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Innovative Thinking + Smart Strategies

2021 Midyear Commentary

Scorecard and Outlook

MV Financial Research & Strategy Group

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I. First Half Review and Scorecard

Every January we publish an annual outlook where, among other things, we offer some views about what might be in store for markets and the economy in the year ahead. Last year we – along with the rest of the known world – got kind of sideswiped on this. All those predictions in the middle of January were upended by the coronavirus pandemic that followed shortly thereafter. The year turned out to be nothing like what anyone would have reasonably thought. And even if you could have guessed that a virulent disease would sweep the globe and bring the world economy to its knees, you would be forgiven for not guessing that world stock markets would stage a rally for the ages in its wake. Or that the country where the pandemic began – China – would snap back so quickly that its actual GDP growth for 2020 was barely different from where economists had predicted it would be before the pandemic hit. Or any number of the year's other bizarre twists and turns.

Fortunately, the current year has been a bit kinder to prognosticators than the previous one. Nonetheless, we think that a midyear review makes sense as a way to check back in with what we were thinking about six months ago. What has changed in our thinking, and what has not changed? This document has two parts. This first part will be something of a scorecard, where we unpack the core elements of our investment thesis from January and measure it against actual outcomes from the first half of the year. The second part will be an outlook, giving you a sense of what is on our mind today as we look ahead to the remainder of 2021. Here we go.

Our January Thesis: Scorecard

Here is a word-for-word replication of the core investment thesis we published in our annual outlook in January:

Low short-term interest rates and supportive monetary policy should continue to be a tailwind for risk assets as the global economy finally transitions from the pandemic to a resumption of consumer spending on the things we all missed for the last twelve-months plus (assuming mass scaling of vaccinations is achieved at least by sometime in late summer). The low rates plus upbeat prospects for corporate earnings should keep valuation concerns more or less in check, though there may be more upside room for less stretched corners of the market like value, small cap and non-US than for the growth darlings of the past five years. But intermediate and long-term interest rates have the potential to steepen (and are less influenced by central bank actions in the absence of an explicit change in standing policy). One potential near-term risk to market upside could be an unexpected surge in inflation. The entrenched groupthink of the bullish consensus itself could also be a risk if it leads to unwarranted overconfidence. Watch out for imprudent enthusiasm by those who fail to distinguish innovation from hype. Longer-term structural risks are less likely to have a direct material impact in 2021, but they are nonetheless present (let 2020 be a warning for the tyranny of the unexpected).

We're going to go through each of the views expressed in this thesis.

i. Short-term rates and supportive monetary policy

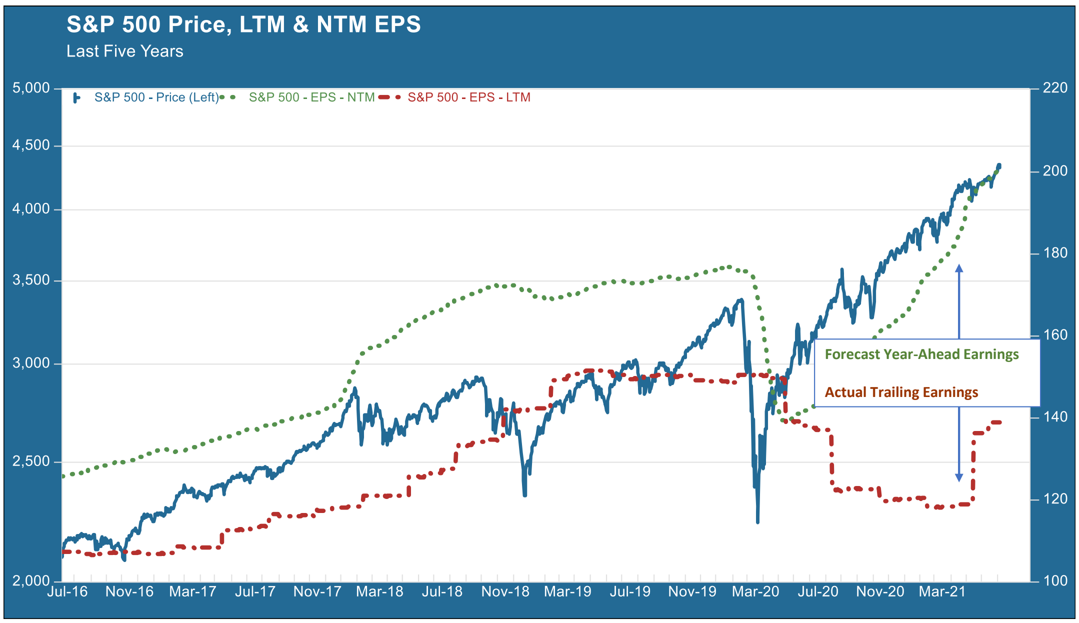
Pretty much as advertised. The Fed has made it clear that it intends to provide a supportive monetary policy until we are well into a full economic recovery. Short term rates today are exactly where they were in January, i.e. at a zero lower bound with the upper end of the range for the Fed funds rate, the overnight lending rate the central bank controls through its monetary policy operations, at 0.25 percent.

