Independence Asset Advisors

MarketMatters

INDEPENDENCE ASSET ADVISORS' QUARTERLY GLOBAL MARKET JOURNAL June 30, 2021

Monthly Snapshot
June 2021

Comparing the first and last day of June would give the impression that it was a relatively uneventful month for U.S. markets.

- Treasury yields diverged.
- Interest rates were unchanged.
- The Dow was flat.
- Growth stocks outperformed.
- Oil prices rose.

But digging deeper it becomes apparent that June was a busy month, with plenty of activity following the Fed's press conference on June 16th.

Despite considerable progress on vaccinations, indications of positive economic activity and strengthening employment figures, the Fed elected to leave its federal funds rate unchanged at 0.00-0.25%, and also announced it would continue to purchase at least $80 billion in Treasuries and $40 billion in agency mortgage-backed securities.

Following the Fed's comments, growth stocks surged and value stocks turned negative. Bond spreads tightened across both investment grade corporate and lower quality high yield and loan sectors, while Treasury yields on the short end of the curve rose meaningfully higher and Treasury yields on the longer end of the curve narrowed by as much as 0.20%.

The deviating returns of U.S. growth and value stocks was the most dramatic monthly observation, with the former outperforming the latter by more than 7% as investors returned to embracing growth, cyclicality and beta. This confirmed the market's fixation on Fed guidance and demonstrated the potential volatility of an S&P 500 Index that ended the month with a weighting of 78% "Economically Sensitive" sectors and 22% "Demand Defensive" sectors, respectively.

Quarterly Market Overview & Key Themes

- Progress on vaccinations slowed the development of COVID-19 infection in some countries, but others continued to report vaccination rates as low as 15%.
- The Fed announced no change to its federal fund rate or its bond purchasing program, but acknowledged higher than expected growth and inflation during recent quarters.
- Growth stocks regained favor in June and outperformed value stocks in the second quarter, but were nearly twice as expensive and lower yielding.
- Global equities gained 7.4% during the quarter, led by U.S. stocks that were up 8.6%.
- Investment grade and high yield bond indexes were positive, but yields continued to decline.

COVID-19

The good news was that vaccination deployment improved in some developed countries during the quarter, and approved vaccines (Pfizer, Moderna, AstraZeneca, J&J) and pending vaccines (Novavax) were reported to be 70-90% effective against COVID strains that prevailed during 2020. As a result, counties such as the U.S., U.K. and China reported vaccination rates as high as 80%. The bad news was that newly identified COVID-19 variants (e.g., Delta) and global vaccine delays (EM ex China at only 20%) could slow the global economic reopening.

Rates

The Fed delivered meaningful forward guidance when it met in June by electing to maintain its bond purchasing program and keeping rates accommodatively low at between 0.00% and 0.25%. While the Fed did not elect to amend its policies in June, it did acknowledge that real GDP and headline PCE inflation were materially upgraded in the fourth quarter (y/y). As such, the Fed amended its median federal funds rate projection ("Dot Plot") to reflect two rate hikes in 2023. Fed Chair Powell also acknowledged that the FOMC had begun actively discussing a timetable for tapering.

Growth

U.S. growth was robust during the first quarter, with real GDP growing at a seasonally adjusted annual rate of 6.4% (q/q). Growth was broad based, led by personal consumption that was up 11.4%, while inventories and trade sectors lagged.

Jobs

Employment figures improved throughout the quarter with 850,000 nonfarm payroll jobs being added in June, and upward revisions made to the May reading. This correlated with a modest rise in wage growth.

Profits

Earnings in the second quarter are expected to be strong, with guidance suggesting that 86% of companies beat EPS estimates and 74% beat on revenue estimates. Most large-cap U.S. companies recovered to their pre-pandemic revenue/EPS levels from early 2019, with tailwinds provided by oil prices and the U.S. dollar.

Inflation

Inflation surpassed the Fed's 2% target by rising 3.9% y/y in May as consumer prices rose at their fastest pace in a decade (CPI); it is yet to be determined how much of this is a result of global supply chain shortages.

Sources: JP Morgan, Eaton Vance, federalreserve.gov

Market Focus – “Growth vs Value”

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In this section we focus on the divergence between growth and value.

We use each issue of *MarketMatters* to explore in greater detail a specific topic that captured the interest of the investing community during the previous quarter. In this issue, we discuss the notion of U.S. “Growth versus Value,” in consideration of the recent momentum shift back to growth stocks following the Fed’s June committee meeting.

