Legacy Trust

Investment Perspectives

Mid-Year Market Update

July 2021

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Key Takeaways

- The global economy is recovering rapidly, although the pace differs based on varying vaccination rates
- Inflation has jumped near-term but many of the factors at play are tied to lingering effects of the pandemic
- Interest rates are still expected to remain lower for longer and fixed income investments are unlikely to provide returns above the rate of inflation
- Despite very strong recent performance, equities continue to look attractive based on the forward outlook for economic and earnings growth

The global economy continues to grow rapidly, as the U.S. has recovered back to its pre-Covid GDP level. Equity markets have continued to rally and corporate earnings growth has been strong. While valuations remain high, leaving the market vulnerable to short-term volatility, equities continue to be attractive as we look ahead to the next economic growth cycle that is just beginning.

The global economy is growing rapidly as consumer activity is returning to a more normal level. The recovery is far from complete, as international travel is still well below the levels seen prior to the pandemic and countries around the world still maintain travel restrictions. Nevertheless, the increase of spending in many large economies has led to a strong increase in overall economic growth. Unsurprisingly, reopenings and activity are proceeding at different paces across the U.S. and around the globe due to varying vaccination rates.

The U.S. continues to lead the global recovery, although momentum is picking up in the UK and Europe as these regions make progress on vaccinations. Expectations for emerging markets are less optimistic as the virus continues to spread in many developing countries, particularly India.

U.S. GDP grew by 9% annualized in Q2 and overall economic activity has recovered back to its pre-Covid level. Employers continue to add to payrolls, but it is clear that many firms are having difficulty in hiring to fill open positions. This labor shortage could be alleviated to some extent this fall through the expiration of expanded unemployment benefits as well as broader school reopenings.

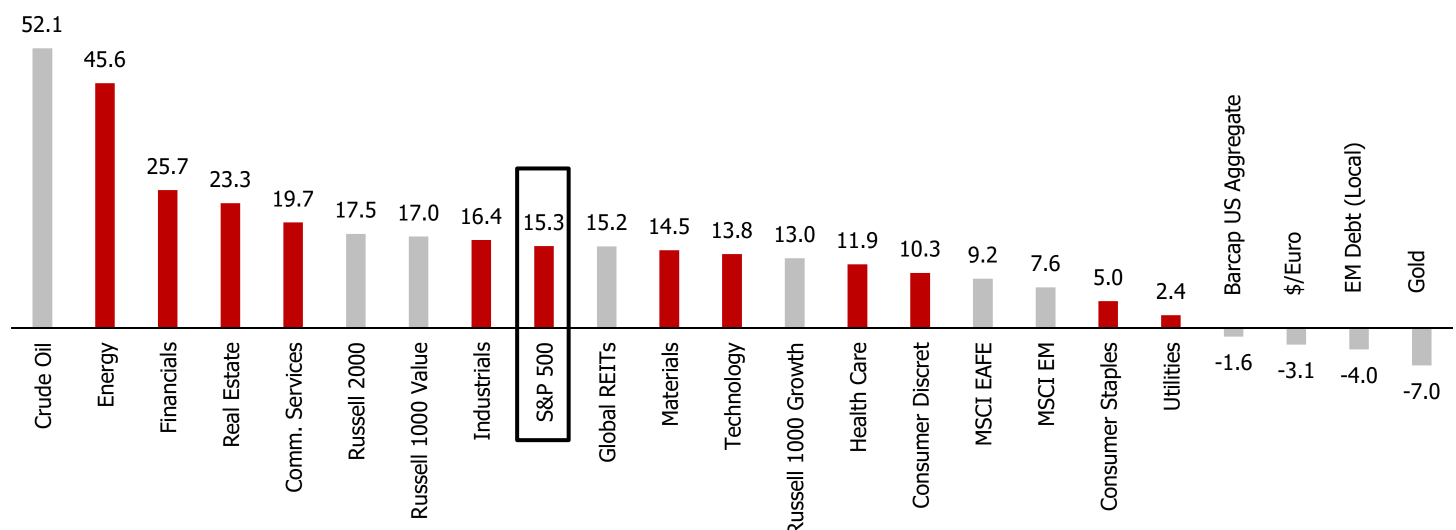
Inflation jumped in the second quarter, as anticipated. The Consumer Price Index is up 5.3% year-over-year, the fastest pace of growth since 2008. This spike in inflation has been driven partly by the effect of the year-over-year measurement that compares current prices to the low point of the recession last spring during the onset of the pandemic. Further, short-term supply chain constraints have also contributed to higher prices, but these are largely after-effects of the pandemic and are expected to moderate over time.

The biggest driver of the CPI increase was energy prices which jumped as activity and travel resumed. The price of oil surged and ended June at $73/barrel compared to $39 just one year ago. While oil could continue to move higher on stronger demand, it is unlikely to rise by the same magnitude moving forward. Used car prices have also been a substantial contributor to near-term inflation, which have been influenced by constraints in new car production due to the global chip shortage. Car prices are expected to moderate as these shortages are alleviated. Airline tickets and restaurants have also been large contributors to higher inflation as labor supply limitations have driven prices higher.

Despite higher inflation readings, interest rates have declined after rising dramatically earlier this year, potentially reflecting investor views that we may have reached a peak in inflation and growth expectations. In our view, rates have moved too low given the underlying economic strength in the U.S. and the continued recovery ahead, but even if the yield curve steepens again rates overall are likely to remain lower for longer and fixed income investments remain less attractive than equities.

Global equity markets gained 7.4% during Q2 and have posted double-digit returns year-to-date, with U.S. equities leading. The S&P 500 is up more than 15% YTD. However, the underlying make-up of the equity rally began to shift in mid-May. The first part of the year was led by the re-opening themes that took off last November, with cyclical sectors and smaller companies outperforming. Since the latter part of May, large cap growth stocks regained leadership and have outperformed their value counterparts into July. The decline in longer-term interest rates since mid-May hints that the market has become less optimistic about the growth outlook which has weighed on cyclical stocks.

Year to Date through June 30, 2021



Source: FactSet Research Systems
Bars in red represent sectors of the S&P 500

Despite the recent outperformance of large cap growth, we continue to believe that positioning for the ongoing cyclical recovery is appropriate. Small-cap stocks are valued more attractively than large-caps and cyclical stocks will benefit more from the improved economy as the virus continues to wane. While there is clearly a higher degree of investor fear and uncertainty surrounding the Delta variant, the fact that we have vaccinations broadly available that are able to handle this more contagious virus has vastly reduced the risk of widespread lockdowns being repeated. Accordingly, we believe this is a near-term setback but not a threat to the overall recovery.

Emerging market equities have lagged developed markets so far this year, largely due to underperformance by Chinese stocks which are up only 2% YTD. Chinese tightening and regulatory actions have weighed on the market. Meanwhile, other emerging markets, especially India, remain vulnerable to Covid-19 restrictions affecting domestic consumption due to low vaccination rollouts. Tensions between the developed world and China continue to escalate, creating a headwind for emerging market investments and U.S. companies with significant China exposure. We continue to favor domestic investments that will benefit most from the post-pandemic recovery.

Barring a major setback with the virus or vaccinations, earnings seem poised for strong growth over the next couple of years which is supportive for equities. The improvement in company earnings has helped to reduce valuations, but they remain elevated. While we expect a growth environment that will benefit equities for the foreseeable future, returns going forward are likely to be lower than average. Nevertheless, equities remain the best choice for growth and maintaining purchase power during a period where inflation is running higher than what bond investments can return due to the low interest rate environment.