The Fed has a dual mandate: to promote stable prices and full employment. The bank has made it clear that the way it interprets that mandate in 2021 is to focus on getting employment back to, or at least close to, its pre-pandemic level. The headline unemployment rate, U-3, was 3.5 percent in February 2020 (it stands at 5.9 percent according to the latest report by the Bureau of Labor Statistics issued on July 2). The corollary to this is that the Fed will overlook any near-term increase in inflation (i.e. months in which reported year-on-year core inflation exceeds the two percent target).

Inflation has indeed recently spiked above two percent and there is much discussion about what that might mean for the Fed's policy timetable. We will come back to this point in the second half of our report below.

ii. Corporate earnings keep valuations in check…

This one wasn't too hard to predict. Earnings for S&P 500 companies fell by more than ten percent in 2020, with the big pullback happening in the second quarter as the economy went into lockdown. The year ended with vaccines having been approved, a new round of fiscal relief payments going out the door (with yet another one to follow shortly thereafter) and thus plenty of evidence that earnings had nowhere to go but up. Earnings grew by 52 percent in the first quarter of this year (from the same quarter of the previous year) and are expected to grow by a full 35 percent for the year as a whole. As the chart below shows, trailing twelve months earnings (in crimson) jumped in the first quarter while forecasted earnings (in green) imply lots more growth to come.



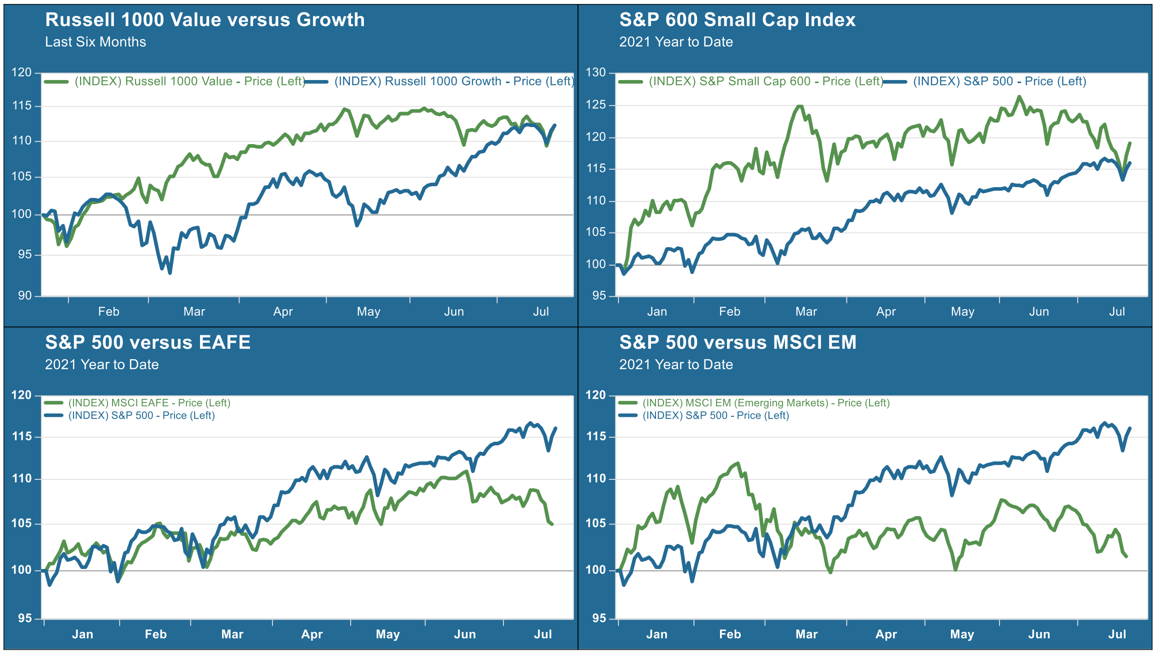
Source: MVF Research, FactSet

Equity prices, of course, have been rising steadily for more than a year and valuations remain not too far from historic highs. But at least the presence of fast-rising earnings keeps the price-earnings ratio, widely used as a valuation benchmark, from getting too much further into the stratosphere.

iii. …But there may be more upside in the less pricey corners of the market

Well, just a bit, maybe. But not really. Trying to outperform the Nasdaq Composite, the Russell 1000 Growth or other repositories of the high-flying US tech sector and its fellow travelers has been a pretty thankless task for most of the past ten years, and not even the ever-cheaper valuations have made the job any easier. That dynamic looked like it might be changing for a sustained period of time starting late last year with the so-called "reflation trade" that progressively gained steam throughout the post-election period. The thinking was that the new administration would unleash a torrent of new fiscal relief/stimulus money into the bank accounts of households and businesses right at the same time as post-pandemic demand started to surge – conditions for a textbook case of inflation.