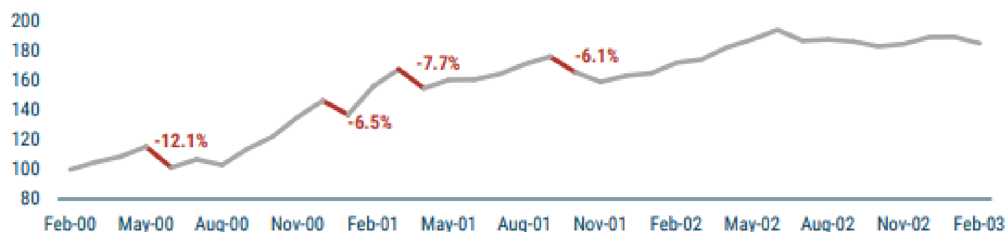
After trailing growth stocks for years, value stocks, or shares of companies viewed as significantly undervalued based on their share price relative to metrics like earnings, revenue or book value, experienced a resurgence in late 2020 and early 2021. Between September 2020 and March 2021, value stocks outperformed growth stocks by more than 19%, with defensive sectors such as Utilities performing better than pro-cyclical sectors such as Information Technology against a backdrop of rising rates.

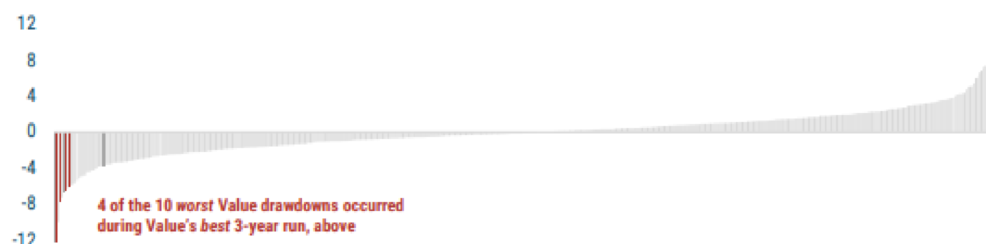
During the second quarter, growth stocks, or shares of companies that are expected to see accelerated earnings and revenue growth, outperformed value stocks by 6.7%. Most of the quarterly outperformance was booked in June, when the Fed’s inaction on rates and bond purchasing served as a temporary tailwind for “Economically Sensitive” sectors, which represented 78% of the S&P 500 Index as of June 30th. “Demand Defensive” sectors, which represented a mere 22% of the S&P 500 Index as quarter-end, underperformed.

The quick momentum shift in June from value back to growth had investors second guessing themselves and questioning whether the value stock rally might have been short-lived (“is this it?”). We do not believe the value ship has sunk, and we view June as more of a lull during what we expect to be a longer-term period of outperformance. Drawdowns are uncomfortable, but with the advantage of retrospect we can see that they are routine occurrences during sustained periods of relative outperformance.

In the top chart below we show the historic 3-year reversal of value versus growth from 2000 to 2003. This was value’s best period in history, and it began for reasons that are similar to today: (1) The valuation gap between value stocks and growth stocks had become extremely wide, and (2) mean reversion was inevitable. In the lower chart, we see that four of the ten worst drawdowns in the 40-year history of the value versus growth relationship occurred during the best 3-year run.

Looking ahead, we believe the factors that drove value stocks to their best 3-year period in history in the early 2000s will also support the value versus growth divergence over the next few years (rising rates should also help), and we suggest value investors maintain their resolve with the understanding that drawdowns are a natural occurrence during some of the best periods in history.





Sources: GMO, eVestment Analytics, JP Morgan, Bloomberg

Key Insights:

- COVID-19 vaccination deployment should steadily improve with the approval of the Novavax vaccine, but the identification of new highly transmissible strains of the virus (i.e., the Delta variant) could reverse some of the progress that has been made.
- The Fed's forward guidance from the June meeting suggests it will keep rates steady at 0.00%-0.25% until labor markets strengthen and inflation remains at or above the 2% target "for some time."
- With economic output less than 1% below peak 4Q19 real GDP, continued growth in consumer spending and investment could push second quarter real GDP above the pre-COVID peak in the second quarter.
- If inflation moves from transitory to an ongoing trend, the Fed may begin taking action to taper its bond buying program sooner.
- Global equity valuations continue to favor U.S. quality value over growth and foreign equities.
- Bonds continue to trade at a premium to par, yield spreads remain tight, and with higher interest rates looming investors should consider taking action now to lower duration in their portfolio to avoid negative total returns.

Our outlook for the second half of 2021 remains positive, but we expect that the road will be bumpy.

The primary bump in the road may be the coronavirus. Newly released data suggests that COVID-19 remains a serious threat to the global population. While vaccination efforts have increased, many countries are still reporting incredibly low rates of inoculation. The more transmittable Delta variation appears to be affecting many U.S. States with low vaccination rates. COVID-19 remains a serious threat, and with new rounds of restrictions being imposed, we should be prepared for periods of slower synchronized global economic growth and higher market volatility.

The secondary bump in the road may be inflation. As data continues to come in, inflation worries are likely to contribute to investor jitters. Rapid shifts between risk-on and risk-off should be expected. In its June meeting, the Fed brushed off sharply higher consumer prices as transitory, citing factors that it expects to be temporary, such as global supply chain bottlenecks and higher consumer demand for goods. But the Fed also indicated it will more aggressively adjust its stance on monetary policy if risks to its goals emerge. In our view, the Fed has already begun to position the market for monetary change by announcing its preliminary plan to begin tapering bond purchases and by increasing the overnight repo rate and the interest rate paid on excess reserve balances to 0.05% and 0.15%, respectively. Investors should expect rates to rise, perhaps sooner than later.

