

Quarterly Insights – July 2021

Optional Title #1: Improvement in the Pandemic Drives Stocks to Record Highs

Optional Title #2: Stocks Hit New Highs as the Pandemic Recedes

Optional Title #3: Another Record Quarter for Stocks

Or

Dear Client,

The S&P 500 rose to another record high during the second quarter as a substantial decline in U.S. COVID-19 cases combined with a near-total economic reopening across the country led a surge in economic growth that helped stocks rally to new highs over the past three months.

The S&P 500 had a strong start to the second quarter thanks to numerous positive developments. First, the pace of vaccinations in the U.S. accelerated meaningfully in April, with daily vaccinations hitting a peak of more than three million per day by the middle of the month. At the same time, the number of new COVID-19 infections fell from approximately 77,000 daily new cases at the beginning of April to less than 60,000 daily new cases during the last week of the month. The increased pace of vaccinations combined with a decline in COVID-19 cases helped numerous states more fully reopen their economies or prompted the announcement of plans to do so in the near future. That served as a positive signal to investors that a return to pre-pandemic normal was now likely just a matter of time.

Meanwhile, the Federal Reserve reiterated its support for the economy and promised not to remove any accommodation in the near term. That continued “safety net” gave investors confidence in the future economic outlook and the sustainability of the economic recovery. Finally, first-quarter corporate earnings were very strong, as the vast majority of U.S. companies beat earnings estimates. These positive factors helped stocks rally throughout the month, as the S&P 500 hit a new record above 4,200 during the final days of April.

The rally paused in May, however, thanks to uncertainty regarding inflation, the labor market and when the Federal Reserve would begin to reduce, or taper, its quantitative easing (QE) program. A disappointing jobs number in early May implied the labor market might not be recovering as quickly as expected. That, combined with inflation metrics hitting multi-decade highs, elicited some concern the economic recovery might not be as strong as forecasted, and that a return of inflation might make the Federal Reserve begin to reduce accommodation earlier than previously expected. But after some volatility early in the month, it became apparent that the lackluster job growth was more a function of a labor supply issue rather than there not being enough jobs available, and investors came to believe that issue will resolve itself as the economy and society continues to return to pre-pandemic “normal.” Meanwhile, Federal Reserve officials reiterated their long-held position that any increase in inflation would be temporary and due to pandemic-related supply chain disruptions and not the return of 1970’s style inflation problems. Investors were comforted enough for stocks to rebound in mid-May and close the month with a small gain.

Stocks resumed the rally in early June, as more state economies returned to pre-pandemic normal (most notably California), measures of economic activity remained strong, and certain inflation statistics implied that inflation pressures were starting to ease, possibly validating the Fed's belief that surging inflation is just temporary. The June Fed meeting provided a small surprise to markets, as it revealed that Federal Reserve officials began discussions about when to reduce the current quantitative easing program, while Federal Reserve forecasts showed interest rates could start to rise late in 2022, sooner than previously expected. Those two surprises caused some mild market volatility late in June, although ultimately investors remained confident that the Federal Reserve will not remove economic support too quickly and the S&P 500 hit another record high during the last few days of the quarter.

In sum, the strong gains of the second quarter and the first half of 2021 reflected continued government support for the economy combined with a material improvement in the pandemic in the U.S., and as we start the second half of 2021, we are happy to say the world looks a lot more like it did pre-pandemic than it did for most of 2020, and that sentiment is supportive of risk assets going forward.

2nd Quarter Performance Review

In a reversal from the first quarter, the Nasdaq outperformed both the S&P 500 and Dow Jones Industrial Average thanks to a June rally in technology shares, as investors began to consider that the intensity of the economic recovery had possibly peaked now that virtually all state economies had fully reopened. Additionally, the Federal Reserve signaling that it has begun discussions to reduce its QE program made some investors nervous that economic growth could slow in the future, contributing to that rotation back towards technology stocks, which tend to be less sensitive to changes in economic growth compared to other market sectors.