Fundamental reasons why this reflation trade would work for the benefit of areas of the market like value or small cap stocks while punishing growth shares seemed to be less important than the simple fact of newfound momentum behind these chronic underperformers. As the first quarter unfolded, so-called factor investment strategies based on momentum found themselves buying more value and small cap names, which in turn reinforced the momentum effect in a positive feedback loop. Again, though, this dynamic played out largely without any kind of structural shift in underlying fundamentals. With the second half of the year now underway, the value performance edge has all but disappeared. Small cap retains an edge but that too has been shrinking. As for non-US shares, another long-underperforming area, performance thus far has lagged in both the developed and emerging markets. The chart below illustrates these trends.

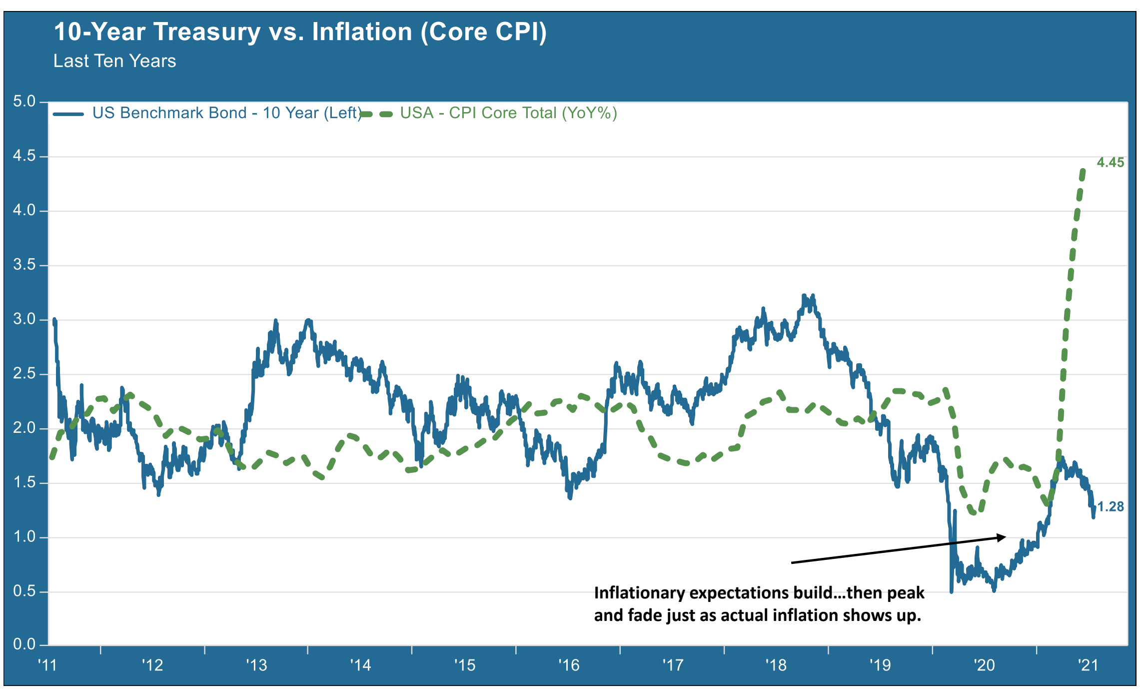


Source: MVF Research, FactSet

On balance, we would have to say that the results are inconclusive. The market has been relatively indifferent to valuation differences between different asset classes for some time now, and the first half of this year does not appear to have changed this sentiment much.

iv. Intermediate and long-term interest rates have the potential to steepen

Rates went up by quite a bit earlier in the year, leading to one of the worst performances by long-dated high quality fixed income securities in many years. Inflationary expectations again were the main culprit:



