

FIRST Forward Investment Insights™

July Commentary

For Whom the Bell Tolls...

With summer ending and students heading back to classrooms and universities all around the country, I was reminded of a notable sensory trigger from my days in school. The sound of a simple, but very loud, school bell. It rang to signal the start and end of each school day. Then throughout the school day, a bell would ring telling me and other students to move from one class to another. And the most annoying of all, yet another bell would ring marking the end of my favorite part of the day—lunchtime. So, from school bells to the familiar sounds of the bell at the New York Stock Exchange, the ringing of a bell often signals the beginning and/or end of an event. Unfortunately for investors, there is no loud, audible bell signifying the beginning of a meaningful equity market rally or market decline.

With that unfortunate reality as our backdrop, few predicted the swift COVID-induced 34% stock market decline last year and even fewer foresaw the unprecedented 100% stock market rally since last March. In fact, the current S&P 500 bull market is the best on record at this juncture, outperforming all previous bull market runs by at least 40%. While timing the stock market precisely is a nearly impossible feat, there are techniques investors can employ to maximize their long-term performance. With calls for a potential pullback ringing an alarm from many, it is essential to put volatility into perspective and address what action you should or should not take when one occurs.

Is Lunchtime Over Already?

Market declines, like market rallies, are part of the very fabric of the financial markets, though the patterns are not always discernible. Pullbacks in the market are normal and one may be overdue. Why, might you ask? Historically, the S&P 500 experiences three to four 5% or more pullbacks per year, and we have not had *one* this year! In fact, the S&P 500 is on the third longest streak without one in the last 25 years (more than 10 months). Using history as our guide, it will come as no surprise if we see a stock market pullback of that size in the second half of the year. A larger pullback is less likely unless we have a major setback in the economic outlook or some tragic, unforeseen “unknown.”

As much as we advise against attempting to time the market, we also coach investors to not allow emotions to dictate portfolio decisions. Too often, they go together, and historical returns reveal just how badly a portfolio can be damaged by emotionally driven, panicked decision-making. Market data shows that an investor who missed the 20 best trading days (of the total 5,030 trading days) over the past 20 years would have posted an annualized price return of -0.1%. By comparison, an investor who remained fully invested and participated in all trading days would have had an annualized price return of 6.6% over that same time period. Even more telling was the fact that these 20 best trading days occurred within two weeks of a 5%+ pullback 90% of the time, reflecting that panic selling during volatility is a sure-fire way to underperform the market. Time in

the market and not timing the market is what builds wealth.

When looking at near-term influences, one that currently gives pause for caution is investor complacency. Not the kind of complacency that signifies indifference to results, but the kind that exudes overconfidence and even carelessness. Currently, three of the most notable bells clanging would be: investor stock allocations are at a three-year high, the percentage of portfolio cash allocations in investment accounts are at the third lowest level in 20 years, and the percentage of analyst “Buy” ratings on individual stocks is at an 18-year high. None of these factors sound unpleasant on their own, and may even be quite satisfying, but clanging together they could be ringing a more ominous tune.

Let us assume history does indeed play out and we see a market decline in the near future. We would view a pullback as a buying opportunity because of the fundamentals that are ringing loud and clear: continued economic growth into 2022, unprecedented profit-making by corporate America, increasing dividends and stock buybacks by some companies, and attractive valuations and investment opportunities relative to bonds. The high note may be that, if and when there is a pullback, we do not expect it to be substantial in duration or depth. Accordingly, we will continue to advise clients to focus on the factors they can control by following their plan and process—patience, discipline, and rebalancing are three key themes to consider in volatile markets.

“We know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don’t know we don’t know.” — Donald Rumsfeld (1932-2021), Secretary of Defense under Presidents Gerald Ford and George W. Bush

The famous quote above was made in 2002, during an Iraq War press briefing, and ironically enough, his tongue twister of a comment could be used today to describe the current investing environment. “Unknown unknowns” (as Rumsfeld called them) are scenarios or developments that appear unexpectedly yet must be prepared for even though they cannot be predicted. The most

recent “unknown unknown” to make itself known is the COVID-19 pandemic.

