AndCo's Monthly Market Update

August 2021

THE ECONOMY

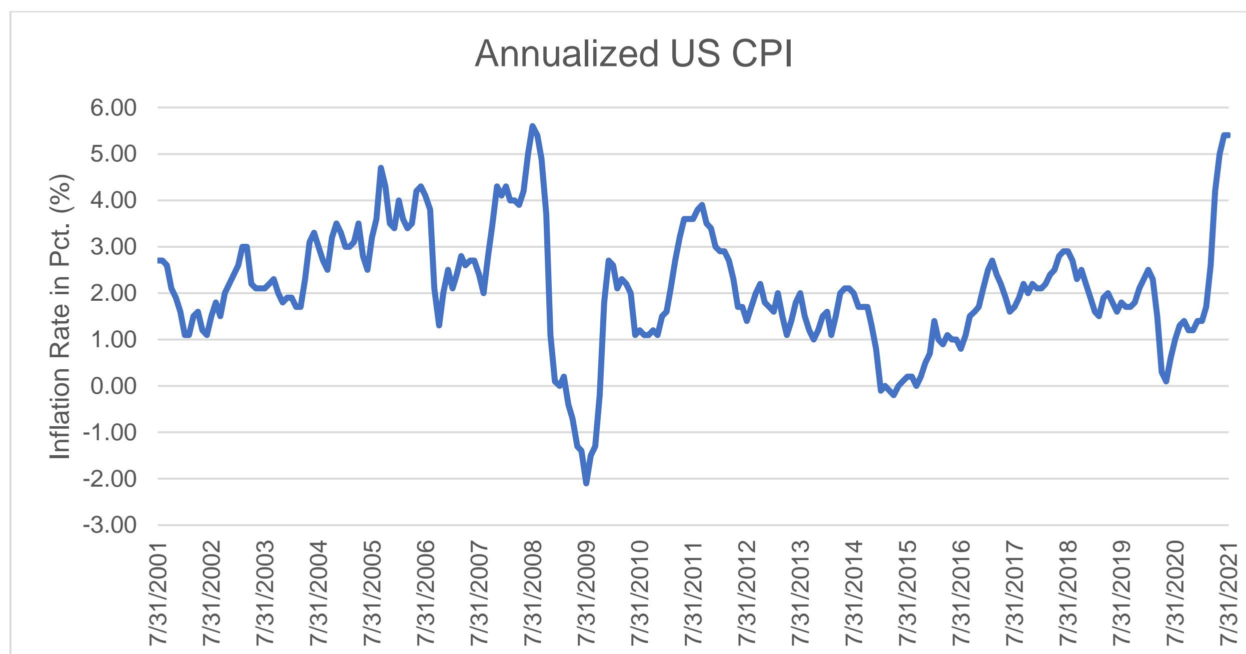
With all of the data coming at investors during the month, what would normally be a major announcement didn't grab much of a headline. On July 19th, The National Bureau of Economic Research (NBER), the official body that dates economic cycles, announced the February 2020 recession it declared back on June 8, 2020, actually ended in April 2020, making it the shortest recession on record. If you're following the dates, it also means by the time the NBER had announced the start of the 2020 recession, it had already ended.

Investors had to sort through a mixed bag of economic data in July. While second quarter US GDP rose by a robust 6.5%, it underperformed the market's consensus expectations of 8.5%.[1] Conversely, the labor market showed signs of strength with 943,000 new jobs created, much stronger than the consensus of 870,000.[2,3] Despite the improving labor situation, concerns remained related to both the Covid-19 pandemic and rising inflation.

The rapid spread of the Delta variant of the virus has caused some states and local governments to re-institute restrictions to slow the spread of the virus. For example, in New York, workers and customers of restaurants, gyms, and theaters will be required to show proof of at least one dose of the vaccine to enter.[4] Similarly, Los Angeles now requires masks indoors in public spaces, regardless of vaccination status.[5] Not surprisingly, the number of reported cases has risen dramatically in those and other areas of the country which precipitated these actions. While we are monitoring these events closely for signs of further societal impacts, we would be remiss if we did not mention the potential negative impacts to the economy should these restrictions eventually lead to another round of business closures or broader consumer restrictions.

The month's report on inflation, as measured by the Consumer Price Index (CPI), showed that consumer prices continued to rise in July at an annualized rate of 5.4%.[6] While the month-over-month change in the rate of inflation moderated slightly in July, the annual rate of inflation remains

above the Federal Reserve Bank's (the Fed) target average of roughly 2.0%.[7] Persistent rising inflation generally has a number of knock-on effects that can both negatively impact corporate operating margins and squeeze consumers. For those companies that have pricing power with consumers, they can simply pass costs along. However, those that are not able to increase prices are faced with shrinking operating margins, diminished profitability, and lower growth prospects. Consumers are equally as impacted by rising costs for such items as food, fuel, clothing, and housing costs. Unfortunately, while average hourly earnings increased at an annualized rate of 4.0% in July, the result has still been a loss of purchasing power as inflation has outpaced wage growth.[8] For these reasons we continue to monitor sectors of the economy that are very sensitive to changes in consumer behaviors such as the housing market and durable goods purchases. New home sales declined in June by -6.6% from May while durable goods order increased by 0.8%, well below expectations of an increase of 2.2%.[9,10] Additionally, we also monitor for changes in consumer sentiment as a leading indicator. For the month of July, the University of Michigan Sentiment Index declined to 80.8, down from 85.5 in June.[11]



