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JULY 20, 2021

Third Quarter 2021 Client Review

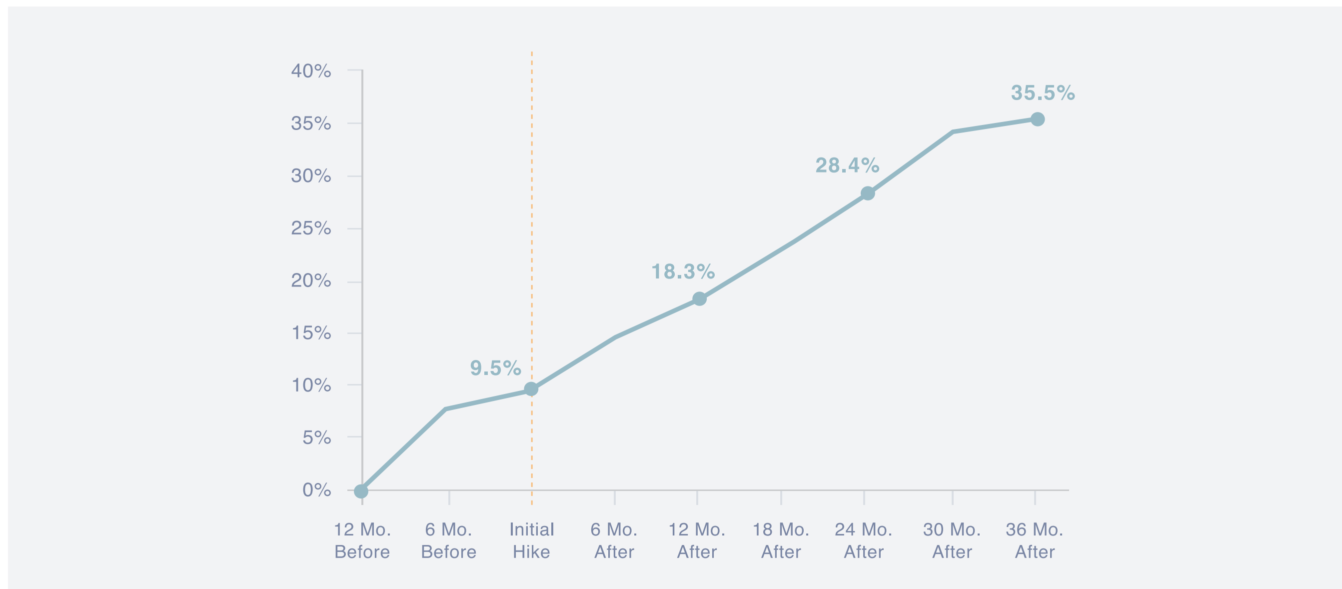
The U.S. economy is humming again, with nearly all 50 states lifting pandemic-related restrictions. The consumer is out in full force, armed with accumulated savings. Spending volume on consumer goods is over 10% higher than pre-pandemic levels[i], and early data suggests consumers are now shifting their dollars to services. Spending on leisure and discretionary services (travel, restaurants, salons, etc.) rose 0.7% in May, while spending on furniture and cars fell by -2.8% over the same period[ii].

The U.S. economy is clearly on strong footing. Strong spending, accelerating demand, and tight inventories are likely to keep inflation as a headline risk, and continued strength in the jobs market and wage pressures may motivate the Federal Reserve to shift into monetary tightening mode sooner than later—at first by tapering bond purchases, and eventually by raising interest rates. The upshot is we may be a few months away from "tapering" and a couple of years away from rising interest rates, with plenty of economic and corporate earnings growth in store between now and then.

In the coming months, the financial news media is likely to push the narrative that Federal Reserve tightening is a negative for the stock market and will drive volatility. In the short-term, they may be right. But over the longer-term, the stock market has weathered initial Fed tightening just fine. As seen in the chart

below, history suggests investors should stay the course even when the Fed starts to intervene. There's a saying on Wall Street that economic expansions end on the Fed's last rate hike, not their first one.

AVERAGE S&P 500 RETURNS BEFORE AND AFTER INITIAL RATE HIKE



Source: Credit Suisse

In our view, earnings growth should continue supporting equities even as the Fed steps-in and tightens monetary policy. That being said, P/E multiples usually contract when interest rates rise, and corporations already face an uphill battle maintaining profit margins with input costs rising. With the cost of everything from lumber, to copper, to gas, to wages, to cargo shipping on the rise, the key challenge for companies will be sustaining topline growth and figuring out how to manage these additional costs. Quality companies with strong market share and pricing power should fare the best.

