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Q2 2021 Review and Outlook

The summer of 2021 has started. Following more than 6-months of expectations, the long-awaited return to 'normal life' is in motion. Restaurants are buzzing and restrictions have generally been lifted. While reopening expectations drove small-caps and more value focused segments during Q1, as the date of the reopening drew closer, the market shifted its attention to what comes next.

During the second quarter, the S&P 500 Index increased 8.5%, bringing its year to date return to 15.3%. The shift away from the reflation trade provided some respite for fixed income markets. The Bloomberg Barclays Aggregate Bond Index increased 1.9% during Q2, reducing its first half contraction to -1.8%.

The Federal Reserve (Fed), had a significant impact on markets during Q2 and will likely remain in the limelight during the second half of 2021. The shift in the Fed's stance on inflation during mid-June increased the focus on large-cap growth while taking some of the shine off international equity markets. In aggregate, markets maintained their leadership ranking from Q1, with U.S. equity markets remaining in the lead followed by international developed markets while emerging markets (EM) lagged. Developed markets (MSCI World ex U.S. Net TR USD Index) and emerging markets (MSCI Emerging Markets net TR USD Index) had a total return of 5.6% and 5.0% during Q2, bringing there YTD returns to 9.9% and 7.4%, respectively.

Business Cycles, Market Cycles and Rotations in Size and Style

Rapid decline and rapid recovery. The staggering amount of global monetary & fiscal stimulus cushioned the economic fallout and hastened the economic recovery. While the market recovered quickly, the economy is still bouncing back.

The U.S. reopening will help hasten the economic recovery, but the global economy is facing an uneven recovery owing to different levels of vaccine distribution and COVID-19 containment. As such, the U.S. economy is further ahead in its recovery and is expected to be the largest contributor to global growth during 2021. U.S. GDP growth (year over year or "y/y") moved back into positive territory during the first quarter, with the y/y change in real GDP growth expected to reach almost 13% in Q2[1] while being in the range of 6.5% - 7% during 2021.[2] During the second half, we expect the market to start looking ahead towards 2022 and 2023, where economic growth rates are expected to normalize, with growth moving back to trend with inflation running just above Fed targets.

In our view, the market is potentially approaching an inflection point. During the first half of 2021, the market enjoyed an abundance of optimistic expectations surrounding the reopening. But the reopening and reflation trade became highly concentrated. As we look towards the second half, U.S. equity markets may be more subdued, waiting for earnings and economic improvements to catch up with the market. However, the combination of an Infrastructure bill and accumulated savings could provide some support.

The recent phase of the stock market recovery favored small cap, low quality, cyclical, non-dividend paying portions of the economy that stood to benefit from the reflation trade. With the change in Fed policy, the market has potentially already started the shift towards larger, higher quality portions of the market.

During Q2, large caps reclaimed the lead, with the Russell 1000 Index rising 8.5%, almost double the return of the Russell 2000 Index (+4.3%). Large caps were powered by large cap growth, with the Russell 1000 Growth Index rising +11.9%. All other style categories had a reasonably similar performance with the

Russell 1000 Value Index, Russell 2000 Value Index and Russell 2000 Growth Index returning 5.2%, 4.6% and 3.9% respectively.

While large cap growth had a solid quarter, small cap value maintained its dominance during the first half. The Russell 2000 Value Index rose 26.7% during the first half followed by the Russell 1000 Value Index and Russell 1000 Growth Index with a total return of 17.0% and 13.0%. The Russell 2000 Growth Index has lagged during the reopening rotation with a total return of 9.0%.

Into the second half, we expect large caps to be well positioned as the market looks to the next stage of the economic recovery. There is currently less consensus in the market and despite subdued market volatility, there is growing concern that future gains may be more challenging.[3]

The Two Tails: Delta and More Permanent Inflation

The recovery is a delicate balancing act. On the one hand, the Delta COVID variant is a risk to global economic growth, while too strong an economic recovery could exacerbate pricing pressures.

