# Investment Commentary

July 15, 2021

**The Pandemic**

The pandemic is slowly fading but concerns remain over the large number of unvaccinated and the spread of the Delta variant. With new mutations discovered every few weeks, many scientists predict Covid will continue circulating around the world for the next two to three years. Public health measures will need to be reintroduced on an ad hoc basis for the foreseeable future.

While high vaccination rates in the U.S. and the warm summer months have bought some extra time, outbreaks across the world are giving a preview of what is to come this fall. Certain parts of the country will reintroduce mask mandates, distancing and occupancy limits. But there will be no repeat of 2020 lockdowns.

**The Economy**

In the first half of this year the financial markets were expecting strong economic growth from government stimulus and passage of infrastructure legislation. Long and intermediate term interest rates moved up and economically sensitive value type stocks performed well. In recent weeks rates have moved back down and the bond market now seems to be factoring in a slower economy in coming months.

While infrastructure legislation appears to be stalled, it will likely pass in some form. There is a long lead time for infrastructure projects so the legislation may not provide much of a boost to the economy in the near term. This appears to be built into the financial markets.

Supply chain disruptions show not sign of abating. The manufacturing sector continues to see rising cost pressures due to workforce shortages and demand exceeding supply. Finished goods manufacturers continue to experience bottlenecks in the supply chain. Until there is more stability in the workforce, the bottlenecks will continue.

The red-hot housing market of the past year is starting to slow down. More houses are now coming on the market. The market is still hot with strong demand buoyed by low interest rates but is not a frenzy anymore. Growth is likely to slow over the next year and then market will look more like a normal market.

**Inflation Expectations**
Inflation spiked up this year but has started to subside. It is likely to drift back down to the 2.0% or less level of the past 12 years. However, there is a case to be made that inflation will drift higher going forward based on the following factors:

- The benefits of globalization and its effect on reducing inflation appear to have been largely spent. Protectionism is rising globally and tariffs are increasing. Lower prices experienced over the past several years are now being reversed.
- With most baby boomers now retired, the U.S working-age population will slow. A rising ratio of non-workers to workers adds to inflationary pressures.
- The rise of e-commerce has had an effect in reducing inflation over the past several years. But e-commerce has matured and will not show significant reductions in pricing going forward.

Any increase in inflation will likely be in the 2.0% to 3.0% range which is still below historical levels. The Federal Reserve Bank sees the current level of inflation as temporary and will not tighten monetary policy anytime soon.

**The Stock Market**
The stock market has performed well so far this year with a return of 16%. The improving economy along with low interest rates continue to provide a good environment for stocks. Value style stocks performed well in the first half while large cap growth stocks have recently started to outperform yet again.

The stock market should continue to perform well going forward but it depends on actions by the Federal Reserve. As long as the Fed maintains “quantitative easing” (buying bonds in the open market) and low short-term rates, stocks will continue to have an upward bias.

Large cap growth stocks will continue to outperform value stocks and the overall stock market in coming months due to slower economic growth and continuing low interest rates.

The Biden Administration has issued an anti-trust executive order that will consider closer regulation of big tech companies. This order directed the Federal

Trade Commission to closely examine the rise of dominant internet platforms, especially those that target growing competitors, offer free products or collect user data. This describes three dominant companies, Amazon, Apple and Facebook. So far the technology sector has brushed off the news. But the effects of more government scrutiny along with overvaluation could slow the tech sector which has been the driving force for the overall stock market.

**International Stock Markets**
Europe has lagged the U.S. in response to the pandemic and associated economic downturn. Their stock markets have underperformed and currently represent good value. As their economies catch up those stock markets could begin to outperform an overvalued U.S. stock market in coming months.

Emerging markets stocks are likely to underperform in the near term due primarily to the Chinese stock market. China, which accounts for almost 37% of the MSCI Emerging Markets Index, poses one of the biggest risks to the broader index. Government scrutiny of the big internet and technology companies has depressed the overall Chinese stock market and there is likely more to come.

**The Bond Market**
In the near term, the bond market has discounted higher inflation and has built in a slower economy in coming months. Long and intermediate term rates could drift higher later on this year but not significantly.

After reaching a high of 1.75% this year, the 10 year U.S. Treasury Note yield is currently 1.30%. The yield could drift back up to 1.75% or even 2.0% in coming months, depending on growth in the economy and actions by the Federal Reserve Bank.

As a defensive measure, for investment grade bonds, it is prudent to consider reducing the allocation to intermediate term bonds in favor of short-term bonds. The yield is not much lower but the potential downside is less if interest rates move up.

**Real Estate**
Real estate investment trusts performed well in the first half of 2021. But there has been a divergence in the performance of various sectors. Self-storage, residential and even regional malls bounced back significantly so far this year. Data centers, lodging/resort and office REITS have not performed as well. Further gains are likely to be modest.

**Cryptocurrency**
After a sharp move up to over $63,500, Bitcoin has dropped to nearly half that amount. This could be a near term bottom in the market with a bounce back up. But this is a very speculative market and it is difficult to know whether the next $5,000 move is up or down.

**Overall Perspective**
Investment portfolios are performing well in spite of a higher than normal level of uncertainty. The bond market will not provide much return for the foreseeable future. But the stock market should provide decent returns for the next two to three years, as long as interest rates remain low.