2021: SEMI-ANNUAL MARKET UPDATE

SUMMARY

The global recovery that began in the spring of 2020 following the shock of the Covid-19 pandemic continued to unfold in the first half of 2021. As demand recovered sharply, commodity prices surged and bottlenecks developed in the global supply chain, leading to concerns over persistent inflation. The Federal Reserve reiterated its view that inflation pressure would be transitory but also provided a hawkish signal at its June meeting, indicating that it may consider tapering extraordinary stimulative measures.

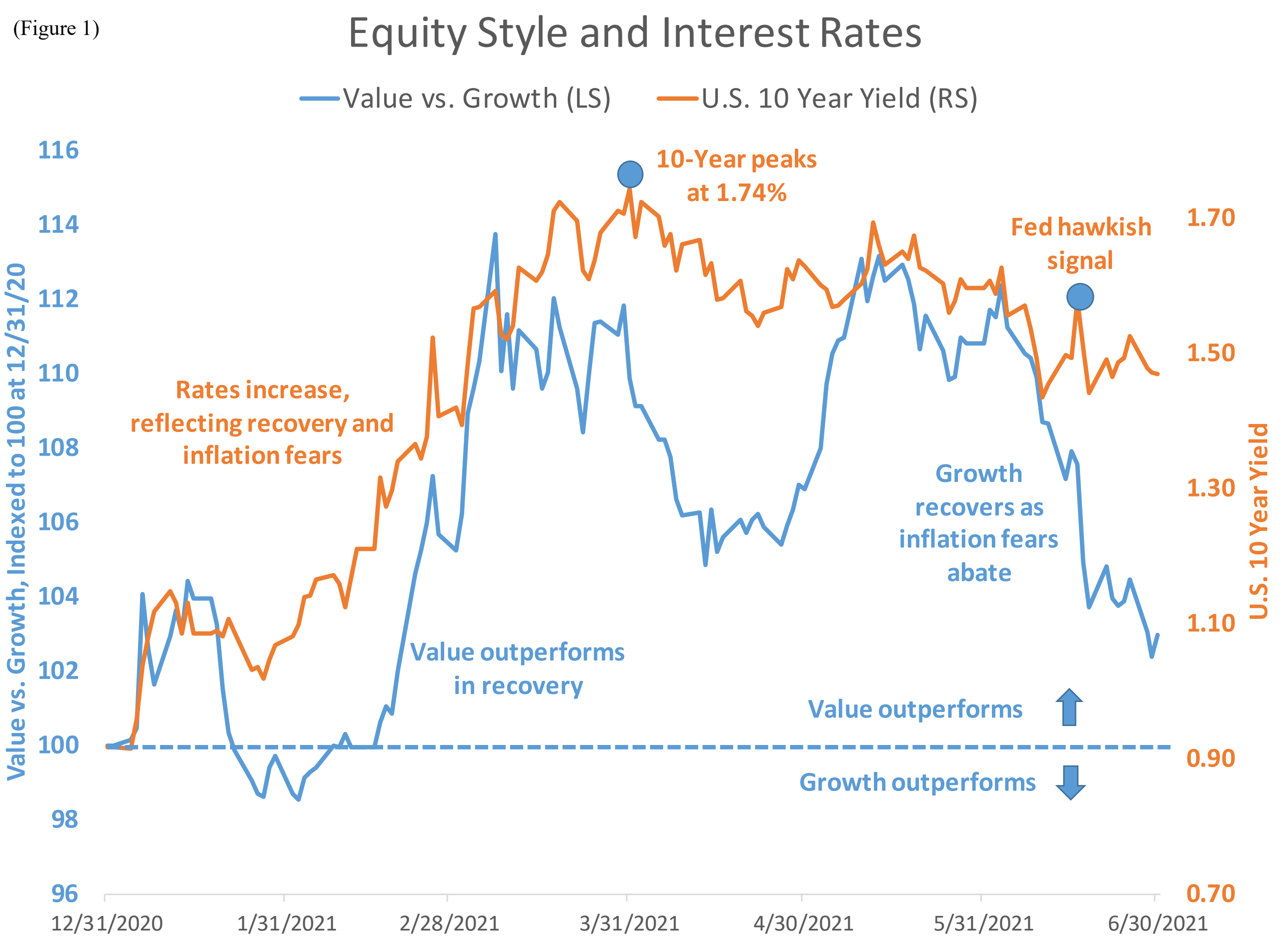
In 2021's first half, global equities gained 12.3% and broad commodities surged by 21.1%. U.S. fixed income declined by 1.6% amid lower market volatility and a stronger U.S. Dollar.

