INVESTMENT OUTLOOK

A PEAPACK PRIVATE WEALTH MANAGEMENT PUBLICATION

SECOND QUARTER 2021: YOU'RE THE TOP

On the top of each peak you are on the edge of the abyss.
--Stanislaw Jerzy Lec

Mountaineers know that the downside of bagging a peak is that the only way to go from there is down—the descent is necessary and inevitable. You can pause at the summit, basking in your achievement and enjoying the panoramic perspective, but sooner or later the next direction is downhill. Similarly, when an economy peaks—that is to say, when it reaches a cyclical top—by definition, it slows from there.

The analogy is imperfect. With economies, it's a little more nuanced. It's not that economies, following peak growth, decline. It's that their rates of growth decline—the second derivative, in calculus terms. Economies may continue to grow, but at a less robust pace. Investors need to be vigilant about such turns, as they require a reset of future expectations.

It appears that US economic growth and corporate earnings are at just such a peak, now. This second quarter may prove to be the fastest GDP growth of the cycle. It may be the largest year-over-year earnings increase. And it could prove to be the cyclical peak in inflation.

In the natural realm, too, it seems we are experiencing peaks. Temperatures in the Pacific Northwest recently topped 100 degrees, setting records. Manatees in Florida are dying off at an unprecedented rate. And it's even a time of peak babies. A 25-year-old woman from Mali gave birth to nonuplets—five girls and four boys—the most children in a single birth to survive.

We don't mean to downplay the economic recovery—some would say, boom. That said, robust growth can lead to peak optimism, to excessive risk-taking as investors become over-enthused (can you say, meme stocks?). Coming down from such a euphoric high can be a painful and dangerous experience. Like descending from Mount Everest—maybe more treacherous than the ascent.

PEAK EVERYTHING: IS THIS AS GOOD AS IT GETS?

Someday I'll wish upon a star
and wake up where the clouds are far behind me.
Where troubles melt like lemon drops
away above the chimney tops,
That's where you'll find me.
–Yip Harburg, 'Over the Rainbow'

Investors may not quite be over the rainbow, but they might well be over the moon with the robust returns bestowed on their portfolios thus far this year. Equities of all stripes rose as vaccination progress enabled pandemic troubles to melt away.

Asset Class	Index	2nd Quarter Returns	Year to Date Returns
US Large Cap Stocks	S&P 500 Total Return	8.6%	15.3%
US Small Cap Stocks	Russell 2000	4.3%	17.5%
International Developed Markets Stocks	MSCI EAFE	5.2%	8.8%
Emerging Markets Stocks	MSCI EM	5.1%	7.5%
Real Estate Securities	MSCI US Real Estate	12.0%	21.1%
Commodities	Bloomberg Commodities Futures	13.3%	21.8%
Bonds	Bloomberg Barclays US Aggregate	1.8%	-1.6%
Cash	FTSE 3-month UST Bill	0.01%	0.03%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

The biggest returns for the quarter, and half year, were in the cyclically sensitive real estate and commodities spaces, but equities domestic and international, large cap and small, all posted solid mid-to-high single digit returns for the quarter—and high single digit to double digit returns for the year to date. Through June 30, US equities have out-performed international markets, reflecting earlier vaccination success rates, and smaller cap stocks were particularly strong given their high operating leverage.

In the fixed income arena, interest rates settled down in the second quarter, thus generating positive total returns. Rising rates earlier in the year, however, have wrought negative year to date bond returns. And, with interest rates in the cellar, cash effectively generated no return.

