Asset Strategy Consultants

MARKET REVIEW

Second Quarter 2021

We are pleased to present *Market Review*, featuring a discussion of the Capital Markets during the Second Quarter 2021 and a summary of historical performance for the major asset style passive indices for the period ending June 30, 2021. We hope you find the information useful and helpful in your investment considerations.

We welcome your comments.

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ASSET STRATEGY CONSULTANTS

Founded in 1991, Asset Strategy Consultants provides investment consulting services to institutional clients representing $7.9 billion under advisement. Headquartered in Baltimore, Asset Strategy Consultants has offices throughout the East Coast.

THE MACROECONOMIC ENVIRONMENT

Tran-si-to-ry (adj.) – of brief duration: temporary (Merriam-Webster)

There was not a lot for investors to complain about in 2Q21, especially when compared to 2Q20. Fueled by rapid progress in vaccinations and re-opening economies, pent-up demand, and continued monetary and fiscal stimulus, consumer sentiment climbed, and economic data were broadly positive.

This spurred sharp gains in global stock markets, commodities, and real estate. Atypically, bonds were even well-behaved and delivered positive quarterly returns in spite of rising inflation and buoyant economic growth. Markets were seemingly undisturbed by the ongoing debate as to whether recent increases in inflation will be short-lived or not, with most of Wall Street being in the Fed's "transitory" camp. Investors were also unperturbed by the Fed's move to a more "hawkish" stance coming out of its recent June meeting (more on both topics later).

According to the Centers for Disease Control, nearly 60% of the U.S. population (ages 18 and over) has been vaccinated (more than 150 million). Aside from the U.K., most developed markets are making slower but steady progress. Japan is an exception. According to the World Health Organization, less than 8% of its population has been vaccinated as it prepares for the Olympics this summer. Japan has faced a shortage of doctors and nurses and, further, has had to import all of its vaccines. Emerging market countries have had mixed success but have generally lagged developed markets.

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Consumer demand for goods and services has been robust, spurred by stimulus and months of forced solitude, while supply in some channels has been constrained by labor shortages and other bottlenecks. Real GDP growth in 1Q surged 6.4% (annualized) and some expect growth to exceed 9% in 2Q. The most recent prediction from the Congressional Budget Office was for GDP growth to be 7.4% in 2021, the fastest pace since 1984 and double its forecast of 3.7% issued in February 2021. Under the hood of the headline GDP figure, personal consumption and business investment grew 11.4% and 11.7%.

Manufacturing and services indices remained strong in spite of supply bottlenecks and widespread labor shortages. The July 1 release of the Institute for Supply Management (ISM) Manufacturing Index was 60.6 (above 50 signals expansion) and the prices-paid component jumped to 92.1, the highest since 1979. The Conference Board Consumer Confidence Index reached a 13-month high, and the "jobs gap," which measures the difference between those indicating that jobs are "easy" versus "hard" to get, reached 43.5%, near an all-time high. Unemployment fell to 5.8% as of the end of May. There are still nearly 10 million people unemployed, yet job openings are at record levels (9.3 million in April according to the Labor Department's JOLTS? report) and labor shortages are widespread. There are a number of theories for this, all of which likely have some element of truth. These range from employees' fear of returning to the workforce given concerns over the virus, to difficulties finding childcare, to a simple reassessment of priorities (early retirements have accelerated) and quality-of-life considerations (did I really like my job?). Further, continued jobless benefits have likely made the choice possible, though this contributor could be short-lived as federal benefits are slated to expire in September and a number of states have already ended theirs. A mismatch in skill requirements is an issue in some industries as well.

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Housing prices have been on a tear. The S&P CoreLogic Case-Shiller U.S. National Home Price Index showed a 14.6% increase over the past year (as of April), the highest reading since data began to be collected more than 30 years ago. Demand for houses has surged throughout the country while inventory has never been lower, and builders have been hampered by high costs and labor shortages. Craig Lazzara, managing director and global head of index investment strategy at S&P DJI, summarized it well, "April's performance was truly extraordinary.... Housing prices in all 20 cities rose; price gains in all 20 cities accelerated; price gains in all 20 cities were in the top quartile of historical performance. In 15 cities, price gains were in the top decile. Five cities—Charlotte, Cleveland, Dallas, Denver, and Seattle—joined the National Composite in recording their all-time highest 12-month gains."

