FIRST Forward Investment Insights™

May Commentary

The Dog Days of Summer

Memorial Day marked the "unofficial" start of summer. For many, it ushered in the start of picnics, cookouts, trips to the beach, and family outings that include hamburgers, hot dogs, apple pie, s'mores, and homemade ice cream. The best thing about this summer is, that it is NOT last summer! Experiences over the coming months will be vastly different than those we faced this time last year as COVID-19 exerted its damaging influence. As we approach the ever-elusive herd immunity, a much-anticipated economic reopening and greater mobility are both welcome contrasts to social distancing, contact tracing, case counts, and trying to "flatten the curve." Even as the economy rebounds and confidence levels grow, considerable work lies ahead. Forward-looking markets continue to factor in an economic recovery littered with obstacles including inflation, higher interest rates, higher taxes, and COVID-19.

"You unlock this door with the key of imagination. Beyond it is another dimension. A dimension of sound. A dimension of sight. A dimension of mind. You're moving into a land of both shadow and substance, of things and ideas. You just crossed over into … The Twilight Zone." - Rod Serling

The Twilight Zone was a quirky science fiction TV show that ran for five seasons from 1959-1964. It was an eclectic mix of comedic-type drama, peculiar scenarios and superstition that often concluded with an unexpected twist and a moral lesson. As we prepare to end the first half of 2021, the backdrop of investing and its tools has evolved in unique and sometimes strange ways, just like The Twilight Zone. Unusual market events in the first several months of 2021 — the GameStop debacle and the Dogecoin phenomena to name a couple — as well as the creation of new investments that sound like science fiction represent new risks and opportunities investors must carefully consider. SPACs (Special Purpose Acquisition Companies), fractional collectibles, cryptocurrency, and non-fungible tokens (NFTs) have experienced attractive returns relative to traditional marketable assets. They are new, intriguing, and evolving ideas that have not experienced a true market cycle allowing for real pricing pressures and, quite honestly, most are hard to understand for even seasoned investment experts. While we currently do not pursue these as investments for our clients, we want to be clear that we are not blindly dismissing these opportunities. They are just still too "Twilight Zone-like" for our comfort and inclusion in client portfolios.

Market Talk

May's equity markets continued the upward trend, though less enthusiastically than in prior months. The push and pull of backward-looking economic data combined with forward-looking projections led to some volatility. Driving market indecision during May were what I will refer to as the three I's: immunity, inflation, and infrastructure.

While vaccinations (immunity) are marching forward and mask mandates are being eased, questions remain about the long-term effectiveness and the potential need for booster shots, and what may happen when the winter months roll around.

Inflation remains at the top of investors' minds though the Federal Reserve views higher inflation as temporary. The annual inflation rate during May reached a 25-year high at 3%. While energy prices remained little changed during the month, costs associated with autos, airfare, hospitality and leisure (hotels), apparel, food, and commodities experienced increases. One area of concern is that the Fed has shifted its approach from being "outlook" based to "outcome" based. In essence, the new Fed officials have gone from driving via looking out the front windshield to driving via the rear-view mirror. They might get where they want to go; but there is the risk that markets may decide they are lagging the clear rise in inflation. Sounds a lot like walking a dog — you eventually get where you are going but with perhaps a few pitstops along the way. More on that in a few paragraphs.

Talks in Washington surrounding infrastructure — its definition and how to pay for it — remain a focal point, although there is very little clarity as political wrangling remains deadlocked. A summer's worth of debate between Congress and White House leadership should increase the likelihood of a deal by fall. The plan, thought to be in the $1-$2 trillion range, will likely include compromises and adjustments to significantly higher proposed corporate and capital gains rates.

Overseas Help and the Fed

Improvement in the management of the COVID-19 crisis across Europe helped push equity indices up during May. As many parts of the world continue to reopen more fully, life across the globe is slowly returning to normal. The United States, Asia and parts of Europe have all been seeing a resurgence in economic and social activity with the U.S. leading the way as economic activity is booming. As a matter of fact, manufacturing and services activity across the U.S. sits at or near record highs, and two other metrics, OpenTable dining reservations and TSA air traffic measurements, indicate more of the country is returning to regular activity. In China and other parts of Asia, manufacturing and services activity also sits near record highs while in Europe, an improved vaccine rollout, as well as reduced Coronavirus restrictions, could help economic trends improve markedly. Overall, conditions continue to strengthen in economically significant areas of the world, helping to lead U.S. and global stocks higher.

