Perspectives

A Quarterly Newsletter for Clients of Parsons Capital Management

Quarter 2, 2021

by John Mullen and Ruth Mullen

Propelled by five consecutive all-time closing highs to end the quarter, the S&P 500 enjoyed its second-best first half since the dot com bubble. The first quarter of the year had been highlighted by soaring value stocks, meme stock mania and a reflation trade as the global economy showed signs of synchronized growth. Stock leadership in the second quarter looked vastly different, however: Growth stocks reasserted themselves as the economic narrative shifted from seemingly limitless expansion potential to "peak everything." Thanks to the strong outperformance earlier in the year, value stocks still held an edge for year-to-date performance—but the gap narrowed from nearly 10.5 percentage points to just two. Mega-cap stocks were the driving force behind the record close at quarter end as the S&P 500 Equal Weighted Index was unable to reclaim its all-time high reached in the beginning of June. Similar to the value/growth dynamic, Mid and Smallcap stocks still held a performance edge for the year to date but saw their largecap peers outperform for the quarter. Looking abroad, foreign stocks largely lagged the US returns as questions surrounding the reflation trade dented Emerging Markets and Covid variants led to fresh lockdowns in some European countries.

Data as of June 30th, 2021	June '21	Qtr. 2 '21	YTD '21
S&P 500	2.33%	8.55%	15.25%
MSCI AC World Index (incl. US)	1.35%	7.53%	12.56%
MSCI EAFE (Europe, Asia, Far East)	-1.10%	5.38%	9.18%
MSCI EM (Emerging Markets)	0.21%	5.12%	7.58%
Russell Largecap	2.51%	8.54%	14.96%
Russell Largecap Growth	6.27%	11.93%	12.98%
Russell Largecap Value	-1.14%	5.21%	17.05%
Russell Midcap	1.47%	7.50%	16.25%
Russell Smallcap	1.94%	4.29%	17.54%

Data compiled by Tamarac Inc.

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Fixed Income Markets

Unlike the first quarter, when the equity market rallied and fixed income markets posted negative returns, the second quarter saw positive returns for stocks and bonds. As the narrative around the reflation trade and synchronized global economic growth began to deteriorate, bond yields fell—resulting in a move higher in prices. Domestically, the fixed income market (as measured by the Bloomberg Barclays US Credit Index) posted a gain of +3.32% for the quarter, although still down -1.28% for the half year after a weak first quarter. Strength was particularly pronounced in the long end of the curve, where the Bloomberg Barclays US Long Credit Index returned +6.45% compared to just +0.61% for the 1- to 5-Year Index. In a sign that questions about growth haven't tipped into a recession call, the High Yield Credit Index posted another positive quarter with a return of +2.77%.

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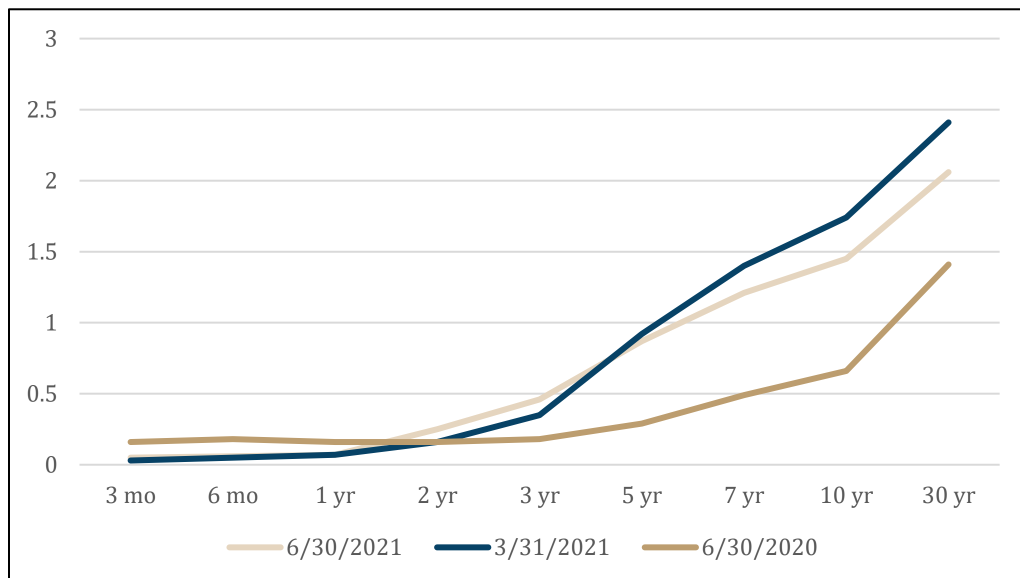
US Treasury Yields