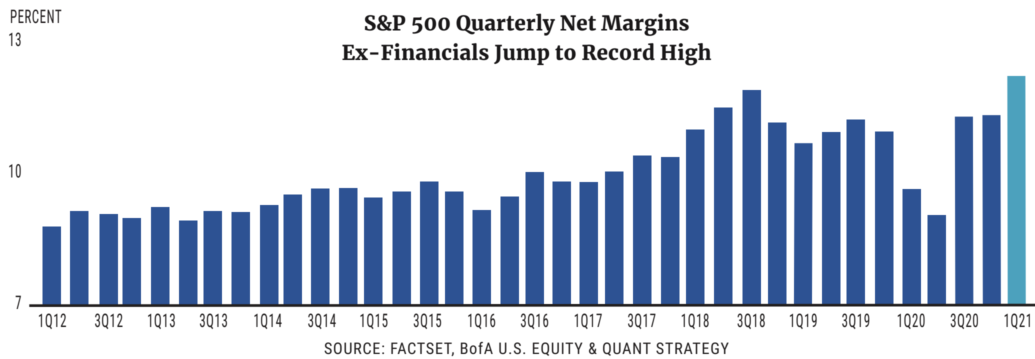
Taken all in all, it doesn't get much better than this—happy little bluebirds, indeed, flying beyond the rainbow.

THE POST-PANDEMIC ECONOMY

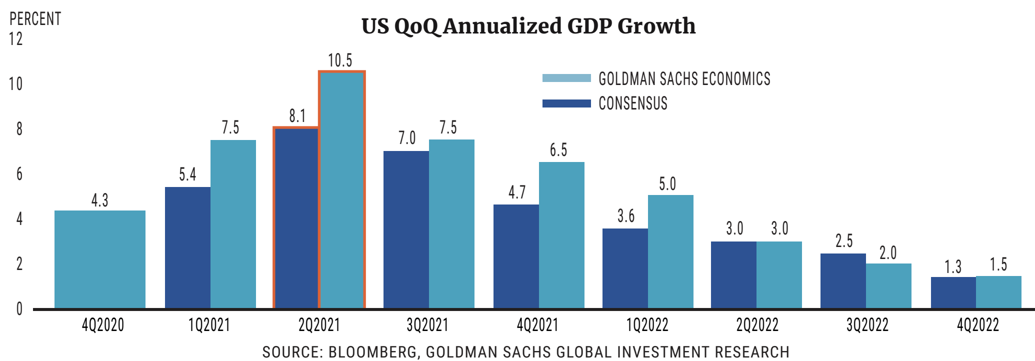
On all peaks lies peace.
–Johann Wolfgang von Goethe

Life is supposed to be a series of peaks and valleys.
The secret is to keep the valleys from becoming Grand Canyons.
--Bernard Williams

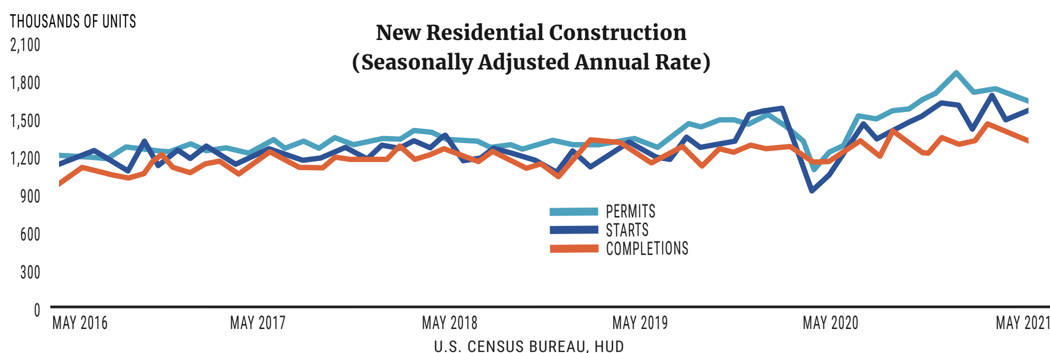
As we look at the economic landscape, we are surrounded by tall mountain peaks. There are many examples of top-of-cycle data—of maximum economic performance. We've already seen peak money supply growth, as the Fed's measure of annual real growth in M2 has contracted from 25% to 14%. In the housing market, home price appreciation clocked in with the fastest appreciation ever, at 14.3% year over year, as measured by the S&P CoreLogic Case-Schiller Index. Corporate profit margins also clocked in at record wide levels.



And there is a consensus among economic forecasters that the broadest measure—GDP growth—peaked during the current quarter. This should not be surprising, as this quarter anniversaries the depth of the pandemic-driven recession in last year's second quarter. First quarter 2021 GDP expanded at a 6.4% annualized pace, and second quarter estimates approach or exceed double digits. Subsequent quarters are likely to show steadily less rapid growth, perhaps reverting ultimately to pre-pandemic levels in the 2% range by 2023.

