fortress
ASSET MANAGEMENT

2021 – 2nd Quarter Review & Outlook

Economic and Investment Review

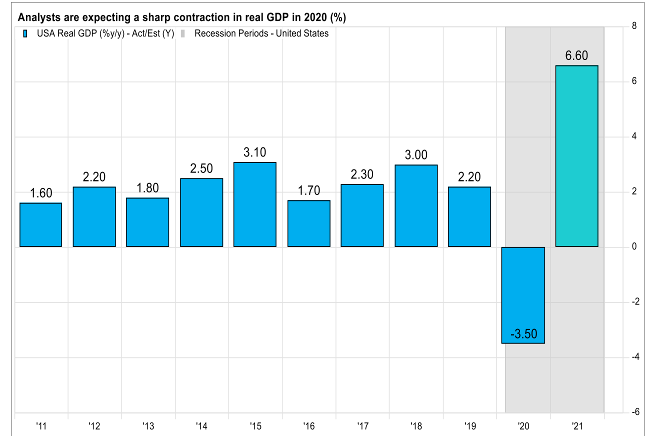
Mark Anderson

Chief Investment Officer

Economic Growth: The country's longest recorded economic expansion of over 10 ½ years was ended by the COVID caused recession. The National Bureau of Economic Research recently announced that the U.S. emerged from the recession in April 2020, making the two-month contraction the shortest on record. The definition of recession has historically been two or more consecutive calendar quarters of negative GDP growth but the Bureau has modified the definition to "a significant decline in economic activity spread across the economy that typically lasts more than a few months." The two months actually spanned two calendar quarters causing the first quarter to be down 5.0% and the second quarter to be down 31.4% on an annualized basis. Some of the reasons identified for the brief contraction are:

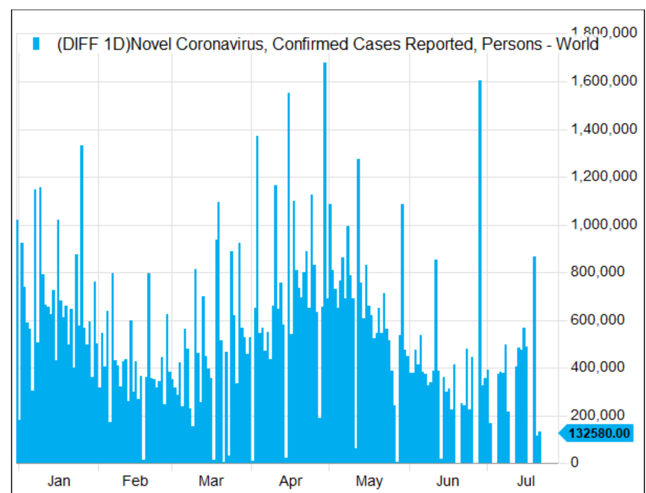
- The strength of the economy prior to the pandemic
- Relatively short lockdown periods by many states and local government entities
- Business' ability to adjust quickly to the new reality
- Consumers seeking necessities and items needed to work from home
- Government stimulus funds

GDP rebounded by 33.4% in Q3 2020, 4.3% in Q4 2020 and 6.4% in Q1 2021. The consensus forecast for Q2 is 9.5% and 6.6% for calendar 2021.



Source: FactSet

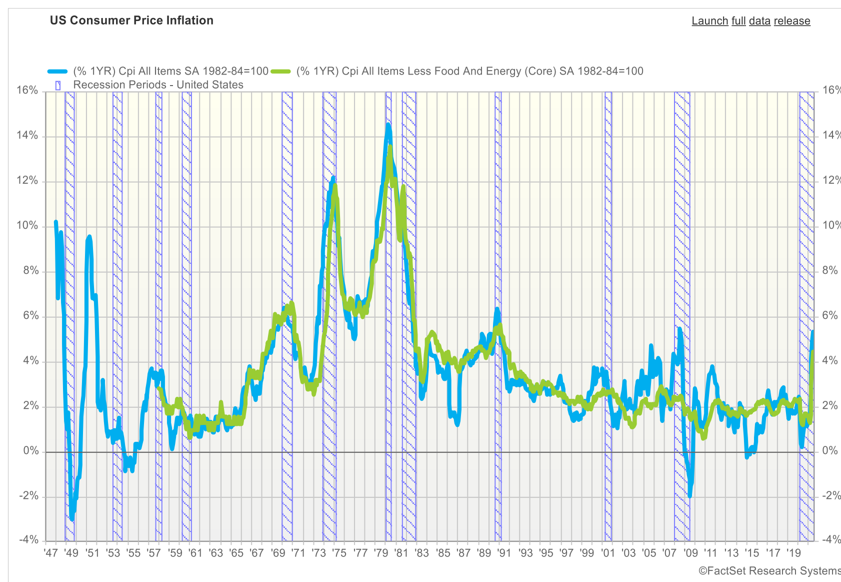
The 2021 consensus forecast has risen significantly from 4.5% just four months ago in March. Economic growth could be even stronger if not for slower demand growth, labor and materials shortages, as well as the spread of the COVID 19 Delta variant. Global COVID cases have trended up recently and are spiking in the UK, Indonesia, Russia, Iran, Spain, Malaysia, Bangladesh, Thailand, Netherlands, Iraq and Cuba.



