SUMMER 2021

Investment Commentary

Q2 2021

withum
WEALTH MANAGEMENT

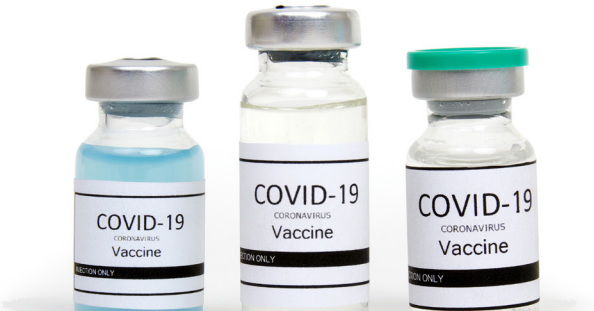
Returning to Normal — 2021 Summer Review

As we continue to climb our way out of the COVID-19 Pandemic, we hope that this letter finds you and your loved ones healthy and enjoying a more normal summer.

Equity markets continued their slog higher in the second quarter with more of the same themes that we wrote about this winter — cyclical sectors and companies led the way as the economic recovery and vaccination progress worldwide allowed people to resume a return to normal. Ever since encouraging news broke about the scientific breakthroughs of the COVID-19 vaccine in the fall of 2020, the focus has shifted away from the negative effects of the pandemic to the positives of the recovery.

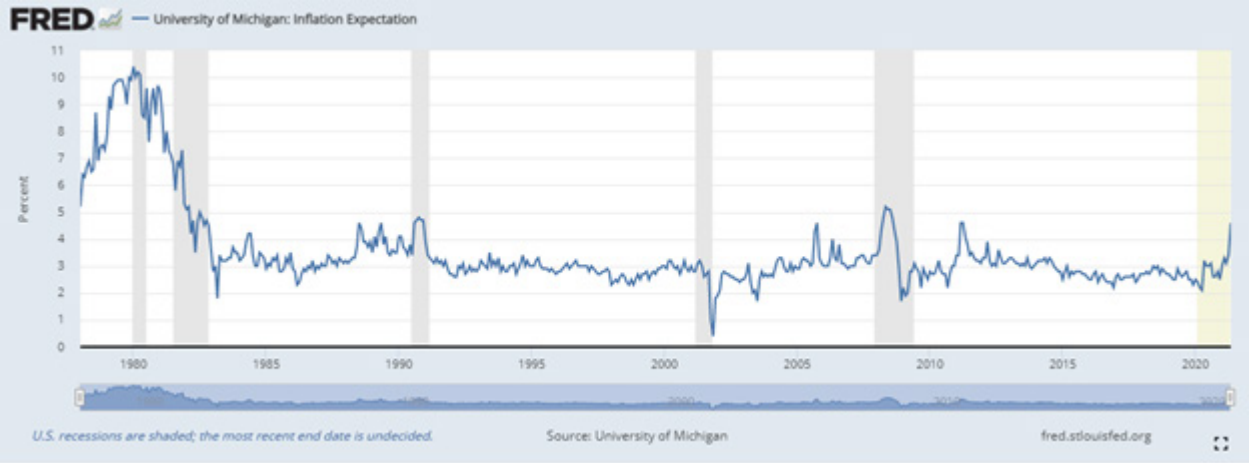
Much of this is due to progress being made not just in the US, but across the world to vaccinate as much of the world's population as possible to prevent the spread and mutations of COVID-19. Here in the US, many states have over 50% of their population fully vaccinated, with even more having received at least one dose of the mRNA vaccines. The best news is that those most susceptible to severe illness are getting vaccinated at higher rates, with nearly 93% of those 65 or older having received at least one shot in the US. Some countries though are clearly behind — Canada for example, opted to give everyone one shot before any got a second which has been a disaster. In addition, countless less economically well off and emerging countries like India are still tragically struggling with their outbreaks. This presents its own problems and risks for mutations, but the days of full lockdowns are likely behind us for good and this means those that were furloughed or laid off can go back into offices and work environments where they can once again feel safe.

The market is reflecting such optimism, and we feel that it is right in doing so. What's been refreshing this year is to see market breadth expand. Big cap technology firms are not the only ones performing well and many sectors of the economy that had been lagging are beginning to see a resurgence. Banks, industrials and energy stocks have led the way the last six months and we think this positive trend may continue.



