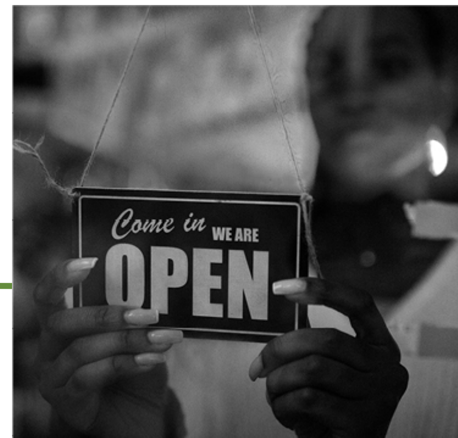
MARKET SIGHT LINES



Mid-Year Inflection Point

Michael O'Keeffe, *Chief Investment Officer*

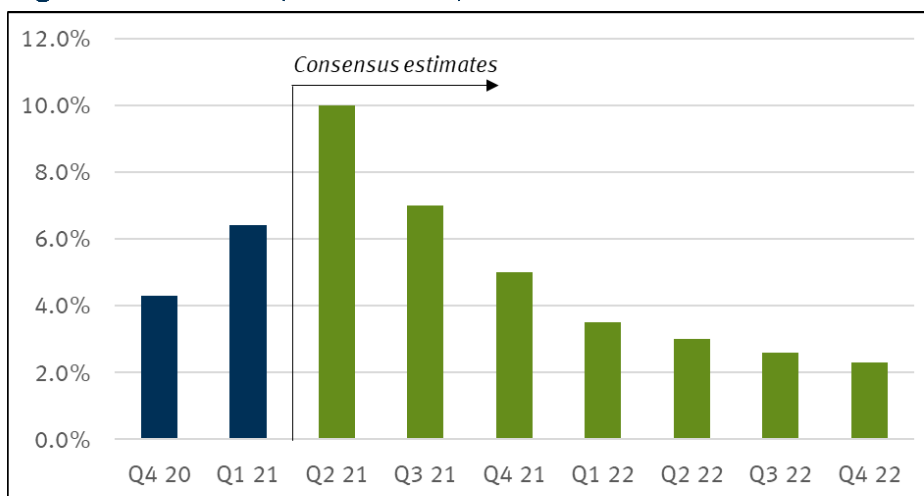
As my team and I advance our work, there is a routine, or even a pattern, tied to the annual calendar. We start each year fresh, with new initiatives and a new outlook on the economy and the markets. We end each year reflecting back, much to prepare for the coming year. But the end of June and the start of summer represent the mid-year inflection point. We reflect on how things have unfolded relative to our expectations, and we focus further on our key initiatives to do our best in the second half of the year. For me, July usually means a week's vacation with family, where I unplug for sure, but inevitably use the quiet time to reflect back and look forward.

In this week's Sight|Lines, we share some observations about this 2021 mid-year inflection point, which coincidentally shows an inflection point in this robust recovery from the pandemic.

Reopenings

I suspect we are all experiencing reopenings in a personal way. For me, some milestones include little things like not having to wear a mask at my gym or work, bigger things like dining indoors at our favorite restaurant or gathering with friends not seen in over a year, and even bigger things like welcoming people back to the office or sending my adult children away from our protective home pod to reengage in their lives. We also see this as we monitor business activity. As we discussed in last week's Sight|Lines, OpenTable restaurant seating is now just about even with levels last seen in 2019, and hotel occupancy rates are improving. In addition, the services purchasing managers' indexes from IHS Markit and ISM have risen from 26.7 and 41.6, respectively, in April 2020 to 64.6 and 60.1, respectively, in June.

Figure 1. Real GDP (QoQ% SAAR)



Source: Stifel Investment Strategy via Bloomberg as of July 7, 2021
Quarter-over-quarter (QoQ) Seasonally Adjusted Annual Rate (SAAR)

