WESTEND Advisors

Economic and Market Commentary

Q2 2021

Speed Bumps, Not Road Blocks, As Recovery Downshifts to Expansion

We expect the economic cycle to evolve quickly from the unprecedented recovery to an expansionary phase, which should present opportunity in select areas of the market as economic growth normalizes.

SUMMARY

- We expect continued economic and earnings growth, along with market gains, as this cycle shifts from rapid recovery to expansion.
- Many recent supply and labor constraints should ease, but we expect more market volatility as investors digest slowing growth.
- We have adjusted portfolio exposures, particularly in and to economically sensitive allocations, reflecting the evolving economic and valuation backdrop.

Q2 2021 REVIEW

The speed of the post-COVID economic recovery has been unprecedented, and equity markets continued to advance in Q2 as the global economy reached a number of milestones. Real U.S. GDP likely reached a new all-time high in Q2, just four quarters after suffering a peak-to-trough decline of -10.1% in the first half of 2020. For comparison, GDP took twice as long to recover from a -4.0% decline after the Great Financial Crisis. Similarly, wage and salaries disbursements exceeded their pre-COVID peak by over 5% in May (despite still-elevated unemployment), and the Conference Board's Leading Economic Index pushed to new highs.

U.S. consumer demand for goods remained well above its pre-COVID trend in Q2, though it eased somewhat amid expanding demand for services like travel and entertainment as vaccination rates rose. Many businesses struggled with supply and labor constraints in the face of resurgent demand. For example, auto manufacturers faced a computer chip shortage, while car rental companies lacked inventory after paring down their fleets during the pandemic. Rising commodity prices, combined with ongoing fiscal and monetary stimulus, fueled inflation concerns, though these eased somewhat with hints the Fed could tighten monetary policy sooner than previously expected and a positive, but weaker-than-expected May employment report.

The S&P 500 Index returned 8.5% in Q2, as 2021 earnings growth estimates for the index were revised up about nine percentage points in the quarter to about 35% year-over-year. Real Estate, Information Technology, and Energy were the best-performing sectors in Q2, while relatively defensive Utilities and Consumer Staples were the worst-performing sectors as the economy continued to rebound. However, Industrials and Materials, two of the most cyclical sectors, also lagged, which we believe may reflect a mix of supply constraints and investors beginning to anticipate a normalization of growth ahead.

Internationally, Europe, which faced renewed lockdowns and lagged the U.S. in its vaccination rollout in Q1, made significant progress on vaccinations in Q2. In Asia, a more established recovery across much of the region continued, but showed signs of decelerating. International stocks generally underperformed the U.S. in Q2, as the U.S. economy rebounded, though a modest decline in the U.S. dollar over the quarter added to U.S. investors' international returns.

U.S. fixed income markets posted positive returns as longer-term interest rates pulled back from recent highs, despite ongoing inflation concerns. Corporate bonds generally outperformed Treasury securities as yield spreads narrowed amid strong economic growth.

OUTLOOK

We believe the sharp economic rebound sets the table for continued expansion as the cycle evolves. While the current burst of economic activity should moderate in coming quarters, we have high confidence that growth will continue. There have been and will be speed bumps in the shift from rapid recovery to expansion (like every cycle), but we do not see these as road blocks for the economy or markets.

Services Recovery: Demand for services like travel and entertainment is now rebounding sharply.

U.S. Economy: Consumers proved eager to spend on services again as vaccinations helped expand economic reopening in recent months. We expect this will continue, backed by over $2 trillion in above-trend savings that consumers accumulated during the pandemic. This is on top of strong continued demand for goods, which remains above its pre-pandemic trend. Businesses have also been investing in both capital goods and inventories to catch up with the rapid rebound in demand. As we write, Q2 real GDP is estimated to have grown at about a 10% annualized rate, a pace not seen pre-COVID since 1978.

