Making Sense of Finance

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Second Quarter 2021 Review

STOCK MARKET

Gains in the stock market persisted into the second quarter as the S&P 500 index hit a record high. All three major U.S. indexes had positive returns last quarter led by the Nasdaq Composite (9.5%) as technology stocks resumed their upward move. The S&P 500 index followed with an increase of 8.2% and the Dow Jones Industrial Average rose 4.6%. Although the indexes charge higher, the percentage of stocks making record highs are dwindling, indicating a stock sector rotation. Most investors would not consider the stock market inexpensive with a current trailing S&P 500 P/E of 31. However, when considering where interest rates are currently, the market may not be considered expensive either when comparing the present equity risk premium to historical averages. Earnings are still the driver of rising stock prices. After a decline of 22% in aggregate S&P 500 company earnings per share in 2020, estimates for this year are for an increase of 53%, bringing them higher than 2019 levels. Earnings growth in most of these companies is not the issue. At this point when it comes to stocks it is more about how they are valued relative to other asset classes; and at this time stocks are favored as evidenced by the high P/E multiples awarded equities.

All stock sectors showed positive returns in the second quarter with the exception of utility stocks which were down slightly. REITs (real estate investment trusts) led the way last quarter (+12%) followed closely by technology (+11%), communication service (+11%) and energy stocks (+11%). The latter sector aided by the 24% increase in the price of oil last quarter, which was a continuance of its large gains in the first quarter. (Have to go back to 2014 the last time gasoline averaged over $3 per gallon in the US). Unlike the first quarter, large capitalization stocks in general outperformed smaller cap stocks in the second quarter.

The MSCI EAFE Index which is a measure of foreign developed markets lagged the US stock market again with an increase of only 4.4% in the second quarter. A few individual stock markets such as Switzerland and Denmark outperformed our domestic counterpart, but overall returns were not as great as in the US. Japanese stocks were virtually unchanged in the second quarter. Many foreign countries still lag the US as far as their economies rebounding from the covid induced recession. Vaccination rates are still low in many countries and numerous countries are yet far behind on returning to "normal".

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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BOND MARKET

The Bloomberg Barclay Aggregate Bond Index, after experiencing its worst quarterly drop in the first quarter in over 40 years, rebounded last quarter with a total return of 1.8%. All bond sectors posted positive returns in the second quarter although the index is still negative year to date. High yield (non-investment grade) bonds were aided by shrinking credit spreads (difference in yields between investment grade and low-quality bonds) which are at historic lows. Emerging market bonds, also a higher risk fixed income category, outperformed the aggregate index. Treasuries and municipal bonds, although showing positive returns last quarter, lagged the index in total return.

The Federal Reserve had indicated in June that it may raise the Fed Fund rate sooner than previously expected, although still way off in the future. This caused rates on short term Treasuries to rise slightly last quarter while at the same time longer term Treasury rates declined, flattening the yield curve marginally. The yield on a 3-month Treasury bill rose from .03% at the end of March to .05% to end the second quarter. Meanwhile the 10-year Treasury note yield declined from 1.74% at the end of the first quarter to 1.45% at the end of June and is currently at 1.35%. In some ways it is hard to understand why the Treasury yields are still so low, however Fed Chairman Powell has indicated the Federal Reserve intends to keep rates low. The Fed's mandate is "full" employment (which we do not have right now) and an average inflation rate of 2%. With a June CPI rate increase of 0.9% from the previous month and 5.4% from the previous year, it appears we have reached an inflation rate way above the sought after 2% average. The response from the Federal Reserve right now is that this inflation is transitory; and that we had previously been below 2% and now we are above it but over time this will average out to a desired range. The Fed also has indicated it will continue its monthly asset purchases: $80 billion of Treasuries and $40 billion of mortgage-backed securities. These purchases have provided great support to these fixed income securities which has kept rates low for some time. The timing of the tapering of these purchases is being closely watched as that may indicate when interest rates will rise.

OUTLOOK

The pandemic will continue to be a factor for the foreseeable future. Although the USA has mostly reopened, many parts of the world are starting to lock down again due to the "Delta" variant of the virus. In a global economy, this will likely continue to cause delays in shipments and disrupt supply chains. However, a combination of continued vaccinations, particularly with the Pfizer and Moderna vaccines in addition to more infections of the population should render the virus less and less deadly to the world population. Our view is that this will be the case effecting economies, as well, with countries learning from past mistakes and being better prepared during each wave.

With a solid start for stocks during the first half of the year, greater volatility seems inevitable going forward. Earnings have continued to rebound which support these lofty stock prices, but investors should remember that if stocks can remain over valued for years, the reverse can occur, too. We think there will be a rotation into sectors that are a bit more stable, such as consumer staples, utilities, and other sectors that have not run up as much, such as smaller cap issues.

The strength in REIT prices surprised us. Given that anecdotal evidence shows companies downsizing and renegotiating office space, we thought that REITs would struggle, particularly retail and office space. Inflation has also reared its ugly head, but we think this will diminish similar to other reactions to Covid-19. For instance, microchips have disrupted the technology market as well as the auto industry due to a lack of capacity compared to demand. Lumber prices also skyrocketed in the first half of the year but have already begun to settle down in the past few weeks.

Fixed income investments have become even less appealing given inflation fears. The 10-year Treasury bond with a 1.35% yield was already slightly below the rate of inflation but this has only worsened with inflation projected to be in the 2.5% range for 2021. Those who continue to seek alternative assets such as bitcoin or precious metals have not fared better. Bitcoin is down over 50% from its highs and is about even from the beginning of the year and both Gold and Silver are down in price, year to date.

Our opinion remains unchanged for the past decade. Equities (stocks), though volatile remain an investor's best chance to outperform inflation and offer the best returns. We continue to believe that we can find better value than most broad market index funds and can add value by selectively harvesting tax losses from individual securities.

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