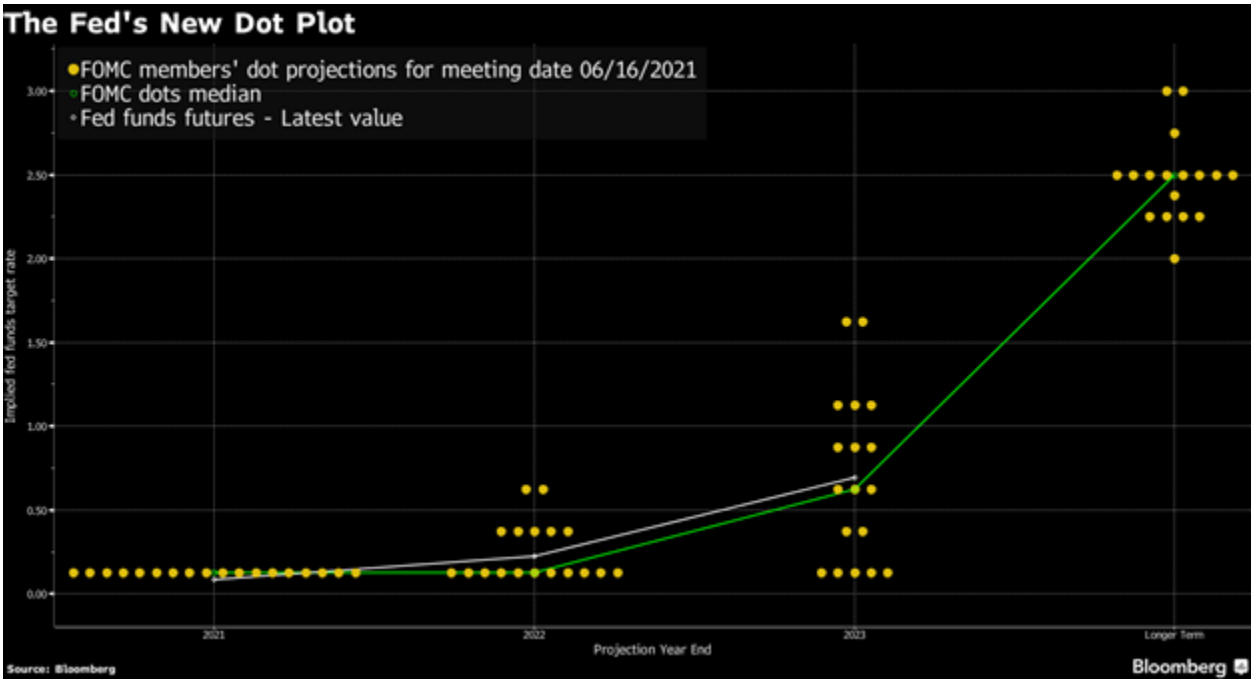
Inflation & Taper Tantrum 2.0?

Quite possibly one of the biggest concerns we hear about today from clients and on the news is the threat of inflation. Many believe that the current inflationary environment will be temporary, or as the Fed loves to say, "transitory". As we have said before, people only have a limited amount of vacation time each year and there are only so many Saturday nights this summer when people can go out for a dinner and a show. This pent-up demand will eventually settle down, and spending patterns should return to normal. The data has been distorted given the year-over-year comparisons to lockdown-era data, so we have only seen inflation spiking. The other good thing about today's current inflationary environment is that the economy is also growing very quickly. Inflation is not the worst thing in the world if the economy is also growing rapidly, and we are expected to have around 6-7% GDP growth for the year. What might also be a beacon of comfort — the days of 10-15% inflation in the 70s and 80s seem like a longshot.



Source: University of Michigan

What is concerning and central to the inflation story is how the Federal Reserve chooses to act in response to inflation. For some time now, Fed Chief Jerome Powell has indicated he wanted inflation to run above the 2.0% goal, but investors have very little clue as to how this might affect markets. The biggest implication here is that the typical tool the Fed uses to dampen inflation is to raise short term interest rates. In Q2 the 10-year Treasury, which is typically a good reflection of long-term inflation expectations, barely budged after jumping drastically in the beginning of this year. Maybe the Fed is on the ball and can let this transitory bout of inflation run hot, above target, while not needing to remove the punchbowl from the party just yet. Eventually, when the Fed does cut back on their bond purchases, and later begins a new rate hiking cycle, financial conditions will tighten and could bring an eventual end to the economic expansion. But it seems it won't be for a few years at least.