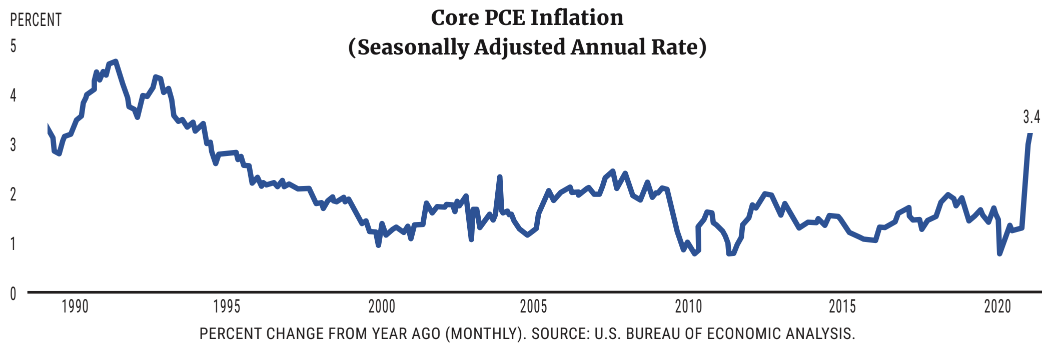


We also see what appears to be a peak in the new home construction market, too. Note the downturn over the most recent three months in housing starts, permits, and completions.



Rising constructions costs, limited land availability, and permitting challenges have led to record-high new home prices and, consequently, lower affordability.

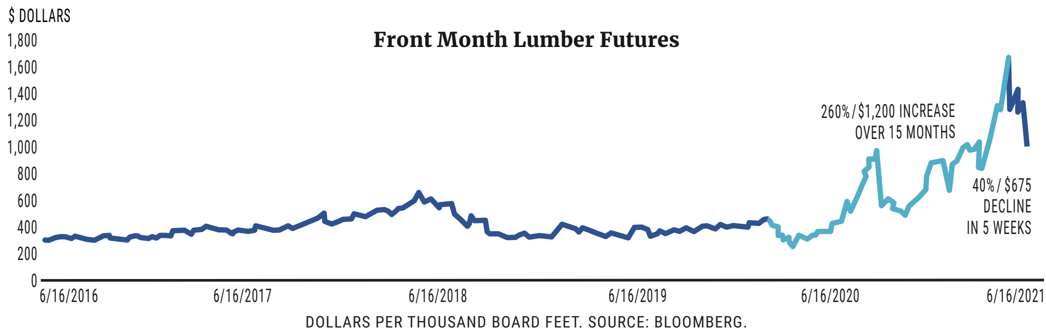
This may also prove to be the quarter for maximum inflation, the leading concern of investors today. Today's inflation readings are the most elevated we've seen in many years. This is, to a significant degree, a reflection of year-ago COVID-driven deflationary data, as well as elevated near-term demand driven by relaxation of pandemic restrictions.



PERCENT CHANGE FROM YEAR AGO (MONTHLY). SOURCE: U.S. BUREAU OF ECONOMIC ANALYSIS.

The Fed's preferred inflation gauge spiked recently, to levels not seen in nearly 30 years. This is attributable largely to 'base effects'—the low year-ago levels to which prices are compared—and, therefore, thought to be transitory. Recent activity in the bond market, in particular the decline in the 10-year US Treasury yield, is supportive of this view of 'peak inflation.'

We can see the potential, too, in commodity prices, which appear to be softening after a big run-up. To wit, lumber.