Source: FactSet

Economic growth will likely remain strong through the remainder of the year as more people are vaccinated and rejoin the workforce, as schools reopen and as enhanced government unemployment benefits run out. Also, inventories will need to be rebuilt in response to a drawdown over the past few quarters.

Inflation has surged in the last few months due to pandemic induced production and labor constraints and shortages combined with increased savings, pent-up demand and government stimulus.



The Fed is now expecting PCE (Personal Consumption Expenditures) to be up 3.4% for 2021 and for the inflation measure to remain above the 2.0% target through 2022. The consensus estimate for CPI (Consumer Price Inflation) for 2021 is 3.5%, up from 3.0% in June.

There is an ongoing discussion about whether the increase in inflation is transitory or if it will have staying power. Jan Hatzius, Chief Economist – Goldman Sachs Asset Management, states that "by fall, we will know much more about whether the goods price surge is indeed transitory and how much of the pressure on labor supply reflects temporary factors." Fed Chairman Jerome Powell said in a House subcommittee that "if you look behind the headline and look at the categories where these prices are really going up, you'll see that it tends to be areas that are directly affected by the reopening." However, he emphasized that shortages will fade over time, bringing inflation closer to the Fed's 2% long-term target.

The areas of greatest inflationary pressure include used autos, appliances, bicycles, boats, RVs, gasoline and rental vehicles. New cars are supply constrained due to semiconductor supply chain issues. Consumers and fleet managers have turned to the used car market to fill in the gap, causing used car prices to increase by 41% over two years. The Wall Street Journal reports that "the monthly used-car price increase represents about a third of total inflation in June."

The unemployment rate declined rapidly from 14.7% in April of last year to 6.0% in March of this year. However, there has not been much headway made since that time. The unemployment rate for June was reported at 5.9%. Even with the improvement in the unemployment rate, the total number of people employed is about 7 million below levels prior to the pandemic. Some portion of the remaining issue will likely be resolved as the COVID related benefits run out and as children are able to return to school and daycare. Unemployment is expected to drop to 5.4% by the end of 2021 and 4.0% by the end of 2022.

Industrial production has been up 12 of the last 14 months on a month-over-month basis and the last 4 months on a year-over-year basis. For the second quarter as a whole, total industrial production rose at an annual rate of 5.5%. The rebound over the past four months has been particularly strong in Oil & Gas Well Drilling, Primary Metals, Transit, Computers and Video & Audio Equipment.

The ISM (Institute for Supply Management) Manufacturing and Services indices both indicated continued expansion at 60.1 and 60.6 respectively. (Any reading over 50.0 indicates expansion and any reading under 50.0 indicates contraction.)

June Retail & Food Services sales were up 0.6% month-over-month and 18.0% year-over-year.

Motor Vehicle sales declined due to supply chain disruptions, negatively impacting inventories. Clothing Stores, gasoline stations and food services & drinking places led month-over-month segment sales. The same segments plus electronics & appliance stores led year-over-year.