Our base case is that inflation is likely to remain transitory with pricing pressures peaking in mid-2021 before returning to more normalized levels. Similarly, due to the current effectiveness of RNA vaccines against the Delta variant,[4] public health experts don't believe a large national surge of cases is likely. While in both cases, expectations are for the recovery to remain intact, these two potential tail risks cannot be ruled out.

Going a bit deeper into the Delta variant, this variant has accumulated a series of mutations, containing two that worry virologists. The first mutation increases the effectiveness of transmission, and the second raises the chances of reinfection. Together, these two aspects help the Delta variant spread more efficiently than other versions of COVID-19.

What's concerning is the success of this variant within a vigilant, developed and heavily vaccinated country like the United Kingdom (UK). The UK has higher levels of vaccinations than the U.S. across both partial (66.9% vs. 54.4%) and complete dose metrics (49.2% vs 46.7%), while maintaining a more aggressive set of social restrictions. Even under these conditions, Delta has been effective in transmitting with numbers quadrupling from ~22 thousand cases a week to 133 thousand cases per week during June.[5]

On the other end of the economic growth spectrum, inflation concerns dominated the headlines, peaking in mid-May. Currently, it appears the markets are accepting the "inflation is transitory" story, though that is not an absolute.

Markets reacted positively to news that Fed Chair, Jay Powell, is more willing to acknowledge rather than downplay positive news about the economy and inflation. This shift in Fed policy had major implications for the reflation trade. Through potentially bringing forward the start of tapering and less supportive monetary policy, the trajectory of the economic recovery may be dampened, thus lowering the risk of inflation.[6] As such, this ushered in a shift from the concentrated focus on sectors and segments of the market that stand to benefit from improved economic activity, towards larger and growthier portions of the market. Due to their scale in the market, this shift towards growth helped boost markets while driving the divergence in performance between large cap growth and most other market segments.

Commodity markets faced two headwinds: USD strength driven by the Fed's acknowledgment of the situation on the ground, and China lowering their metal stockpiles.[7] As such, industrial metals, including copper, declined since mid-May. Lumber is another commodity that experienced a sharp decline in prices, with future contracts for July delivery giving back almost all their year to date gains. While this has alleviated some inflationary pressures, drought and heatwaves have the potential to impact soft commodity prices, with grain futures rising. Additionally, transportation costs remain elevated with the Baltic Dry Index closing the quarter near its highest level since 2010.[8] Global supply chain bottlenecks impacted the availability of containers, while COVID-19 containment efforts reduced port efficiency.[9] These are factors currently

contributing to pricing pressure. But demand for services rather than goods has the potential to alleviate some of these pricing pressures.

Over the past 100 years, U.S. inflation averaged 3%, so far in 2021 inflation has been running at 8% annualized.[10] While we believe inflation will moderate, it could easily remain at somewhat elevated levels relative to recent history. Should supply constraints remain an issue into the years ahead, this could result in expectations for higher prices which could help perpetuate a rising price cycle. While this is not currently our base case, it remains a tail risk that we are monitoring.

Savings = Flexibility

Wages and labor market constraints are the largest risk to inflation expectations. According to Gregory Daco, chief U.S. economist at Oxford Economics, "It's going to be a weird summer. Some of the factors that have been holding back labor supply are starting to roll off and should give us a lift -- but that isn't going to be too clear until September."[11]

COVID-19 accelerated the trajectory of secular trends such as older workers leaving the workforce permanently and created profound changes in consumer behavior that could change the future of American economic activity. Part of this shift was employees, especially in lower-wage service sectors, becoming pickier about the type of positions they are willing to take, prioritizing stability, job security, hours and income.[12]

Additionally, labor market churn is at its highest level in 20 years.[13] The paradox of the labor markets is that the economy is experiencing elevated levels of unemployment, yet at the same time, companies are struggling to find qualified workers. While jobs openings reached a record high of 9.3 million in April,[14] the number of unemployed remains elevated at 9.5 million.[15]

Currently there are reallocation frictions in the labor market. The labor market is changing quickly, jobs are evolving. Employees are using the current environment to better position themselves for the future, taking advantage of their improved financial flexibility owing to higher savings rates or temporary enhanced unemployment benefits.

