

ECONOMIC OUTLOOK

Summary

As we close the book on the second quarter, there seems to be little debate the economy is on solid footing. If anything, a debate could center on whether the overall economy will end up getting “too hot.” For example, first-quarter GDP came in at 6.4% and the Atlanta Fed currently estimates second-quarter GDP to be 8.3%. Though they were both influenced by prior stimulus from the government, these numbers still stand out as impressive, and not just because we don’t typically see such strong back-to-back readings. Here, we’ve seen significant strength even in the face of economic headwinds such as chip shortages, slower-than-anticipated job growth and spikes in the prices of raw materials causing slowdowns, among other things.

As updated data filters in week by week, several economic debates continue. Inflation, for one, has been highly disputed the past several months—with some (including the Federal Open Market Committee) falling in the transitory camp, and others believing it is longer lasting inflation. Ultimately, the camp you side with likely depends on your definition of “transitory.” Additionally, are jobs not growing at the rate that was expected during the past few months due to a Federal weekly unemployment supplement causing a disincentive to work, or for other reasons? We should have a better idea by September.

Despite the overall strength, some data remains mixed. Retail sales have trailed estimates and disappointed throughout the past couple of months. Home builders are backed up because of supply issues and vaccine hesitancy has prevented the U.S. from reaching the vaccination percentages thought to achieve herd immunity. Furthermore, companies are being forced to raise salaries in an effort to convince workers to come off the sidelines. This period, which is sometimes referred to as “The Great Resignation,” has seen an atypical number of people quitting their jobs in search of higher paying, more flexible or remote opportunities, which will likely continue to squeeze corporate margins.

Regardless, consumer confidence sits at 127.3, which is easily the highest since the beginning of the pandemic and is approaching the pre-pandemic readings. Productivity is surging as we have higher GDP levels with fewer people in the workforce. PMIs for both services and goods remain extremely elevated. And while the savings rate has dropped significantly, it’s still historically elevated. Virus variants notwithstanding, all of this points to continued strength, likely through at least the remainder of this year.

Positives

Consumer confidence jumped by 10 points from 117.2 to 127.3

ISM PMIs (both Manufacturing and Services) remain over 60

Leading economic indicators remain elevated (1.3% month-over-month)

Negatives

Retail sales continued its recent downward trend month-over-month (-1.3% vs -0.8%)

CPI was +5.0% year-over-year, though it still includes some base-effects

The labor force participation rate declined by one-tenth in June (61.6%)

EQUITY OUTLOOK

Summary

Equity markets continued to grind higher with the S&P 500 adding 2.3% in June and closing the month and second quarter at an all-time high. With long duration treasury yields retreating a bit, growth stocks regained momentum relative to value during the month. The Russell 1000 Growth Index climbed 6.3% in June while the Russell 1000 Value Index shed 1.1%.

The growth/value or momentum/reopen tug of war appears to be a battle that is seemingly being waged on a daily basis. Proponents of both approaches make solid arguments as to why their particular style will outperform going forward. The frequency of the rotations between these styles in recent months make it difficult for equity investors to determine future leadership.

There is a case to be made, however, that we might be in a period where growth and value can both work well together. Through the end of June the Russell 1000 Growth Index is up 13.0% and the Russell 1000 Value Index has gained 17.0% year-to-date. So in spite of the quarterly, monthly and even daily rotations between them, both growth and value have produced impressive absolute returns especially coming out of the rally that closed 2020.

There are still several factors that are likely to propel markets higher. Progress has been made on some infrastructure spending and the Federal Reserve remains accommodative. Corporate earnings are expected to be quite strong, which should continue to push stocks higher over time. We will continue to invest in companies with strong fundamentals and pricing power. This strategy should be rewarded over time regardless of whether the stocks are growth or value.

Positives

Accommodative Federal Reserve and global central bank policy

Lack of return competition from other major asset classes

Reopening of America is gaining steam with few immediate setbacks

Negatives

Stock valuations, by some traditional measures, look relatively stretched

Rising material and labor costs

Unknowns

How long before the threat of inflation forces a response from the Fed

Are equity fundamental growth rates peaking

FIXED INCOME OUTLOOK

Summary

Given the strength in the economy as it rebounds from the pandemic and the elevated inflationary pressures, it is not overly surprising the Federal Reserve brought forward their expectation for their first rate hike. At the June meeting of the Fed's Open Market Committee (FOMC), 13 of the 18 voting members indicated they now expect they will be increasing the overnight rate sometime in 2023. Additionally, the consensus of the group is there will actually be two rate hikes, not just one. At their March meeting, seven members expected to be increasing the Fed Funds rate but with 11 members believing that more time would be required before achieving their objectives. The consensus then was for no rate increase through the year end 2023.

As the Fed Chair commented, predicting the path of the economy and the level of inflation multiple years out can be a humbling experience. While our outlook has generally been in agreement with the Fed's, given the rebound in activity seen so far this year, reversing some of the emergency pandemic-related actions sooner makes sense to us. To that end, we soon expect that they will officially begin to discuss tapering the amount of monthly open market balance sheet purchases. By late summer they could announce a scheduled reduction that could start around year end.

With new projections for the overnight rate, the 2-year Treasury yield increased by 11 basis points (bps) to end June at 0.25%. The 5-year note increased 9 bps to 0.89%. It appears investors have become increasingly confident the Fed will not allow the economy and inflation to run too hot, for too long and have therefore pushed longer maturity yields lower. The 10-year Treasury note declined by 13 bps during the month to end at 1.46% while the 30-year dropped nearly 21 bps to 2.08%.

Treasury bonds delivered their third consecutive positive monthly return, although without help from the longer maturity bonds, the intermediate maturity notes had a slightly negative month (-0.07%). Led by the industrial sector, and specifically energy companies, corporate credit continued its winning streak with solid returns across all maturities.

We believe short rates accurately reflect the future path of the overnight rate and they should not move meaningfully higher in the near term. Longer maturity bonds have found a strong bid but we still believe there could be one more move slightly higher later in the fall or winter. Credit spreads are historically tight, but with the rapidly improving economy, we see no catalyst for a meaningful reversal anytime soon.

Positives

Institutional rebalancing out of equities and into bonds

Longer rates reacted favorably to news the Fed is expected to hike in 2023

Longer maturity yields still near pre-pandemic levels

Negatives

Year-over-year inflation reports still alarming to investors

Massive deficit spending proposals in Washington

Unknowns

Spread of Delta variant

Reaction to Fed tapering announcement