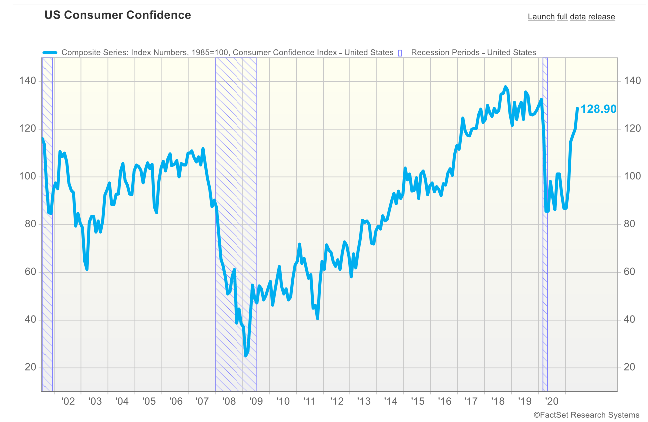
Concerns about a global growth slowdown have increased due to the virus resurgence. However, much like the U.S., there is significant pent-up demand combined with excess savings that should act as economic support and stimulus so long as the resurgence does not result in another round of lock-downs. Goldman Sachs estimates "that households have accumulated $5tn in excess savings globally, with 90% held in developed markets, especially the US (50%) and the Euro Area (20%).

The International Monetary Fund (IMF) expects the world economy to expand 6.0% this year. The IMF states that "vaccine access has emerged as the principal fault line along which the global recovery splits into two blocs." The IMF has increased growth rate expectations for developed countries and lowered expectations for emerging market countries because of higher vaccination rates in developed countries and lower vaccination rates in emerging market countries.

In addition to an increase in COVID cases and inflation, economic and market headwinds also include potential tax increases, increased regulation and restrictions on energy production and exploration.

President Biden has proposed higher taxes on households with income of more than $400,000. However, certain events may place households with income below the $400,000 threshold in a higher tax bracket. The sale of assets such as a home, business, stock or other asset that has appreciated significantly in value may trigger a higher tax rate on capital gains during the year that it is realized. The impact of capital gains on the sale of a primary residence is reduced by a $250,000 per-person exclusion or $500,000 per couple. The proposal also allows for a $1,000,000 per-person exclusion of other unrealized capital gains on property transferred by gift if held at death.

U.S. consumer confidence continued to push higher in July due to improvements in the labor picture and stronger than expected manufacturing.

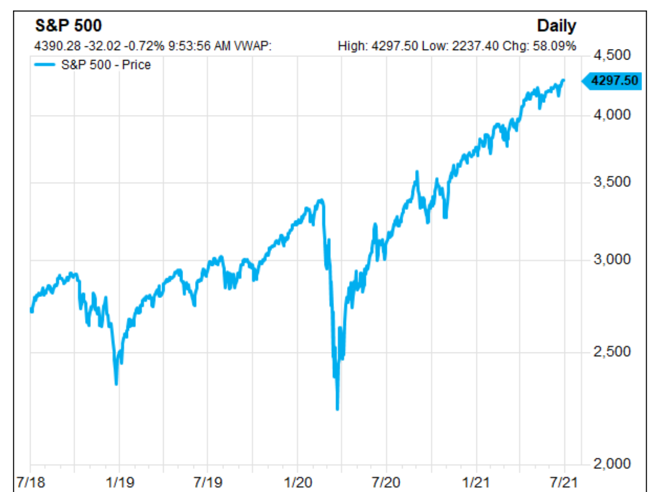


Source: FactSet

The median existing-home sales price rose to $363,300 in June, a 23.4% increase from the same time last year. Demand for houses has exceeded supply as fewer people were moving during the pandemic and builders have struggled with labor shortages and rising material costs.

Equity Markets

The S&P 500 closed at 4297 on June 30, up 8.6% in Q2 and up 15.3% YTD.



Source: FactSet

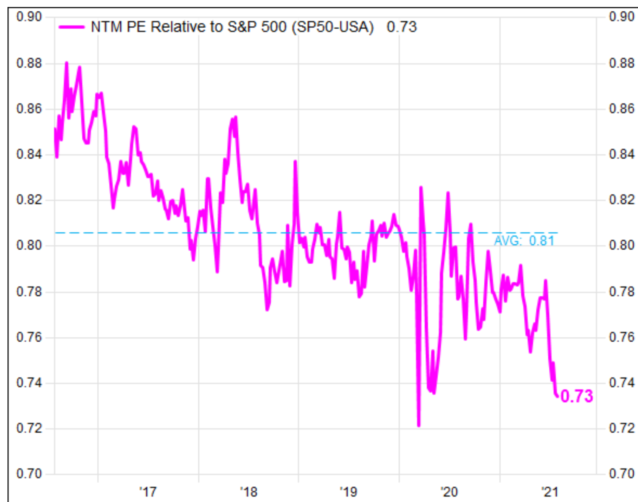
Growth stocks outpaced value stocks in Q2 after lagging in Q1. Value remained ahead of growth on a YTD basis but trailed for longer periods.