Source: MVF Research, FactSet

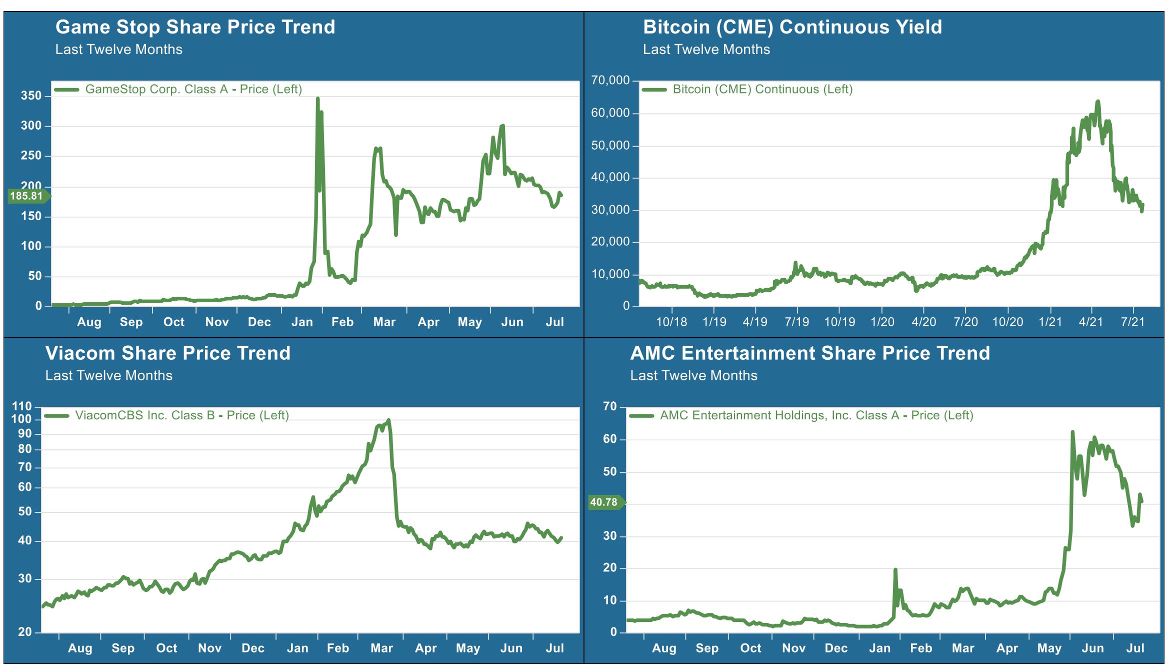
The interesting thing about the strong rise in bond yields during the first three months of the year is that they – correctly, it seems – anticipated a near-term surge in inflation. But once the actual inflation numbers stated to come in higher, first with the April report published in May, rates started to decline. Even more paradoxically, the decline in rates accelerated after the June meeting of the Federal Open Market Committee (FOMC). That meeting drew close scrutiny from investors because several members of the committee indicated, in the Fed's published "Summary of Economic Projections," their expectations for the Fed to start raising short-term rates again before the end of 2023. Such a move would happen, presumably, if the Fed was taking the inflationary threat more seriously than its earlier stated position – in which case the rational expectation would be that intermediate-long term rates would move higher.

Rational expectations, as hopefully we have all learned by now, are not a useful metric for observing what markets actually do, as opposed to what the finance textbooks say they ought to do. There could be any number of reasons why bond prices rose (i.e. yields fell) as the market absorbed the impact of the monthly inflation reports and the June FOMC meeting. Perhaps the most likely one is simply that if the Fed does move to raise rates on a more accelerated timetable than previously anticipated, it will shorten the duration of the economic growth cycle and thus raise the profile of traditional safe haven assets – like high-quality bonds – at the expense of the cyclical equity market sectors that (as noted in the previous section above) started to underperform the overall market. Alternatively, the fall in yields may prove to be a technical rather than a fundamental shift that will revert in due course as inflation continues to grow in the months ahead.

