WILKINS
INVESTMENT COUNSEL

2021 SUMMER INVESTMENT OUTLOOK

The U.S. economy and capital markets enter the summer months with the same optimism and strong momentum that has persisted since the announcement of the first successful COVID-19 vaccine last November. With nearly 65% of adults and 53% of the total population having received at least one vaccine dose, the country is experiencing rapidly improving health trends, enabling state and local policymakers to lift the remaining mandates and restrictions on businesses and individuals. This has led to a resurgence in service sector activity with the ISM Services Index bouncing to 64.0 for the month of May, an all-time high.

GDP exited the first quarter of 2021 surpassing the peak level achieved during the same quarter a year ago on a nominal basis and just 0.9% short of the all-time high in inflation-adjusted terms. Real GDP has grown 14% on an annualized basis since last summer's bottom, underpinned by extraordinary fiscal and monetary support, and second quarter growth should be similarly stellar when the economic data is released in late July. With $2 trillion in excess household savings still on the sidelines from multiple stimulus packages and financial conditions the easiest in the post-WWII era, the U.S. economy should perform above its potential through at least the end of next year, leading to a rapid recovery in employment as well as inflation levels above the central bank's intended target in the short run.

The equity market has reflected this economic optimism with the key S&P 500 Index moving 11% higher in 2021 on a year-to-date basis. Such appreciation emulates the rise in 2021 earnings expectations since early in the year, the continuance of a highly correlated trend throughout market history between corporate profit growth and stock prices. The resurgence in fundamentals has been the essential driver of equity market performance over the past year since stocks entered last June at a similar valuation as today's P/E multiple of 21x forward earnings.

Commodities (per the CRB Index) have risen more than 25% in 2021 on a year-to-date basis and 57% over the past year due to the uptick in growth as well as the production discipline that occurred during the height of the pandemic across many materials. The sharp price snapback has pushed commodity indices to 6-year highs, although broad prices still remain well below 2011 levels when China's economy started to slow as well as the mid-2008 historical peak when Brent crude oil touched $138 per barrel. Nonetheless, the commodity price increases are beginning to feed into consumer inflation with the core CPI gauge up an average 2.8% y/y over the latest three months, the strongest gains since autumn 2006 and something to watch closely.

Despite the rise in commodity prices and consumer inflation, the bond market is relatively sanguine at the moment regarding future price momentum and central bank policy. Although the 10-year Treasury note has risen 56 basis points on a year-to-date basis to a current yield of 1.48%, the rise in yield has stalled since hitting 1.75% in late March with levels falling back 27 basis points since then. Based on historical measures of commodity prices, consumer inflation, and leading indicators the 10-year Treasury note would normally be priced well north of 2.0%. The bond market has modestly rallied throughout the second quarter in response to an ebbing of positive economic data surprises in parts of the economy such as the labor market and housing.

Despite corporate credit spreads nearing all-time tight levels, the rise in longer maturity rates has led to losses in bonds for broad investors with the Bloomberg Barclays Aggregate Index down 1.6% year-to-date, although fixed income portfolios of shorter maturities like ours have eked out positive gains. Combining such bond returns with the strong gains in equities has led to the Lipper Balanced Index appreciating 7.0% thus far in 2021 as of this writing, a return through just six months that is generally experienced on average over a full year.

Equity Markets – 6/18/21

	Index Price Level	2021 YTD Total Return
Dow 30 Industrials	33,290	9.8%
S&P 500	4,166	11.7%
NASDAQ Composite	14,030	9.2%
MSCI All Country World Index ex-USA	351	9.0%

Outlook

The inflation debate has come to the forefront of the capital markets in 2021 with a tug of war emerging between stock and bond markets in the second quarter that has not been seen in some time. The 60-day correlation between stocks and bonds of +0.55 is as high as it has been in more than 20 years, meaning when bond markets have down days (and yields rise) then stocks tend to do the same, and vice-versa. While such a relationship only partially explains the movement in stock prices as there are certainly other factors at play, it does highlight the increasing sensitivity of stocks recently to the change in interest rates. Hence, the evolution of inflation and Federal Reserve policy will be heavily scrutinized by equity investors through the remainder of the year.

The latest data show inflation accelerating at the fastest pace in many years. The Fed's preferred core PCE price index increased the most in nearly two decades for the month of April, rising 0.7% mo./mo., while yr./yr. gains of 3.1% were the highest since July 1992. May data per the core CPI shows similar momentum.

Although the recent monthly data appears alarming, it is important to understand the factors driving this rebound in prices as well as the central bank's shift in how it views its inflation mandate. Much of the latest inflation can be attributed to the effects of reopening and supply disruptions. The May CPI data showed a 7.3% surge in used car prices, a 7.0% rise in airfares, and a 12.3% increase in car rental rates, all on a month-over-month basis as consumers ramp up purchases of such services into the accelerating reopening. However, many of the travel-related items are coming off a very depressed base and still see their current prices well below pre-pandemic levels of February 2020.

As businesses prioritized survival over growth at the height of the pandemic, they slowed production, liquidated inventories, and cancelled orders. As consumer demand snaps back on the heels of extraordinary stimulus and a full reopening, many companies are struggling to adjust production and supply chain planning to this rapid rebound, leading to shortages in goods such as semiconductors, metals, lumber, and autos. Such supply-demand imbalance has led to much higher current prices and the shortages, bottlenecks, and supply chain frictions will take a year or more to resolve. Labor shortages could also lead to some additional pricing pressure throughout the summer months and persist until the extended emergency unemployment benefits expire nationally in mid-September. Despite a record number of job openings, companies are finding it quite difficult to fill new positions. Thus, it's not a surprise that teens are filling many of the current openings across the service sector as summer begins, pushing the unemployment rate for 16-19 year olds to a 55-year low.