THE INFLATION MENACE

The beginning of the year could be described as "the Great Inflation Scare of 2021." While much of the increase in inflation can be attributed to a rebound in sectors affected by the pandemic and supply chain disruptions, inflation readings exceeded expectations and reached levels not seen since 1990.

Concerns over excessive stimulus led bond markets to quickly reprice inflation risk, causing yields on the 10-year bond to spike by 0.83% in the first quarter to a peak of 1.74%. Bond prices are inversely related to their yield and bond indices declined as a result. Market leadership moved to value stocks, closely tracking the recovery and concurrent rise in yield (figure 1).

(Figure 1)



"In my experience, there is no such thing as luck."

- Obi-Wan Kenobi

In many ways, the recovery followed a traditional playbook as value and small caps outperformed. However, this was not random happenstance as value stocks tend to offer higher dividends and generate higher near term cash flow than growth stocks. This lower "duration" of cash flows helps value stocks outperform in periods of rising interest rates. Among value stocks, long out-of-favor natural resources and financials benefitted the most thanks to a cyclical recovery in commodity prices and steeper yield curves. Our contrarian positions in these sectors provided strong uplift to client portfolios.

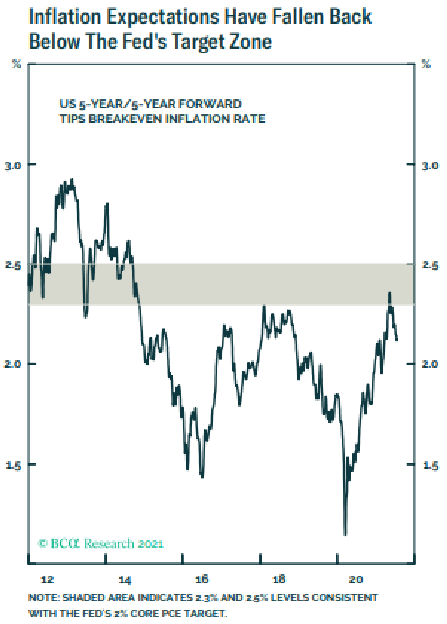
"Great, kid. Don't get cocky." - Han Solo

What diverged from expectations in this period was the continued outperformance of U.S. over foreign equities. Foreign equity indices are more highly geared to global growth but suffered from slower vaccine deployment, which delayed their recovery. However, vaccine makers are on course to produce over 10 billion doses in 2021. Many of these will find their way to emerging economies, which have struggled to obtain adequate supplies[1]. As vaccines become more available globally, we expect growth in foreign markets to catch up to the U.S. later in the year.

In the second quarter, bond yields declined on signs that U.S. growth had peaked and the Fed's signaling at their June meeting that they may not tolerate a prolonged inflation overshoot. Technical factors further contributed to the decline in yields as the Treasury Department drew down its cash balances at the Federal Reserve instead of issuing new debt, thus limiting supply of government securities in the near term and boosting the price of bonds.

These developments have tempered inflation expectations since March (figure 2) and helped growth stocks regain the upper hand through the end of the first half. As shown in figure 2, inflation expectations (as proxied by the 5-year/5-year forward breakeven rate on Treasury Inflation Protected Securities) have sunk back to 2.11%, below the Fed's target zone of 2.3%-2.5%.