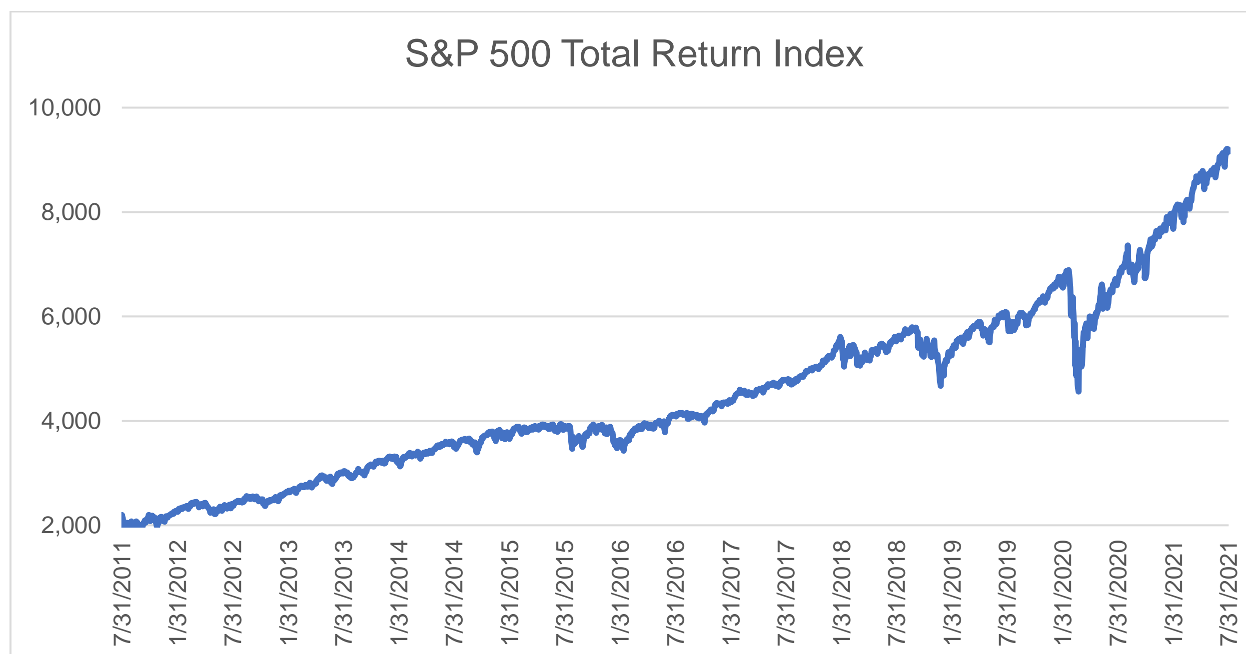
Source: Bloomberg as of July 31st, 2021

The wildcard in all of this is the Fed. At the most recent meeting, the Fed left interest rates unchanged between 0.0% to 0.25% and remained committed to purchasing $120 billion of US Treasury and Agency bonds monthly.[12] While their lack of a policy change at the meeting was not much of a surprise, the Fed subtlety hinted that it may consider tapering its bond purchases should the economy make further progress. It could be argued that the Fed has already made a policy

error by remaining too accommodative for too long, resulting in higher-than-expected inflation and the continued rise in risk asset prices. One specific concern is the Fed could begin to taper its purchases later this year as economic growth begins to slow back towards the long-term trend. The likely result would be higher interest rates for longer-term US Treasury bonds and mortgages. Conversely, the Fed could remain accommodative for too long resulting in higher-than-expected inflation. Since either move will be highly scrutinized with perfect hindsight, the Fed is in a tenuous position.

EQUITIES

Equity returns were mixed in July with large cap growth stocks significantly outperforming small cap and value-oriented stocks. The continuation of the positive momentum trend we have witnessed in recent months contributed to the rise in growth-oriented stocks. For the period, the S&P 500 Index rose roughly 2.4% to close the month at an all-time high while the technology-heavy Russell 1000 Growth Index gained 3.3%.[13] In contrast, small cap stocks disappointed with the Russell 2000 Index declining by -3.6%.[14] Looking at relative sector performance, cyclical and financial sectors lagged primarily due to the decline in long-term US interest rates. In contrast, this factor acted as a catalyst for both technology and health care companies. As we move deeper into the second half of the year, economic growth is expected to decline towards its long-term trend. As a result, the recent trend of growth outperforming value, and large caps outperforming small caps, may persist as investors look for companies that can continue to grow their earnings and potentially protect to the downside.