The final bump in the road may be the lack of investment opportunities. There are few investment choices currently available that offer a favorable balance of risk and return. Global equity markets are incredibly expensive and low yielding, bond markets are likewise expensive and low yielding, and many smaller niche sectors are subject to specific risks like historically narrow credit spreads or currency fluctuations. As such, many investors have sought to improve their total return by extending into riskier market sectors or by increasing the level of cheap leverage on their portfolios. In our view these decisions could be costly.

With most intermediate-term capital market assumptions being adjusted lower, and plenty of headwinds to contend with, where do we see the best opportunities in the market? For equities, we favor high quality U.S. large cap value and cyclical stocks. These equities offer decent relative valuations and should be supported by natural mean reversion and rising interest rates. In fixed income markets, we prefer higher quality floating rate loans, which will offer protection as rates rise (along with a higher yield), and shorter-duration, higher quality, high yield bonds.

Sources: IAA Proprietary

Contacts:

Independence Asset Advisors

Scott Renninger
President & CIO
scott@iaadvisors.com

Katie Kearns
Vice President & Managing Director
katie@iaadvisors.com

Tom Grugan
Director, Research & Portfolio Management
thomas@iaadvisors.com

Rebecca Saukaitis, CFP®
Director, Client Portfolio Management
rebecca@iaadvisors.com

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Global Market Investment Returns — June 30, 2021

		June 2021	YTD	1-Year	3-Years	5-Years	10-Years
U.S. Large Cap Equities	S&P 500	2.33%	15.25%	40.79%	18.67%	17.65%	14.84%
U.S. Small Cap Equities	S&P SmallCap	0.33%	23.56%	67.40%	12.20%	15.82%	13.49%
Energy Infrastructure Equities	Alerian MLP	6.16%	48.26%	63.25%	-1.79%	-2.58%	-0.09%
U.S. Real Estate Equities	Dow Jones U.S. Select REIT	2.66%	21.70%	37.82%	9.95%	6.13%	9.24%
Global Equities	MSCI All Country World Index	1.32%	12.30%	39.26%	14.57%	14.61%	9.90%
International Developed Equities	MSCI EAFE	-1.13%	8.83%	32.35%	8.27%	10.28%	5.89%
Emerging Market Equities	MSCI Emerging Markets	0.17%	7.45%	40.90%	11.27%	13.03%	4.28%
U.S. Taxable Fixed Income	Barclay's U.S. Aggregate	0.70%	-1.60%	-0.33%	5.34%	3.03%	3.39%
U.S. Tax-Exempt Fixed Income	Barclay's Municipal Aggregate	0.27%	1.06%	4.17%	5.10%	3.25%	4.28%
High Yield Fixed Income	Barclay's U.S. Corporate High Yield	1.34%	3.62%	15.37%	7.45%	7.48%	6.66%
Floating Rate Loans	S&P/LSTA Leveraged Loan	0.40%	3.27%	11.64%	4.39%	4.99%	4.39%
International Fixed Income	Barclay's Global Aggregate Ex-U.S.	-2.02%	-4.42%	4.60%	3.12%	1.63%	0.99%

- Global equity market returns were mixed in June, with U.S. indexes broadly positive and foreign equity indexes either muted or negative.
- China, the UK and the U.S. ended June with the highest portion of vaccinated citizens (50-80%); India, Japan, Brazil & South Korea were at only 15-30%.
- U.S. large cap stocks gained 2.3%, improving the 12-month return to 40.8%, almost 4x the average 12-month return of 10.3%.
    - Inflation remained elevated in May at 5% year-over-year, the highest rate since 2008, but employment numbers remained lackluster.
- Growth stocks outperformed value stocks by 7.4% in June, while the 12-month index returns were nearly equal at approximately 43%.
- At month-end, the weight of the top ten stocks in the S&P 500 Index was 29%, with an average P/E of 30.1 (153% of the average).
    - Value stocks, by comparison, remained relative cheap with a current P/E of 16.9, or 124% of the 20-year average P/E.
- Outside of the U.S., international developed equities pulled back in June while emerging markets equities managed to stay slightly positive.
    - The price-to-earnings discount for international equities versus U.S. equities was 26.9% at month-end.
- Investment grade bonds were positive in June but yields remained low; nominal 10-Year Treasury yield was 1.5% with a real yield of -2.3%.
- High yield bonds remained highly correlated to U.S. equities and gained 1.3% in June; the default rate dropped to 2.0% versus the 3.5% average.
- Floating rate loans underperformed high yield bonds in June, but offered slightly better pricing and a 0.2% yield advantage.
- International fixed income declined in June amid a 3% strengthening of the U.S. dollar.

Source: eVestment Analytics, JP Morgan *Guide to the Markets*, Macrotrends

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