(Figure 2)



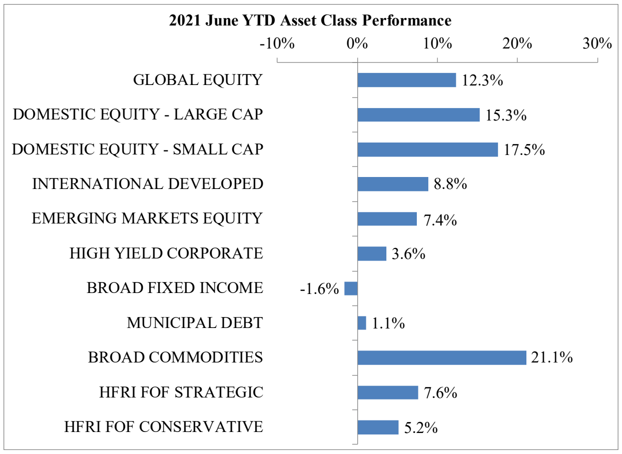
Inflation Expectations Have Fallen Back Below The Fed's Target Zone

NOTE: SHADED AREA INDICATES 2.3% AND 2.5% LEVELS CONSISTENT WITH THE FED'S 2% CORE PCE TARGET.

Source: BCA Research

Reflecting the ongoing market recovery, equity volatility as measured by the VIX index declined from 22.8 at the end of 2020 to 15.8 by the end of June. The yield on the benchmark 10-year U.S. Treasury note peaked at 1.74% at the end of March, declining back to 1.47% by the end of June as inflation fears abated. The U.S. Dollar appreciated with the Fed's hawkish turn and gold weakened concurrently during the first half.

(Figure 3)



Source: Bloomberg

[1] BCA Research, July 16, 2021.

Year-to-date, all asset classes except broad fixed income delivered positive returns (figure 3). Broad commodities posted the best performance, reflecting tight supply conditions and high demand.

ATTACK OF THE LOANS

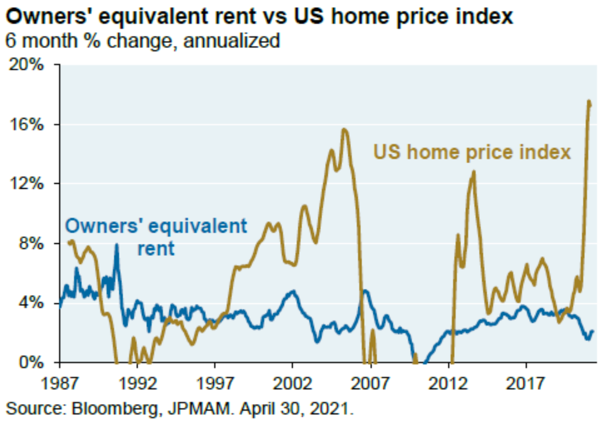
So far, the market seems to be falling in line with the Fed's assessment that the recent increase in U.S. inflation will be transitory.

"The emperor does not share your optimistic appraisal of the situation." - Darth Vader.

There is little doubt that inflation will decline from recent pandemic-related levels, particularly in the travel and leisure sectors as well as in areas affected by supply bottlenecks such as autos. The key question is whether inflation will decline as substantially as the market is currently discounting.

Wages have mainly accelerated in low-skilled and labor intensive sectors such as retail and hospitality. Labor scarcity "should" ease later this year with the expiration of pandemic related unemployment insurance programs. However, workforce participation rates may have been affected long-term, and a large skill mismatch remains in high-skilled areas of the market such as manufacturing and engineering. If labor scarcity doesn't ease as expected, markets would react negatively to persistent wage inflation.