The Consumer Price Index (CPI) rose 5.0% over the last 12 months (as of May), exceeding expectations and notching the largest increase since 2008. Core CPI (ex food and energy) was up 3.8% year-over-year, the largest increase since 1992. The Fed's favored measure, core PCE, climbed 3.9% (3.4% core) for the period, well above its long-term 2% target. While leaving the Fed Funds rate alone at 0.0%-0.25% at its June meeting, the Federal Open Market Committee turned a bit more hawkish. Seven of the 18 committee members see the first hike in 2022 and thirteen members expect ae hike in 2023. In March, there were four members expecting a 2022 hike and seven expecting a hike in 2023. The Fed also sharply raised its expectation for inflation, measured by the PCE, in 2021 (from 2.4% in March to 3.4%). Asset purchases of $120 billion per month continue, but Chairman Jerome Powell did acknowledge that "tapering" had been a discussion item at the meeting. It would not be a surprise to see asset purchases tempered at some point this year.

A wide-ranging debate around whether inflation increases will be short-lived is ongoing. Supporting arguments for this include:

- Current inflation figures are off of a low pandemic-induced base and thus unsustainable
- Downward price pressures from secular themes such as globalization and an aging workforce will resurface
- Intensity/pace of this economic rebound has created short-term supply-related price pressures that will subside

For those concerned about more stubborn inflation increases, the following points are cited:

- Wage pressures can be expected to climb as workers demand higher compensation
- Price increases have been broad-based (used cars, food, energy, construction, car rentals, airfare, appliances)
- Supply constraints could be longer lasting and lead to "cost-push" inflation

Interestingly, the bond market appears to be unfazed and yields fell steadily throughout the quarter after rising sharply in 1Q. One may wonder what the bond market is seeing that others are missing. ■

GLOBAL FIXED INCOME

The 10-year U.S. Treasury yield declined steadily throughout the quarter, from 1.74% as of 3/31 to 1.45%. TIPS outperformed nominal Treasuries for the quarter given strong relative performance in April and May. The Bloomberg Barclays US Aggregate Bond Index rose 1.8% but remains down 1.6% YTD. Strong equity performance and robust economic data fueled risk appetites, and lower-quality securities were the best performers again this quarter. Corporates outperformed Treasuries as investors continued to reach for yield in spite of the paltry yield advantage (the average option-adjusted spread on the Corporate Index was 80 bps as of quarter-end, the lowest since 1998). The Bloomberg Barclays High Yield Index was up 2.7%. The absolute yield-to-worst for the Index reached an all-time low of 3.75% and its option-adjusted spread hit 268 bps, the lowest since 2007. Municipals (Bloomberg Barclays Municipal Bond Index: +1.4%) performed in line with Treasuries for the quarter.

The U.S. dollar was mixed versus developed market currencies, but shifts were fairly modest. Thus, currency was not a major contributor to relative results for global ex-U.S. indices. The Bloomberg Barclays Global Aggregate ex-US Bond Index rose 0.9% (+0.4% hedged). Emerging market debt performed well; the JPM EMBI Global Diversified Index gained 4.1% and the local currency JPM GBI-EM Global Diversified Index was up 3.5%. Both remain down YTD, however; -0.7% and -3.4%, respectively. ■

GLOBAL EQUITIES

The S&P 500 Index closed the quarter at a record high and registered an 8.5% gain in 2Q, bringing its YTD return to 15.3%. The Index is up 40.8% over the past year and the annualized return over the past 10 years is a healthy 14.8%. The S&P 500 Index hit 34 record highs in the first half of the year. First quarter earnings were up over 50%, according to FactSet, and second quarter earnings are projected to grow more than 60% (YOY). Real Estate was the strongest-performing sector in the S&P 500 for the quarter (+13.1%) with Technology close behind (+11.6%). Utilities was the only sector to post a negative result (-0.4%). Growth stocks outperformed value (R1000 Growth: + 11.9%; R1000 Value: + 5.2%) but lag for the YTD period (+13.0% vs. +17.0%) Small cap lagged large (R2000: +4.3% vs. R1000: +8.5%) and also trails by a modest margin YTD (15.0% vs 17.5%).