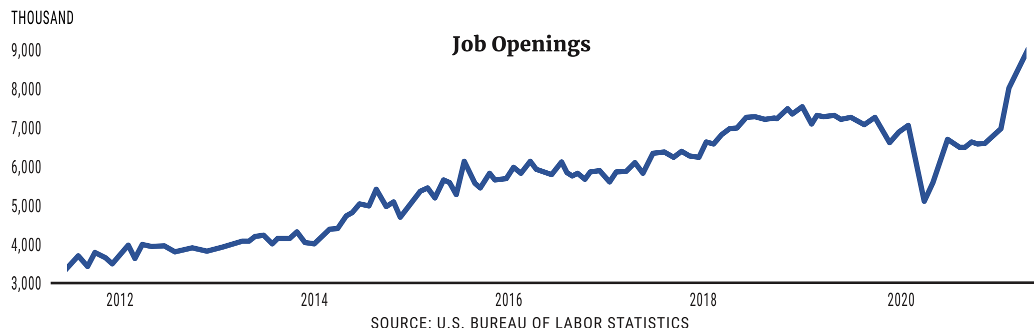


DOLLARS PER THOUSAND BOARD FEET. SOURCE: BLOOMBERG.

There are shortages and backlogs—semiconductor chip availability issues have impacted automobile production and raised prices, OPEC has exhibited discipline in expanding oil production, driver shortages are causing shipment delays and higher shipping costs—but, generally, in an age of oversupply production will rise to meet demand… thereby, reining in rising costs.

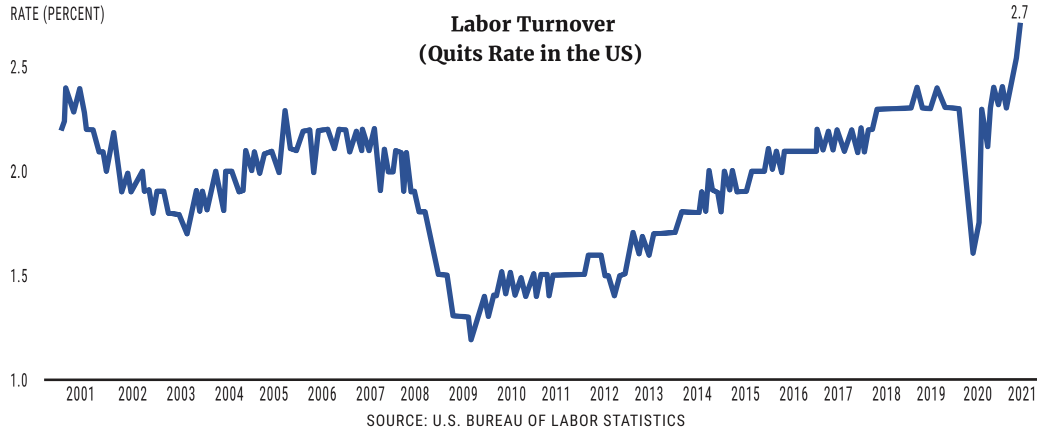
By contrast, we are not even close to experiencing peak employment levels. We are still 6.8 million jobs short of pre-pandemic levels. June labor data include an unemployment rate of 5.9%, 9.5 million people unemployed, labor force participation rate of 61.6%, and average hourly earnings up 3.5% versus year-ago levels. These data points suggest the Fed is at a considerable distance from its maximum employment mandate.

Having acknowledged that, it's a great time to be a worker. As of the end of April, job openings reached a record 9.3 million.



SOURCE: U.S. BUREAU OF LABOR STATISTICS

Additionally, the number of workers voluntarily leaving their jobs—the 'quits' rate—is also at a record high.



SOURCE: U.S. BUREAU OF LABOR STATISTICS

A high quits rate is generally interpreted to mean that workers believe they can easily find a new job that is better than the one they left.

We might anticipate that as more people are vaccinated and COVID fears lessen, as children return to full time onsite schooling in the fall, and as enhanced unemployment benefits expire at the end of September, jobs will be filled, labor shortages will diminish, and upward pressure on employee pay will ease.