One preemptive question we need to ask as we prepare to exit the first half of 2021 is whether we are facing a long-lasting economic boom. At this point, we are anticipating a boom and then a gradual "settle" scenario, in part because we may be facing another peak in the growth rate for both the economy and corporate earnings. Last year at this time, U.S. economic growth, as measured by Gross Domestic Product (GDP), contracted by -31.4%. That was followed by an eye-popping rebound of +33.4% in the third quarter, with the fourth quarter coming in at a more moderate +4.3%. This year's first quarter saw growth of +6.4%, with the second quarter expected to jump to +9.4% as the economy fully opens. Bloomberg's tracking of expert estimates suggests the first two quarters will be followed by steadily descending, but still positive, growth rates in the third and fourth quarters (+6.8% and +4.8%, respectively).

Other contributing factors for less-robust economic data and the "settle'" side of the boom are the fading impact of governmental help via direct stimulus checks and the reality that supplemental unemployment insurance is set to expire in early September. Although the Federal Reserve has not yet put all its crisis tools back in the toolbox, the impact of less fiscal stimulus has already led to a slowdown in the excess money supply fueling the recovery.

Walking the Dog

If you can use your imagination a little, understanding the relationship between the economy and the stock market is a lot like taking a dog for a walk. Here is a simple illustration:

A dog owner is walking his four-legged friend home from one corner of the park to the opposite corner, on a diagonal, yet in a relatively straight line. He strides steadily along knowing where he is going and is reasonably confident how long it should take to arrive. Tagging alongside him is his faithful canine companion tethered on a long leash that is bouncing all over the place. The dog meanders left to right, right to left, walking, running, sitting, sniffing in no predictable pattern — the owner's walking buddy is in fact on a "sniffari" (combination of sniffing and safari). She is distracted by squirrels, other dogs, other walkers, birds, an endless amount of attractive and distracting scents, and of course stops for an occasional marking. If you can, imagine that the man walking the dog is the economy and that his dog is the stock market. The daily financial news and all its machinations are not at all interested in the economy's long-term steady march but instead focus solely upon the dog's frantic, winding path, all the while guessing at the next move. Most investors insist they pay attention to the economy (the old man) but are instead intent on watching the market (the cute dog) and join the culmination of hundreds of millions of people's greed and fear as they react to the market news. Market pundits are asked endlessly what the dog will do next (market predictions), but most say a lot about themselves, how cute the dog is or is not, but utter very little about the direction of the economy. It is vital to understand that the stock market leads the economy and over the long term, the market's wild ride is indeed tethered to the economy's leash and smoother path. So, without question the economy and the market are moving together, going to the same place, just like the dog and her owner. Their paths may not be in lockstep with one another and sometimes they do not even appear to be walking together. However, as well-informed investors, we know they belong together, and will watch them both all the way to their destination. If you are a dog owner like me, you could probably easily relate to this analogy. It made me realize why it feels like my Goldendoodle, Marley, is always the one taking me for a walk… I am just the economic means tethered to her next meal.

The Bottom Line

Looking ahead to the second half of 2021, the economic recovery should continue, but as mentioned earlier we think there are some concerns the market will need to flush out. The combination of peak economic/earnings growth rates, higher inflation, potential higher taxes, increased government spending and Fed policy (rising interest rates) may lead to more volatility. We believe, however, the positives for our economy, corporate America, and consumers still outweigh the potential negatives. As a gentle reminder, just as panic is not an investing strategy, neither is FOMO (Fear of Missing Out).

- Ignore the well-known financial market adage of "sell in May and go away" and review your portfolio regularly. Stock returns are historically less robust in the May through October period, but they are generally positive.

- Inflation pressures, supply disruptions and worker shortages may linger and weigh companies and their ability to meet surging demand. Investors should consider these setbacks temporary obstacles in the ongoing recovery. (The couch my wife and I ordered in early March has now been delayed until November!)

- The possibility of higher corporate and individual taxes is growing due to policy proposals from Washington. But alone, higher taxes would be unlikely to disrupt market momentum longer term, in our view.

- Companies are struggling to find qualified workers even as the unemployment rate remains elevated. This can be attributed to federal unemployment benefits exceeding potential wages, unqualified workers, lack of available childcare, retirement of workers, and virus concerns.

Perhaps some of you recall the memorable 1970s TV commercial featuring a gentleman eating a chocolate bar who slips on a roller skate and falls down a flight of stairs, landing on a little boy holding a jar of peanut butter. “You got peanut butter on my chocolate,” declares the man; “well you got chocolate in my peanut butter,” the boy exclaims. This accident, at least from an advertising standpoint, gave rise to the Reese’s Peanut Butter Cup — one of the most iconic candies ever created. Two very different, yet incredibly tasty ingredients made better together while creating something new and delicious.

Maybe we should all view the combination of our economy and the market as a delicious treat. Not as tasty as a peanut butter cup, but more rewarding in the long run!

Happy investing and enjoy the summer -

by David Lackmann
Florida Director of Investment Management

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