Source: Bloomberg

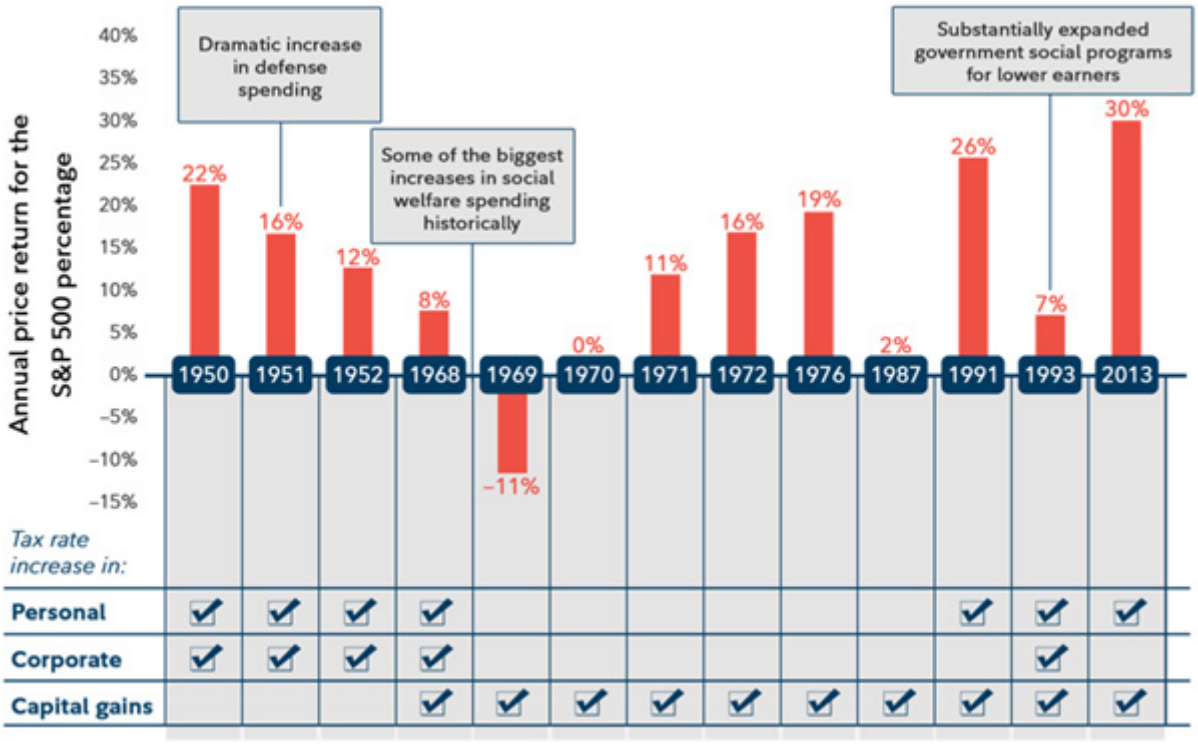
Based on the Fed "Dot Plot" above, which shows where each Fed member expects rates to be at the end of the coming years, we can see that a minority anticipate even one, let alone two rate hikes over the next 18 months. At this point, this seems too far off to put any weight on selling stocks now, but we are experiencing increasing volatility like in 2013 around the first instance of "Taper Tantrum" when Fed Chair Janet Yellen started talking about tightening monetary policy. Again — not a reason to be scared, but something to be aware of as a policy misstep could be bad for markets.

TAX AND INFRASTRUCTURE DEBATES

One of the three main market drivers, other than investor sentiment and actual company earnings is the current political climate. Cue the eyerolls — how can we be talking about politics so soon after the election?! Just as inflation has caused some worries of late, so too have tax hikes and rumors of a massive infrastructure spending bill.

Numerous types of tax hikes have been floated since Biden's election, but one seemed to rise to the top this last quarter — raising the capital gains tax rate. We don't think it's worth speculating on what the specifics of a deal might end up including, but we can certainly use historical references to try and make future predictions about the impact on the market. It might be surprising to hear that there have been no discernable effects on the market when capital gains taxes have been raised or lowered.