Yields steadily fall throughout quarter…

The yield on the US 10-Year Treasury peaked at 1.74% on March 31, nearly double where it started the year at 0.93%. With inflation running hot and talk spreading of stimulus-fueled growth, it seemed just a matter of time before the 10-Year breached 2% on its steady march higher. Instead, yields fell throughout the second quarter as investors increasingly began to question the growth outlook amid mixed data. By the end of the quarter the yield curve had flattened, with the spread between the 2- year and 10-year Treasuries down 38 basis points to 1.2%.

Curve lower, flatter…



Commodities

Commodities notched another strong quarter with energy again leading the way higher. Beyond the impressive gain for oil, gasoline futures jumped by +14% while natural gas finished the quarter with a 40% gain.

All things energy higher, other commodities mixed…

Other corners of the commodities market saw a more mixed bag of returns. Copper, long seen as an indicator of global economic activity, rose over 7% in the quarter but finished 10% off the highs seen in earlier months. Silver also posted a gain of over 7%, although still down for the half year.

Gold managed to reverse its slide from the first quarter with a minor gain. Lumber, the epicenter of the reopen mania for much of the past year, fell 30% in the quarter.

Commodity	Qtr. 2 ‘21	Year to Date ‘21
CRB (broad index)	15.37%	27.19%
Oil	24.11%	51.93%
Gold	3.33%	-6.46%

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Economic Overview

Peak growth?...

Have we already seen peak growth? Will economic expansion actually manage to synchronize globally? At the beginning of the year the answers to these questions seemed simple: no and yes respectively. With a cascade of muddled data points to close out the quarter, however, the picture is not so clear.

While overall economic growth in the US has been robust as the increasing availability of the Covid vaccine has enabled states' economies to reopen, a multitude of data points cast some doubt on the path of the ongoing recovery. Part of this can be traced to certain readings having reached historical levels where a pullback was inevitable, but in other cases the unusual nature of the economic rebound clearly is having an impact:

Some warning signs in recent data…

- The June Services ISM (Institute of Supply Management) reading of 60.1 missed expectations of 63 following May's all-time high of 64
- The June Manufacturing ISM also missed, falling -0.6 points to 60.6 vs. 61 expected
- Non-farm payrolls added 850,000 in June while jobless claims fell 51,000 to 364,000 vs. expectations of 400,000, yet labor force participation remained weak at 61.6%
- May durable goods orders (+2.3%) and retail sales (-1.3%) were both below expectations

Inflation clearly having an impact…

Looking under the hood at the ISM readings provides some clarity on the current state of the economy. Both saw a drop in their new order components while the prices paid results hit levels last seen in the 1970s. This shows that inflation is having an impact. Perhaps most notable was the 1-point drop in the employment sub-index for the manufacturing survey to 49.9, the first contraction reading since November of last year.

