Second Quarter Market Review and Comment
July 2021

Updated Market Performance

Returns	2nd Quarter 2021	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**8.55%**	**40.79%**	**18.67%**	**17.65%**	**14.84%**
DJIA	**5.08%**	**36.34%**	**15.02%**	**16.66%**	**13.50%**

Performance: April added gains right where March left off posting a return of 5.34%. We lost some steam in May but still added a little returning 0.70%. After taking a breather in May, June was able to continue our forward momentum adding 2.33% ending the quarter with a total return of 8.55%.

After the 1st quarter posted a gain of 6.7%, the 2nd quarter continued the advance rising 8.55%. The Dow Jones Industrial Average (DJIA) underperformed the SP500, posting 5.08% gain over the same period. For the previous twelve months the SP500 has returned 40.79%, handily outpacing the DJIA which returned 36.34% over the same period. The annualized three-year returns are well above average (around 10%) with the SP500 one-year returns posting 18.67% and the DJIA one-year returns increasing 15.02%. Over the last five years the annualized returns are running well above historical norms (around 10%), with the SP500 returning 17.65% and the DJIA posting 16.66%. The ten-year annualized numbers are also running above long-term averages (around 10.00%); the S&P500 posted 14.84% vs the DJIA which turned in 13.50%.

Breaking down the returns for the Q2 2021, we note that there were four outperforming sectors and seven underperformers. **The best sectors were Real Estate (12.31%), Information Technology (11.30%) and Communication Services (10.48%)**. **The losers during the quarter were Utilities (-1.13%), Consumer Staples (3.17%) and Industrials (4.12%).** The clear winners the last twelve months were Financials (58.40%), Industrials (49.09%) and Communication Services (46.96%). Bringing up the rear were Utilities (12.06%), Consumer Staples (20.00%) and Health Care (25.79%).

Economy: Growth in the economy has accelerated. The economy is now continuing to accelerate but at a slowing pace. We are seeing signs of inflation but currently they look to be transitory. If they are not, then the Fed will need to tighten monetary policy sooner than anticipated to prevent runaway inflation. Once the economy is fully operational, spending slows, and the fed begins to tighten monetary policy the economy will go back to below average growth (Historical growth is ~3.00%). We do not currently see recession risks on the horizon. Normally when the federal reserve begins to tighten monetary policy and raise short term rates, they usually end up thwarting growth and causing the economy to go into recession. Currently, it looks like the Fed does not have plans to raise short term rates for the foreseeable future.

The third estimate of 1st quarter Gross Domestic Product (GDP) is 6.4% according to the report released at the end of June by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the 1st quarter increased 2.1% from the 4th quarter 2020 and was the same as the second estimate. GDP for 2020 came in at -3.5% compared to 2.2% in 2019, 2.9% in 2018 and 2.2% in 2017. Currently the New York Fed Staff Nowcast (Forecast of U.S. GDP Growth) has forecasted 2021 Q2 GDP growth at 3.19% and 2021 Q3 GDP growth at 3.81%. By comparison, China says their GDP increased at 18.3% in the 1st quarter of 2021. Rebounding from 1st quarter 2020 contraction of -6.8%. China became the first major economy to report growth following the coronavirus pandemic. China's 2019 GDP was 6.1%, 6.6% in 2018 and 6.8% in 2017. Growth rates for the European Union (EU) and the Euro Area were -1.20% and -1.3% respectively in the 1st quarter 2021. For 2019, GDP rose 1.5% for the EU and 1.2% for the Euro Area. This is down from the 1.9% growth achieved by the EU and the 1.8% achieved by the Euro Area in 2018. GDP Growth forecasts for the end of the 2nd QTR 2021 are 12.80% for the EU and 12.60% for the Euro Area.

Unemployment is continuing to trend down but is still above historical norms (~5.77%). Once all the restrictions on the economy subside the unemployment rate will decrease back to below historical averages. According to the Bureau of Labor Statistics, June unemployment Increased to 5.9% from 5.8% in May. Unemployment for 2020 came in at 8.11% and was 3.67% in 2019. The number of unemployed was little changed in June at 9.5 million. Although both measures are much lower than their April 2020 highs, they are a little less than twice their pre-pandemic levels in February 2020 of 3.5% and 5.7 million, respectively. The labor force participation rate was 61.6% in June little changed from May and 1.7% lower than in February 2020.

Inflation increased 5.40% in June, marking the largest inflation increase since August 2008. After averaging 1.90% in the 1st quarter 2021, inflation as measured by the Consumer Price Index (CPI) increased to an average of 4.87% for the 2nd quarter 2021. The average rate of inflation for 2020 was 1.23% and was subdued by historical standards (~2.31% over last 30 years). The index for used cars and trucks continued to rise sharply, increasing 10.5% in June. This increase accounted for more than one-third of the seasonally adjusted all items increase.

Consumption is an important driver of the economy as it represented 68.3% of 1st quarter 2021 nominal GDP. The U.S. Census Bureau announced in June that retail sales for May 2021 were down -1.3% from April and were up 28.1% above May 2020. Clothing and clothing accessories stores were up 200.3% from May 2020, while food services and drinking places were up 70.6% from last year.

