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Although it seems like we just celebrated the end of the longest year on record, the halfway point of 2021 has officially been reached. In retrospect, the last six months brought remarkable progress in the health crisis and the reopening of the U.S. economy. Mask-less social gatherings, spectators at live events, and crowded restaurants are once again routine. A sense of normalcy seems to have finally returned to our day-to-day lives, but with possibly more appreciation. Along with the return of humdrum daily life comes the uncertainty of: What happens now? There are no living experts around to provide guidance on emerging from a pandemic. Even if there were, the unique aspects of this pandemic and the government response to the recession make it impossible to offer predictions based on linkages to the past.

What we do know is a good deal of the positive effects of the reopening has already been priced into U.S. markets over the past year. Now that the much-anticipated growth phase of the recovery is upon us, investor attention has shifted from the hope of reopening to the implications and potential unintended consequences of the journey to get here. The economic impact of government policies implemented during the pandemic will be better understood in the coming months, while the policies to pay for the pandemic (and more) are very much in motion. The winds of change are blowing as the markets grapple with the dichotomy of a robust economy, ample liquidity, and a supportive Federal Reserve along with the effects of rising prices, proposed tax changes, and signs of euphoric investment behavior.

Second Quarter Recap

US stock prices continued their steady march higher, up 8% during the quarter and 15% year-to-date.[1] Gains for the year have been concentrated in more cyclical areas of the market; on average bank stocks +25%, energy/oil +45% and Real Estate (REITs) +20%. These sectors were battered during the lockdown and have gradually recovered to pre-pandemic levels. Returns so far this year are in sharp contrast to the large technology (FANG stock) fueled rally of 2020. Stocks in developed international economies, which are largely trailing the U.S. in reopening efforts, returned 7% for the quarter and are up 12% for the year.[2]

U.S. bond prices rose slightly as yields drifted lower during the quarter from 1.70% to the current reading of 1.46%.[3] This decrease in longer term yields is a bit of a surprise, as robust economic data plus inflation should lift rates. The drop in yields may be related to short-term technical factors or the market might be signaling that peak growth in the economy is behind us and inflationary pressures will ultimately fade. Bond returns for the year are still in negative territory, down 1% due to longer term interest rates increasing from 2020 levels.[4]

[1] As measured by the S&P 500 stock Index
[2] As measured by the MSCI EAFE Index
[3] Yield on the 10-Year U.S. Treasury Note
[4] As measured by the Barclays Intermediate Govt/Credit bond Index

A Stealth Correction

Although the broad U.S. stock indexes (Dow Jones, S&P 500) experienced a fairly steady rise during the quarter, certain pockets of the market underwent severe bouts of volatility. If you did not notice wild swings in your portfolio value during the quarter, that's because most of the volatility was relegated to the largely speculative areas of the investment world. During the months of March and April, inflationary worries along with the prospects of higher interest rates negatively affected stock prices most reliant on a low-rate environment. Technology stocks with big future promises but little current profits were one of those areas. The highflying ARK innovation fund, which focuses on investing in such aforementioned companies and has become popular among young retail investors, lost 37% from February-to-May before recovering slightly in June. The cryptocurrency Bitcoin, which has been advertised as an "inflation hedge" by some, declined over 40% during the second quarter as consumer prices rose sharply. Bitcoin may have some staying power as a speculative investment, but its functionality as a currency or store of value is yet to be proven (or explained as noted by the cartoon below). Many commodities have also slipped into correction territory with prices of some construction and agriculture goods declining over 10% since the peak in mid-May. Although this recent bout of volatility was not widespread, it illustrates the risks inherent with asset prices that have recovered sharply from a year ago and that are bolstered by excessive investor optimism.

Hot Inflation has Arrived…Will it Stay?

The pandemic shortages of toilet paper, Clorox wipes, and hand sanitizer have given way to post-pandemic shortages of cars, semiconductors, and houses. The pent-up demand surge of the reopening is upon us, which continues to cause supply shocks and distortions in various segments of the economy. As supply and demand battle it out, price is acting as the referee. The previous quarterly commentary detailed our thoughts on inflation, which included – it's really hard to predict. Not only do you have to accurately determine when prices will rise, but how high and for how long? Will high inflation effect labor, material, and commodity costs or just certain areas? There are multiple outcomes that can occur and many "what-ifs". Looking at the situation from a probability standpoint, the most likely scenario may be that when the one-off impact of the reopening and fiscal stimulus fades, prices revert more in-line with historic trends. However, as inflation stabilizes it very well could remain above the Fed's target of 2%. The bond market (breakeven rates) is indicating that prices will remain elevated for the foreseeable future, but not get out of control. Likewise, gold (a classic inflation hedge) declined 7% during June, not reflecting any investor anxiety related to inflation data. Markets are forward looking mechanisms, but the risk remains that inflation overshoots current expectations, causing a chain reaction in markets. As discussed in previous commentary, the path of inflation is unknown and unfortunately out of our control. What we can control is the structure of client portfolios. To borrow a quote from Oaktree Capital's Howard Marks, "It's better to structure a portfolio that can succeed in a variety of environments versus building the perfect portfolio for one outcome." We have laid out investment ideas for a rising inflationary environment previously and stand by our preference for short duration bonds, additional international stock exposure, and owning companies that provide consistent cash flows with the ability to adjust prices (price makers, not price takers). These investments should provide some protection in the event of prolonged, elevated inflation in the U.S., but also offer attractive risk-adjusted return potential if it doesn't play out. As the summer season turns to fall, the focus may likely shift from the risk of rising prices to the risk of rising taxes. More to come on this topic in future commentary.

Firm Updates

Jacob in 2008 versus 2021

As we close out our 26th year in business, we have some bittersweet news to share. Jacob Benedict will be joining the University of Notre Dame as a member of the team that manages the endowment's portfolio of outside money managers in the public securities space. For those of you who know Jacob, he bleeds Notre Dame blue and gold. Not only did he graduate from Notre Dame, but his grandfather, wife and father-in-law also attended the school. While it was a difficult decision for Jacob to make, this is his dream job and he will be a great success. We are very proud of him! He started at AMI as an Intern when he was sixteen years old. He returned to the firm thirteen years ago and has been a valuable partner and contributor to our team. His last day at AMI will be July 30th. We will miss seeing him in the office every day, but we plan to meet quarterly to stay in touch, discuss investment ideas and maybe beg for a few Notre Dame football tickets 😊.

On July 1st, we started our 27th year in business. Erica Gulick will start her fourteenth year with AMI next month. Ryan Kay, CFP®, AIF® is starting his eighth year this month. Shelby Carmichael started her sixth year this past April. This spring we also added two new but very experienced members to the team, Ben Shively, CFP®, CIMA and Victoria Roberts. While we will be sad to say goodbye to Jacob on July 30th, we have a strong team in place and we look forward to serving our clients for the next 26 years.

Thank you for your confidence and trust. We will continue to work hard each day to meet your investment goals. Please do not hesitate to contact your AMI team with any comments or questions.

Sincerely,

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Ryan A. Kay, CFP®, AIF®
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