v. Complacency, groupthink and irrational exuberance

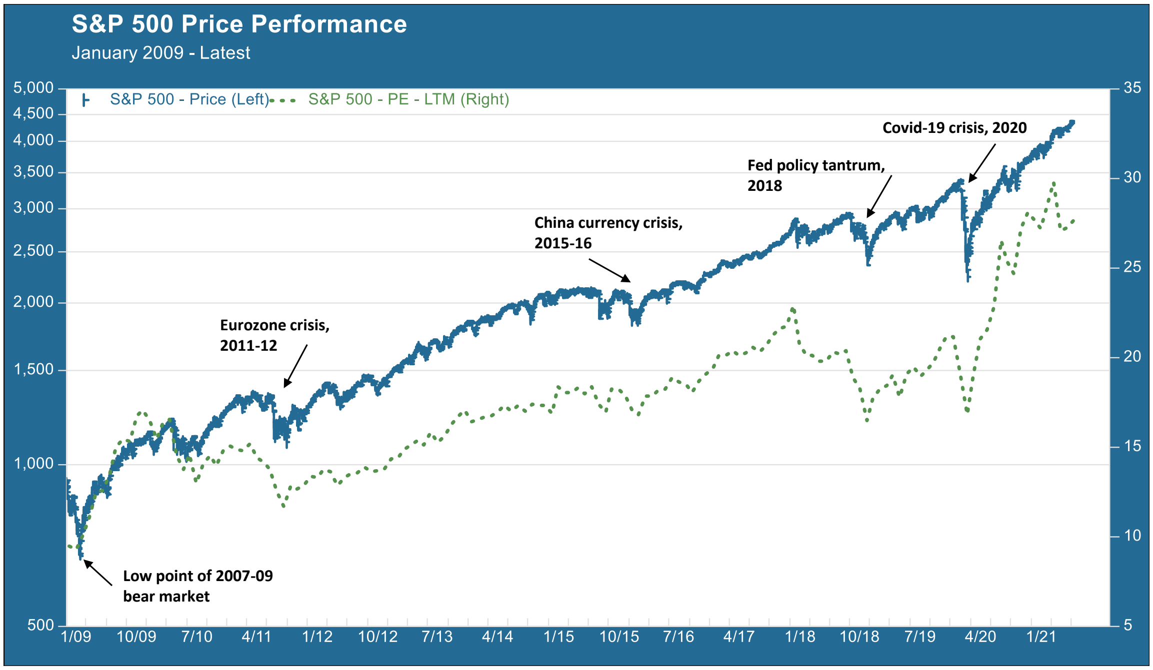
The final point from our January thesis we will note here is the potential risk of giddy overconfidence finding its way into ill-advised enthusiasm for highly questionable investments. In our annual outlook we spent several pages talking about bitcoin and other decentralized cryptocurrencies, warning about the dangers of investing in something with no value apart from other people saying it has value. At the time, bitcoin was trading around \$35,000, on its way to nearly doubling that already overhyped level, bitcoin topped out around \$64,0000 before falling back to either side of \$30,000, where it sits in a fragile state today.

It turns out that bitcoin was far from alone in being the object of a speculative frenzy. The first quarter of 2021 saw the flowering of the "meme stock" – shares of generally third-rate companies soaring to incomprehensible heights on the basis of overactive neurotransmitters frenetically careening all over social media.



Source: MVF Research, FactSet

We have made the point a few times in our regular weekly market commentaries that the bull market that began in 2009 didn't end when the coronavirus panic pushed the S&P 500 down 34 percent from its previous high. Yes – that was technically the "end" of the bull, but it really was more of a brief – if deep – pullback similar to a handful of near-bears that cropped up over the course of the 2010s. You can see what we mean from the chart below.



Source: MVF Research, FactSet

The post-Covid rally, and particularly the fascination with junky meme stocks and cryptocurrencies (not to mention non-fungible tokens bestowing gilt-edged asset values on those cat videos that have circulated around the Internet for the past twenty years) filled in the final missing piece of this long bull market: the irrational exuberance that usually serves as the final stage of the growth cycle. This is a good note on which to end our review of what has been, and look ahead to what may be in store for the rest of the year.

II. Second Half Outlook

It's quiet out there. It's too quiet.

That corny line from who knows how many old suspense movies seems to fit the moment in the early weeks of the year's second half. Financial news commentators, grasping for something new to talk about in their daily recaps, trumpet every new record high in the S&P 500 or Nasdaq Composite as if something unprecedented were happening. Those new highs, on most days, come about as the index lazily drifts up by a couple tenths of a percent from where it opened. Not much more exciting than watching grass grow – but they have to have something to talk about.

But nothing stays the same forever, and we know from past experience that today's serenely calm seas can turn into a raging tempest in no time at all. With that in mind, here is our outlook for a few things that have the potential to impact performance for the rest of the year. We'll check back in in six months to see how we did. Always remember that any prediction about the future is subject to any number of unknown variables that could render it worthless. As we said in our annual outlook in January: "let 2020 be a reminder of the tyranny of the unexpected." We're not predicting another pandemic, a cyberterrorist shutdown of the electrical grid or a particularly destructive climate-related event, but we know that those threats are always present. On these, especially, we hope our prediction of them not happening will ring true.

Midyear Outlook

i. Core inflation will be closer to 2 percent than 3 percent by the middle of the fall

