MLL
INVESTMENT ADVISORS

July 2021

INVESTMENT REVIEW AND OUTLOOK

Trend Change

The economy and the stock market continued to make strong progress in the second quarter. Real GDP was forecasted to rise at an annualized rate of 7.9% in the quarter, according to data compiled by the Federal Reserve Bank of Atlanta. Measures of employment and consumer confidence also reached their highest levels since the onset of the COVID pandemic. The Center for Disease Control (CDC) reported that over 55% of U.S. adults had received at least one vaccine dose by June 30, and daily new COVID cases in the U.S. declined 76% from March 31 to June 30.

As measured by the S&P 500, the stock market posted a total return of 8.5% during the quarter and this brings the year-to-date return to 15.3%. Given that the long-term *annualized* return for the stock market is approximately 9%, these 6-month gains are well above average and follow a strong stock market recovery in 2020.

Beneath the surface there were several important trend changes in the broader stock market and interest rate picture. Interest rates, as measured by the 10-year U.S. Treasury bond, declined from 1.7% to 1.4% during the quarter. This is a meaningful decline under any circumstances, but particularly given the strong economic data. Within the stock market, there was also a notable change in leadership. Following a strong performance from value stocks in late 2020 and early 2021, growth stocks led the market in the quarter and the Citigroup Growth Index returned just under 12%, while the Citigroup Value Index returned 5%. Within the Value Index, some of the more economically sensitive sectors such as consumer discretionary, materials and industrials were notable laggards.

The decline in interest rates and the accompanying shift in stock market leadership could simply represent the ebb and flow of the capital markets in what is an ongoing economic recovery. However, there are a number of forces at work which will likely slow the rate of economic growth in the months ahead.

From a Rapid Boil to a Simmer

Two important sources of economic stimulus over the last 18 months have been the extraordinary monetary policies of global central banks and the large fiscal stimulus provided by national governments in the U.S. and abroad. In the case of global central bank policies, conditions remain accommodative: the Federal Reserve in the U.S. and the European Central Bank have both continued their open market purchases of government securities while maintaining low policy interest rates. However, recent statements from the U.S. Fed have communicated an intention to begin the "tapering" process in 2022 (whereby open market purchases are gradually curtailed).

Looking at the fiscal picture for the year ahead, we can expect a significant economic "headwind" from a reduction in government spending programs related to the COVID pandemic. In the U.S. alone, Strategas Research estimates the reduction in COVID-related spending by the federal government to be $1.8 trillion for fiscal 2022 (October).

The Biden administration has proposed spending and tax legislation which, if enacted, could impact consumer and business sentiment and/or spending in the year ahead.

In addition to the fiscal and monetary changes, consumers and businesses are being faced with higher prices almost across the board, including gasoline (+45% year-to-date), lumber (+10%), and copper (+20%). New home prices in June increased 18% year-over-year according to the National Association of Realtors. Prices for used cars and trucks are estimated to have increased 40% since 2019 according to the National Automotive Dealers Association.

With the decline in COVID cases globally, we have witnessed a powerful global economic recovery since late 2020. While we can expect this positive economic momentum to continue, there are significant countervailing forces at work as we enter the second half of the year. In brief, we can expect the economy to decelerate from a rapid boil to a simmer.

Not Quite Back to the Future

Given the various economic cross currents, it is reasonable to expect a deceleration in real GDP growth in 2022. The Conference Board forecasts real year-over-year U.S. GDP growth of 3.8%. While this is a reduction from the robust growth of 2021, it compares favorably with the long-term pattern of U.S. economic growth. Interest rates, as measured by U.S. Treasury yields, have rallied from the very low levels of 2020, but remain below the average levels of the last decade.

In some respects, the economic and interest rate environment today resembles that of the period from 2016-2019. Economic growth is modest, but consistent, and interest rates remain low by historical standards. Central banks continue to be accommodative and financial liquidity is plentiful. During the 2016-2019 period, as is the case today, the price/earnings ratio for the U.S. stock market remained above the long-term average, which reflected steady economic growth and the low level of interest rates.

There are two important differences between today and the period of the late 2010s. First, central bank activity has grown significantly during the 2020-2021 period. In the U.S., it is estimated that the Federal Reserve has increased its balance sheet by over 90% in the last 18 months. To place this figure in perspective, it is estimated that the growth in the Fed balance sheet in 2020 was equal to 13.4% of GDP, as compared to 4.5% of GDP during the 2008-2009 financial crisis. Another key difference between today and the prior decade is the advent of incipient inflation in today's economy. The higher prices cited above represent, to a degree, bottlenecks and shortages related to the economic recovery following the pandemic. Given the extraordinary central bank policies of the last year and a half, the prospect of more persistent inflation is real, and will need to be monitored carefully.

Finding Relative Value

We have written extensively in recent letters about some of our concerns in the current stock market environment. These include high valuations for faster growing companies, multiple signs of speculation on the part of individual investors (meme stocks, Bitcoin, Robinhood, etc.) a robust market for initial public offerings and record levels of margin debt. These developments are occurring against a backdrop of extraordinary monetary policies which, although targeted to promote economic activity, have clearly spilled over into the broader capital markets.

For some time now investors have been faced with a dilemma. Conservative investments such as government bonds, high quality corporate bonds, and traditional value stocks have provided less than adequate returns. Meanwhile, growth stocks, as well as some of the more speculative categories cited above, have generated robust returns. In some cases, the size of the reward has been directly proportionate to the severity of the entity's financial distress. As an example, AMC Entertainment is a heavily indebted owner of a national chain of movie theaters whose debt is rated CCC by Moody's Investor Services (last December Moody's cited "substantial doubt" about the company's ability "to continue as a going concern"). Nevertheless, the stock price has risen over 2,000% from December of 2020 until early June of this year. There are dozens of similar examples of marginal enterprises or "concept" companies achieving spectacular stock market gains.

For fiduciaries, the "two tier" nature of the stock market has provided a textbook example of foregoing investment returns in order to remain true to the principle of financial prudence. In managing client portfolios, we have strived to achieve a balance in our asset allocation and sector positioning. We have maintained exposure to the faster growing and innovative sectors of the economy through ownership of well-established companies that demonstrate strong growth in earnings and cash flow. However, we have, over the last 6 months, slightly reduced our weightings in instances where valuation levels were a concern. In addition, we have increased our holdings in more established sectors of the economy including aerospace, large capitalization pharmaceuticals, and materials. In making these changes we have emphasized not the cheapest stocks in these sectors, but rather companies trading at reasonable valuations *relative* to their expected earnings growth rate. At this juncture in the investment cycle, we are mindful of mitigating risk while also providing the opportunity for long-term growth.

As always, we welcome your comments and questions.