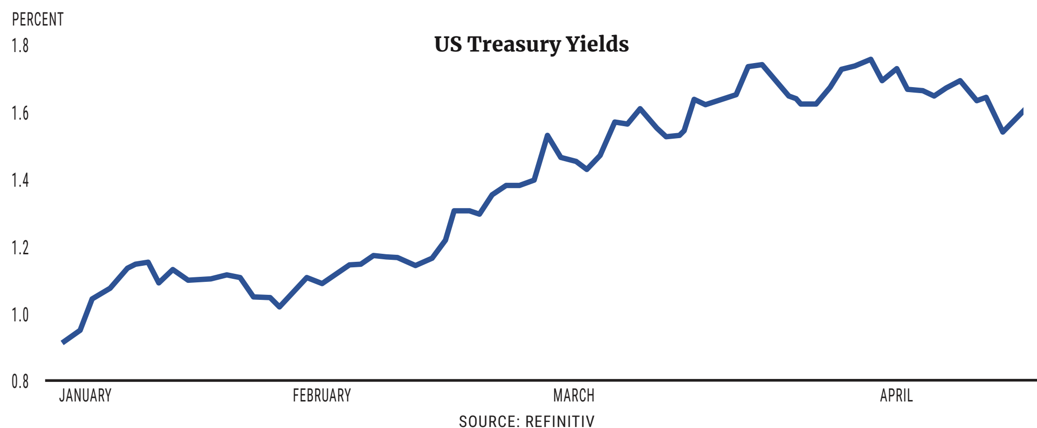
PEAK MARKETS, PEAK VALUATIONS?

All of life is peaks and valleys. Don't let the peaks get too high and the valleys too low.
–John Wooden

Peaks are visible in financial markets, too. The most obvious? Stock markets, of course. With investors celebrating the successful rollout of vaccinations, easy monetary policy, substantial fiscal stimulus, and surprisingly strong first quarter earnings, the S&P 500 notched new all-time highs 34 times in the first half of 2021.

Interest rates, too, appear to have crested in the second quarter.

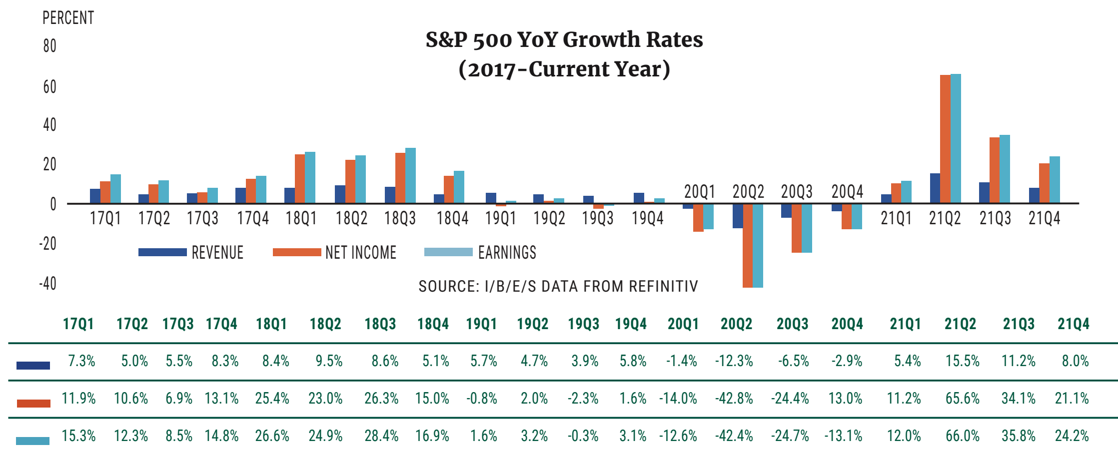
The yield on the 10-year US Treasury bond rose to 1.76% during the period, as investors worried that pent up consumer demand and ample liquidity would lead to an acceleration in inflation. Once again, however, the Fed came to the rescue with reassurances that price increases would prove temporary and an indication that it is ready, at last, to "talk about talking about" reducing bond purchases. By quarter-end, the 10-year US Treasury yield had fallen to 1.47%.



