Wellington Shields

July 2021

Quarterly Market Strategy Report

Welcome the Bump in the Road

The S&P 500 and the Wilshire 5000 both rose to record highs at the end of June capping a wonderful first six months of 2021 for equity investors. Most broad market indices had year-to-date advances of 14%, which for most calendar years would be considered a terrific performance. One historical tidbit suggests that solid gains in the first half of the year tend to be followed by further advances in the second half, so there is reason to be optimistic for the intermediate term. But more importantly, the main characteristic of the 2021 stock market to date was the shift away from the perennial leadership of technology and growth stocks and to a range of stocks that can best be described as inflation driven. Sectors such as energy, REITs, materials, industrials, and financial outperformed the S&P Composite by a wide margin in the first six months of the year. And given the outlook for inflation, this performance may continue in the second half.

MORE INFLATION AHEAD

Some of this leadership shift was due to the belief that the global economy is conquering the spread of COVID-19 and the new Delta virus, which suggests that most trade and business activities will soon return to normal. To a large extent, this has encouraged investors to invest in economically sensitive, or cyclical stocks. However, a more significant driver of this leadership shift was a ubiquitous rise in prices. Soaring costs for energy, lumber, semiconductors, and a variety of raw materials is expected to be transient according to the Federal Reserve. But in our view, the dislocations from production and shipping that developed during the shutdown in 2020 will take quite a while to return to its typical standard. Energy prices are rising from a combination of green energy policies imposed by governments globally, a breakdown in OPEC discussions and a simultaneous rise in demand. Semiconductors are in short supply due to an increase in demand but more importantly, a concentration of manufacturing in one area of the world – Taiwan. This has exposed the semiconductor industry to a risk in terms of production and geopolitics. These are just some of the reasons why price increases are broadly based and may not be transient. General Mills' (GIS - $59.99) recently announced that as a result of more expensive ingredients, packaging, trucking and labor costs, the company expects wholesale costs will be about 7% higher over the next year or so. These costs will be passed on to consumers. Therefore, it seems inevitable that households will be facing higher expenses throughout the second half of 2021, and this could alter consumption

Summary

Inflation continues to be the major theme of 2021. This has the potential to shift consumption patterns, change monetary policy and lower PE multiples. Investors should therefore focus on companies that benefit from higher pricing, have solid earnings potential, and have modest PE multiples. Equities with dividend yields greater than the 10-year Treasury note yield would make excellent bond substitutes.

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patterns. Investors should therefore focus on companies that will benefit from higher pricing.

MONETARY POLICY RISK

Counterbalancing higher expenses for households and businesses are the ongoing stimulative monetary and fiscal policies seen in the US. Since the pre-pandemic era, or the end of 2019, the Federal Reserve has increased its balance sheet by $3.85 trillion. Additionally, the Fed's purchases of $120 billion of securities each month is open-ended. Unfortunately, much of this liquidity remains immobile within the banking system. Customer demand deposits at commercial banks increased $2.2 trillion in the same period and commercial bank reserves at the Federal Reserve have been on the rise. In other words, households are not consuming, and businesses are not investing, and cash continues to build within the banking system.

The injection of liquidity into the banking system is only one of the tools used by the Fed to stimulate the economy. The other tool is the fed funds rate. The effective fed funds rate was 0.06% at the end of June. The CPI closed June with a rise of 5% YOY. This combination means the real fed funds rate is negative 4.9% -- the lowest, and the most stimulative, fed funds rate seen in 70 years. It is also the lowest rate ever experienced during an economic expansion. An extraordinarily low cost of capital should inspire substantial investment and it has been instrumental in supporting a booming residential housing sector. But low interest rates have done little to inspire strong business investment or commercial loan growth. According to the Bureau of Economic Analysis, there was a rebound in domestic investment in equipment and software in recent months and hopefully this will be a sign of a better trend. Yet while the Fed's actions have not triggered significant business spending it has supported higher stock prices. And the combination of low interest rates, quantitative easing and fiscal stimulus should continue to support stock prices through the end of the year.

SPEED BUMP

Nevertheless, we would not be surprised if the Fed and the stock market face a speed bump in the second half of the year. The longer the Fed continues its easy monetary policy in the face of an expanding economy, the more it risks fanning the flames of inflation and instigating a stock market bubble. Therefore, we expect the Fed to change its policy sometime in the second half. The Federal Reserve's prestigious annual Jackson Hole policy symposium will be held on August 26 through August 28, and this may be the perfect opportunity for Fed governors to begin a discussion of lowering or ending quantitative easing and/or changing their forecast for higher interest rates. The significance of a Fed policy change cannot be underestimated. Since April 2020, Fed policies have been extraordinarily supportive of equities. Therefore, the Fed will face a challenge to convince investors that a change in monetary policy from easy to neutral is not the equivalent of a change from easy to tight policy or a hostile Fed.

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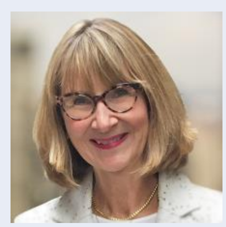

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All in all, an underlying prop for investors is apt to disappear later this year. While a shift in Fed policy could shake investor confidence in the next six months, underlying fundamentals should be able to soothe concerns. Equities are not wildly overvalued, and we do not expect the downside risks for stocks to be extreme if a correction materializes. In fact, earnings growth has been excellent this year. According to IBES data from Refinitiv, S&P 500 earnings grew nearly 53% YOY in the first quarter and in the quarter ending June 2021, earnings are expected to rise 65% from a pandemic-depressed second quarter of 2020. For the full year, IBES is estimating earnings will be $191.37, a gain of 37% YOY. For calendar 2022 the estimate rises to $213.76, a gain of 12% YOY. These are excellent numbers, and they currently translate into PE multiples of 23 times this year's and 20 times next year's earnings. PE's of 20+ are above the long-term average but are in line with multiples seen in recent quarters. However, if inflation continues at or near its current pace of 5% YOY, PE multiples are at risk of contracting substantially. For this reason, a shift in Fed policy, which would help temper inflation going forward, should be viewed as a positive long-term event – even if it produces a bump in the road.

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