US consumer seems unphased…

Bucking the trend of weaker data, US consumer confidence ended the quarter at 127.3—the best level since February of 2020—with both present situation and future expectations moving higher. When looking at some of the direct impacts on US consumers, it is no wonder they have an upbeat outlook:

- The FHFA home prices index rose 1.8% month over month and is 15.7% higher than a year ago
- Personal income fell 2% month to month (better than an expected 2.5% drop) but is 13% higher year over year
- Job openings hit 9.3 million while a record 4 million people quit their jobs in April (2.7% of the total workforce) in a sign of confidence in job prospects

Puts and takes with international data as well…

Similar to the US, the international economic picture remains muddled. When the year began it seemed just a matter of time before the global economy would synchronize as Covid was tamed, but by the end of June this narrative was in question. Out of 18 major global economic surveys covering the service and manufacturing segments of multiple economies, 16 remained in expansion territory in June. Somewhat troubling, however, 10 of those 16 saw their growth weaken from the May reading. Germany, Australia and Brazil, all countries intricately tied to global growth, saw the strongest readings, which is an important positive.

A common theme for countries and regions seeing weaker growth readings for June compared to May is renewed Covid-related lockdowns. The UK, Japan, India and China headline the list of global economies with weaker readings. The disparate statistical results measuring economic activity make it increasingly apparent that the course of Covid, especially where flare-ups occur, will dictate near-term economic outcomes.

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Investment Implications

Stocks high, expectations higher…

With stock prices hanging at or near historic highs vs. earnings and so much fiscal and monetary stimulus already in the system, earnings will need to take over the driver's seat and close that gap to keep this bull market going. Expectations will need to translate into financial reality. Perhaps even more important than earnings results will be the outlook for margins as investors try to get a handle on what higher input costs and bottlenecks mean for future earnings.

Blowout 1Q results leading to elevated 2Q hurdle…

This began to happen in the blowout first quarter earnings season (results reported mostly in April and May) where a record 87.5% of companies topped earnings estimates and the bar for the second quarter was raised substantially. The strong showing for earnings in the quarter resulted in analysts moving their earnings expectations higher by a record +7.3% over the past three months. This compares to the five- and 10-year average decline of -3.4% and -4% in earnings expectations during a quarter. If second-quarter earnings deliver against raised expectations and forward-looking comments are still positive, which will play out over the summer, the market should react favorably.

Participation narrowing while sentiment running hot…

One of the more concerning elements of the market currently is participation. While the final day of the quarter marked the 34th new closing high for the S&P 500 this year, only 8% of stocks in the S&P managed to trade to a 20-day high. Such narrow participation leaves the market vulnerable to a quick drawdown if just a few of the supporting stocks stumble.

Another corner of the market flashing a warning sign is sentiment. The multitude of concerning headlines were unable to hold back the flood of money into stock ETFs in the first half of the year. Those six months saw $356 billion of inflows, already good for an annual record even if not a single dollar were to come in for the rest of the year. The AAII (American Association of Individual Investors) final survey of the half year backed up the buoyant fund flows with 48.6% of respondents classifying themselves as bullish compared to just 22.2% bearish. This compares to a historical average of 38% and 30.5%, respectively.

Macro influences producing a shift in leadership…

The faltering economic data points were not the only force behind the shift in market leadership witnessed in June. Value/cyclical stocks had been primary beneficiaries of President Biden's policy proposals as a looming wave of government spending was primed to drive growth in the near term. As it became apparent that the most far-reaching spending plans were unlikely to pass a narrowly divided Congress, investors began to recalibrate expected stimulus, suggesting a shift back to growth over value.

Climbing the wall of worry…

While the market clearly faces hurdles, key pillars of support remain. Higher input prices are forcing companies to become more productive, a key to sustained economic growth. The Federal Reserve continues to reiterate they will not meaningfully tighten until further progress is made in the recovery. Even with inflation running hot, the tepid jobs market gives some cover for a continued dovish stance. The economic reopening continues, and earnings are growing at near historically high rates. Potential pitfalls are plentiful, but markets tend to do best when there is a large wall of worry to climb.

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