SOURCE: REFINITIV

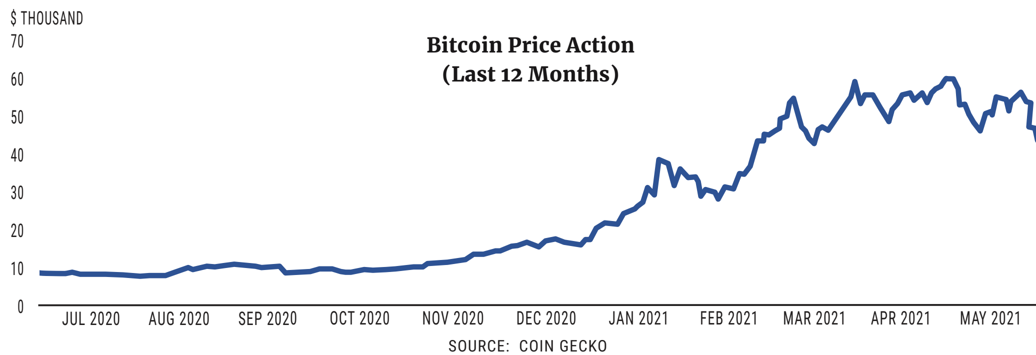
Looking ahead, perhaps most importantly for equity markets, the second quarter is likely to represent peak year-over-year earnings growth. In the first quarter, S&P 500 companies reported a 10.9% rise in revenues and a 52.8% rise in earnings. A record 86% of companies exceeded analysts' earnings estimates; actual earnings were 22.5% above forecasts, the second highest on record.

Expectations for the just-completed second quarter are sky-high. According to FactSet, analysts estimate that revenues will grow 19% and earnings will grow 62%. Successive quarters are projected to record impressive but lesser growth rates: third quarter estimates are for 11.6% revenue growth and 22% earnings growth, and fourth quarter estimates are for 8.7% revenue growth and 17% earnings growth. FactSet's data are similar to Refinitiv, below.



	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4
	7.3%	5.0%	5.5%	8.3%	8.4%	9.5%	8.6%	5.1%	5.7%	4.7%	3.9%	5.8%	-1.4%	-12.3%	-6.5%	-2.9%	5.4%	15.5%	11.2%	8.0%
	11.9%	10.6%	6.9%	13.1%	25.4%	23.0%	26.3%	15.0%	-0.8%	2.0%	-2.3%	1.6%	-14.0%	-42.8%	-24.4%	13.0%	11.2%	65.6%	34.1%	21.1%
	15.3%	12.3%	8.5%	14.8%	26.6%	24.9%	28.4%	16.9%	1.6%	3.2%	-0.3%	3.1%	-12.6%	-42.4%	-24.7%	-13.1%	12.0%	66.0%	35.8%	24.2%

While we're on the subject of tops, let us hope we have seen peak insanity in the speculative arena. In the IPO market, issuance was robust—113 IPOs raised just shy of $40 billion, exceeded only near the end of the dot-com mania in 2000.



In the cryptocurrency world, Bitcoin appears to have crested; just below $65,000 in mid-April, subsequently falling by more than 40% to end the quarter at $34,290.

We also hope we have witnessed maximum investor euphoria for the so-called meme stocks, touted on Reddit's WallStreetBets forum and traded actively on finance app Robinhood. We note that movie theatre operator AMC soared 455% in the second quarter, despite being on the brink of bankruptcy, and the company raised over $1.2 billion selling additional shares.

We wouldn't argue with observers who label such market developments as 'frothy.'

PEAK PATIENCE

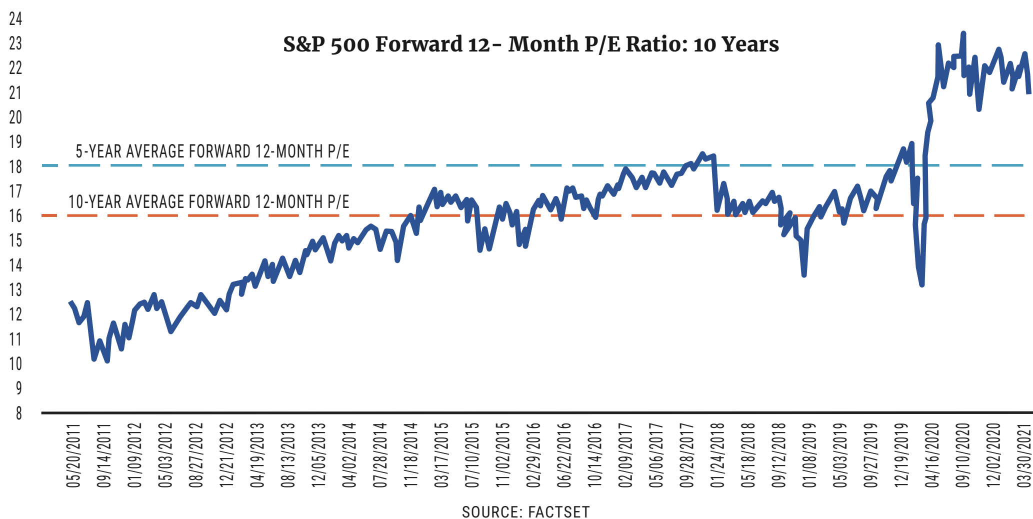
Times of luxury do not last long, but pass away very quickly;
nothing in this world can be long enjoyed.
–Buddha