The burst of activity surrounding reopening, and the overall rapid pace of recovery since mid-2020, have created supply constraints, which, while not unusual in a recovery, appear unusually pronounced this cycle. These constraints, including tightness in the labor market (even as unemployment remains somewhat elevated) may serve as a headwind to further growth. These constraints also have increased near-term inflationary pressures and expectations, which, in turn, have stoked investor fears that the Fed will be prompted to tighten monetary policy too soon and potentially undermine the expansion.

We see these challenges as temporary, and consistent with the transition from rapid recovery to expansion. We expect companies will work though labor and production supply constraints, and that inflation pressures should moderate as supply chains catch up with demand. We believe that pent-up demand, consumers' savings, and business investment should drive continued, but moderating economic growth into 2022 and beyond.

U.S. Equities: We anticipate continued positive equity returns this year, as earnings growth should more-than-offset price-earnings ratio (P/E) contraction and deliver positive equity returns into 2022. Still, the transition to more normalized economic growth could contribute to market volatility. For investors, the biggest speed bump may prove to be the *magnitude* of economic deceleration. Slowing growth is normal at this stage of the economic cycle, but the path to healthy levels of expansionary growth could feel jarring from current extreme levels. Investors could extrapolate the deceleration to predict excess inventories or a double-dip recession, which we view as very unlikely.

The burst of economic activity from reopening so far this year has supported a roughly 15 percentage point upward revision in S&P 500 2021 earnings estimates. This essentially matches the index's 15.3% return YTD. Looking forward, the overall level of earnings growth in 2021, combined with upside potential we see to earnings estimates for 2022 (particularly in certain sectors), should continue to outpace valuation contraction, which is normal in a recovery. Further, while P/Es are high, we see them as reasonable versus history when adjusted for interest rates, and attractive given high earnings growth.

Across our portfolios, we adjusted some U.S. large-cap sector exposures in Q2 in view of the strength and speed of the recovery, as well as the rapid evolution of the cycle we anticipate. We increased exposure to the Information Technology sector, which should face less revenue and earnings deceleration than other economically-sensitive sectors as economic growth normalizes, thanks to strong secular demand and likely post-COVID tech capex spending. We also added to our Financials allocation. We believe a normalization of monetary policy and continued economic growth is likely to drive short and long term interest rates higher, which could be a significant tailwind for bank revenue and profits, and the sector has been trading near the low end of its historical relative valuation range. We funded these additions with a reduction in Industrials exposure. In our view, the rapid demand recovery for industrial products may leave less pent-up demand for the sector than in prior cyclical recoveries, while the sector's valuation seemed to already price in a strong continued earnings rebound. In global portfolios, we also eliminated an allocation to U.S. small-caps, which outperformed in the economic rebound, but could underperform as growth moderates.

International: A key development in Q2, in our view, was continental Europe's progress on vaccine distribution. After early setbacks, accompanied by a surge of new COVID infections and some renewed lockdowns earlier in the year, major Eurozone countries rapidly scaled up their vaccination programs and now appear on pace to match or surpass U.S. vaccination levels in Q3. This gives us greater conviction that Europe's economy will rebound, and possibly see higher growth than the U.S. in late 2021 and 2022. Correspondingly, in global portfolios, we increased allocations to Europe in Q2 (reducing our underweight), though we remain cognizant of ongoing political head-winds and structural limitations to the region's fiscal stimulus impact.

We remain overweight Emerging Asia. We anticipate the region's early recovery and favorable mid-cycle sector composition should have lasting benefits as the global economic cycle evolves.

Fixed Income: While we expect inflation pressures to moderate as supply and labor constraints ease, we still see the possibility of a continued rise in interest rates from normalizing real rates (currently negative) as the economic expansion proceeds. Given this, and our positive outlook for equities, we remain modestly underweight fixed income in balanced portfolios, and, within fixed income allocations, we retain a short average duration to limit interest rate sensitivity.

WestEnd Advisors Investment Team | July 1, 2021