Since the beginning of the year, we've seen some shifting around in market leadership. Up to the middle of May, the so-called 'reflation trade' outperformed—cyclicals, value stocks, and shares of companies believed to benefit most from economic reopening led the market. The Russell 1000 Value index rose +15% compared to just +2% for the Russell 1000 Growth index[iii].

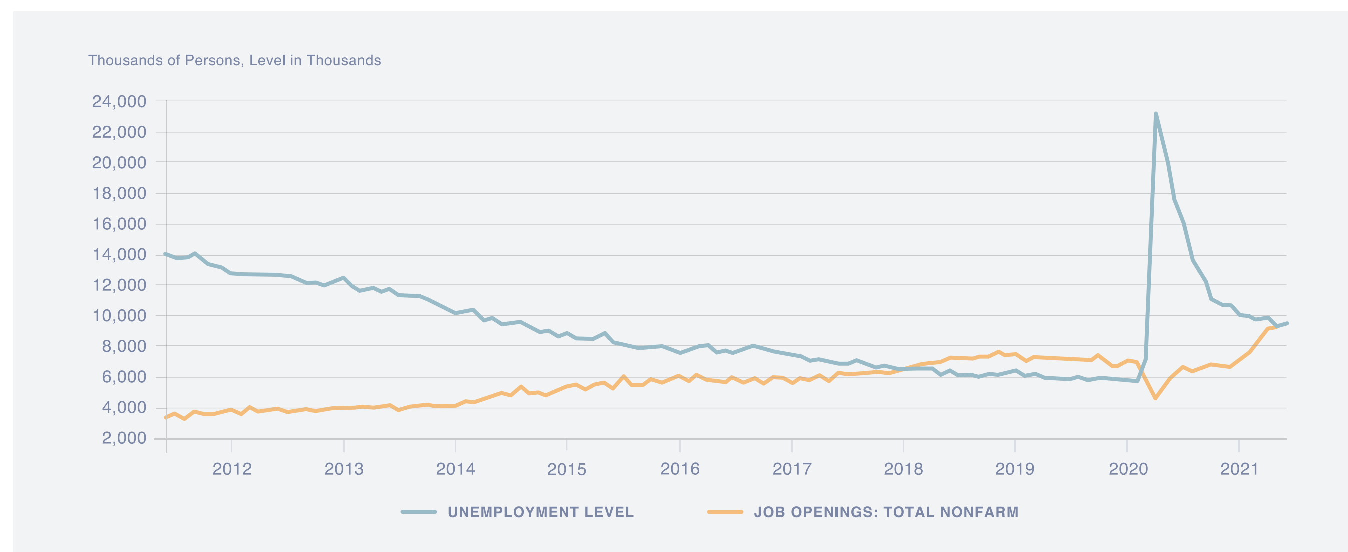
Since mid-May, however, leadership has reversed. U.S. growth stocks (+12%) have outperformed, while value stocks have lagged (+2%)[iv]. This rotation in equity markets was commensurate with a rally in U.S. Treasury bonds, which saw the 10-year Treasury bond yield decline from around 1.7% to around 1.4%[v]. This decline in Treasury yields marked a reversal from the sharp rise early in the year. Where leadership goes from here is an open question, but it could be choppy as we learn more about inflation and growth in the coming quarters. In our view, a diversified approach focused on quality makes most sense now.

The U.S. Economy is in Growth Mode, But It's Not Perfect

In the first six months of the year, the U.S. economy added 3.3 million jobs, but it is still 7.6 million jobs shy of pre-pandemic levels[vi]. Perhaps unsurprisingly, new jobs at restaurants, hotels, stores, salons, and other in-person service industry roles accounted for nearly 50% of all payroll gains since the start of the year[vii]. A tight labor market has created headaches for many small and medium-sized businesses while also giving workers some leverage—according to ZipRecruiter, about 20% of all June job postings offered a bonus, up from 2% of jobs advertised in March. Wages are also on the rise.

Even though there are 9.2 million jobs available in the U.S. economy, 9.3 million Americans remain unemployed.

