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Second Quarter 2021 Market Commentary

Equities

Stocks move higher led by growth, while COVID variant causes recovery jitters

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July 8, 2021

COVID spawn, what's that variant goin' on,

Could it shut down travel spots like days gone by?

And did I hear you say, higher prices are here to stay,

Hope stocks keeps climbing to the sky!

Apologies to Alex Harvey
"Delta Dawn"

Stocks jumped to record highs in the second quarter as the S&P 500 turned in its strongest first-half performance since 1998. Continued post-pandemic economic acceleration, decreasing unemployment and low interest rates buoyed investors' spirits and fueled the equity market gains. While most major sectors and styles were higher, there was significant dispersion in performance with a rotation back into the perceived "safety" of large cap technology and other higher multiple growth equities and out of cyclical related issues tied to the post-pandemic economic recovery. The shift to growth intensified as investors grew uneasy that the global economic rebound could be upended by the spread of the fast-spreading COVID-19 Delta variant, labor and supply shortages, or the possibility of the start of less-accommodative monetary policy. Despite these rotations between sectors and styles, I am pleased to report our equity-oriented and balanced accounts participated in the market advance and generated competitive results.

While the S&P 500 registered an 8.55% gain, technology (+11.38%) and Communications (+10.88%) were the only major sectors to outperform the Index in the second quarter. Energy stocks and Real Estate also achieved double-digit gains, but represent only 2.33% and 2.41% respectively, of the broader index. With large sectors like Consumer Staples gaining only 3.09% and Industrials 4.33%, there were plenty of ways to underperform. Ten (yes one third!) of the 30 Dow Industrials lost value, with Intel's value chipped by 12.3%, Caterpillar crawled to a 6.1% loss, Boeing descended 6.0% and Walt Disney lost a mousey 4.7%. Twelve of the Dow mighty gained less than the S&P 500 and only eight were rewarded with double-digit gains. In short, don't let the over 8% S&P 500 gain fool you, as the Russell 1000 Index gained only 5.88% and the Russell 2000 index of small cap stocks eked out a modest 2.32% gain.

Technology and Communications issues now represent over 38% of the market, so their performance drives the S&P market benchmark. The top 5 stocks in the index (all technology stocks) comprise 19.8% of the entire market and have a greater impact on the capitalization-weighted index than the 350 smallest companies! While we own some of these mega-capitalization tech issues, we have them sized appropriately for client portfolios. In addition, we are cognizant of the growing regulatory pressure these companies are facing with legislative bills currently in the works that take aim at limiting their power and making it easier for the government to sue to break them up.

The broader economic recovery remains in place. Demand remains robust for housing and autos and spending continues to rebound for travel, entertainment, and other businesses that were closed or limited by the pandemic social-distancing rules. Unfortunately, the surge in post-pandemic demand is causing shortages of products and raw materials, and production bottlenecks at manufacturers resulting in higher prices. Furthermore, shipping costs have soared as freight companies struggle to keep up with demand. Lastly, finding workers has become increasingly difficult, as many unemployed continue to earn more by not working than when they were employed. I can almost hear Dire Straits sing, "Money for nothing and you can live rent free". That largesse will end soon as the strong demand for workers has caused many states to begin to limit or end the expanded unemployment benefits.

Initial jobless claims fell to a post-pandemic low of 364,000 a week ago and June's non-farm payrolls increased by 850,000 with average wage gains on a year-over-year basis of 3.6%. Nonetheless, the unemployment rate in June ticked up to 5.9% and Federal Reserve officials noted in recent weeks that overall employment numbers are ten million below the pre-pandemic level. As such, they see plenty of slack in the economy and are willing to be accommodative well into the next year.

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As noted above, inflation is rising, and wage and input costs have accelerated dramatically in recent months. Housing prices have leapt 14.6% on an annual basis through April, the fastest rate since S & P Core Logic began tracking them in 1987. The Federal Reserve is betting that this inflation jump is “transitory” and is willing to accept higher short-term inflation readings until we get nearer to full employment. As such, you can expect continued news reports and stories of companies raising prices and wage pressures building. In recent weeks, Chipotle Mexican Grill announced it is raising prices by as much as 5% and food manufacturers Campbell Soup, J. M. Smucker and General Mills announced they are raising prices due to higher costs. General Mills’ CEO noted that the company “expects the highest level of input cost inflation in ten years during the current fiscal year.” Cargo shipping rates from China to the West Coast have jumped 66% since January and are up more than 400% since the beginning of 2020 (source: Freightos Baltic Index), while FedEx has raised prices and actively culled certain customers as it struggles with labor costs and surging demand. As mentioned last quarter, chip shortages and strong demand have led to a dearth of cars on dealer lots and a surge in prices for new and used autos. Those conditions have not abated, and Ford just announced it will be forced to reduce output at a half dozen factories in July and Jaguar Land Rover recently noted that second quarter sales will be 50% worse than initially thought. The lack of supply is pushing prices higher with widespread reports of buyers paying well over MSRP for cars.