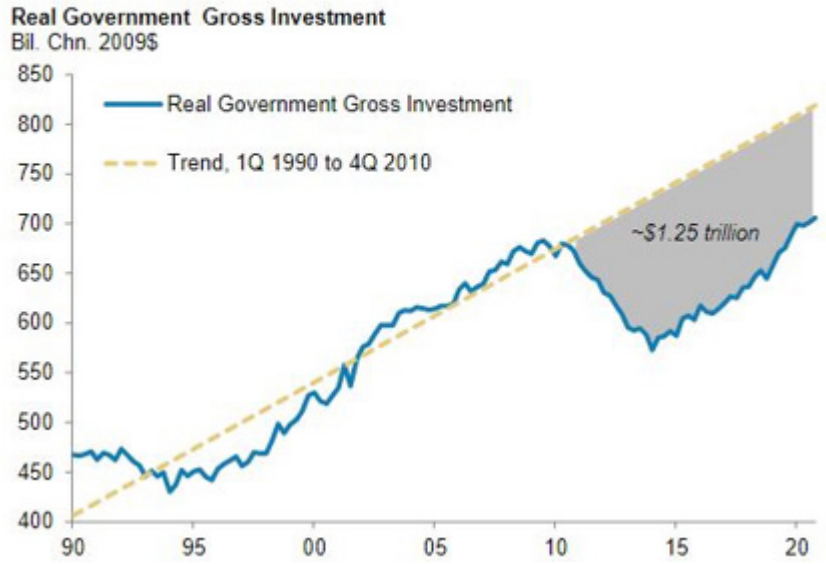
Markets are far more concerned with political unrest, current economic conditions and company profits than a change in policy.



Source: Haver/FMR/Fidelity Investments

The biggest reason for increasing taxes would be to support and pay for a massive infrastructure bill. The original size was much larger, but as of this writing, the Senate agreed to a smaller, budget neutral bipartisan deal that would give money to an array of much needed infrastructure projects without the need to hike any tax rates. In fact, this, or a larger bill could be helpful on two fronts — first, by helping the economy to get folks back to work as post-lockdown unemployment is still stubbornly high, and second, by recouping some of the infrastructure "debt" that was underspent in the last decade. People on both sides of the aisle might agree that our countrv is behind others in terms of our rail systems, airports, roads, tunnels, and bridges.

