

## EQUITY MARKET UPDATE

As of 5/31/21 | Volume 10, Issue 5 | FFTAM.com

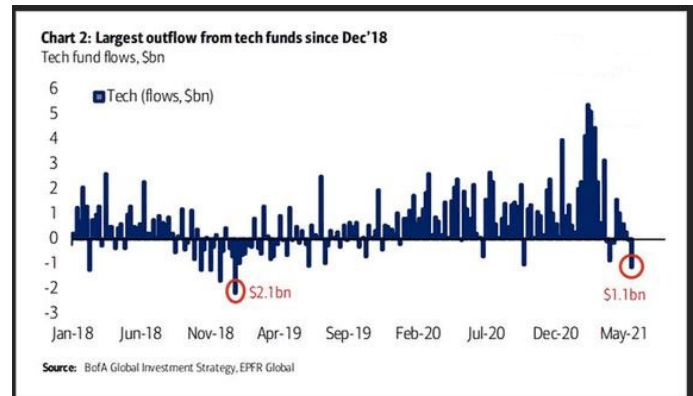
Most stock indexes were positive in May. Investors continue to debate the potential for future inflation. The Fed insists that the current inflation data is “transitory” and will normalize over the next 12-18 months. As a result, monetary conditions remain very accommodative, which is fueling increases in the stock market. However, shortages in products and labor, along with consumers flush with cash and additional spending proposals from the Biden Administration are resulting in outperformance in economically sensitive sectors.

### US Stocks Advance, but NASDAQ Retreats on Tech Stock Outflows

The S&P 500 gained 0.70% in May. The Index was powered by the highest beta names in energy, materials, and financials. Those three sectors are the highest performers thus far in 2021 with total returns of 39.22%, 20.91%, and 29.53%, respectively. These numbers far surpass the S&P 500’s year-to-date return of 12.61%.

The Dow Jones Industrial Average increased by 2.21% last month. A lower allocation to technology, along with sharp rallies in Goldman Sachs, Caterpillar, and Boeing accounted for the outperformance versus the S&P 500. Year-to-date, the Dow is up 13.76%.

The NASDAQ was once again the worst performer among the three large cap indexes. It fell by 1.44% in May as \$1.1 billion came out of tech-specific funds, the largest monthly outflow since the market crash of December 2018. In 2021, the NASDAQ significantly trails the S&P 500 and the Dow Jones Industrial Average with a total return of 6.98%.



The best yearly results continue to come from mid and small-sized companies. The S&P 400 Mid-Cap Index increased another 0.20% in May, while the S&P 600 Small-Cap Index gained 2.07%. Both indexes are benefitting from a rotation towards more economically sensitive stocks. Small-cap indexes are also being powered by large gains in stocks like AMC Entertainment and GameStop as retail investors chase ideas being spread on the social media platform Reddit. Thus far in 2021, mid and small-sized companies have rallied 18.81% and 23.14%, respectively.

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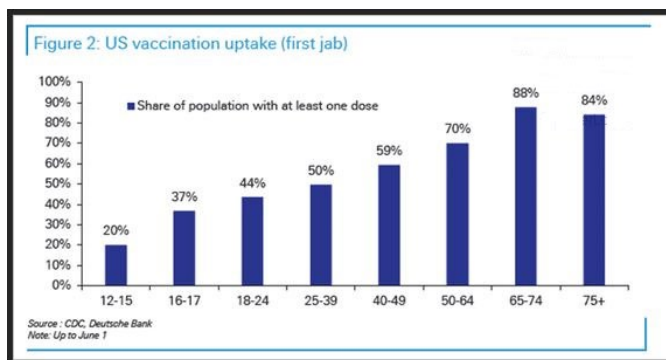
## International & Emerging Market Stocks Rally as European Economy Reopens

The European Union, which had lagged the US for months in vaccinations, gained ground in May with over 20 million people getting vaccinated weekly. Almost 40% of Europe's population has received at least one shot. This enabled Germany, France, Italy, and Greece to lift restrictions. The region is also preparing to allow vaccinated American tourists to travel unconditionally in the summer. As the European economy reopens, inflation in May accelerated to 2% (in-line with the ECB's target), but price hikes were limited to areas sensitive to reopening such as oil and raw materials. With 1.3 million fewer jobs in Europe than pre-COVID, the ECB believes there is plenty of slack in the economy before monetary conditions need to be tightened. These items aided European stocks, which hit a record high in May. The MSCI EAFE Index jumped 3.66%. The results were unfortunately weighed down by rising COVID-19 infections in Japan just two months before the start of the Summer Olympic Games in Tokyo. Year-to-date, the MSCI EAFE Index is up 10.76%.