2021 Q2 Returns				
		YTD	1 Year	3 Years
EQUITY	**Q2 2021**	**6.30.21**	**6.30.21**	**Annualized**
S&P 500	8.55	15.25	40.79	18.67
S&P 500 Value	4.90	16.30	39.54	13.14
S&P 500 Growth	11.84	14.31	41.36	23.08
Dow Jones Ind Avg	5.08	13.79	36.34	15.02
S&P Mid Cap 400	3.53	17.59	53.24	13.17
S&P Small Cap 600	4.33	23.56	67.40	12.20
MSCI EAFE	5.38	8.83	32.35	8.27
MSCI Emerging Mkts	3.84	7.45	40.90	11.27

Source: FactSet

Mid Cap and Small Cap stocks continued to push higher during the quarter but at a slower rate than large cap stocks. However, Mid and Small Cap stocks have been primary beneficiaries of the reopening trade and remain star performers for 1 year.

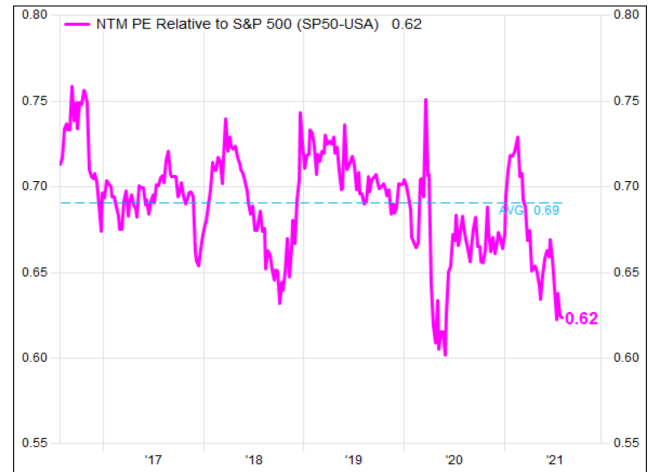
Developed markets (MSCI EAFE) were up 5.4% in the quarter but continue to lag for longer periods. Developed markets look attractive on a relative valuation basis but may be differentiated based on vaccination rates and developed immunities in respective countries. Canada, United Kingdom,



Source: FactSet

Spain, Italy, Germany and France lead the world in vaccination rates.

Emerging markets were up 3.8% in Q2 and 7.5% YTD. Emerging markets look attractive on a relative valuation basis but may remain below long-term averages until vaccination rates and immunity levels more closely resemble the developed world.



Source: FactSet

Our current 12 month forecast for the S&P 500 is 4,476, indicating an upside of less than 2% from the current level of 4,400. The forecast is based on consensus EPS numbers of 191.32 for 2021, 212.03 for 2022 and 230.95 for 2023. The EPS numbers imply growth of 38.6% in 2021 and 12.7% in 2022. The price earnings multiples being used in the forecast indicate a slow adjustment toward the long-term average.

The consensus target price is 4826, indicating an upside of nearly 10%. The consensus target price indicates a PE multiple of 22.8X the 2022 EPS estimate. This is equivalent to the current PE multiple for 2021 allowing for no adjustment towards the long-term average. The PE multiple for 2022 is currently 20.8X.

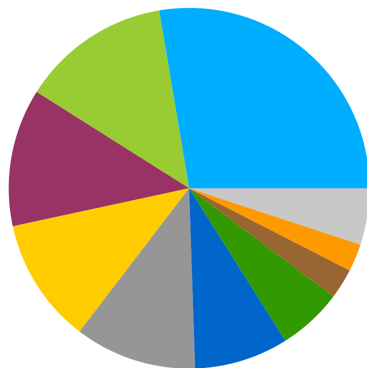
Source: FactSet

The Goldman Sachs forecast is 4,450 for 12 months and the Raymond James forecast is 4,400 for year end 2021.

Higher than average PE multiples are currently supported by historically low interest rates and extraordinarily strong earnings growth. When interest rates begin to adjust up or earnings growth begins to trend down, PE multiples will likely trend toward long term averages. The 20-year average PE for the S&P 500 FY1 is 17X.