Saved by the Bell... The Diversification Bell

While pullbacks are a natural, dare I say, healthy occurrence in the equity markets, they can be quite uncomfortable. But once an appropriate asset allocation is established, rebalancing becomes fundamental to achieving investment goals consistent with a predetermined level of risk. History shows rebalancing (either monthly, quarterly, or annually) is vital. However, over the past year, many investors have resisted the idea of rebalancing their portfolios after experiencing an extended period of robust equity market performance. Inevitably, rebalancing can carry its own explicit costs for individual investors in the form of capital gains realization (i.e., the difference between the cost basis of an asset versus what that asset can be sold for today). Lest we forget, Uncle Sam wants his share of that profit as a capital gains tax, and while paying taxes is never fun, it is an inescapable reality of living in the greatest country in the world. Furthermore, it helps to remember that generating positive rates of return is the fundamental purpose for investing! Another less recognized outcome that occurs when rebalancing a portfolio is that it carries a natural value bias. Most often, investors sell assets with the greatest appreciation (which are now typically less attractively priced) and buy or hold onto assets that are currently undervalued and haven’t performed as well.

Can You Repeat That Please?

“When E.F. Hutton talks, people listen.” Who remembers that iconic commercial and quote? Today, the man everyone is listening to is Federal Reserve Chair Jerome Powell, and for good reason. The Fed Chair’s actions on monetary policy have the potential to be enormously influential on both the markets and the economy. However, as important as the Fed is, it would be unwise to lose sight of the larger picture when it comes to assessing the markets—corporate earnings and profits.

Company earnings are a key measure of the fundamental health of the economy and, thus far, results have not disappointed. The unusually strong

second quarter earnings season and positive outlooks from management teams have helped the S&P 500 reach a new all-time high as of this writing. With 85% of S&P 500 companies having reported results so far, second quarter earnings growth is at an impressive 93% year-over-year — in simpler terms, nearly all the companies reporting so far have almost doubled their earnings when compared to last year. Consequently, the U.S. equity market has continued to drift higher despite the shrill sounds of several bells: delta variant challenges, the recent plunge in Treasury yields, ongoing inflation and supply chain challenges, and uncertainties about the economic recovery. Is the market being complacent? No, not if you consider the greatest of all motivators: profits. Rightfully so, investors seem more focused on what truly makes the market tick over the long run—corporate profit growth.

Market Snapshot

Following the frantic market activity observed in the first quarter of 2021, which was largely fueled by excess from government coffers, the second quarter felt almost normal. Equity market returns were strong across the board and the period's biggest gains were seen in value-oriented large cap equities, and not the high-growth, high-valuation issues that dominated market returns the past year or so. During the quarter, the S&P 500 Index posted a broad-based 8.5% gain, with 10 of the 11 S&P 500 sectors delivering positive results as strong earnings growth boosted most sectors. Only the utilities sector (often viewed as a bond proxy) finished in negative territory, with a slight decline of 0.4%. And, although they lagged large-cap stocks for the quarter, small- and mid-cap U.S. stocks also added to year-to-date gains with mid-single-digit returns. Core fixed income (bonds) also posted positive returns during the second quarter, with the Bloomberg Barclays U.S. Aggregate Bond Index posting a 1.8% gain that cut its year-to-date negative return nearly in half. Bond prices benefitted from falling interest rates during the quarter as the 10-year U.S. Treasury Yield dipped from 1.74% to 1.47%.

In short, the second quarter was a period of exceptional economic recovery and market performance, particularly within areas more tightly linked to improved levels of economic activity. The second half of the year, however, has gotten off to

a slightly rockier start, with equity prices signaling a less “linear” recovery from here. It could be said that a more cautionary “tone” has crept into the narrative.