(Figure 4)

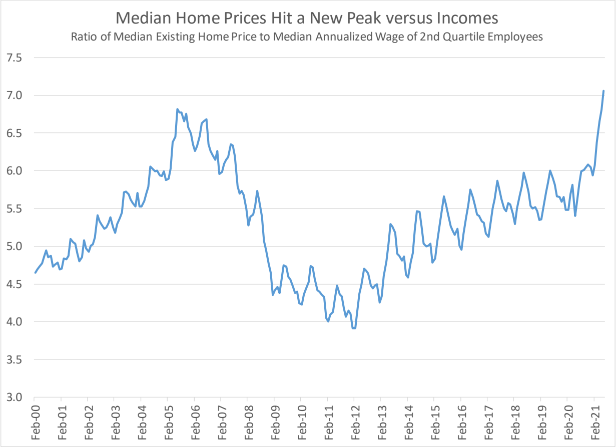


Source: Bloomberg, JPMAM. April 30, 2021.

Another area of uncertainty remains in the housing market. U.S. home prices surged during the pandemic thanks to low interest rates, a sudden migration to less densely populated suburbs and acute housing shortages (figure 4). However, the Fed's inflation measures only consider "owner's equivalent rent" (24% of the U.S. CPI basket and its largest component), which is a smoothed and backward looking statistic.

While low interest rates helped maintain housing affordability, home prices have reached a new peak relative to income (figure 5). Households will increasingly find themselves shut out of the market and turn to renting despite a preference for home ownership. In addition, incentives that were offered to renters during the pandemic to maintain occupancy are unlikely to be renewed, which should also contribute to a sustained catch-up in rental prices.

(Figure 5)



Source: Bloomberg

While the Fed routinely excludes volatile food and energy prices from its decision-making, a commodity super-cycle could help unmoor inflation expectations. Commodity prices have eased recently, but years of underinvestment in these sectors have resulted in tight supply conditions and created the conditions for recurrent price spikes.

Finally, as discussed in our earlier "Inflation and Real Assets" note, we see nothing transitory in the mountain of debt that is currently being accumulated in developed economies. Having learned from their mistakes in the wake of the 2008 recession, governments are now willing to do whatever it takes to support their economies, and central banks are facilitating the process. In the

U.S. the pending $600bn infrastructure bill will maintain this dynamic, as will Europe's €750bn *Next Generation* fund. We are often asked how this will end. Frankly, we are not sure how long it might take but it doesn't appear to be a near term issue as these new policies are being put in place. Eventually, this surge in government loans will require higher rates to contain inflation pressures or a market bubble.

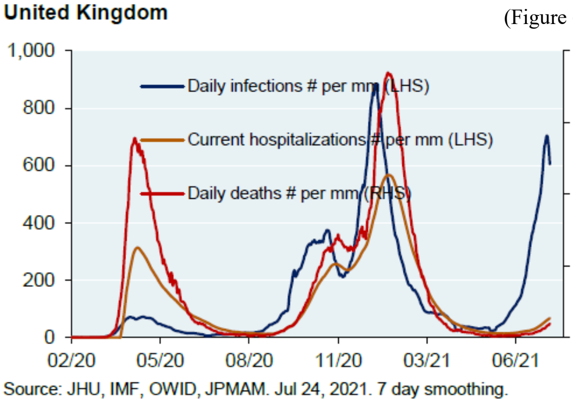
We continue to think that inflation risks are now greater than they have been over recent decades, warranting a greater emphasis on inflation protection in investment portfolios, favoring housing and commodities at this point. The long-term threat of rising interest rates also leads us to prefer lower duration strategies in equities, bonds and alternatives. Examples of lower duration strategies include value-oriented equities or private credit strategies within alternatives.

REVENGE OF THE VIRUS?

The spread of the Delta variant of the virus is causing near-term anxiety due to the possibility of renewed lockdowns that could impede the economic recovery.

However, reimposing lockdowns now that vaccines are broadly available seems out of the question. In addition, data out of the U.K. offers some hope that while infections may be on the rise due to the Delta variant, hospitalizations and deaths appear contained, at least among a highly vaccinated population (figure 6).

(Figure 6)


United Kingdom

Source: JHU, IMF, OWID, JPMAM. Jul 24, 2021. 7 day smoothing.

