

Highlights

- **Economic growth is above trend.**
- **Demand is supported by liquidity.**
- **Investors should look beyond the recovery.**

Economy

Economic growth in the US, measured by gross domestic product (GDP), is expected to run at or near 6.5% for 2021-possibly the best 1-year growth rate since WW II. Employment continues to improve although the number of people working remains well below pre-pandemic levels. Higher inflation has materialized in monthly and year-over-year (Y/Y) numbers as anticipated, due a lack of inventory (commodity and finished goods) and a large spike in spending on services such as travel and leisure demand as the economy reopens.

Monetary and fiscal stimulus continue to boost liquidity. The federal reserve remains committed to supporting the economy with low interest rates and the Biden administration is seeking to double-down on already unprecedented transfer payment mechanisms.

Despite large increases in consumer spending, checking accounts and cash in the system remain at record-high levels. The M2 money supply, which measures checking accounts, CD's and savings balances grew over 25%, from pre-pandemic levels to a new record.

All of this suggests there is an ample supply of liquidity in the system; so, pressure is building on the government to pull-back or "taper" excessive support to keep inflation in check.

The fed is walking a tight rope. At its June meeting, the fed admitted that the rate of economic recovery and inflation are ahead of what it expected by mid-year. This implied a possible tapering of easy monetary policy. Indeed, the fed showed some action when it raised interest rate on bank deposits at the fed to 0.05% from zero and said it would sell

corporate bonds it purchased for its account during 2Q-2020. But these actions were small compared with the ongoing \$120 billion of purchases of mortgage-backed securities (MBS) and treasuries.

We agree with the fed that inflation is transitory, but we expect some degree of higher prices to remain even when the rate inflation growth dissipates.

If the fed tightens, stocks will decline. But there are many incremental steps the fed can take before actually raising interest rates. Look for the credit rate on bank deposits to go higher, and an announcement that it will reduce the purchases of MBS in the 1st half of 2022. A cut in treasury purchases could come next, possibly by year-end 2022, and if inflation levels off above its 2% target by then, it could move to raise the fed funds rate in 2023 – but don't bet on it; the fed is highly politicized now and doesn't want the blame for killing the economy.

Capital Markets

Stocks ripped higher again this quarter, piling on to late 2020 returns.

Major Indexes	2Q-2021	YTD
Short-Term Treas. (1-3 Yr.)	0.0%	-0.1%
Barclay's Aggregate Bond	1.8%	-1.6%
S&P 500 Index	8.5%	15.3%
Russell 2000 (Small Cap)	4.3%	17.5%
MSCI EAFE (International)	5.2%	8.8%
MSCI Emerging Mkts.	5.1%	7.6%
Bloomberg Commodity	13.3%	21.2%

Growth stocks, that were on the sidelines in 1Q, when it looked like the fed would be forced to raise interest rates sooner, outperformed value stocks late in 2Q when investors reasoned that if the economy slows, growth stocks would be a better place to be.

Bonds were positive during the quarter due to a similar reaction – if inflation proves transitory, then the fed will keep rates low. Bond market investors moved decisively to gather up any yield they could find, pushing prices up and yields down.

Real assets were mixed again. Hard commodities spiked but came off highs by quarter-end while real estate moved higher. REITs gained for two reasons: dividend yields are well above bonds, and real estate transaction prices, not just in housing, are supported by liquidity looking for a home. Gold faded as inflationary fears declined.

The price of oil moved above \$70 per barrel as demand exceeds supply. Drilling activity remains subdued and environmental pressures have accelerated, limiting supply growth. The Biden administration cancelled pipeline contracts and halted leases on federal land drilling programs.

Investment Strategy

There is a lot of bullish sentiment in stocks right now. GDP, inflation, and corporate profits will remain high into the 3rd quarter but it's important to look beyond these data points to developing trends.

The rate of change drives returns. Trends suggest a slowing economy after the demand and artificial liquidity levels peak.

Bond yields may move lower as the rate of economic growth slows. Despite the fed's talk of starting to normalize, it will keep rates low.

Although profits are high, equities will soon face headwinds from: higher input costs, wages, higher taxes, and a slowing rate of demand growth. Earnings growth estimates for 2022 will begin to decline by year-end due to the comparison with the strong pandemic recovery rate of 2H-2020.

From a macro perspective, a regime change may materialize as the rate of growth slows while prices will continue to rise - a potential state of stagflation.

Nevertheless, with interest rates low and the government maintaining a high level of stimulus,

equities are favored over bonds for long-term investors. But recognize that the S&P 500 has returned 14.8% over the last 10-years and 17.7% over the last 5-yrs. – well ahead of the long-term average return of approximately 10%.

We expect volatility to increase when economic reports confirm a slowing rate of growth. Quality growth stocks (those with real earnings and high cash flows) and dividend payers will be favored.

Energy, financial and real estate are the top-sectors YTD. When growth slows, watch the bottom-performers: consumer staples and utilities.

A healthy allocation to bonds should be maintained to protect capital. We still prefer a short-duration profile to reduce interest rate risk. Yield can be enhanced by bond-substitutes such as REITs, hedged equity income strategies, utility and consumer defensive stocks and small allocations to ETF's and closed end funds invested in energy pipelines.

G. Foley – July 2021

Please call or email with questions or comments!