Quarterly Commentary: Q2 2021

VALLEY NATIONAL
FINANCIAL ADVISORS

Stocks

Each of the three major U.S. equity indices – the Dow, S&P 500, and Nasdaq – were up between 12.5-14.4% through 2021's first six months. The Dow had a quick start to the year while the tech-heavy Nasdaq lagged, but at this point, the performance disparity between any of three indices is immaterial, illustrating the breadth of the market rally.

Generally speaking, companies in the Nasdaq are more rapidly growing but less profitable today. For companies who have the bulk of their profits in the distant future – companies disproportionately located in the Nasdaq – rising interest rates are relatively harmful. This is because all corporate profits must be discounted to the present to derive a company valuation; profits further out are discounted more. By contrast, companies in the Dow are predominantly harvesting their profits in the present moment; thus, they are more immune to rate changes. Interest rates rose sharply to begin the year; as a result of the dynamic just described, this negatively impacted Nasdaq constituents more severely than companies in the Dow. However, rates stabilized – and have even declined – over the past couple of months, during which time the Nasdaq made up ground on its counterpart indices.

Bonds

Interest rates nearly doubled during Q1, as the 10-year treasury bond increased from approximately 0.90% to greater than 1.70% in the three-month span. Bond prices fall as rates rise; thus, major bond indices declined in Q1. In Q2, however, the 10-year fell to a range between 1.40-1.50% by period-end, and bonds were buoyed to end the first half.

The rate environment must be considered both in the context of historical precedents and current inflation expectations. On the former, rates remain extremely low, as the 10-year treasury generally hovered between 4-5% prior to the Great Financial Crisis and its subsequent monetary stimulus. Low rates facilitate economic activity, as consumers and businesses alike are incented to borrow money, spend on goods and services and invest in growth initiatives.

On the other hand, central banks are averse to inflation. Their means of obstructing this insidious force is hiking interest rates. Inflation simply refers to higher prices of goods and services. Prices are driven by supply and demand. Higher rates work to offset demand for goods and services because they encourage consumers to save their money rather than spend it.

The Federal Reserve – the U.S. central bank – holds a long-term inflation target of 2%; however, Jay Powell, Fed Chairman, has stated that he is willing to let run inflation run above this target over the short and medium term in order to facilitate economic growth. In April, inflation was 4.5%, its highest figure in some time; the figure decelerated to 3.5% in May. Chairman Powell believes that the high inflation numbers are the result of pent-up demand being unleashed on a globally constrained supply chain. Powell forecasts that inflation will moderate further over the coming months as supply chain bottlenecks resolve.

Outlook

Historically, strong first-halves in the equity markets portend strong second-halves; per Refinitiv, in every year since 1950 in which the S&P and Dow were up double-digits to start the year, they were positive in the final six months. Economic indicators also suggest a healthy second half of 2021 is forthcoming. The unemployment rate is well within normal range, sitting just below 6%, while the housing economy – represented by home prices and remodeling & renovation activity – is in its strongest condition since the Great Financial Crisis. Crude oil is priced at $75 – a three-year high – as the appetite for travel and mobility are surging. As a result of these trends and more, the International Monetary Fund has increased its projection for U.S. 2021 GDP growth from 4.6% to 7%; should the forecast come to fruition, it would represent one of the strongest years on record.

If there is a risk to the economy – and therefore, possibly the markets – over the coming six months, it is that of overheating. At present, the market is expecting the Fed to hike rates twice in 2023. However, if inflation persists – contrary to Chairman Powell's forecasts – the U.S. central bank may be forced to take hastier action. Nevertheless, modestly higher rates are unlikely to unhinge the financial markets so long as economic growth remains strong.