consumer discretionary, were the best performing sectors during that period. On the opposite side of the spectrum were your more yield-oriented sectors such as real estate, communications, utilities, and consumer staples.

A closer look at asset class performance during the 2013 taper tantrum shows that the VIX was the best performing asset class, followed a close second by WTI oil. REITs, emerging markets, and bonds were the biggest losers.



Source: Strategas

U.S. nonfarm payrolls rose a strong +850,000 month-over-month in June with small upward revisions to prior months.[1] Bottom line is that an improvement in the labor market remains important as we move past the large fiscal boost we have been receiving. The weekly jobless claims data along with surging job openings indicate continued strength. The recent report itself may not be enough to change anyone's mind on the employment outlook, but having previewed the discussion about removing emergency accommodation, the Fed can continue its set path.

Oil has been on a tear since the virus broke last spring. WTI oil prices are now up to $76.[1] The recent OPEC+ meeting ended without an agreement on production increases. The standoff between the United Arab Emirates ("UAE") and the rest of the cartel could mean there will be no production increase at all.

As we've noted previously, this business cycle has been atypical, as it has been driven by services and a health crisis rather than goods and/or a financial crisis. Productivity has improved as firms seek to regain levels of production with fewer workers. The future path of the economy looks to be dependent on the ability to continue output per hour gains, allowing profits and wages to rise together with the longer-term inflationary impulse controlled.

Looking abroad we saw Eurozone equities gained in the quarter, supported by a strong corporate earnings season and an acceleration in the pace of vaccine roll-out in the region. Many European countries saw COVID-19 infections fall over the quarter and were able to loosen restrictions on social and economic activity. We continue to watch the impact of the delta variant of COVID-19 on re-opening plans.

Emerging market equities registered a strong return over the second quarter as well. Brazil was the best performing market in the MSCI Emerging Markets index. Meanwhile, China's economic growth likely slowed in the second quarter, as higher raw material costs hurt factories and new COVID-19 outbreaks weighed on consumer

spending. GDP will likely increase but not to the record level in the first quarter. The world's second-largest economy has been recovering since the second quarter of last year, buoyed by solid overseas demand for its exports, but growth is losing steam as manufacturing activity slows on higher raw material costs and supply shortages, while small COVID-19 outbreaks have also kept a lid on consumer demand.

Looking towards the bond market, U.S. Treasury yields declined over the second quarter, with the 10-year falling from 1.7% to 1.5%, retracing some of the large move higher in the first quarter.[1] The Fed policy meeting in June was closely watched and saw a hawkish shift. The open market policy committee shockingly indicated through their "dot plot" projections that interest rates will likely rise earlier than expected.

Corporate bonds performed well, outpacing government bonds. Both global investment grade and high yield produced positive returns. U.S. investment grade rebounded well following the decline in Q1. For educational purposes, investment grade bonds are the highest quality bonds as determined by a credit rating agency; high yield bonds are more speculative, with a credit rating below investment grade.

The outlook for municipal bonds has improved this year as the economy recovers, tax revenues increase, and state and local governments receive federal aid. This is a reversal from the credit stress experienced last year from the pandemic. As credit quality and demand for municipal bonds increases, this causes prices to rise and as a result yields fall, and spreads also tighten.

As we look towards the back half of the year, there are several other questions investors must consider. A few of note are, is the cryptocurrency craze the first step in a digital revolution that has come to financial services? Is the meme-stock phenomenon a durable development that changes the nature of investing? Lastly, and most importantly, as the global economy recovers, how will monetary policy be unwound without upending the economy and markets? We often see market corrections be the result of policy mistakes.

Again, our prediction on the long-term direction of the market is always based on fundamentals. They should remain strong as the economy continues to be driven by the resumption of activity by the U.S. consumer. The path to restarting the global economy will likely face many hiccups along the way. A taper tantrum 2.0 could be in the cards over the next 12-24 months. As this becomes more apparent, bouts of market volatility will inevitably ensue. These are all things to be navigated and not feared, for they are part of the recovery.

However, this does not mean the market won't face difficult times or avoid corrections. Despite the raging bull market, which we have witnessed since 2008, corrections are normal and are viewed as healthy by some. Progression higher in the markets is almost never smooth and steady if we look out long-term. We expect and plan for corrections. We cannot tell exactly what will cause this beforehand nor when it will occur, but the history of markets suggests this is a near certainty.

Despite the potential resumption of volatility in the markets, our long-term investment approach remains steadfast. Stay invested for the long term, have an investment plan that incorporates both safe and growth assets, and remain nimble to market changes and future opportunities.

To discuss this commentary further, please contact us at 914-825-8630.

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[1] Morningstar Direct

[2] Strategas Securities, LLC

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