AVAILABLE JOBS ARE ROUGHLY EQUAL TO UNEMPLOYED PEOPLE



Source: Federal Reserve Bank of St. Louis

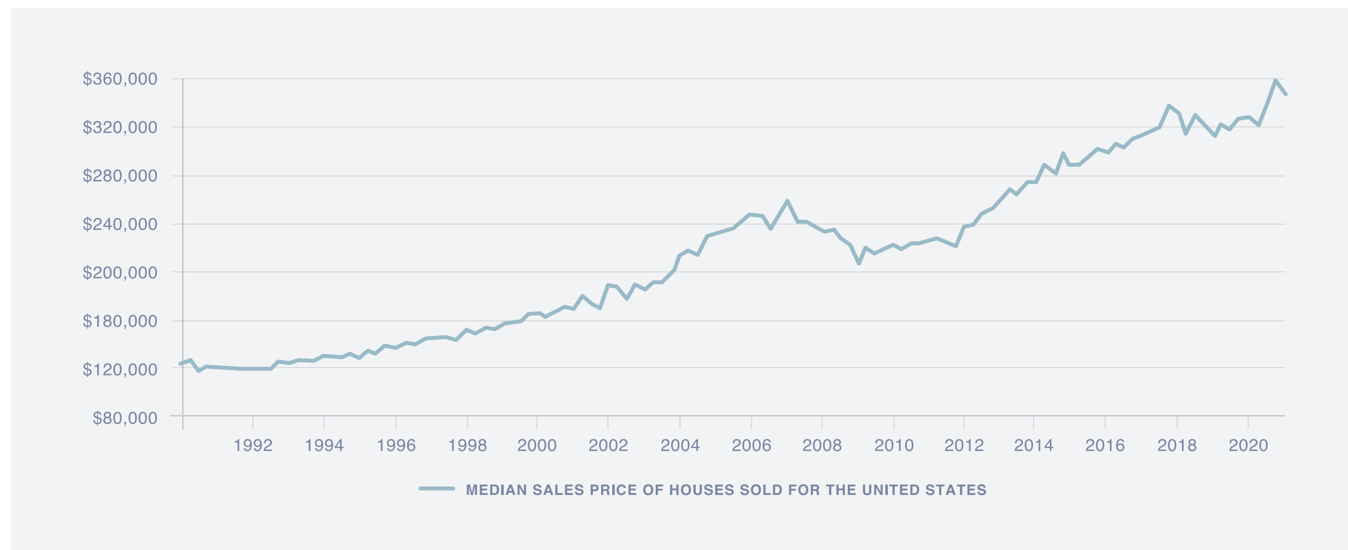
Economists have not pinpointed an exact cause for the disconnect, but it is likely a combination of several forces: expanded federal unemployment benefits are crowding-out the private sector; families have child care needs during the summer months; baby boomers have left the labor force; and wages on offer are too low. September could be a telling month for how sticky the labor market issue ultimately is. By then, kids will (hopefully!) be back in school and all expanded unemployment benefits will come to an end.

Factories are also experiencing some issues in the economic recovery. Manufacturers continue to struggle with supply-chain bottlenecks, price shortages, and rising materials prices. Factories are also reporting lengthening wait times and several commodities in short supply, from cold-rolled steel to caustic soda. But

at the end of the day, manufacturers aren't complaining—struggling to keep up with demand is a preferred problem to have, especially with overall activity hovering near historic levels. According to the Institute for Supply Management, its manufacturing PMI index registered at 60.6 in June, which indicates strong growth for the 13th consecutive month.

Housing prices in the U.S. and around the developed world also keep moving higher. According to the Organization for Economic Co-operation and Development, home prices are accelerating at a pace last seen in 1990. Here in the U.S., Americans took out more mortgages than ever before in 2020, and the median sales price for a home crossed $350,000 for the first time ever[viii]. Rising prices have been good news for owners and sellers but have created challenges for first-time buyers.

HOUSING PRICES HAVE BEEN CLIMBING



Source: Federal Reserve Bank of St. Louis

One of the bigger issues in the housing market today is lack of supply. According to a 2021 report from the National Association of Realtors, home construction over the last 20 years has fallen 5.5 million units short of historical trends. A housing shortage is being met with surging demand, particularly as millennials take advantage of low interest rates and the sweeping arrival of remote and hybrid work. When it comes to overall demand, millennials are often first-time home buyers, and there are a lot of millennials! As you can see in the table on the right, the most common ages in the U.S. today are between 25 and 35 years-old:

THE 10 MOST COMMON AGES

2010	2020
50	29
49	30
19	28
48	27
47	31
46	26
20	32
45	35
18	25
52	34

Source: U.S. Census

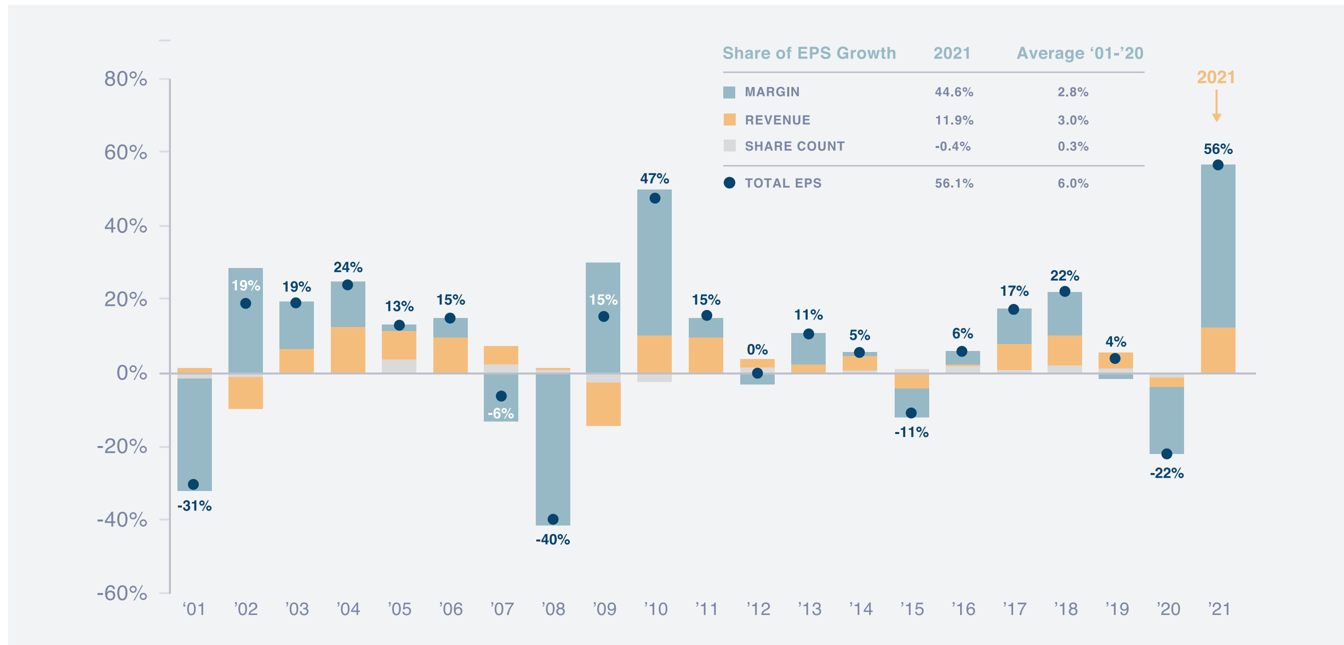
Oil prices have marched higher over the past year and are now approaching six-year highs. Demand has returned rapidly as Americans hit the road for summer travel and as the economy fully reopens. But supply has not kept up. OPEC cut its collective output by about 9.7 million barrels a day last year in the midst of the pandemic, but it has not brought that oil production back online. In OPEC's June meeting to increase production, the United Arab Emirates (UAE) balked at an agreement to increase production by 400,000 barrels a day each month through late 2022, mostly because the UAE wants most of that production for itself. OPEC data suggests the market needs an additional 2 million barrels a day by the end of the year. Without additional supply, oil prices—and gas prices—could remain sticky in the months ahead.

Finally, business investment is also trending nicely higher. Nonresidential private fixed investment, which is a proxy for business investment, increased at a seasonally adjusted annual rate of 11.7% in Q1, following double-digit increases in Q3 and Q4 of last year[ix]. Following the "Great Recession," businesses were more reluctant to invest in capital and equipment, and labor was cheap. In the current economic recovery/expansion, labor is tight and wages are rising, so businesses are opting to increase spending on computers, equipment, technology infrastructure, and software in an effort to drive productivity. There is also greater desire in the business community to build supply chain resiliency and to 'on-shore' more production, all of which is being helped along by historically cheap borrowing costs.