The MSCI Emerging Markets Index only gained 1.16% in May due to some political events in China. First, the Chinese government continued its crack down on the use of crypto currencies. Next, President Biden expanded the executive order from President Trump on banning American investments in companies linked to the Chinese military to 59 firms from 31. Third, China released results from their census that showed the working age population decreased by 45 million people from the previous decade. The Communist Party responded by allowing families to now have three children, and they plan to boost investment in automation technologies. Finally, manufacturing and service-based PMIs in China weakened slightly due to supply chain disruptions and spreading COVID-19 cases in Asia. Year-to-date, emerging markets remain the weakest performer gaining only 6.01%.

## FDA Approves COVID-19 Vaccine for Kids 12-15, while Daily Cases Fall

The FDA approved the use of Pfizer's COVID-19 vaccine for children ages 12-15. The announcement comes on the heels of Moderna announcing their vaccine is 100% effective in teenagers after two shots. More importantly, they found efficacy to be 93% in teens receiving only one shot. Daily new cases of COVID-19 in the United States continues to fall to levels not seen since the onset of the virus last spring. According to the CDC, 51% of Americans have been vaccinated, and over 84% of senior citizens have received both shots. The high percentage of people aged 65+ being fully vaccinated is leading to a sharp decline in daily deaths. We are seeing similar results in Israel and Britain. Unfortunately, COVID-19 continues to rapidly spread in several Asian countries including Japan, Singapore, Taiwan, and India. Finally, President Biden has ordered an investigation into the origins of COVID-19 after an intelligence report requested by President Trump showed plausible evidence that the illness came from the Wuhan Institute of Virology.



## US Reopening Remains on Track, but Labor and Product Shortages Stoke Inflation Fears

Economic data showed further improvement in May. Non-farm payrolls increased by 559,000 jobs, but that number lagged consensus forecasts for a second straight month. The disappointment was not a demand issue as total job openings reached a record 8.1 million. The supply of workers remains constrained, and it is causing an increase in hourly wages. A shortage of workers is occurring in most industries with the problem most acute in the leisure, hospitality, and food services segments of the economy.

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Retail sales spiked once again as consumers spent money from their stimulus checks. With more people vaccinated and the economy reopening more widely, the spending is shifting towards services over goods with large increases seen in recreation and restaurant dining. The brisk pace of consumer spending is leading to critically low inventory levels in many products. ISM Manufacturing PMI data shows further expansion with large increases in new orders; however, the backlog time to get the finished products is lengthening as factories are having difficulty hiring new employees. The ISM Services PMI data showed similar results. To encourage more people to return to the workforce, 24 states have decided to end enhanced unemployment benefits before the July 31<sup>st</sup> federal deadline.

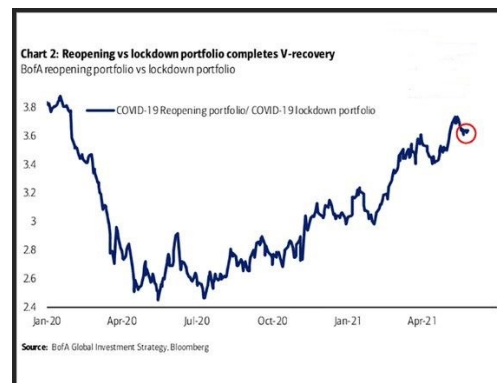
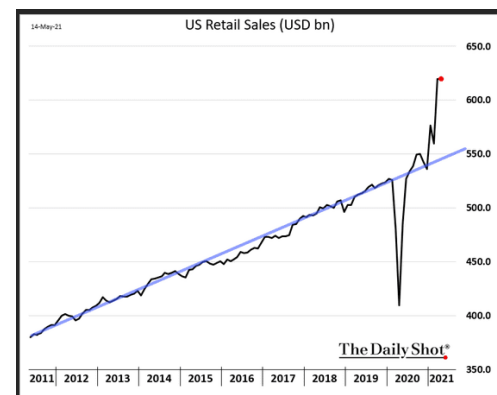
The shortage of workers and products resulted in PPI and CPI data running hotter than consensus estimates. Air fare, used cars, hotels, transportation, and entertainment events explained most of the gains. Fed Chairman Jerome Powell reiterated that above average inflation data is transitory and will return to normalized levels once more people have spent their stimulus checks and return to the workforce. The minutes from the most recent Fed meeting showed a growing number of participants suggesting that a conversation on tapering asset purchases may be needed if the economy continued to make rapid progress towards the Fed's goals on unemployment. The Fed did announce they were winding down their \$13.7 billion corporate debt and ETF portfolio they purchased last spring.