As you go through life, you've got to see the valleys
as well as the peaks.
–Neil Young

Buddha may not have burnished his repetition as an optimist with such a perspective, but the warning is timeless. After the pandemic-induced record-fast recession and bear market last year, we've experienced a record-fast if uneven recovery in both the economy and the stock market.

Investors have enjoyed ever loftier portfolio values over the past fifteen months. As we peek into the future, what's visible? Well, if earnings growth rates are decelerating, it seems likely that the pace of stock market appreciation will, at a minimum, also decelerate. Higher stock prices generally require at least one of two conditions: higher earnings, or investors' willingness to pay a higher price for those earnings.

It appears that investors have discovered a ceiling in how richly they will pay up for earnings. As the chart indicates, there was a quantum leap up in the market's price/earnings multiple in midyear 2020, as monetary and fiscal stimulus alleviated healthcare concerns and dramatically lower interest rates contributed to a recalculation in the value of future corporate profits. Since then, the market has traded in a range of 21–23 times estimated next twelve months' earnings. Given a number of potential headwinds—higher corporate taxes, near-term cost pressures from both materials and labor, a more challenging regulatory environment—there is little reason to anticipate multiple expansion.



SOURCE: FACTSET

A better earnings outlook may be required to support the stock market at these levels, never mind drive it higher. While that does not seem like an impossible ask, a further climb from current levels is likely to be lesser in magnitude and speed.

Within equity markets, we note that the out-performance of value stocks in the prior two quarters stalled out in the most recent quarter. Growth stocks took the lead, as interest rates fell. This reversal could prove to be a pause that refreshes, as the cyclical growth/reopening-the-economy narrative may not have reached its conclusion.

In the bond market, interest rates have flatlined at lower levels. Investors have set aside their inflation worries, for the nonce. Or, perhaps, they are anticipating slower economic growth next year—which, in turn, would diminish inflation concerns. With slim yields on government bonds, investors have gone out on the risk spectrum, scooping up corporate bonds, agency securities, junk bonds, and other higher yielding debt instruments—resulting in historically low spreads to Treasurys. In that regard, there is little value to be found almost anywhere in bondland.

The dominant themes powering markets continue to be economic recovery from the effects of the coronavirus and global central banks' highly accommodative monetary policy. The transition is well under way in the US from stay-at-home beneficiaries to recovery plays such as the travel, leisure, hospitality and entertainment industries.

"'Anywhere' is very popular right now."

Americans are eager to resume dining out, attending sporting events, going to the movies, and, most especially, traveling. Among the most coveted destinations this summer are beaches and mountains.

As for beaches this year—it's peak hot dogs. At Coney Island, anyway. At the annual Nathan's Famous Hot Dog Eating Contest, perennial winner Joey Chestnut consumed a record 76 hot dogs (and buns!) in ten minutes. All those nitrites and nitrates—beware of peaks! Not the prettiest sight, either!

Travelers around the globe enjoy holidays in the mountains. Mountaintop views are justly celebrated—they're breathtaking. We wish such holidays would go on forever, but of course they don't.

So we have to come down from the mountain. As we descend, however, there's no need to have a fit of pique. Valley views may lack the scope and drama of peaks but have their own charms. As we descend from peak everything, investors would do well to turn their gaze from peak growth. It's time to manage our expectations. And that may require us to exhibit peak investment patience.

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