Given the $4.5 trillion of fiscal stimulus measures passed since March of 2020 and the current strength of the economic recovery, it might be surprising to learn that there is a push to pass a bi-partisan infrastructure bill to fix roads and bridges and provide money for other government programs. Creating and passing legislation in Washington is like making a hot dog or sausage – you know what you want it to look like at the end, but if you knew the gory details of how it was made you might be disgusted. Expect lots of ups and downs in the months ahead as the fighting factions try to have their imprint and ingredients in the sausage making, but in our opinion, some deal will happen that will leave everyone with a case of indigestion. Importantly, the process will end with more demand for products and services made in America and created by American workers.

More fiscal spending could add to the inflationary pressures the Federal Reserve is convinced are transitory, but should we question or worry about the long term? Yes, that’s our job. We worry about not just what could and should happen, but what happens if the prevailing wisdom is wrong and how it could affect our clients’ portfolios. While financial stocks have been battered by the lower-rates-for-longer thinking, we believe the risk reward for them is compelling at current levels. If inflation proves to be more sustained, the group could provide significant upside from here.

In the pandemic era, companies spent massive amounts of money to be able to operate remotely. Traditional spending on capital projects and long-term capacity additions were shelved. Now, as companies see surging demand and a return to normalcy, they need to play catch up to expand capacity and upgrade equipment. One sign of this happening is

United's announcement last week of its largest purchase ever for $30 billion of Boeing and Airbus jets. It is quite the change from a year ago when the skies were nearly empty, and investors were wondering which major airline would fail and if Boeing would survive without Federal aid. Now, the concern is with demand so strong, how will producers manage surging manufacturing activity?

The ISM manufacturing index for June of 60.6 indicates demand is robust (anything over 50 signifies expansion), but 17 of 18 manufacturing industries noted they were suffering from slower deliveries due to raw material or input shortages. The Architectural Building Institute's index of activity has jumped, while new project inquiries have soared. Kermit Baker, the Chief Economist for the American Institute of Architects summed up the current situation succinctly, "Despite ballooning costs for construction materials and delivery delays, design activity is roaring back as more and more places reopen." We own a variety of companies benefiting from the accelerating demand for capital spending projects across a host of industries, with many still selling at attractive valuation levels.

Energy prices have rebounded dramatically in recent months as demand for gasoline and energy products has improved and OPEC has managed to add production capacity in a disciplined manner. Rebounding demand for rigs and oil services will help not just the energy sector, but other industrial manufacturers as well. We continue to maintain positions in the energy sector due to their attractive yields (now seemingly safe once again) and conservative valuations. We understand that the sector is hated and a target for environmental groups, but many energy companies are improving their business practices and transforming their business models. We think it is worth keeping some Rodney Dangerfield's in your portfolio; aka "No respect" stocks.

A recovering economy, increased employment and surging demand for capital equipment will provide a tailwind for corporate earnings. The million-dollar question remains "at what price or multiple should those earnings be priced?" Nobody can say for sure, and multiples can stay at historically-high levels with interest rates at historically-low levels for a long time, but we doubt valuations can move meaningfully higher from here. The Fed's pinkie promise that it won't raise rates until at least 2022 reduces the risk of a major down draft due to valuation, but it doesn't eliminate it and poses a greater risk to high multiple stocks.

The stock market can and does confound the majority of investors and it wouldn't surprise us if the stock market corrected before the peak in earnings growth occurs. It is rare to have a year without a pullback of 5% or correction of 10%, and after five straight quarters of gains there are some signs of complacency. Individual investors made net purchases of $28 billion of stocks and equity ETFs in June, the most since 2014 (source: Vanda Research), indicating there is a bit of frothiness in the current equity market. Thus, we expect the next few months could be somewhat choppy

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as investors react to the latest inflation data, look for signs of margin pressure in the upcoming earnings season, brace for higher taxes, and keep tabs on the latest COVID developments heading into the start of the school year.

