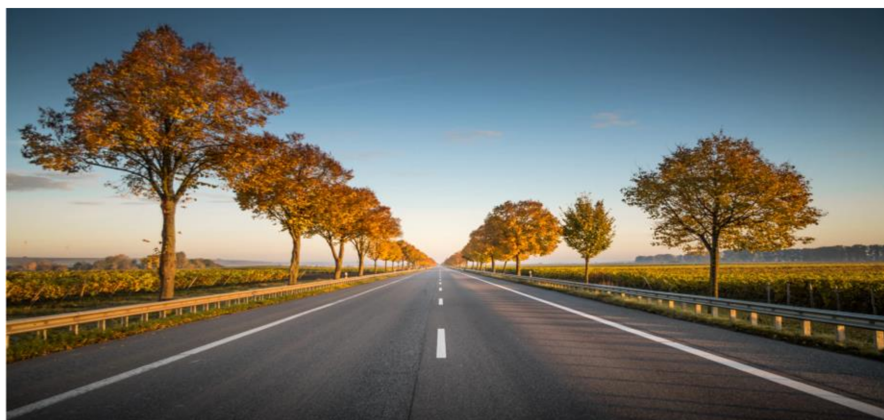
Legacy Financial Strategies

Mid-Year Market & Economic Review 2021

- *Economic growth is strong and the 2020 U.S. recession only lasted 2 months*[1]
- *The government's financial response to COVID exceeds that of World War II*
- *Inflation concerns causing challenges to bonds (and stocks)*
- *Corporate earnings in Q1-20 were higher than expected boosting stock market returns*
- *Corporate earnings fell less and are recovering faster than any recession since 1950*
- *A stock market correction is possible if history is a guide but not certain*
- *Cryptocurrency creating more volatility than value.*

STAY THE COURSE!



While COVID-19 is still a part of our lives, the economy continues down the path of re-opening. The delta variant is grabbing more headlines, and this may add to market volatility. The post-pandemic recovery has been compared to a post-war recovery due to the economic impact and government's response to it. So far, government stimulus is equivalent to 35% of U.S. GDP which is larger than the policy response to World War II[2]. The vaccine has been the real stimulus because it positively affects our health and the economy by getting people back to work. A job is enduring while a government check is temporary.

Lag Time

The U.S. has had 3 consecutive quarters of strong economic growth and GDP is less than 1% below its previous high in Q4-2019[3]. If the forecast for Q2-21 holds, we should exceed the previous high. The National Bureau of Economic Research, the official arbiters of recessions declared on July 19, 2021 that the U.S. recession ended in April 2020 or 14 months ago. This should come as no surprise. The previous recession ended in June 2009 but was not official until September 2010, or 15 months later.

Labor Pains

As businesses open more fully, there is a shortage of workers to fill positions. Based on the May labor report[4], there are 9.2 million open positions in the U.S., nearly 2 million more than the prior peak in January 2019 when the unemployment rate was 4%. Why? Federal unemployment programs are paying people to stay home (even some not seeking employment); some workers fear returning to work

for health reasons; and geographical mismatch of workers and jobs. The "Quit Rate," a measure of workers who have recently quit their jobs was 2.5%, a near record high number putting more pressure on companies to pay more and keep people. In a March survey[5] from Prudential, 42% of respondents would quit their job and seek other employment if their employer did not allow them to work from home permanently. Yikes!

Inflation Consternation

Nobody likes paying more for stuff. Rising inflation is negative for bonds and potentially for stocks which is why it has dominated the headlines. Conversely, rising inflation is a positive indication that the economy is improving or healthy. Therefore, inflation watchers prefer a "goldilocks" scenario – not too low but not too high. The June Consumer Price Index ("CPI") reported year-over-year inflation growth of 5.4%, well above average. When you take a closer look at the report, Energy and Used vehicles account for 3.2% of the year-over-year increase! Exclude them and inflation looks a much tamer 2.2% which is below the long-term average. The housing market is hot, but CPI does not capture home prices. The CPI reports homes as an investment item, not a consumption item using the term Owners' Equivalent Rent of Residence. If you wanted to rent a house today, this measures the increase of what it would cost relative to a year ago. That figure was up 2.3% from last year and makes up 33% of the CPI index. According to the National Association of Realtors, home prices increased 23.6% as of May 2021.

Inflation Explanation

One explanation for the rise in prices is called the "base effect" meaning that we are comparing prices to one year ago when prices were lower due to the economic shut down. Second, supply chains were damaged and the demand for goods is now higher than the ability to produce them. Shutting down the global economy and re-starting caused tremendous disruptions to the labor force, sourcing production inputs and transportation of goods. All of these factor into the price of what we pay for stuff. Third, the government stimuli put additional dollars into the hands of consumers. Some need it for basic necessities but others use it for discretionary spending. The CPI measures a wide variety of expense and spending habits are not the same for every household.

Stocks in Review

Stock market returns for the first half of 2021 have been strong posting a 15% return for the S&P 500 index. Historically, positive stock performance continues through the rest of the year after a strong start but July tends to be volatile[6]. That is proving to be the case at the time of this writing. In the short run, there is always uncertainty which causes the stock market to go up and down. Long-term stock returns are driven almost entirely by corporate earnings (profits) and dividends. 2021 earnings growth has been stronger than forecasted which provides a positive outlook for stocks. The Millennial demographic, higher savings rates and lower household debt service ratios are potential tailwinds for positive stock performance and economic growth for years to come.

Market Correction?

Stock prices have recovered faster than profits since the S&P 500 bottomed on March 23, 2020. This has many in the financial media suggesting that the stock market is over-valued. When comparing stock prices to earnings (P/E ratio), stocks are "more expensive" than their long-term average. For stocks to be more fairly valued, one of two things need to happen: Either corporate earnings need to catch up to prices or stock prices need to "catch down" to corporate earnings (i.e., stocks fall in value). Another, but more frustrating scenario is for the stock market to trade in a range ("go sideways") for a period of time while earnings catch up to prices. In the last four post-recession stock market recoveries since 1980, the stock market has gone sideways and/or experienced a correction improving valuations and enticing investors to start buying[2].

Looking forward…

There is no investment playbook for a self-induced global recession so uncertainties remain. We expect the economy to exit recession status and continue growing as it has after recessions historically. The savings rate is very high due to stimulus money and may lead to increased consumer spending in the future. A growing economy provides fertile soil for corporate earnings growth and positive stock returns long-term. Stocks should protect your purchasing power from inflation. We anticipate that inflation will be higher than the past 10 years but lower than the current level long-term. Bond returns will likely be below their average because of higher inflation but still provide a buffer against volatility. As always, we strive to invest your money in a manner consistent with your tolerance for risk. We believe our clients benefit from time in the market, not timing the market.

As always, we genuinely appreciate the trust you place in your financial advisor and our firm.

Chris Proctor
Chief Investment Officer

Sources:

[1] National Bureau of Economic Research (NBER); [2]Leuthold Group; [3]FRED – Federal Reserve; [4]Bureau of Labor Statistics;
[5] Prudential's Pulse of American Worker Survey – March 2021; [6]FundStrat; 7

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