Source: JP Morgan

"The greatest teacher failure is." - Yoda

Now that the initial shock is past, individuals and businesses are adapting to cope with this endemic situation, and we think that the economic disruption will continue to lessen over time.

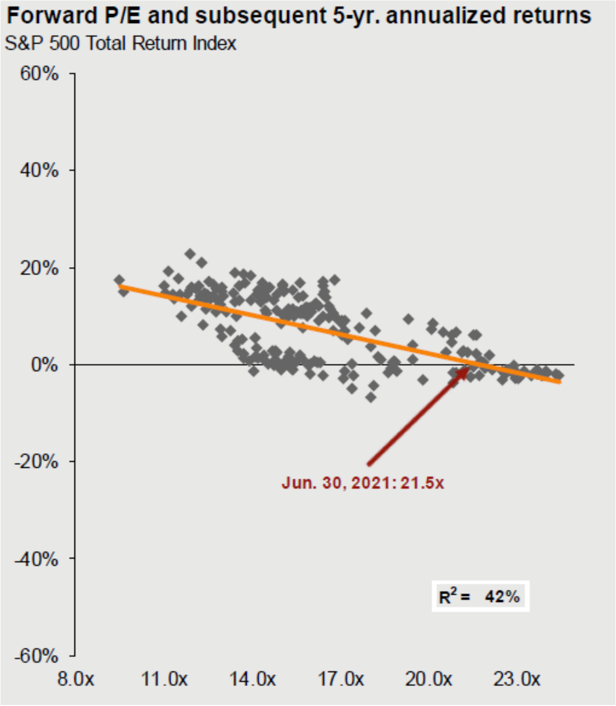
A NEW HOPE

As inflation fears recede and pandemic disruptions wane, market fundamentals should return to the forefront. With bond yields near historical lows and a rising threat of inflation, the opportunity cost of holding cash and bonds is high, although low volatility and liquidity remain valuable attributes. As a result, in most investors' minds, "there is no alternative" (TINA) to stocks. Unfortunately, this has contributed to expensive valuations, particularly in U.S. stock indices.

"Never tell me the odds." - Han Solo

Current valuation levels on the S&P500 index are consistent with flat return expectations over a five year horizon, as shown in figure 7. What then should investors do?

(Figure 7)


Forward P/E and subsequent 5-yr. annualized returns

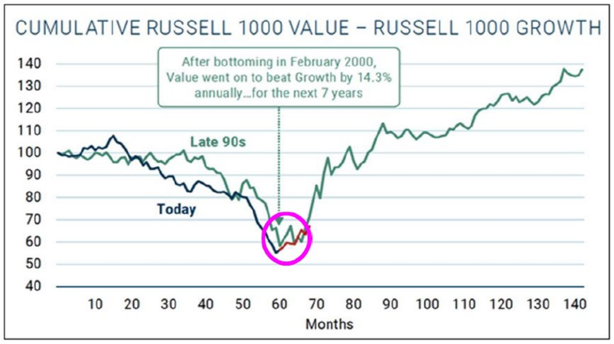
S&P 500 Total Return Index

Source: JP Morgan "Guide to the Markets"

One answer at this stage of the market cycle is to turn to active strategies. By definition, active managers seek to invest in good businesses at a discount to intrinsic value. When valuations run hot, active managers turn to areas of the market that offer better margin of safety. This can lead to underperformance relative to indices over the short-term. However, maintaining valuation discipline ensures stronger performance outcomes over a full market cycle.

The difficulty in recent years has been the recurrence of central bank interventions, which repeatedly inflated the valuation of longer duration financial assets such as growth stocks. However, monetary stimulus is reaching its practical limits and 2021 showed cracks in the leadership of growth stocks. If history is any guide, there is a long runway for value stocks to outperform (figure 8).