Manufacturing economy grew in June. Economic activity in the **manufacturing sector** expanded for the month of June, with the overall economy notching its 13th consecutive month of growth. The Purchasing Managers Index (PMI®) registered 60.6, a decrease of 0.6 from May's reading of 61.2. The Manufacturing PMI® continued to indicate strong sector expansion and U.S. economic growth in June. Four out of five subindices that directly factor into the Manufacturing PMI® were in growth territory. All the six biggest manufacturing industries expanded, in the following order: Computer & Electronic Products; Chemical Products; Fabricated Metal Products; Transportation Equipment; Food, Beverage & Tobacco Products; and Petroleum & Coal Products. The New Orders and Production indexes continued to expand at strong levels. The Supplier Deliveries Index continued to reflect suppliers' difficulties in maintaining delivery rates, due to a lack of direct labor, transportation challenges and increased demand. The overall economy grew for the 13th consecutive month, according to the nation's supply executives in the latest Manufacturing ISM® *Report on Business*®. Based on historical relationships between PMI and GDP, a PMI of 60.6 corresponds to a 5.0% increase in real gross domestic profit (GDP) on an annualized basis.

Home prices continue to show gains in April. According to the S&P Case-Shiller Home Price Indices home prices rose in April with the S&P CoreLogic Case-Shiller National Home Price Index rising 14.6% over the last 12 months. Phoenix, San Diego, and Seattle had the largest year over year increases with 22.3% for Phoenix followed by 21.6% for San Diego and 20.2% for Seattle. According to the National Association of Realtors, the year over year change in existing home sales was 47.9% in May for Single family homes between $250,000-$500,000 and housing supply continued to remain tight in May with 2.4 months of supply.

Markets: The markets are being swayed less by the Covid-19 virus, when restrictions will be lifted, and when the economy returns to normal. At this time, the market is being driven more by fiscal spending, dovish monetary policy, Inflation, and some actual fundamentals.

Covid-19 Virus: The market reacted fast and furious as it priced in a worst-case scenario. We have since rebounded and ended 2nd QTR 2021 at all-time highs on the SP500. The SP500 posted 33 new closing highs in 2020. The 2nd QTR 2021 started right where we left off last quarter hitting 34 new all-time highs so far Year-to-Date. As we continue to work to get on the other side of the virus and the economy returns to normal capacity equity markets should benefit from ultra-low interest rates and the tail wind of all the economic stimulus we have and will receive. The old acronym TINA (There is no alternative) will come back to fashion.

- **Earnings growth for the SP500 is expected to increase 64.0% for the 2nd quarter 2021. If the actual increase for the quarter is 64.0%, it will mark the highest year-over-year earnings growth rate reported by the index since Q4 2009 (109.1%).** According to FACTSET, of the SP500 companies that have reported earnings as of 9 July (Approximately 18), 83.3% reported earnings above the mean estimate and 94.4% have reported sales above the mean estimate. Looking at future quarters, analysts project double-digit earnings growth for the remaining two quarters of 2021.
- **While valuations remain stretched, we believe we can sustain these levels with the economic recovery, easy money policy, and improving corporate profitability.** ***Earnings growth will be above average for the next couple quarters due to higher earnings and from weaker earnings in 2020 due to the negative impact of COVID-19 on numerous industries (The bar is set low).*** The current 12-month forward Price Earnings (PE) multiple on stocks is 21.5. The long term (20 Year Average) PE for stocks is 15.8, so we do not see a lot of room for valuations to move higher without growth. Lower interest rates allow for higher multiples, so we could maintain these higher levels of P/E's until interest rates return to meaningful levels.
- **Short Term Interest Rates are still near Zero again and the Fed is still waiting in the shadows ready to do whatever it takes, but they might have to tighten policy sooner than anticipated if inflation increases to fast.** The Federal Reserve dropped short term rates 1.50% in March of 2020 and launched multiple quantitative easing programs. Rates have since been left unchanged at a range between 0.0-.25%. The Fed continues to closely monitor developments and is prepared to adjust plans as appropriate.
  The Fed has said that it expects to keep its benchmark short-term interest rate near zero through at least late 2022 or early 2023. The 10-year treasury started the year yielding .93%, ended the 1st quarter at 1.74%, and ended the 2nd quarter at 1.45%.

Forecast:

We think the biggest threats to the stock market are the uncertainty presented by the Covid-19 virus variants, interest rates continuing to increase accompanied by runaway inflation, the Fed beginning to tighten monetary policy, and large tax increases on corporations. We think the SP500 will end the 3rd Quarter between 4,300 and 4,400. At this juncture, we venture a guess that stocks will end somewhere between 13% and 15% for the year.

For the next six to twelve months, the Federal Funds rate should remain at its current range of 0%-0.25%. **The 10-year Treasury which is currently priced at ~1.45% should remain in a range between 1.30%-1.60% through the end of the 3rd quarter.**

As always, we appreciate your continuing confidence in our firm. Please let us know if you have questions.

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