Elevated savings for individuals who kept their jobs during the pandemic, placed them in a position with greater financial flexibility. Thus, increasing employee willingness to change jobs. The labor market is currently consolidating 2020's and the current year's employee driven job changes into a single period. Understandably, the quit rate has been highest in sectors with a large increase in job openings. This has predominantly impacted the leisure and hospitality as well as manufacturing segments.[16]

Large Sector Divergence Driven by Fed Shift

Ten of the eleven S&P 500 GICS Sectors had positive returns during the second quarter, with four sectors providing double digit returns. Real Estate (+13.1%), Information Technology (+11.6%), Energy (+11.3%) and Communication Services (+10.7%) were the top performing sectors.

- The Real Estate sector benefited from an improved sense of normality and the increasing push towards employees returning to the office. This sector benefited from the reopening and reflation trade.
- Information Technology (IT) was quite the turnaround story during the quarter. In mid-May, when inflation concerns were near their peak, IT was the weakest sector. Value and reflation orientated market segments were adversely impacted by the Fed's policy shift driving a distinct rotation from value to growth.
- The Energy sector had a volatile quarter, ending on a strong note. This sector benefited from WTI Crude oil prices increasing steadily during the quarter. Crude prices ended the quarter at $73.77 / barrel, its highest level since October 2018.

- Communications Services benefited from the shift in market sentiment towards growth. However, this sector was generally reasonably strong throughout the quarter.

Utilities (-0.4%), Consumer Staples (+3.8%), Industrials (+4.5%) and Materials (+5.0%) were the weakest sectors.

As defensive value sectors with a negative sensitivity to changes in the 10-year Treasury yield, both Utilities and Consumer Staples had a challenging start to the year.[17] The shift in market sentiment towards growthier segments also provided no respite for these areas.

Both Materials and Industrials were adversely impacted by the shift in market sentiment surrounding inflation. Performance of the Materials sector was also impacted by commodity prices, which generally peaked in mid-May when inflation fears were their highest.

Energy (+45.6%), Financials (+25.6%) and Real Estate (+23.3%) were the top performing sectors YTD while Utilities (+2.5%) and Consumer Staples (+5.0%) lagged.

Reversals All Round – Long-Term Treasuries Came Roaring Back

The Fed's change in stance resulted in lower expected economic growth and reduced long-term market yields. As such, the Treasury yield curve flattened slightly while remaining upward sloping. The 10-year Treasury yield started the quarter at 1.74%, declining to 1.45% by mid-year.[18]

Fixed Income benefited from the more favorable market environment, with the Bloomberg Barclays Aggregate Bond Index increasing 1.9% during Q2. Long duration products outperformed, with majority of the quarter's return occurring during June.

YTD fixed income remained a challenging area. While Treasury yields declined during Q2, this did little to offset the YTD increase, with the 10-year Treasury yield rising from below 1%, the Bloomberg Barclays Aggregate Bond Index remained in negative territory during the first half.

What's next?

With the economy largely open, there is less anticipation and focus on a single idea. We believe the easy gains have been realized, smarter gains are our focus.

We believe the reflation trade has predominantly run its course. Consumer spending patterns are likely to shift from furniture and electronics to vacations, with higher income consumers already ramping up their service spending.[19] Spending on goods is facing supply disruptions and we believe that given this shift towards services spending, goods consumption could slow while remaining at an elevated level. This should cool inflation pressures in certain areas of the economy while maintaining the focus on the labor supply to service-oriented areas.

This shifts the focus away from manufacturing and goods related inflation. As such, it also shifts some of the focus from cyclical sectors such as Industrials and Materials towards growthier areas that lagged during the reflation trade. Conversely, the bipartisan $1.2T U.S. infrastructure spending deal should provide some support for these segments of the market and could act to further stimulate the economy over time. The deal appears to have a good chance of passing as it is politically expedient for both parties. More left leaning Democrats are likely to only support the bipartisan plan in parallel with legislation not touched on in the bipartisan deal. This segment, which would need to be passed through budget reconciliation, is likely to benefit growthier segments of the market including CleanTech. Due to the nature of physical infrastructure spending, the digital infrastructure portions that will go through budget reconciliation may provide more short-term economic benefits.