FactSet reports that approximately 25% of the companies in the S&P 500 have reported Q2 revenue and earnings to date. A positive revenue surprise was reported by 88% of those companies and also 88% reported a positive earnings surprise. The 5-year average percent of companies reporting earnings above estimates is 75%. FactSet also states that "in aggregate, companies are reporting earnings that are 19% above estimates, which is also above the 5-year average of 7.8%."

Breaking down the S&P 500 into economic sectors reveals an interesting dynamic. The Information Technology sector has grown to account for 28% of the index. The sector made up as much as 33% of the index during the internet bubble in 2000 and as little as 14% in 2003 after the bubble burst. The

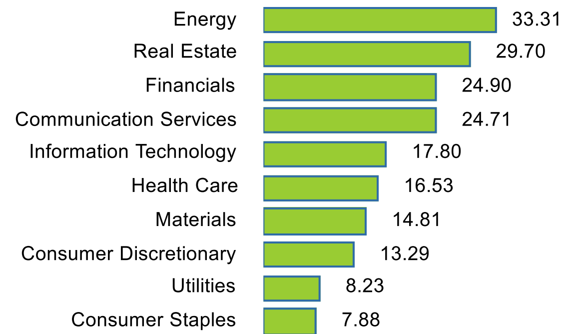


Source: FactSet

difference this time is there are real earnings behind the sector and not just some pie in the sky estimates, as was the case during the internet bubble time period.

YTD sector performance continues to be led by the Energy sector. However other sectors have taken

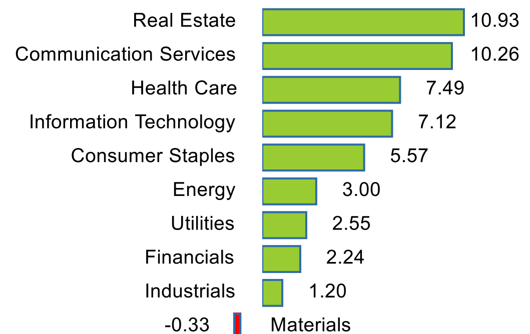
YTD Total Return Change - Top/Bottom 5



Source: FactSet

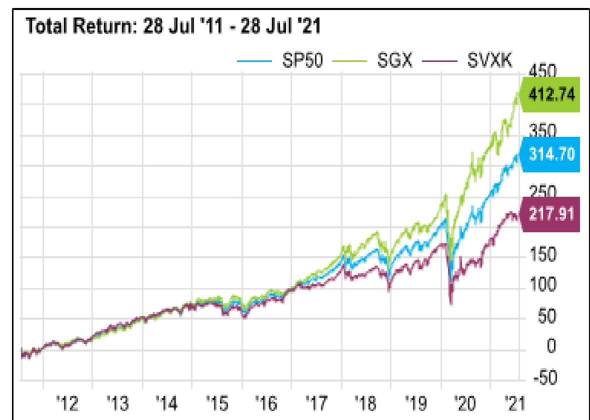
the lead over the past 3 months. Real Estate and Communication Services have made up significant ground during the period.

3 Months Total Return Change - Top/Bottom 5



Source: FactSet

Over the past decade growth stocks (SGX) have significantly outperformed value stocks (SVXK).



Source: FactSet

So far this year we have seen significant rotation from growth to value and back to growth from value. Variables typically used to explain rotation are interest rates, inflation, economic growth and earnings growth. Interest rates in conjunction with duration, (generally a measure of bond sensitivity to changes to interest rates) are used to value expected cash flows. Expected cash flows from growth stocks extend much further into the future and thus have longer durations, making them more sensitive to changes in interest rates. Growth over value has been positively correlated with the decline in interest rates in the past 10 years but that has not always been the case.

Sean Markowicz, CFA – Strategist – Schroders produced a report earlier this year which stated that a "contributing factor may be the speed of rate movements. Performance seems unrelated to gradual increases, while sharp and sudden changes are associated with having a large impact." He also stated that "performance is also generally unrelated to small changes in inflation expectations… In fact, contrary to popular belief, value stocks have tended to underperform growth stocks in periods where inflation expectations have increased by 1 standard deviation or more."