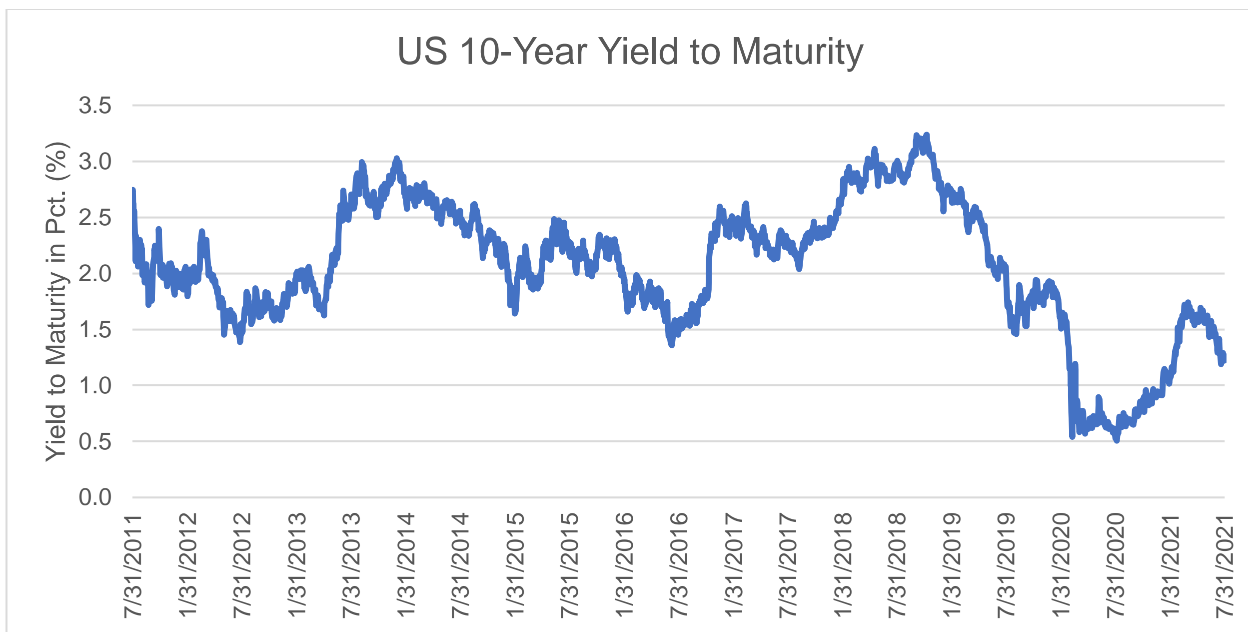
Source: Bloomberg as of July 31st, 2021

Overseas, developed markets produced positive returns with the MSCI EAFE Index rising by roughly 0.8%.[15] Despite rising concerns related to the pandemic and new restrictions in both the UK and Europe, investors were focused on improving economic conditions. The EU is forecasting that the economy will expand by 4.8% in 2021 and 4.5% 2022.[16] Emerging markets lagged during the month as China continued its decline due to the regulatory crackdown by the government related to technology and property companies. For the month, the MSCI Emerging Market Index declined by approximately -6.7%.[17]

FIXED INCOME

Fixed income delivered solid returns across most market segments in July, headed by higher quality bonds. Fears associated with both rising inflation and the Delta variant led to the rally in quality and a general decline in interest rates. For the month, the yield on the US 10-year Treasury bond declined by roughly 25 basis points which resulted in a return of roughly 2.0% while the benchmark Bloomberg Barclays US Aggregate Bond Index returned 1.1%.[18]

From a fundamental perspective, most US companies reported solid earnings growth during the second quarter as the economy continued to expand. However, concerns related to slowing future growth and continued pressures on margins from rising inflation resulted in muted performance for corporate bonds. Credit spreads for both investment grade and high yield credit bonds widened during the month by 6 basis points and 54 basis points, respectively.[19] Despite that, returns were positive with the US investment grade bonds gaining 1.4% and high yield bonds rising by 0.4%, respectively.[20] Moving forward, we believe there are reasons to remain positive on corporate bonds over the near-term. Broadly, the market's expectations related to potential defaults remains low and companies can issue debt at relatively low rates given the significant amount of liquidity and strong investor demand. In combination, both factors should provide for a positive environment for corporate bond investors.



Source: Bloomberg, July 31st, 2021

APPENDIX

1. Bloomberg, August 2021
2. Bloomberg, August 2021
3. https://www.bls.gov/news.release/empsit.nr0.htm
4. https://www.nytimes.com/2021/08/03/nyregion/nyc-vaccine-mandate.html
5. https://www.latimes.com/california/story/2021-07-15/l-a-county-will-require-masks-indoors-amid-covid-19-surge
6. Bloomberg, August 2021
7. Bloomberg, July 2021
8. Bloomberg, July 2021
9. Bloomberg, July 2021
10. Bloomberg, July 2021
11. Bloomberg, July 2021
12. Bloomberg, July 2021
13. Morningstar, July 2021
14. Morningstar, July 2021
15. Morningstar, July 2021
16. https://ec.europa.eu/commission/presscorner/detail/en/ip_21_3481
17. Morningstar, July 2021
18. Bloomberg, July 2021
19. Bloomberg, July 2021
20. Morningstar, July 2021

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