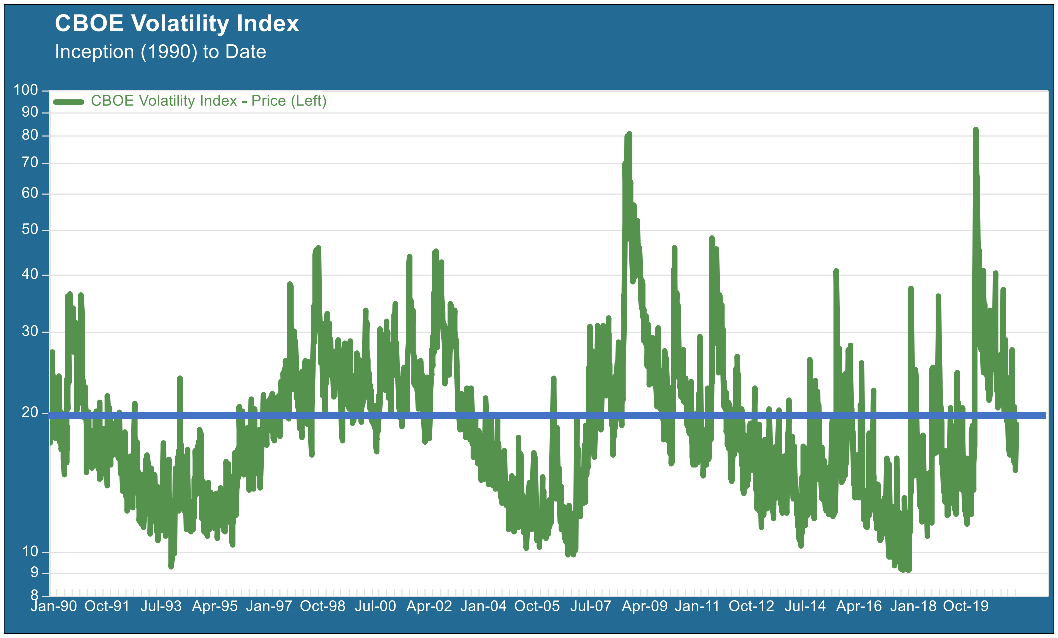
We're kind of out on a limb on this one, with inflation currently running well ahead of three percent. There are two reasons why we think that we are probably close to or even past peak inflation at present. First, the biggest drivers of month-to-month consumer price increases now are items that either are rebounding from near-total shutdowns during the pandemic, or are caught up in dysfunctional supply chains. Used cars are the marquee item here: in the month of June alone the price of used cars increased by more than ten percent. There are a number of interwoven factors here including the persistence of a global shortage of semiconductor chips (which has a more direct effect on the supply of new cars but has a knock-on effect on new cars) and dealer inventory levels that were sharply reduced during the pandemic. These hiccups are not permanent, and while it is unlikely that all the kinks will be worked out of the supply chain before the end of the year, we do believe that supply and demand will come more closely into balance before then.

The second reason behind our peak inflation prediction is the fact that the Fed keeps saying that it is. No, we don't ascribe any kind of magical powers to the men and women of the Eccles Building, but we do understand that actual inflation is very much based on expectations. Simply put, prices can rise for no other reason than that enough people think they are going to rise and take actions accordingly. This is what developed over the course of the 1970s. It took drastic action, in the form of then-Fed chair Paul Volcker's interest rate hikes, to snuff out persistent expectations for high inflation. This time around, the Fed is trying to front-run the need for a repeat of the Volcker years by driving the point home over and over that the factors driving inflation today will prove to be temporary. They (and we) may not be right, of course, but so far the data seem to be validating the Fed's argument (and they keep on making it, to try and leave no room for doubt).

ii. Mostly low volatility, but good odds for a meaningful pullback

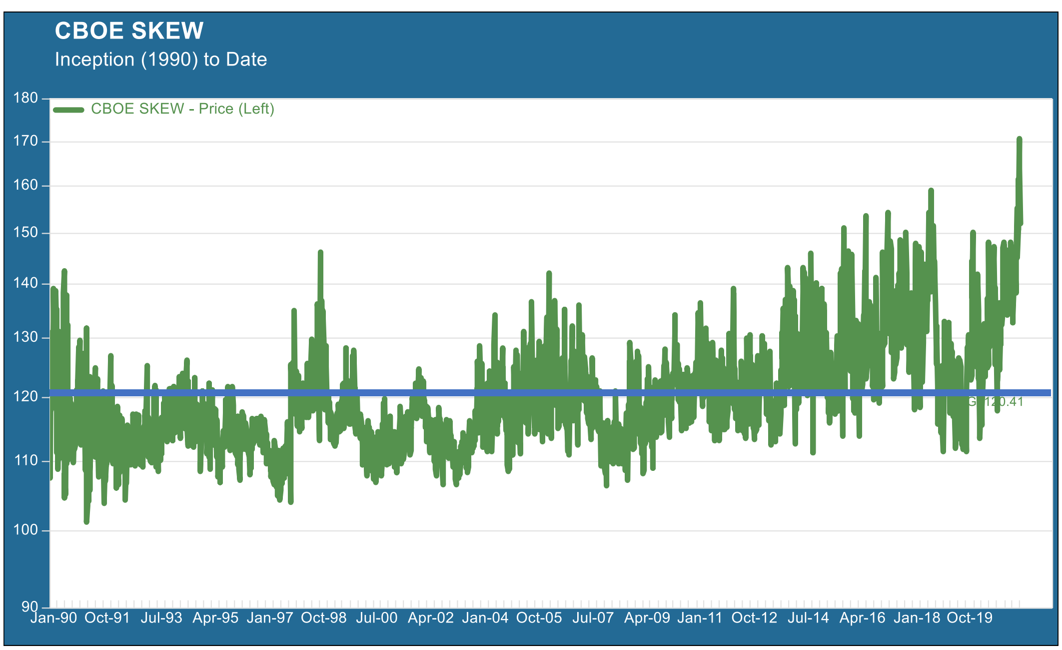
Market volatility has settled down recently, after persisting at very elevated levels well after the worst of the 2020 market crash had passed. As we noted above, conditions in asset markets are remarkably quiet at present. The counter-rotation out of the reflation trade that started in mid-May was pretty subdued, with performance leadership quickly falling back to those old favorites of the last decade, the mega-cap tech and digital entertainment stocks. Subdued interest rates could be telling us several things – that we are heading back to a world of slow growth and Fed dependence, or that investors are seeing high quality bonds as a safe haven against risks in other asset markets, or maybe a bit of both. Other traditional safe haven assets like the Swiss franc and Japanese yen have also been performing strongly in recent weeks.