Developed ex-U.S. stocks also had a strong quarter with virtually all developed market countries posting positive returns. The MSCI ACWI ex-USA Index rose 5.5% for the quarter and is up 9.2% YTD. As in the U.S., Utilities (-0.4%) was the lone sector to produce a negative return. Health Care (+9.9%) and Energy (+8.2%) were the top-performing sectors. Canada (+10.0%) was a strong performer and Japan (-0.3%) was notable as the lone country to deliver a negative return. The U.S. dollar was mixed against developed market currencies and thus shifts were not a major contributor to relative results. The MSCI EM Index performed in line with developed markets (MSCI EM USD: +5.0% and +7.4% YTD), but country returns were mixed. Brazil (+23%) and Russia (+14%) were top performers while Chile (-14%) was at the bottom of the pack. China was up 2% and China A-shares (+9.2%) did especially well as softer economic data in May appeared to ease investors' concerns over potential policy tightening. ■

REAL ASSETS

Real assets did very well as the economy continued to gain traction. The Bloomberg Commodities TR Index rose 13.3%. Oil prices continued to climb, closing at more than $73 per barrel, the highest in almost three years. The Alerian MLP Index was up 21.2% for the quarter and 47.8% YTD. The S&P GSCI Index climbed 15.7% and is up 31.4% YTD. REITs, as measured by the MSCI U.S. REIT Index, rose 12.0%. The Bloomberg Barclays US TIPS Index gained 3.2% and the Dow Jones Global Infrastructure Index climbed 6.9%. Gold (S&P Gold Spot Price: +3.3%) was an underperformer for the quarter. ■

CLOSING THOUGHTS

The recent rise in inflation may indeed be transitory, but so may the pace and longevity of the economic recovery. Consumer and investor exuberance may also be transitory, especially when considering base effects (very low one year ago—not so low today!), the potential for the dangerous Delta variant to cause disruption, and a slow-to-heal labor market. On the flipside, inflation increases may prove not to be transitory and rate hikes could be needed sooner than expected. In either scenario, there are a variety of paths that markets could take. Meanwhile, there are few (any?) investment options that can be argued to have “attractive” valuations and thus it is sensible to temper going-forward return expectations. In this vein, it will come as no surprise that Asset Strategy Consultants continues to advise adherence to a disciplined investment process that includes a well-defined long-term asset allocation policy. ■