Many of the above price pressures are considered transitory by the central bank, supporting the policy stance of maintaining very low interest rates for at least the next couple of years. The Atlanta Fed's core "sticky" price index for items that see less frequent price adjustments is still well contained and within the range that has persisted over the last five years. Two-year rates of change, which compare current prices to 2019 pre-pandemic levels, are also less sharp than the year-over-year data. Parts of the commodity market have also stalled and seen price corrections since early May with copper falling 13%, agricultural prices declining 12%, and lumber collapsing 47% from peak levels. The amount of credit being deployed into the Chinese economy is also slowing, which can impact price movements. Such loss of momentum for various commodity inputs if sustained means less fuel for spurring additional inflation later in the year.

Nonetheless, the recent inflation readings have gotten the attention of some FOMC committee members. At the latest FOMC meeting on June 16th, the Fed maintained its current bond buying and interest rate policies but the latest economic forecasts portend a potential shift in consensus down the road. For 2022, 7 out of 18 participants now expect at least one interest rate hike in 2022 and 11 out of 18 members are forecasting two rate hikes by the end of 2023. This is a substantial shift from the March meeting when members saw zero rate hikes through 2023 based on median projections. Members are also forecasting much higher core inflation of 3.0% in the fourth quarter of this year (vs. a projection of 2.2% at the March meeting) but to moderate to 2.1% by the end of next year.

The shift in the so-called "dot plot" forecasts probably did the Federal Reserve a favor in that it helps squelch some speculation in inflation sensitive markets like commodities. Since the meeting, the Treasury yield curve has flattened with shorter maturity yields moving higher following the hawkish dot plot. Broad consensus expects the central bank to introduce guidance regarding the tapering of its bond buying at the September meeting and with implementation beginning early next year. The reduction in quantitative easing during the last cycle saw longer maturity yields decline initially as inflation expectations moderated.

Chairman Powell, however, still seems keenly focused on reducing unemployment whatever the impact on short term inflation although such a feat has been complicated by the fiscal policy choice of allowing states to extend emergency unemployment benefits through mid-September. The Federal Reserve has undershot its 2% inflation mandate by a cumulative 6% over the past two decades and is intent on examining the price data in the rearview mirror to ensure that its average inflation target is durably achieved over the longer run. This is especially important for an economy laden with high amounts of debt as the only means to reduce such a burden over the long run (short of a restructuring) is through higher prices.

The government policy regime in response to a recession has also changed, although neither the Fed nor fiscal leaders will explicitly acknowledge such as shift. Austerity measures implemented by many developed economies during the previous economic cycle were a detriment to growth. Thus, governments are currently intent on running high deficits, implicitly monetized by the central bank, to restore growth and full employment. Maintenance of such easy financial conditions for too long in the face of a strong recovery, rising inflation, and sustained fiscal spending could lead to asset price bubbles, misallocation of capital across the economy (see cryptocurrency and meme stocks), and currency debasement. If inflation were to prove more enduring and less transitory than the Fed expects, then monetary policy would need to be tightened much greater and much sooner with capital markets experiencing a volatile re-set in valuations alongside the rising discount rate.

Value stocks across sectors such as energy, industrials, and financials have outperformed growth stocks since September of last year and such a trend could continue in the second half of 2021, benefitting more diversified portfolios. Earnings are being revised higher across these sectors at a greater magnitude than other parts of the market and valuations are still at a substantial discount to growth sectors on a relative basis versus historical averages. Such stocks are benefitting from the cyclical economic recovery and rising interest rates. The price of crude oil has firmed above $70 per barrel and should continue to find support in the second half of the year as excess inventories are depleted and current production moves towards deficit relative to rising demand.

Cyclical stocks could also benefit from the passage of an infrastructure bill. The Biden administration appears to be moving towards passing such legislation before the end of September via its thin Congressional majorities using the budget reconciliation procedure as bipartisan compromise seems to have stalled. Such a parliamentary move would likely mean higher taxes on corporations and wealthy individuals to help pay for the spending, although the magnitude of potential tax hikes has moderated somewhat relative to last year's presidential campaign based on recent chatter from the administration.

A potential stock market pullback in the face of higher taxes, central bank tapering of bond purchases, and an inflation spike should not necessarily alarm investors. The second year of a bull market tends to be choppier with moderating but still positive returns. The largest intra-year pullbacks during the second year of a bull have averaged -9.8% in the post-WWII era, essentially the textbook definition of a correction. The market still managed to generate an average second year gain of 13.3% by the end of the calendar year with returns positive in every instance over each of the last nine cycles. While current stock market valuations are as high as any cycle other than the late 90s bubble, that doesn't necessarily portend the end is near for the current bull. However, long term investors should consider that compounded future returns are likely to be less than recent experience.

Investment Conclusion

Although elevated equity valuations currently make it a challenge to invest excess cash, we are finding select investments in parts of the technology sector appealing with durable secular growth. Investment in information technology continues to capture a growing portion of fixed investment across the economy, driving productivity gains for both companies and consumers. Parts of the healthcare sector are also attractive and should benefit from the economic re-opening and a return to more normalized consumption trends. Corporate bonds in the 3-4 year maturity spectrum offer the best value in fixed income relative to government bonds, munis, and money market rates but yields still fall short of the inflation rate. As always, we continue to be disciplined with new investment under the premise that future returns are highly dependent on prices paid in the present.

June 21, 2021