Exhibit 1: Government Investment Has Been Running Below Trend Since 2010

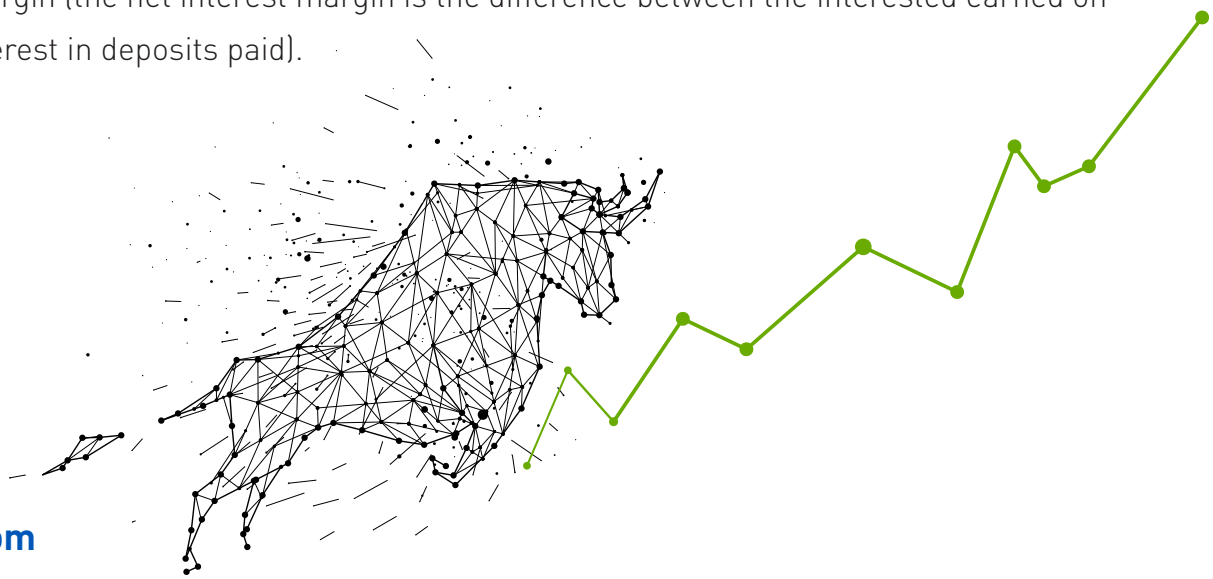


Source: Bureau of Economic Analysis, Morgan Stanley Research

ROTATIONAL THEMES DEVELOP

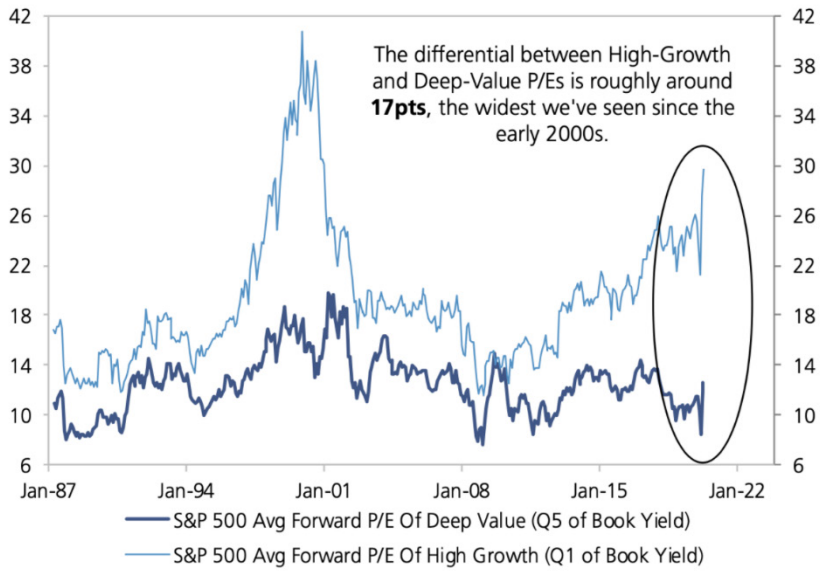
One of the largest discussion topics of the quarter was the clear shift in investment themes from the previous year and bull market. Since the news of vaccines broke, small cap and value-oriented companies have taken the lead, outperforming their big cap, mostly tech and growth-oriented peers.

The 2009-2020 bull market for the most part was dominated by three major trends. Large cap companies outperformed smaller companies, growth companies outperformed value companies and US companies vastly outperformed foreign companies. To some extent, this year has seen all three of these trends from the last bull market reverse. Typically smaller, more cyclical companies perform better coming out of recessions, so this rotation is not entirely surprising. Additionally, if the amount of fiscal and monetary stimulus becomes a concern for inflation or questions the validity of our debt, the dollar might weaken, which would boost foreign stock performance and earnings. Lastly, growth and tech companies might have stronger headwinds in a higher rate environment when the Fed eventually begins to tighten monetary policy, which will be a tailwind for the banks as it enables them to increase their net interest margin (the net interest margin is the difference between the interested earned on loans versus the interest in deposits paid).



Whether these trends we have seen so far this year continue or not remains to be seen, however we have and will always advocate for a diversified portfolio of holdings, rather than concentrating in large cap, US tech stocks that performed extremely well from 2018-2020. Another interesting trend that we have seen is the dispersion between very overvalued and very undervalued companies expand since the pandemic. In some ways, this makes sense - never have airplanes become temporarily "obsolete" so quickly, and never has a video conference tool like Zoom become so integral to our everyday working lives. But times are changing and so too are earnings expectations. On the aggregate, average valuations are rising, but the last time we saw this sort of gap between richly valued and lowly valued stocks, was at the peak of the tech bubble in 2000.

Widest Valuation Gap Between Growth and Value Stocks in 20 Years



Source: FactSet, UBS

In our view, this becomes less of a cause for concern because we understand why some companies are priced for perfection. But rather, it puts more of an emphasis on stock and sector selection or your goals and objectives. With more undervalued stocks we are presented with more opportunities.

As stewards of your wealth, we take the above responsibility very seriously and as always welcome your thoughts, comments and encourage you to call if there is a reason to reevaluate your planning and investment needs.

Stay healthy & enjoy your summer.

withum
WEALTH MANAGEMENT

Need More Information? Please do not hesitate to contact a member of the Withum Wealth Management Team with any questions or concerns:

T (732) 450 0147
info@withumwealth.com
withumwealth.com