Still, with the economic recovery intact, we believe it is more probable that any downdraft will be short- lived and possibly lead to a renewed rotation out of highly valued stocks and into cheaper energy, materials, financials and industrials. According to LPL Financial, when stocks rise 12% or more in the first half of the year, they have averaged additional gains of 8.4% the past six times it occurred. Lastly, there is a boatload (technical term) of private equity chomping at the bit to buy financial assets and corporate buybacks are on the rise, helping limit the near-term risk for undervalued market sectors.

It is an honor to manage a portion of your assets and, as always, we welcome your comments and questions.

James P. O'Mealia manages separately managed equity and balanced accounts for institutions, foundations, and high-net-worth individuals, as well as four pooled investment funds.

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Intermediate Municipal Bonds

A Late June Re-Assessment, But Then…

Tom Dalpiaz – Portfolio Manager, Intermediate Municipal Bond Strategy

July 8, 2021

Municipal bonds have navigated the stormy seas of the past year and a quarter in typical resilient fashion. Considering the early 2021 forecast of seriously choppy waters for fixed income investments, municipal bonds sailed into port at this year's halfway point having logged in a reasonable performance, particularly compared to Treasuries. The ICE BofA 1-10 Year Municipal Index finished the first half of 2021 with a total return of +0.41% compared to -1.07% for the 1-10 Year Treasury Bond Index. The Seelaus Asset Management Intermediate Municipal Strategy finished the first half of this year with a +1.15% total return as the predicted spread tightening on Single A and BBB rated credits intensified.

The return numbers for municipal bonds would have been somewhat stronger had there not been a surprise backup in municipal bond yields in the last two weeks of June. This backup was notable for a few reasons. First, its direction was disconnected to the movement of Treasury bond yields. Second, the backup occurred even though the long-standing strong fundamentals of limited supply and sizable positive inflows into municipal bond funds and ETFs had not changed. Third, the array of explanations for the move hint at a combination of concerns that could dog the municipal bond market for the remainder of this year.

What were those explanations? Perhaps it was a general agreement by Congress on a Federal infrastructure bill that would likely increase municipal bond issuance down the road. Perhaps the lack of a tax increase in the agreed infrastructure framework punctured the easy assumption that higher tax rates (and still higher demand) were a certainty for the future. Perhaps it was simply a pause required by municipal bond market participants as positive prevailing winds were widely recognized and fairly spent. Signs of economic recovery and the return of revenues were understood news: improving credit quality was recognized and credit spreads tightened. Stimulus money had been disbursed to states and localities: more was not likely to come. Municipal bond yields, while not at historic lows, remained not too far above those levels and looked rich when compared to Treasury bond yields. The municipal bond market, with half of 2021 in the books, managed to mostly mitigate a widely touted rate rise. Is it any wonder that late June may have been a time for municipal bond market participants to step aside and re-assess a bit?

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The concerns outlined above will likely return as reasons the municipal bond market's second half of 2021 could have difficulty matching the generally positive vibe of the first half. And yet, as a true testament to how market reasoning can change quickly, municipal bond yields in the first week of July fell sharply, nearly erasing the late June rise. A sharp decline in Treasury bond yields led the way along with a growing concern about the Delta variant, its impact on future economic activity, and the timing of the Fed's eventual dialing back of its accommodative monetary stance. Such is the tug-of-war municipal bond investors will grapple with in this year's second half.

For the rest of 2021, municipal bond values will be influenced by the direction of Treasury bond yields while bouts of re-assessment on muni-specific factors (similar to the late June episode) may limit future upside price moves. Wherever interest rates go, we can say this for municipal bonds currently: scarcity and the strong fundamentals of robust demand and limited supply are firmly entrenched. In addition, the bond math on municipal bonds continues to make sense for top income tax bracket investors. In a market where the seven-year Treasury bond yields 1.05% and the ten year 1.28%, even modest intermediate-maturity tax free yields of 1.8% to 2.2% equate to 2.85% and 3.49% in the Treasury bond market for top Federal income tax investors. However municipal bond total returns finish this year, 2021 is likely to be a year where municipal bond investors renew their appreciation of municipal bonds' diverse investment credentials: providing tax free income along with relative safety, modest volatility, capital preservation, and returns uncorrelated to other asset classes. In these challenging markets, we continue to believe our focus on finding value at every point in the interest rate cycle and our use of defensive bond structures in the intermediate maturity municipal bond space will benefit the portfolios we manage.

Tom Dalpiaz has managed the Intermediate Municipal Bond Strategy since January 2014.

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