Conclusion

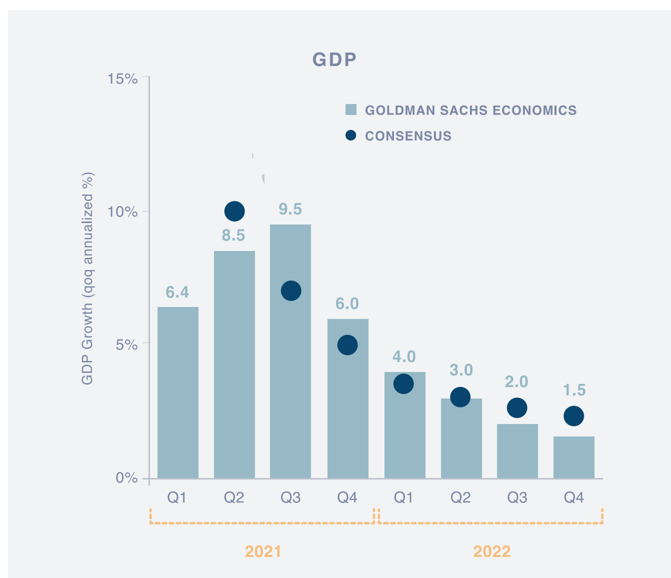
Strength across virtually all economic indicators helped produce a robust corporate earnings season in the first quarter, with over 85% of S&P 500 companies reporting better-than-expected results in Q1 2021[x]. Second quarter earnings season—which is kicking off now—should deliver even stronger results. S&P 500 CEOs have raised earnings per share (EPS) estimates for 2021 from $167 at the beginning of the year to $191 by the end of Q2[xi]. As you can see in the chart on the next page, surging margins and revenues across Corporate America are contributing greatly to accelerating earnings:

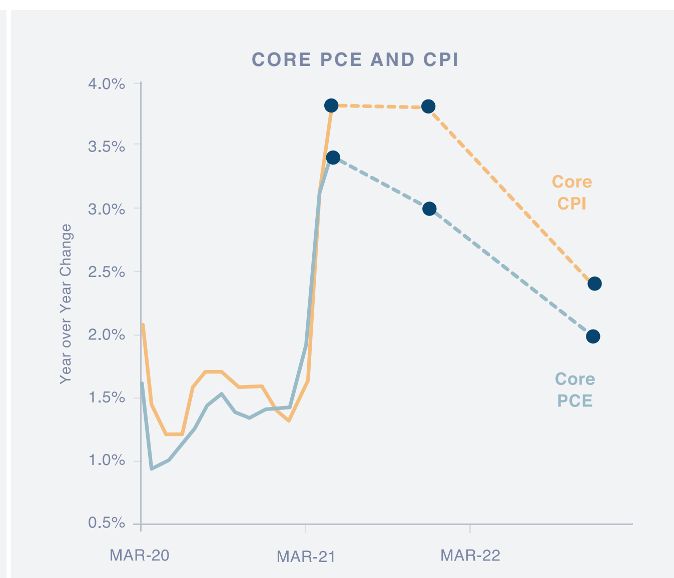
S&P 500 YEAR-OVER-YEAR OPERATING EPS GROWTH



Source: J.P. Morgan

For now, the outlook for U.S. economic growth is strong, as are corporate earnings expectations. The combination of these better-than-expected indicators has arguably continued supporting higher stock prices. As we discussed in our June 7 letter, however, inflation remains a concern, but supply chain disruptions and dislocations may work themselves out just as the initial surge of consumer demand tapers off. According to Goldman Sachs, the U.S. economy may hit peak economic growth in Q3 and may have already hit peak liquidity, meaning inflationary pressures could ease from here.





Source: Goldman Sachs

Many pundits and analysts are likely to frame decelerating economic and corporate earnings growth as negatives for stocks, and Fed "tapering" and tightening are likely to garner headlines as well. In our view, market volatility could increase as the initial burst of growth wears off a bit, but at the end of the day, growth is growth—and we should see a lot of it in the second half of the year.

If you have any questions about this review or your portfolio, please do not hesitate to get in touch with us. We'd be happy to answer any and all questions you may have. In the meantime, we hope you enjoy the rest of your summer, and hope it's filled with family, friends, and maybe a little vacation time.

Sincerely,

Paul Thompson, Jr CFP
Ascension Capital Advisors

Sources:

[i]Source: U.S. Commerce Department
[ii]Source: U.S. Commerce Department
[iii]Source: Strategas Research
[iv]Source: Strategas Research
[v]Source: Strategas Research
[vi]Source: Bureau of Labor Statistics
[vii]Source: Bureau of Labor Statistics
[viii]Source: U.S. Census Bureau
[ix]Source: Federal Reserve Bank of St. Louis
[x]Source: FactSet
[xi]Source: FactSet

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