Market is Up – Will the Economy Match the Growth and will Inflation be a Problem?

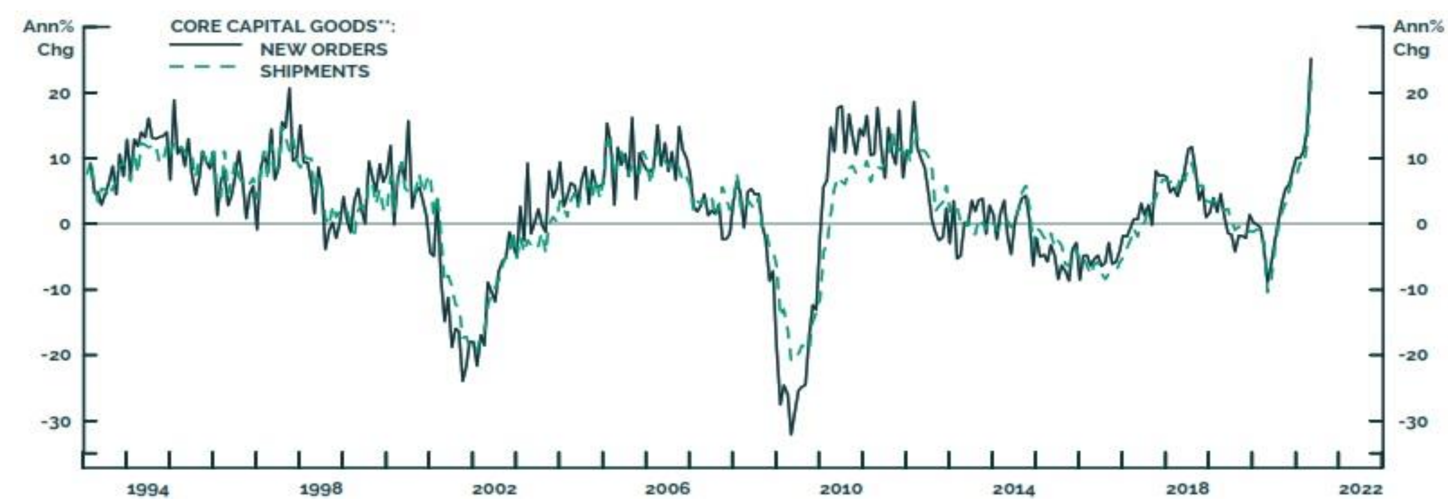
The stock market continued its relentless accent in the second quarter with the S&P 500 advancing by 8.55%. Growth reasserted itself, outpacing Value by about 7%, although Value still has the edge year-to-date. International stocks lagged again up around 5%. The biggest fear of investors going into the quarter was the belief the Federal Reserve (Fed) was too soft on inflation. However, the Fed signaled they expect to raise interest rates by late 2023, sooner than anticipated which convinced many that the Fed will not let inflation get out of control. As a result, market-based inflation expectations look calmer, interest rates dropped, fixed income assets rallied, and equity investors ran back to Growth.

Clearly, the easy money off the Covid-19 bear market has been made and any advances from current levels will likely be more modest and labored and dependent on improvement in earnings. While inflation fears have receded, they may resurface given the level of stimulus in the pipeline. Former Treasury Secretary under President Clinton, Larry Summers, who was very critical of the lack of support following the Great Financial Crisis (GFC) is sounding alarm bells. Talking to the *Financial Times* he said: "Today's stimulus is above 10% of GDP in the face of a gap that is 3% or 4% of GDP. Relative to the gap, this stimulus is already of the order of five or six times as large as in 2009. Not even the most extravagant critics of the 2009 stimulus have suggested it should have been six times as large."

Other warning signs include high margin debt, money pouring into stocks at the fastest pace since 2015, and wild speculation on meme stocks and parts of the cryptocurrency market. Dogecoin, a digital currency that was started as a joke, was valued at almost $50 billion during the quarter, although it has backed off from that level. While valuations are a lousy timing tool the relationship between valuations and subsequent long-term returns is strong. High valuations historically have meant low returns over the next 10 years, but importantly have little correlation over the next year or two.

Stock market bulls have plenty of ammunition. Market breadth has been good which is usually a sign of resiliency. Investors have confidence in the economic outlook and have bid the yield spread on low-rated corporate bonds over Treasuries to their lowest level in more than a decade, below 3 percentage points. This optimism is borne out by the data**. All key components of the economy are humming -consumer spending, manufacturing, labor markets and capital expenditures (capex-see chart)**. Economists have been complaining about low capex since the GFC. Capex is seen as the main driver of productivity gains, increased wages, and living standards. Currently, capex spending by companies is rising at an annual rate of 15%, unheard of in recent time. All this good news is showing up in rising earnings expectations. S&P 500 earnings per share estimates for 2021 are $191, up from $167 at the beginning of the year. Healthy earnings may end up justifying current valuations, especially given the lack of alternative investment opportunities.

As the market has moved higher, we have reduced risk by trimming some winners and moving into laggards. The Low Volatility factor has struggled over the past year. We had been significantly underweighting this factor but have been buying lately as it tends to hold up well in choppy markets. Summing up our thoughts, until something changes, the path of least resistance for stocks appears higher. As always it is a good time to review your allocations with us.



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