There are different ways of measuring risk, of course. One of the most widely used for US stocks is the CBOE VIX index. The VIX measures the cost of buying protection against equity market risk in the form of put options. The higher the VIX, the higher the level of market risk by this measure. Since its inception in 1990 investors have used a VIX level of 20 or higher as a "fear gauge." As you can see in the chart below, the VIX fell below that fear threshold in the early part of this year, after being above it consistently throughout the pandemic in 2020.



Source: MVF Research, FactSet

CBOE (which is the Chicago Board of Options Exchange) operates another risk index which doesn't get as much visibility as the VIX but which tells a different story. The CBOE SKEW measures the cost of positioning for extreme events via derivative; at one end, levering up for an explosive market rally, and at the other end buying protection against a market crash. The chart below shows the SKEW's performance since its 1990 inception.



Source: MVF Research, FactSet

As the chart shows, the SKEW recently hit an all-time high and remains well above its long-term average of 120. The higher the SKEW number, the more investors are paying for protection against a dire crash than they are gearing up for a major bull run.

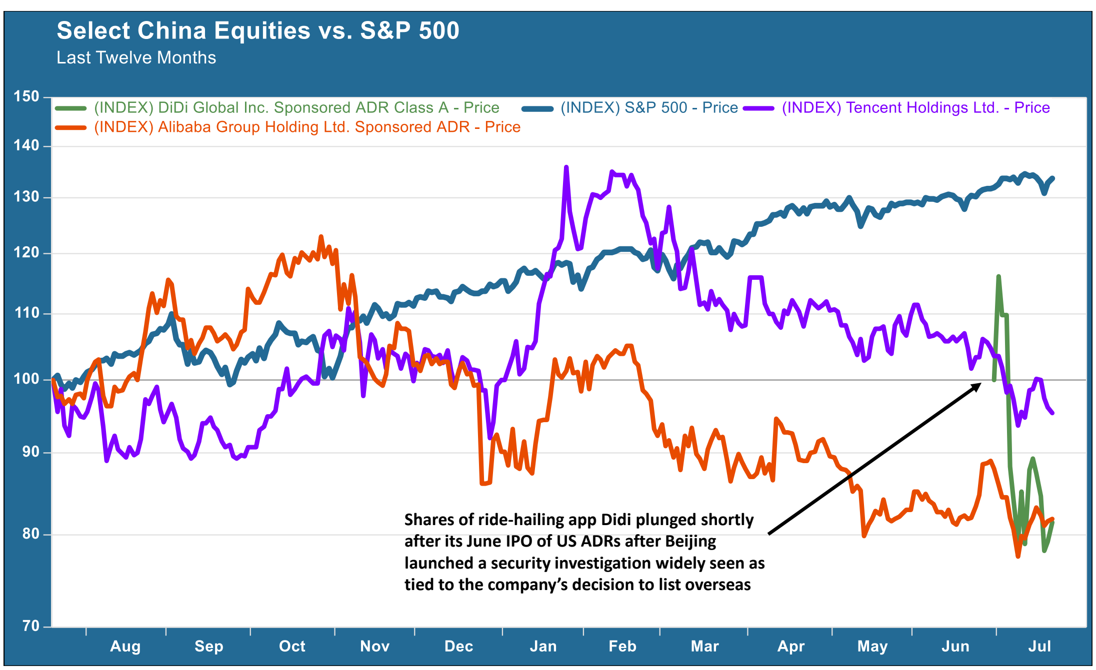
We should note here that the SKEW is a distinctly poor metric for predicting a crash; not once in the three major drawdown periods of its existence – the dot-com crash of 2000, the financial crisis of 2008 and the pandemic of 2020 – did the index give any kind of clear warning about the impending disaster. That doesn't come as much of a surprise to us. Investors' collective sense of timing about major market moves tends to not correlate very well with the actual events.

