Moving On

The bull market continues. In fact, the second quarter S&P 500 Index return of 8.5% even bested its first quarter showing. To go from such a precarious position to today so quickly, well, as they say: truth is stranger than fiction. We don't know how financial historians will ultimately characterize the pandemic, but the markets' panic of 15 months ago was in anticipation of damage that was feared but ultimately circumvented (we're talking Wall Street, not Main Street). That stands in stark contrast to other recent market collapses; much of the economic rot was already baked in prior to markets sniffing it out. We point this out because previous financial calamities often stay top of mind for years, to some extent coloring post-panic decisions long after they usefully should. This time seems different.

The typical recession has a couple of ingredients: a substantial excess of investment and a Fed determined to slow things down. The build-up of excess is generally years in the making and the Fed's response is often equally drawn out, as they hope to cool rather than freeze. This slow walk to the breaking point is why recessions mostly catch us by surprise and why the first signs of trouble are often ignored. And it's also why the fiscal and monetary authorities are slow, even reluctant, to react. The pandemic was obviously completely different. The authorities recognized the seriousness of the situation and reacted with unprecedented speed and magnitude. And it's evident from the last couple of earnings reporting periods that the underlying economy, excepting a few unfortunate sectors, remained in decent shape. Excess hadn't been building, and thanks to unparalleled stimulus, we've popped out on the other side of the pandemic with our clothes still on, mostly. And we aren't sitting around scratching our heads, fretting about how we got into the mess or beating the last dog that bit us. We are moving on, but exactly where isn't obvious.

The first two quarters of the year give clear evidence of this. In the first quarter, the reopening trade (businesses most likely to benefit from the reopening) led the market. Broadly, that included the economically-sensitive, often characterized as value stocks, and small caps. A number of these stocks eclipsed old highs even as their businesses were just beginning to ramp up. The market anticipates, but did it get ahead of itself? This quarter, growth stocks led, and by a substantial margin. The S&P Growth Index was up nearly 12%, while the Russell 2000 Index, a measure of small cap stocks, rose 4%, almost the mirror image of the first quarter. This seesawing isn't unusual, but the magnitude of the differences is. Lately, this change in leadership has been unswervingly correlated to changes in the 10-year Treasury bond yield. And it makes good sense that equity investors take cues as to the health of the economy from the bond market, but the latest move back to growth may be extreme and more rote than reasoned.

But before we go on, please indulge a little background history. In the decade prior to the pandemic, growth stocks dominated the performance of the stock averages primarily because the growth of the underlying economy was never sufficient to give the economically-sensitive businesses enough oomph to gain favor relative to the faster growers. Hence, evidence that the next leg of our economic journey might not be as robust or as durable as originally thought could cause a rotation back into growth stocks.

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Moving On (continued)

Fast-forward to the Fed's June meeting, and that's essentially what's happened. Since the early days of the pandemic the Fed has been saying that they would leave rates unchanged through 2023. They repeatedly stated that they'd let the economy run hot, and that inflation would be transitory. They were essentially saying that they were fine with extreme stimulus being piled on top of an economy rapidly reopening into bottlenecks and shortages. But in the June meeting the Fed changed the guidance to include two rate hikes in 2023. They blinked! It seems the accumulating inflationary evidence was too great for them to hold the line. Long bond yields declined as investors took seriously the prospect of a more hawkish Fed cutting the party short, and equity markets violently re-rotated back into growth stocks, anticipating the eventual slowing of the economy.

We're happy to be moving on, but, honestly, we don't know how this unusual set of circumstances will be resolved: trillions in fiscal stimulus, zero percent interest rates, a rapidly reopening economy, extreme pent-up demand, and shortages and bottlenecks everywhere. Low wage jobs are plentiful but willing workers and housing are scarce. Earnings will be good but there will be more negative commentary about inflation, wages and shortages. It still seems likely to us that we will have a longer than normal period of strong growth because supply constraints will govern our ability to consume what we want. We can't just binge. Pent-up savings and demand will have to be worked off over a longer period of time, and this seems like a good scenario for the reopening beneficiaries, given that growth stocks are expensive. And any one-armed economist will tell you it's better to have pent-up demand than a lack thereof. However, the Fed is in an exceptionally tight spot and inflationary pressures are real. We haven't changed our view that stocks are more attractive than bonds, but expect more volatility as we work our way through this unique period.

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