HANOVER ADVISORS

Market Commentary

Second Quarter 2021

Economic Outlook

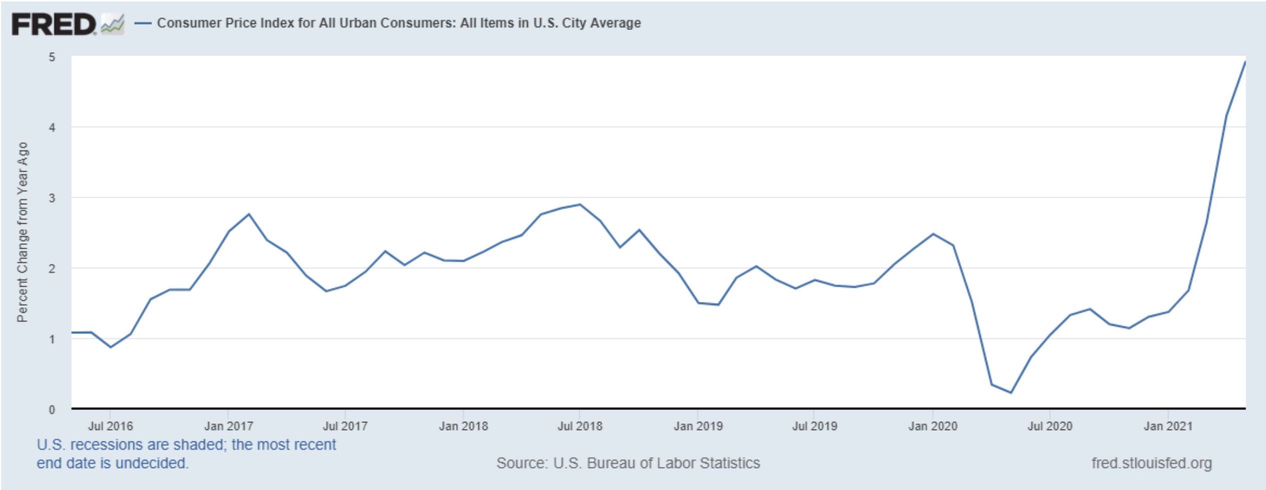
The global economic recovery continued its acceleration in the first half of 2021, though unevenly in some regions where lagging vaccination rates and the emergence of the "Delta variant" have driven up case numbers. In the U.S., the robust recovery has continued largely unabated. The Atlanta Fed's GDP tracker is forecasting Q2 growth to reach 10%, while the Fed projects total year GDP growth of 7%. Economic output came close to pre-pandemic levels in early spring, so Q2 will almost certainly surpass 2019 levels of economic activity.

Growth in the U.S. is expected to moderate in the back half of the year as enhanced unemployment programs end and the impact of fiscal stimulus fades, but it will likely remain robust. The median net worth of U.S. households is at an all-time high, and consumers are sitting on $1 trillion in excess savings. Retail sales in May disappointed, declining 1.3% from the previous month, leading some economists to wonder if we will follow a similar trajectory as China, where consumers have remained hesitant to open their wallets even after the virus has been largely contained. The consensus remains, however, that pent-up consumer demand and excess cash on hand will lead to a flurry of spending over the summer.

Economic growth outside the U.S. is expected to outpace the U.S. as the rest of the world catches up to our vaccination rate and economies reopen more fully. Global manufacturing continues to accelerate, and the purchasing manager's index (PMI) for the Eurozone remains above 50, meaning that manufacturing activity is expanding.

Inflation: Transitory or Here to Stay?

Despite efforts to ramp up manufacturing, persistent supply chain disruptions, material shortages, and Covid outbreaks in key manufacturing areas in Asia, have caused a bottleneck that is delaying orders and causing backlogs to pile up. This means that constrained supply is butting up against unprecedented demand, driving up prices. The consumer price index was up 5% year-over-year in May, the largest annual increase since 2008.



The key question for investors is whether this trend is, as the Fed asserts, transitory in nature. Some economists argue that the price increases we are seeing are simply a byproduct of the economy springing back to life after the pandemic and that they will subside once supply and demand return to equilibrium. They also assert that the so-called base effect is skewing the inflation gauges, as year-over-year price comparisons are magnified by the downward price pressures seen in the early days of the pandemic.