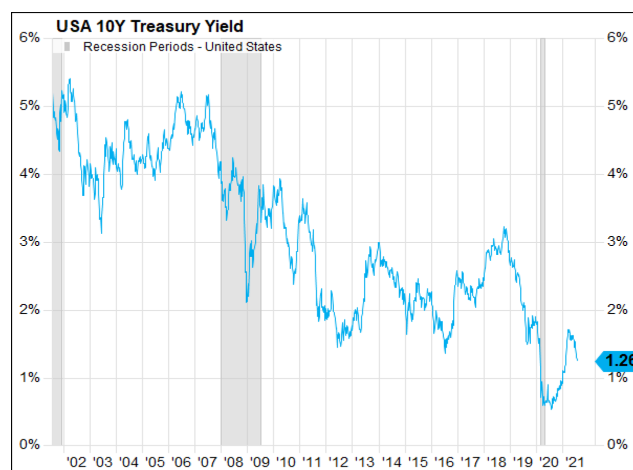
The amount and timing of economic growth correlates with performance of cyclical sectors. Cyclical stocks have benefited from improvement in the economy and the reopening trade. Cyclical sectors are largely thought to fall in the value camp but this is not always the case.

Ultimately the market and individual stocks are driven by EPS growth and dividends. When EPS growth is limited to a narrow group of stocks, investor focus is placed there. When EPS growth is occurring for a wide group of stocks, valuation becomes more important to investors.

It is important to remember that value stocks are not always value stocks and growth stocks are not always growth stocks. Growth stocks may transition to value over time and value stock valuations may rise to the point where they can no longer be included in the value group.

Fixed Income Markets

Fixed income investments have historically been used to provide income and to manage volatility of a diversified portfolio. Bond holders have benefited on a total return basis from the general decline in interest rates over the past twenty plus years. The 10-year U.S. Treasury yield was above 5% nearly 20 years ago and worked its way to below 1% last year.



Source: FactSet

Yield on the 10-year began to rise following the pandemic caused recession. Most observers expect the yield to trend up over time, with the consensus estimate reaching 1.94% at year-end 2021 and 2.10% in 2022. The arguments for the increase include strong economic growth in the near term, record fiscal deficits and related debt issuance and the potential for increasing inflation. The recent upward trend reversed course recently, giving back about 0.25%. The move may be a bit of a flight to quality or perceived security in reaction to the resurgence in the coronavirus or a lack of concern about inflation being more than transitory.

Investment grade bonds (Barclays U.S. Aggregate Index) improved by 1.77% in Q2 but remained negative YTD and for 1 year.

2021 Q2 Returns				
FIXED INCOME	**Q2 2021**	**YTD 6.30.21**	**1 Year 6.30.21**	**3 Years Annualized**
B B US Agg Bond	1.77	-1.60	-0.33	5.34
S&P National Muni	1.46	1.12	4.04	4.93
B B High Yield	2.44	3.02	14.12	7.11

Source: FactSet

Based on the expectation for interest rates to trend upward, we recommend modestly shortening duration (reducing the sensitivity to changes in interest rates) of bond portfolios and bond funds held.

Municipal bonds, as represented by the S&P Municipal Index, were up 1.46% for the quarter and up 4.04% for one year through June 30.

There was some concern that some municipal bonds may be subject to downgrades and possible defaults due to the impact from COVID. However, the vast majority of related entities seem to have weathered the storm well and the default rate on investment grade municipal bonds remains extraordinarily low.

It is important to note that if the Biden administration is successful in moving tax rates higher, demand for municipal bonds will increase.

High yield bond spreads relative to comparative US Treasuries widened to extreme levels during early days of the pandemic and related lock downs. Default rates increased due to the impact of the pandemic on business operations and cash flow. However, default rates have since declined and spreads have receded to long-term low levels. High yield bond returns will likely be more confined to income production than any further tightening in credit spreads.

Disclosures

This commentary is provided for informational and educational purposes only. The information, analysis and opinions expressed herein reflect our judgment as of the date of writing and are subject to change at any time without notice. They are not intended to constitute legal, tax, securities or investment advice or a recommended course of action in any given situation. Forecasts, estimates, and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Investing in the markets is subject to certain risks including market, interest rate, issuer, credit and inflation risk; investments may be worth more or less than the original cost when redeemed. No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission.

All investments carry certain risk and there is no assurance that an investment will provide positive performance over any period of time. Information obtained from third party resources are believed to be reliable but not guaranteed. Past performance is not a guarantee or a reliable indicator of future results.
Mark Anderson, Brock Bowden, Mark Johnson and Don Wiscomb are all investment advisor representatives of Dynamic Wealth Advisors, a registered investment advisor. All investment advisory services are offered through Dynamic Wealth Advisors.