“The bell never rings itself; unless someone handles or moves it, it is dumb.” — Plautus (184 B.C.), Rome’s greatest comic playwright

The reopening of the U.S. economy has created anomalies in both the market and the economy, which will likely continue to play out through the end of the year. For example, as individuals were shuttered-in during the height of the pandemic, spending moved away from traditional consumer discretionary items and focused instead on home improvement. This dramatic increase in demand by consumers had a massive effect on the lumber market, which is historically positioned for home builders and renovation contractors. These demands, along with reduced production capacity as sawmills limited operations due to COVID-19, triggered a meteoric rise in lumber prices — \$10 for a 2x4, nearly \$100 for a sheet of plywood, etc. As consumer spending shifted this summer toward leisure and hospitality services, the price of lumber has fallen while the costs of other items (such as rental cars and hotel room rates) have skyrocketed. We believe these swings will continue globally across markets as the year wears on and consumption habits continue to shift and evolve.

The argument for continued economic recovery and expansion into the second half of this year and beyond is supported by record levels of household wealth, strong economic fundamentals, and unprecedented policy support. During the pandemic, consumers stockpiled an estimated \$5.4 trillion of additional savings while low interest rates reduced household debt service to the lowest levels in 40 years. This could suggest that household financial strength and consumer spending may be more sustainable over a longer period, rather than just a temporary caffeine buzz from pent-up demand.

Jobs are Back—But Where are the Workers?

Maybe we should ring an old-fashioned dinner bell and the workers will come running. Evidence suggests that during the height of the pandemic, the travel and hospitality industries emerged as

two of the most severely impacted sectors of the U.S. economy. This summer, as Americans ventured from the confines of their homes and set-off on long-awaited vacations, widespread shortages in both labor and goods became obvious. In actuality, the scarcity of qualified workers has affected all sectors of the economy as businesses compete to fill empty slots by offering higher wages, signing or retention bonuses, and other perks. While the winding down of enhanced pandemic unemployment benefits triggered a return to the workforce for some, others used their time at home to reconsider their career plans or opt-out altogether. According to a July 9, 2021, Wall Street Journal article titled “Job Openings Are at Record Highs. Why Aren’t Unemployed Americans Filling Them?”, 55% of job seekers are searching for work that can be done remotely. In fact, a new survey found that nearly 31% of those who lost their jobs during the pandemic do not want to return to that same job. This phenomenon is creating a mismatch between the positions that are available and the skills needed to fill them.

Under normal conditions, as the job opening rate increases, the unemployment rate falls. As of July 2021, the unemployment rate fell to 5.4% from a COVID-19 peak of 14.8%, yet the job opening rate is the highest it has been in decades with approximately 9 million unfilled jobs. The most unexplainable thing about this data is that both job openings and unemployment have remained elevated simultaneously for months. This unusual scenario is causing labor inflation (more jobs than workers) in what historically would be a high unemployment period – maybe it is because

workers are expecting higher wages, better benefits, working from home, etc. Hopefully, the fact jobs are filling more slowly will lead to better job matches, longer job retention, and a reduction in employee turnover.

The Closing Bell...

Despite the obvious headwinds, we are seemingly in a much better place as a country on both the public health and market fronts than we were even a couple of months ago. We remain enthusiastic as we watch this path unwind because it confirms our belief that healing of the economy will prevail, and any resulting permanent damage should be limited. That said, the month of July also reminded us that real risks to recovery remain.

Clearly, the markets’ results over the past year have been breathtakingly (and unexpectedly) positive. Acknowledging this, what can we reasonably conclude? How can we confidently devise portfolios that will endure through the “unknown unknowns?” We believe that two major investment principles hold the answer: 1) Broadly diversified portfolio investments that utilize appropriate strategies and security types in alignment with each investor’s unique objectives and risk tolerance levels; 2) portfolios that are rebalanced regularly to ensure allocations remain at an optimized level for both a client’s risk profile and market conditions.

Until next month... happy investing. Lastly, make sure any bell you may hear calling you to action is ringing loud and clear, because you cannot “unring” a bell.

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