Economic Growth

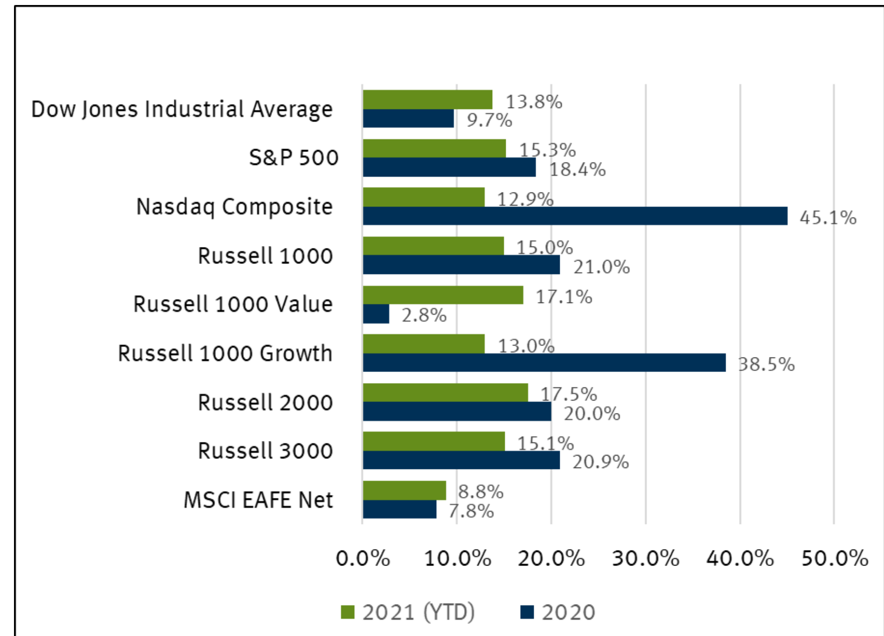
With the reopenings, we're all experiencing, I suspect, a sense of a burst of activity. And the data shows that U.S. economic growth in this recovery is likely peaking in the second quarter of this year. Consider Figure 1. In the wake of the big decline in the

first half of 2020 and the bounce that occurred in the third quarter of 2020, we've seen growth building each quarter from the fourth quarter to the peak in the second quarter, followed by the inevitable slowdown toward longer-term trend growth each quarter through 2022. The Fed forecasts long-term trend growth to be 1.8%, and consensus indicates we'll be back there around 2024/2025.

Market Results

As we discussed last week, equity markets have posted positive returns in the first half of 2021. Figure 2 shows the data. Two popular indexes, the Dow Jones Industrial Average and the S&P 500, returned 13.8% and 15.3%, respectively. The Nasdaq Composite, the tech-oriented index, posted a return of 12.9%, a modest slowdown after returning 45.1% in 2020. The Russell 2000, an index of small cap companies, returned 17.5%, outpacing the large cap Russell 1000 return of 15.0%. Value stocks outperformed growth, and U.S. stocks performed better than non-U.S. stocks, as measured by the developed market EAFE Index.

Figure 2. Equity Market Returns



Source: Stifel Investment Strategy via Bloomberg as of June 30, 2021
All index returns are total return.

While earnings have been recovering, much of the total return of stocks in this recovery is the result of P/E expansion. For example, the forward P/E of the S&P 500 sat at 14.0 at the market low in March 2020. By June 30, it had risen to 22.7. As we've discussed elsewhere, returns from here will depend on the fundamentals, especially earnings growth.

Returning to the Fundamentals

This idea of returning to the fundamentals will be seen in many ways. Enhanced unemployment benefits will be discontinued, and relief checks will be spent. Some living on this support will head back into the job market, and consumer spending will depend on earnings. Businesses aided by government support will reengage and rebuild, and their success will eventually depend on delivering valuable goods or services, managing revenue and expenses, and delivering earnings to shareholders. Economies supported by the effects of this fiscal stimulus will grow based on these fundamentals. Eventually, interest rates – including the fed funds rate – will rise, and governments, businesses, and consumers alike will be tested as their cost of debt rises.

A Look Ahead…and Scenarios

As we hit this mid-year inflection point, we look forward to the second half of the year and try to discern – where do we go from here? Consensus signals above-trend economic growth, but slowing. We see interest rates rising modestly. And for stocks, we're modestly positive looking forward, expecting low—to-mid-single-digit returns for the second half of the year. But with this view, we point to our scenarios. There is a chance of surprises to the upside, and economic and market growth unfolding better than expected. But there's also a chance of downside surprises, such as sustained inflation or a virus variant that spreads to the point of a slowdown or reversal in the reopenings. And worry about these risks will likely increase volatility for the balance of the year.

Conclusion

Each calendar year, as we hit mid-year, start summer, and take a little vacation, we reflect on year-to-date results versus our expectations, and where we're headed for the balance of the year. And in 2021, this inflection point has more meaning, as economic growth from the recovery peaks and market performance is driven by a shift to the fundamentals. We will once again focus further on our key initiatives, seeking to do our best in the second half of the year and gear up for what lies ahead in 2022.

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