As we move from the reflation trade into the next phase of reopening, there is potential for markets to be more balanced between growth and value. However, improved underlying economic growth prospects are likely to keep a greater focus on valuations. We believe that the market is likely to be more selective as we move into the second half.

Footnotes:

All data sourced from Bloomberg

1. BofA estimate as of 6/30/2021
2. NDR, *NDR Mid-year outlook – inflation debate and market implications for the second half*, 6/17/2021
3. WSJ, *Stock markets cruise to records in first half, but investors grow uneasy*, 6/30/2021
4. NYT, *The Delta Variant: What Scientists Know*, 6/22/21
5. Bloomberg data, 7/1/21
6. Forbes, *Did the Fed policy shift destroy the reflation trade*, 6/20/2021
7. WSJ, *China to release metal reserves in effort to tame commodities rally*, 6/16/2021
8. Bloomberg data as of 6/30/2021
9. WSJ, *Fresh COVID-19 outbreaks in Asia disrupt global shipping, chip supply chain*, 6/11/2021
10. BofA, *The Flow Show*, 6/24/21
11. Bloomberg, *U.S. job market begins a weird summer with choppy recovery*, 6/28/2021
12. NBC News, *Is it a sluggish labor market – or workers positioning themselves for better opportunities?,* 6/28/2021
13. Bloomberg, *U.S. job market begins a weird summer with choppy recovery*, 6/28/2021
14. U.S. Bureau of Labor Statistics, *Job openings and labor turnover summary*, 6/8/2021
15. U.S. Bureau of Labor Statistics, *Employment situation summary*, 7/2/2021
16. BofA, *US economic weekly: No June swoon for NFP*, 6/25/2021
17. NDR, *NDR Mid-year outlook – inflation debate and market implications for the second half*, 6/17/2021
18. Bloomberg data as of 6/30/2021
19. BofA, *BofA on USA: Look at who is spending on service*, 7/1/2021

Definitions

Baltic Dry Index: This index is issued by the London-based Baltic Exchange and is reported globally as a proxy for the price of moving major raw materials by sea. The index includes three key shipping sizes across 23 different global shipping routes carrying coal, iron ore, grains and other commodities.

Bloomberg Barclays U.S. Aggregate Bond Index: The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-through), ABS and CMBS (agency and non-agency).

Bloomberg West Texas Intermediate (WTI) Cushing Crude Oil Spot Price Index: Designed to track the spot price of WTI.

Global Industry Classification Standard (GICS): This is a standardized classification system to sort business entities by sector and industry group. It consists of 11 sectors, 24 industry groups, 68 industries and 157 sub-industries.

MSCI World ex USA Net Total Return Index: The index captures large and mid-cap representation across Developed Markets countries –excluding the United States. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI Emerging Markets Net Total Return Index: The index captures large and mid-cap representation across emerging market countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

Russell 1000 Total Return Index: Consists of the largest 1000 companies in the Russell 3000 Index. This index represents the universe of large capitalization stocks from which most active money managers typically select.

Russell 2000 Total Return Index: Consists of the smallest 2000 companies in the Russell 3000 Index, representing approximately 8% of the Russell 3000 total market capitalization.

Russell 1000 Growth Total Return Index: The index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000 Value Total Return Index: The index measures the performance of those Russell 1000 companies with lowest price-to-book ratios and lowest forecasted growth values.

Russell 2000 Growth Total Return Index: The index measures the performance of those Russell 2000 companies with highest price-to-book ratios and highest forecasted growth values.

Russell 2000 Value Total Return Index: The index measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.

S&P 500 Total Return Index: The index includes 500 leading U.S. companies and captures approximately 80% coverage of available market capitalization.

Treasury Yield: Interest rate paid by the U.S. government to borrow money for different lengths of time.

Index returns are for illustrative purposes only and do not represent actual fund performance. Index returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

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