While the broad consensus remains that a return to the hyperinflation seen in the 1970s is highly unlikely, the Fed may be wrong about the transitory nature of this inflation spike, which could prove to be more persistent—and pernicious—than the Fed realizes. The CPI and the personal consumption expenditure index (PCE)—the Fed's preferred inflation gauge—omit housing costs, viewing it as an investment rather than a consumer product. This ignores a key component of most Americans' budgets and obscures just how much more expensive the cost of living has become.

The housing market has been red hot since the pandemic, as the advent of remote work has caused millions of Americans to look for more spacious housing. At the same time, the number of homes available is at a historic low, and massive demand meeting little supply has driven home price growth to unprecedented levels. Year-over-year home price growth hit a record 14.59% in May, the highest ever for an index that goes back more than 30 years, topping even the gains seen during the run-up to the 2007 housing bubble. Renters are also feeling the pinch, with the national median rent climbing nearly 10% in the first half of the year and hitting a new record in June.

Another potential driver of inflationary pressure is wage growth. There are a record number of open positions in the U.S., and in an effort to fill them, employers are beginning to raise wages. The portion of workers leaving a job who have done so voluntarily is also at an all-time high, and traditionally workers only quit because they believe they can get better compensation elsewhere. While this is good for the workers who secure higher wages, the employers will likely push their increased labor costs onto consumers by raising prices, further driving inflation.

While fears of runaway inflation are likely overstated, even a few consecutive quarters of moderate inflation, say 3% to 5%, could hinder economic growth. Recent reports suggest that the supply chain disruptions and shortages will continue through the end of the year. If consumers are still facing higher prices and product shortages when they begin their holiday shopping, then "transitory" will feel like an obviously inapt descriptor. Underlying all of this is the broader macroeconomic factors that drive inflationary cycles. The Economic Cycle Research Institute's future inflation gauge remains in an upswing and is expected to remain so until at least later this year, meaning that inflationary pressure is likely to persist. If the spike in inflation does prove to be more long-lasting or more severe than the Fed expects, their only options to combat it risk derailing the economic recovery.

Can the Fed Ensure a Soft Landing?

In the early days of the pandemic, the Fed slashed rates and enacted a massive asset purchasing program, which ensured liquidity and helped stabilize the financial markets. Now, with the crisis largely behind us, the Fed faces the difficult task of bringing a skyrocketing economy back down to Earth without driving it into the ground.

At the most recent Federal Open Market Committee meeting, the Fed struck a slightly more hawkish tone, with the consensus around a rate hike shifting to 2023 rather than the previous estimate of 2024. Still, the Fed signaled no change in their thinking with regards to taping off asset purchases, though they acknowledged that they had begun discussing it. Even this subtle change in thinking was enough to roil investors, however. The yield curve flattened abruptly, and stocks posted their worst week since February following the meeting. This shows how precarious the Fed's situation is, and every piece of good economic news—especially with regards to employment—has the potential to spark volatility as investors speculate on how it will shift the Fed's thinking.

There is more danger, unfortunately, in the Fed delaying a policy change. Larry Summers, who served as Treasury Secretary for President Clinton and acted as an economic advisor to President Obama during the 2008 crisis, recently warned that the Fed's overly accommodating stance, coupled with massive stimulus spending from the government, runs the risk of overheating the economy and leading to persistent inflation. The Fed's only option to combat this would be an abrupt and severe rate hike, which could cause an economic downturn. Summers warned that previous disinflationary efforts have all resulted in the economy entering a recession, a fate we may similarly face. Economists also warn that keeping rates low for too long may sour foreign investors to U.S. debt, and the Fed may be forced to further ramp up its asset purchases to make up for the shortfall, further fueling the monetary inflation it seeks to combat.

Stocks

The Fed's current policies also have the unfortunate consequence of driving up already inflated stock valuations. While we remain cautious of a potential bubble in the making and concerned about extreme levels of speculation with regards to cryptocurrency and SPACs, the stock market is not wholly detached from reality. Broadly, the stock market is overvalued, but not to unsustainable levels, especially if earnings remain strong. We cannot discount the possibility of a major correction in the next 12-18 months, especially if the economic recovery stalls or the Fed abruptly shifts its thinking. We will continue to prepare for this by building tactical positions to neutralize exposure and adjusting allocations according to changing market conditions.