By market capitalization, large-cap stocks outperformed small-cap stocks, which was a reversal from the previous two quarters. Small-cap stocks tend to outperform during periods of accelerating economic growth, like we saw in the fourth quarter of 2020 and the first quarter of 2021. But with investors considering that the intensity of the economic recovery may have peaked in the second quarter and that the Fed may reduce QE in the future, they rotated back into large caps as the outlook for future economic growth became slightly less certain.

From an investment-style standpoint, growth handily outperformed value thanks to the aforementioned tech sector rally, as again investors positioned for the possibility that the intensity of the economic recovery may wane in the coming months.

On a sector level, 10 of the 11 S&P 500 sectors realized positive returns in the second quarter with real estate and tech outperforming. The real estate sector was boosted by a decline in mortgage rates combined with consumers returning to malls and shopping centers, while a drop in Treasury bond yields helped fuel the rotation back to tech stocks.

Sector laggards last quarter included consumer staples and utilities as the former registered a small gain while the latter was the only S&P 500 sector to finish negative for the quarter. Those traditionally defensive sectors outperform when investors expect an outright economic slowdown, and while some investors believe the acceleration in the economic recovery may have peaked, most analysts are expecting the economic recovery to continue, just at a moderating pace, making defensive sectors such as utilities and consumer staples less attractive.

US Equity Indexes	Q2 Return	YTD
S&P 500	8.95%	15.25%
DJ Industrial Average	4.81%	13.79%
NASDAQ 100	13.07%	13.34%
S&P MidCap 400	3.57%	17.38%
Russell 2000	5.47%	17.54%

Source: YCharts

Internationally, foreign markets saw positive returns in the second quarter thanks to further declines in COVID-19 cases, rising vaccination rates, and more widespread economic reopenings across the EU and UK. Emerging markets also rallied in the second quarter on hopes of a global economic recovery, although they slightly underperformed foreign developed markets as the Chinese government reduced support for its economy following a large increase in inflation indicators. Foreign developed markets again lagged the S&P 500.

International Equity Indexes	Q2 Return	YTD
MSCI EAFE TR USD (Foreign Developed)	5.03%	9.17%
MSCI EM TR USD (Emerging Markets)	4.88%	7.58%
MSCI ACWI Ex USA TR USD (Foreign Dev & EM)	5.38%	9.45%

Source: YCharts

Commodities posted strong gains for the third quarter in a row and once again outperformed the S&P 500 over the past three months. Major commodity indices were led higher by another large rally in crude oil futures as demand rose for both oil and refined products following the U.S. and European economic reopenings. Additionally, despite the resumption of nuclear negotiations between the U.S. and Iran, sanctions remained in place preventing Iran from selling oil on the global market while compliance to self-imposed production targets by members of "OPEC+" remained historically high, keeping global oil supplies subdued. Gold, meanwhile, posted a small gain as investors rotated back to gold following a spike in inflation metrics, combined with an increase in volatility in Bitcoin, which sent money back into more traditional non-correlated, safe-haven assets.

Commodity Indexes	Q2 Return	YTD
S&P GSCI (Broad-Based Commodities)	15.34%	31.40%
WTI Crude Oil	27.29%	51.53%
Gold Price	3.41%	-6.74%

Source: YCharts/Koyfin.com

Switching to fixed income markets, second quarter total returns for most bond classes were positive, a reversal from the first quarter. Despite inflation indicators surging to multi-year highs in recent months, investors viewed those increases as temporary phenomena related to the global economic reopening and short-term supply chain issues. As such, investors took advantage of relatively higher bond yields in the second quarter.

Looking deeper into the bond markets, longer-duration bonds outperformed those with shorter durations in the first quarter. That substantial outperformance was driven by the market's view that the increase in inflation was indeed temporary, combined with effective messaging by the Fed that interest rates would remain near 0% for the foreseeable future.