(Figure 8)



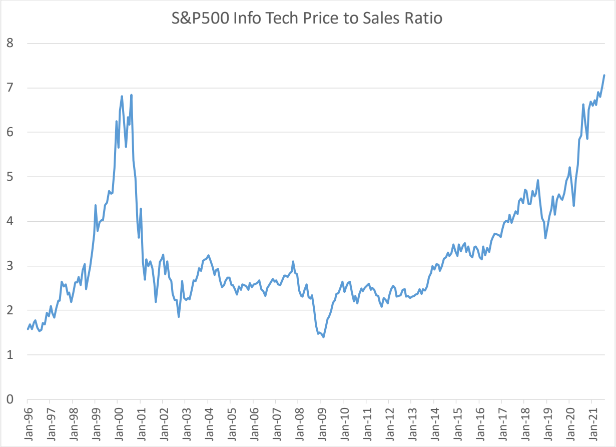
Source: GMO

"I have a bad feeling about this." - Han Solo

Consider U.S. technology stocks, whose price to sales ratios have now exceeded 7x, a level last seen during the dot-com bubble of 2000 (figure 9).

These extreme valuations were bolstered by very low interest rates making these stocks increasingly sensitive to the direction of interest rates, as discussed with figure 1. The tech sector is also facing rising input costs, higher taxes and stricter regulations, which could affect profitability and compress valuations.

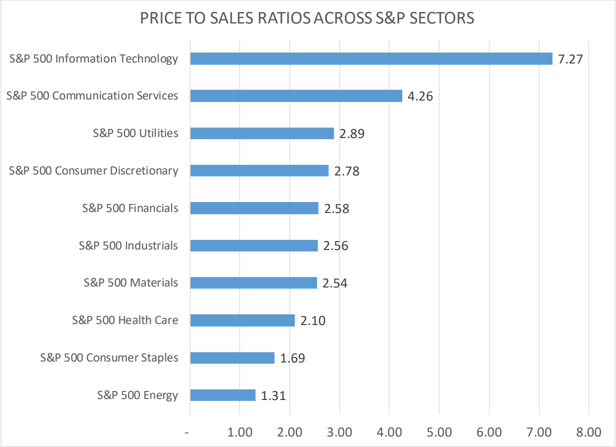
(Figure 9)



Source: Bloomberg

Within the S&P500 index, the technology sector is by far the most expensive (figure 10). Hence investing in technology requires extreme selectivity. By contrast, active managers have ample opportunity to seek higher long term returns in more reasonably valued sectors such as financials, industrials or health care.

(Figure 10)



Source: Bloomberg

"Would it help if I got out and pushed?" - Princess Leia

While U.S. equity indices may deliver flattish performance overall in the medium term, we think significant market rotations will take place, offering opportunities for active management.

These comments on U.S. equities also apply to other areas of investing. For the time being, monetary and fiscal policies remain accommodative globally, which is supportive of risk assets, but after good returns since the beginning of the year, valuations are high across the board. This means that future performance will rely more and more on active selection of idiosyncratic opportunities

Beyond public markets, we continue to find opportunities in alternative strategies with shorter investment horizons such as a private credit, which can offer strong downside mitigation and equity-like returns when deployed opportunistically. In private equity, deeper relationships with our investment partners are allowing for greater participation in their best ideas via co-investments.

MAY THE FORCE BE WITH YOU

Global growth is peaking but remains above trend and the economic impact of virus variants will likely decline over time. The longer monetary accommodation remains in place, the greater the risk of future inflation. While bonds and equities are both expensive from an absolute standpoint, equities look relatively more attractive in this environment. This will present an opportunity for active management as it relates to identifying companies able to effectively implement price increases with customers in order to offset rising commodity and labor costs and maintain earnings growth. For the first time in years, commodities look attractive from a top-down perspective given improved supply/demand dynamics and high correlation to inflation. For clients who can tolerate illiquidity, we continue to prefer alternative strategies across hedge funds and private assets, where managers can deploy a broader toolset and increase selectivity in best ideas.

“This is the way.” - The Mandalorian

We take a final cue from our favorite science fiction franchise to continue to advise for portfolio diversification and a focus on longer term returns. Even bonds have a role to play as a liquid reserve while we work to uncover the next most attractive opportunities.

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