The insight that we take away from the SKEW is the idea that a great many investors see the current environment as fragile. This aligns with a view we support and discussed earlier in this report: despite the fact that we experienced a technical bear market in March 2020, we are not in the first year of a new bull cycle as much as we are in the final stage of the long bull run that began in 2009. We came close to a bear market twice during this period – in 2011 and 2018 – before finally going over that 20 percent drawdown threshold in 2020. Each of these drawdown periods was brief in duration, and each recovery was premised almost entirely on the assumption that the Fed would do whatever it had to in order to prop up asset prices.

Late-stage bulls are fragile creatures, never far from any given day when a few random news headlines converge and trigger a massive knee-jerk selling wave. We think the odds are pretty good that we could see one or two before the year is over. However steep in magnitude they might be, though, we think the chances that they would morph into an actual structural bear market before the end of the year are fairly slim.

iii. China may be the geopolitical story that bites

Markets tend to ignore geopolitical conflict. But the US-China relationship, which we believe is the single biggest geopolitical issue in today's world, has the potential to be the exception to this rule. The relatively weak performance of Chinese equities in the year thus far, shown in the chart below, is not all or even mostly due to the deteriorating political relations between the two countries. Domestic economic factors and global momentum trends are also at play. But there are indications that some kind of decoupling may be under way between the two countries, with trillions of dollars of foreign investment in the balance.



Source: MVF Research, FactSet

In late June Chinese ride-hailing app Didi Chuxing launched an initial public offering of American Depositary Receipts (ADRs) for trading in the US. Almost immediately the company was caught up in the crosshairs of a security investigation by Chinese regulators, sending the company's newly-issued shares tumbling more than 20 percent. The coincidence of Beijing's heavy hand and a foreign securities listing was hardly by chance; investors well remember the debacle surrounding Ant Group, a Chinese financial technology company owned by tech colossus Alibaba that was scheduled for an IPO last November. That deal was scotched when the financial regulators came up with some new laws on the eve of the election effectively rendering the Ant Group business model non-operative. The problem appeared to have less to do with any newfound insights on the part of the regulators and more with the Chinese Communist Party's displeasure with Alibaba head Jack Ma and some recent comments of his deemed critical of the party.

The potential decoupling of share listings is by no means one-sided. US securities regulators have long complained about disclosure exemptions given to Chinese companies listing US ADRs. There is a growing sentiment in Washington that, the country's colossal economic firepower notwithstanding, it is high time to impose tighter restrictions on these companies or boot them off the US exchanges. That in turn has major implications for just about any mutual fund or exchange-traded fund with any emerging markets exposure.

Nor is it necessarily the case that a major decoupling of these two asset markets would be a bad thing for China's access to capital. Mainland China has built up a highly sophisticated financial infrastructure in Hong Kong over many decades now, even preceding the island territory's handover to the mainland from Great Britain in 1997. In the past couple years China has moved aggressively to end the so-called "one country, two systems" framework that was supposed to have lasted for 70 years after the 1997 handover. If the country's most promising companies can't list in New York, there is always Hong Kong. Foreign investors, as always, will vote with their wallets and self-interest before offering any kind of principled resistance to accumulating more Chinese assets.

iv. All the Rest

We have focused on three things in this section because we believe each of them to be reflective of different currents of activity that could influence market activity in the coming half year: economic (inflation), structural (market price volatility) and geopolitical (US-China). Obviously that is just a small slice of all the variables at play, any of which could prove to be decisive influencing agents. The Fed, the European Central Bank and other monetary policymakers will try to keep their dirigiste model running effectively as they try to steer the global economy back to full health. Germany will have a consequential election in the fall that will set a new tone for the country as Angela Merkel steps off the stage. The pace of economic recovery will remain uneven as much of the world deals with new Covid variants while trying to bring up their presently low vaccination rates. Companies in most industries are still trying to understand how their product markets have changed since the pandemic and what their new competitive challenges are likely to be. Speaking of competition, there is a discernible change taking place in the US with regard to antitrust regulations. After four decades of laissez-faire towards big companies getting ever bigger through acquisitions, the Biden administration is sending out signals that antitrust is back. The giants of Silicon Valley and Seattle may be in for some interesting times ahead. We imagine we will have more to say about this when we sit down to write our annual outlook next January.

Until then, the twists and turns of the second half await to unfold. Back to work we go.

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