In the corporate debt markets, investment grade bonds solidly outperformed lower-quality, higher-yielding bonds. That investment grade outperformance reflects confidence in the sustainability of the U.S. economic recovery but also acknowledges that the pace of economic growth may moderate in the coming months.

US Bond Indexes	Q2 Return	YTD
BBgBarc US Agg Bond	1.82%	-1.60%
BBgBarc US T-Bill 1-3 Mon	0.00%	0.02%
ICE US T-Bond 7-10 Year	2.50%	-3.30%
BBgBarc US MBS (Mortgage-backed)	0.36%	-0.77%
BBgBarc Municipal	1.40%	1.06%
BBgBarc US Corporate Invest Grade	3.70%	-1.27%
BBgBarc US Corporate High Yield	2.96%	3.62%

Source: YCharts

4th Quarter Market Outlook

The gains during the third quarter were driven by legitimate fundamental factors, as the corporate earnings outlook did improve, the Federal Reserve met market expectations in not reducing stimulus until very late in 2021, and the economic recovery showed impressive resilience in the face of yet another COVID wave.

But, as was reflected in the September market volatility, despite those positives this market and the economy more broadly faces several sources of uncertainty as we begin the final quarter of the year.

First, the budget battle in Washington is now in full swing, and the threat of a government shutdown and Debt Ceiling breach weighed on markets in September. Positively, both events are unlikely to cause material volatility, but until they are resolved the uncertainty will be a headwind on stocks.

Additionally, the fate of Democrat's \$3.5 trillion social overhaul and tax increase plan hangs in the balance, as does the fate of the \$1.2 trillion bi-partisan infrastructure bill. How those events are resolved will impact markets in the 4th quarter positively or negatively, and that uncertainty will also be a headwind on markets over the coming weeks.

Regarding Federal Reserve policy, the Fed has made clear that it will begin to reduce (or taper) its quantitative easing program in November or December. But, it has not revealed the details of its plan just yet, and the specifics of their tapering plan (specifically how quickly it will reduce QE) could cause volatility if it differs from market expectations.

Finally, inflation remains elevated and at multi-decade highs, and that combined with continued supply chain disruptions due to the ongoing pandemic is starting to impact corporate margins and profitability. If many companies warn about future profitability due to these factors at the upcoming third quarter earnings season, it will negatively impact markets.

Bottom line, the fundamental outlook for stocks and other risk assets remains positive: The Fed will remain historically accommodative long after tapering has begun and rate increases remain at least a year away, COVID cases are receding once again and the world is learning to “live with” COVID so that it does not cause major societal disruptions, corporate profitability remains very strong on an absolute basis and economic growth is robust. But, markets are facing elevated uncertainty as we enter the final three months of the year, and as such we should not be surprised if markets are more volatile than they have been so far in 2021 (which has been a historically not-volatile year).

But, it’s important to remember that volatility is historically normal, and volatile markets do not mean poor returns. Yes, risks remain to the markets and the economy, as they always do, it is important to remember that a well-executed and diversified, long-term-focused financial plan can overcome bouts of even intense volatility, like we have seen over the last 21 months.

At **John Doe Advisors**, we understand the risks facing both the markets and the economy, and we are committed to helping you effectively navigate this still-challenging investment environment. Successful investing is a marathon, not a sprint, and even temporary bouts of volatility like we experienced during the height of the pandemic are unlikely to alter a diversified approach set up to meet your long-term investment goals.

Therefore, it’s critical for you to stay invested, remain patient, and stick to the plan, as we’ve worked with you to establish a unique, personal allocation target based on your financial position, risk tolerance, and investment timeline.

The economic and medical progress achieved so far in 2021 notwithstanding, we remain vigilant towards risks to portfolios and the economy, and we thank you for your ongoing confidence and trust. Please rest assured that our entire team will remain dedicated to helping you successfully navigate this market environment.

Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio review.

Sincerely,

Signature

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