Source: Asset Strategy Consultants and Callan Associates

PRELIMINARY RETURNS FOR VARIOUS PERIODS: 2Q21

		April	May	June	Last Quarter	Year to Date	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
EQUITY	1 Russell:3000 Index	5.15	0.46	2.47	8.24	15.11	44.16	18.73	17.89	14.70	10.78
	2 Russell:1000 Index	5.38	0.47	2.51	8.54	14.95	43.07	19.16	17.99	14.90	10.89
	3 Russell:1000 Growth	6.80	(1.38)	6.27	11.93	12.99	42.50	25.14	23.66	17.87	13.53
	4 Russell:1000 Value	4.00	2.33	Z	5.21	17.05	43.68	12.42	11.87	11.61	8.01
	5 Russell:Midcap Index	5.10	0.80	1.47	7.50	16.25	49.80	16.45	15.62	13.24	10.53
	6 Russell:Midcap Growth	5.62	(1.53)	6.80	11.07	10.44	43.77	22.39	20.52	15.13	12.10
	7 Russell:Midcap Value	4.84	1.97	(1.16)	5.66	19.45	53.06	11.86	11.79	11.75	9.11
	8 Russell:2500 Index	4.00	0.21	1.18	5.44	16.97	57.79	15.24	16.35	12.86	10.25
	9 Russell:2500 Growth	3.51	(2.78)	5.37	6.04	8.67	49.63	20.15	20.68	14.83	12.04
	10 Russell:2500 Value	4.29	2.03	(1.32)	5.00	22.68	63.23	10.60	12.29	10.93	8.41
	11 Russell:2000 Index	2.10	0.21	1.94	4.29	17.54	62.03	13.52	16.47	12.34	9.51
	12 Russell:2000 Growth	2.18	(2.86)	4.69	3.92	8.98	51.36	15.94	18.76	13.52	10.89
	13 Russell:2000 Value	2.02	3.11	(0.61)	4.56	26.69	73.28	10.27	13.62	10.85	7.90
	14 S&P:500	5.34	0.70	2.33	8.55	15.25	40.79	18.67	17.65	14.84	10.73
	15 S&P:400 Mid Cap	4.50	0.20	(1.02)	3.64	17.60	53.24	13.17	14.29	12.40	10.43
	16 S&P:600 Small Cap	2.04	2.08	0.33	4.51	23.56	67.40	12.20	15.82	13.49	10.45
	17 MSCI:ACWI ex US	2.94	3.13	(0.65)	5.48	9.16	35.72	9.38	11.08	5.45	4.85
	18 MSCI:EAFE	3.01	3.26	(1.13)	5.17	8.83	32.35	8.27	10.28	5.89	4.40
	19 MSCI:EM	2.49	2.32	0.17	5.05	7.45	40.90	11.28	13.03	4.29	6.61
	20 MSCI:ACWI	4.37	1.56	1.32	7.39	12.30	39.26	14.57	14.61	9.90	7.60
FIXED INCOME	21 Blmbg:Aggregate	0.79	0.33	0.70	1.83	(1.60)	(0.33)	5.34	3.03	3.39	4.43
	22 Blmbg:Gov/Credit	0.88	0.51	1.01	2.42	(1.96)	(0.39)	5.95	3.31	3.71	4.58
	23 Blmbg:Credit	1.06	0.72	1.50	3.32	(1.28)	2.99	7.42	4.63	4.92	5.61
	24 Blmbg:Corporate High Yld	1.09	0.30	1.34	2.74	3.62	15.37	7.45	7.48	6.66	7.53
	25 Blmbg:Municipal Bond	0.84	0.30	0.27	1.42	1.06	4.17	5.10	3.25	4.28	4.50
	26 Blmbg:US TIPS	1.40	1.21	0.61	3.25	1.73	6.51	6.53	4.17	3.40	4.56
	27 Blmbg:Glob Agg ex USD	1.62	1.36	(2.02)	0.92	(4.42)	4.60	3.12	1.63	0.99	3.09
	28 S&P:LSTA Levg Loan	0.51	0.58	0.37	1.47	3.28	11.65	4.39	4.99	4.39	4.63
	29 ML:US Treasuries 1-3 Yrs	0.05	0.08	(0.15)	(0.03)	(0.08)	0.07	2.68	1.60	1.20	2.17
	30 LIBOR - 3 Month	0.01	0.01	–	–	–	–	–	–	–	–
	31 3 Month T-Bill	0.00	0.00	0.00	0.00	0.02	0.09	1.34	1.17	0.63	1.08
REAL ASSETS	32 Blmbg:Commodity TR Idx	8.29	2.73	1.85	13.30	21.15	45.61	3.90	2.40	(4.44)	(3.00)
	33 GS Commodity Index	8.23	2.52	4.29	15.72	31.40	57.37	(2.72)	1.73	(6.48)	(6.37)
	34 MSCI:US REIT Index	8.05	0.93	2.69	12.00	21.80	38.05	10.14	6.32	9.38	7.01
	35 Alerian:MLP Index	7.15	7.57	5.18	21.23	47.84	63.98	(0.33)	(1.05)	1.07	5.85
	36 DJB:Glbl Infrastructure	4.68	1.61	0.49	6.88	12.58	18.75	7.95	6.85	8.22	8.36
	37 US DOL:CPI All Urban Cons	0.82	0.80	–	–	–	–	–	–	–	–

Source: Callan Associates