In the near term—the next 6 to 12 months—we remain optimistic about the stock market's prospects, but a moderate correction remains possible. After the rally we have seen in recent months, a contraction is to be expected. Many of the workplace changes that started as a response to the pandemic are likely to stick around, which is expected to increase productivity. Inflation can negatively impact stocks, but so long as economic growth keeps pace, earnings should remain strong. After a 14-year run of being outpaced by growth stocks, value stocks have outperformed by a wide margin this year. Historically, value stocks also outperform during inflationary periods, so the trend is likely to remain. This provides the opportunity to realize meaningful gains outside of the richly valued tech giants that have dominated in recent years. Inflationary periods have historically seen elevated levels of volatility, but the Vix "fear" index has declined significantly in recent months, sitting at a level only slightly above its historical norm. This signals a good deal of confidence on the part of investors and may preclude wild swings in the stock market.

Fixed Income

After a volatile few months at the start of 2021, the bond market was surprisingly quiet in the second quarter. After climbing from less than 1% at the start of the year to a peak of 1.7% in March, ten-year Treasury yields have hovered in a range near 1.5%. The Treasury market has largely shrugged off news that seemingly would have roiled the market, such as spiking inflation and uncertainty around Fed policy. Yields are expected to resume their climb in the second half of the year, with 10-year yields rising to the 2-2.5% range. Even at this level, many Treasuries will see a negative rate of return. Conservative inflation expectations put it at a range between 2% and 3% over the next ten years, outpacing yields even if they continue to climb.

Historically, if there is a major correction in the stock market, Treasuries can serve as a ballast against losses there. However, in the short term, the most likely causes of a correction would be climbing inflation or an abrupt shift from the Fed, which would also roil the Treasury market, reducing their potential efficacy as a hedge.

Our preference remains for highly rated investment-grade corporate bonds, where higher yields can be found without taking on much additional risk. We also think now is a time to heavily diversify fixed income holding, especially with regards to U.S. and foreign bonds. With the potential of the Fed raising rates on the horizon, duration should be only short or intermediate to minimize interest risk. We also continue to see municipal bonds as very attractive, especially for investors in a high tax bracket. The interest paid on muni bonds is generally tax-free, which may be especially attractive with the possibility of tax increases later in the year.

International Markets

Much like in the U.S., central banks and governments around the globe slashed rates and injected stimulus into their economies, and they now find themselves in the same position as the Fed, finding a path to normalize their monetary policies and fend off inflation. According to the Organization for Economic Cooperation and Development (OECD), consumer prices in the organization's 36 members, mostly rich nations, rose at the fastest pace in more than 12 years. Prices in OECD nations were 3.3% higher in April than they were a year before. Among the G20 nations, which account for about 80% of all global economic activity, inflation climbed 3.8% annually, up from a 3.1% increase in March.

Some central banks, such as Brazil's and Russia's, have already raised interest rates. The People's Bank of China has recently made an effort to curb credit growth and contain rising debt levels. Not all central banks are eager to end their easy lending policies, however, as neither the European Central Bank (ECB) nor the Bank of Japan have signaled any intent to raise rates from their near-, or below-, zero levels.

Despite the challenges facing central banks around the globe, the global economy is expected to see a robust rebound this year, with economic growth in both international developed economies and emerging nations expected to outpace U.S. growth. The International Monetary Fund (IMF) is forecasting global growth of 6% in 2021, fueled by global vaccine initiatives, additional fiscal stimulus, and businesses learning to adapt in regions where vaccine distribution is lagging. If the IMF's projections are accurate, 2021 would see the fastest pace of global economic growth in nearly 50 years. The Eurozone is expected to lead global growth, due in large part to the region's delayed economic reopening and slow vaccine rollout. While America's economic rebound may have peaked in the second quarter, and China's peaked in the fourth quarter of 2020, Europe's post-pandemic growth is not expected to peak until later this year, fueled by the ECB, which has ramped up its bond purchases and is set to rollout Europe's largest-ever stimulus package.

In most global recessions, emerging market economies tend to suffer worse than their developed counterparts. In 2020, however, emerging markets fared better, seeing a GDP decline of just 2.2% compared to a 4.7% drop in developed nations. They are also poised to outperform this year as well, with the IMF projecting GDP growth of 6.7% in emerging markets, well above the 5.1% growth forecasted for developed economies. Emerging market currencies have also proven to be resilient, with the MSCI Emerging Market Currency Index hitting an all-time high in May. The rebound in emerging markets is due in no small part to surging commodity prices, which are the foundation of many emerging market economies. Should global consumer demand prove to be more muted than expected or if inflationary pressures subside, a drop in commodity prices could derail the rebound of many emerging markets. Although because they engaged in much lower levels of fiscal policy than developed nations, emerging economies do not face many of the challenges central banks are grappling with.

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