## Market Flatlines Towards Month-End with Debates on Valuation and Inflation

Currently, the S&P 500 trades at 22.48x 2021 EPS estimates. This is far better than the 29.91x trailing earnings reading, and it shows how rapidly corporate profitability has improved. If you fast forward to the 2022 and 2023 profit forecasts, the index trades at 20.11x and 18.19x, respectively. All these valuations are well above the historical median of 16.61x, and they do not consider President Biden's proposed tax increases.

As I have mentioned many times before, the rally since November is being driven by a sharp rise in the price of cyclical stocks with leadership seen in high beta and deep value factors. The best performing industries are those most sensitive to interest rate breakeven levels—a signal for inflation expectations. However, a recent research piece from Bank of America showed a complete v-shaped recovery for reopening vs lockdown trades. They, along with Morgan Stanley, believe we are reaching a peak in year-over-year profit growth, inflation, and investor risk taking.

All these indicators signal the market has baked-in much of the upcoming improvements for the economy; therefore, stocks are vulnerable to further consolidation or pullbacks in the next few months. We expect volatility to remain high as the economy transitions from the early to the middle stages of the business cycle.



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## Our Outlook & Strategy

For the last few months, I have written that elevated risk taking and preference for the most economically sensitive stocks is coming at the expense of companies with strong balance sheets. In May, financial quality was the fourth lowest performing factor, and it has trailed the market for seven consecutive months.

This has impacted our results. First Financial has historically underperformed during the early cycle stage of the business cycle which typically lasts around one year. Our focus on owning financially strong companies with durable competitive advantages is not in vogue in the early days of the economic recovery. Since we tend to hold high quality companies for several years, our best relative performance has historically occurred during the middle and late cycle stages which last several years.

As we evaluate our roster of holdings across our equity styles, we remain highly selective about which companies to own. We are constantly searching for companies that will benefit from long-term secular trends that can produce top-line revenue growth and sustainable cash flows. The increased appetite for economically sensitive stocks that do well in inflationary environments has negatively impacted our holdings in technology and healthcare more so than other sectors.

The effects of COVID-19 will likely create a new “normal” for investors to consider. We have accelerated the time frame on the use and adoption of mobile technologies for education, shopping, entertainment, doctor visits, etc. We have also adapted to a non-centralized workforce. We have seen from the past two administrations that the United States wants to encourage domestic manufacturing of semiconductors, medical equipment, and other items deemed to be of national security importance. Finally, the rush to develop a vaccine has brought many new healthcare related technologies to marketplace. When considering all of these items collectively, the Fed is likely correct that total inflation will prove to be transitory as productivity rises from these technological innovations; however, a misallocation of workers and skillsets increases the likelihood that certain pockets of the economy will see above average inflation for many years.

Finally, elevated valuations on stocks and the likelihood of higher interest rates as we progress through the business cycle will serve as challenges for all investors. When stocks have historically traded at these PE values, forward one-year and five-year total returns are well below average. This makes stocks very sensitive to changes in central bank policy, taxation, and regulations. The market is likely entering a period of consolidation in which PE ratios compress as earnings grow into the price.

This creates a headwind for unprofitable companies or those with excessive valuations. Investors should also be on the lookout for any unexpected event that could trigger a market correction.

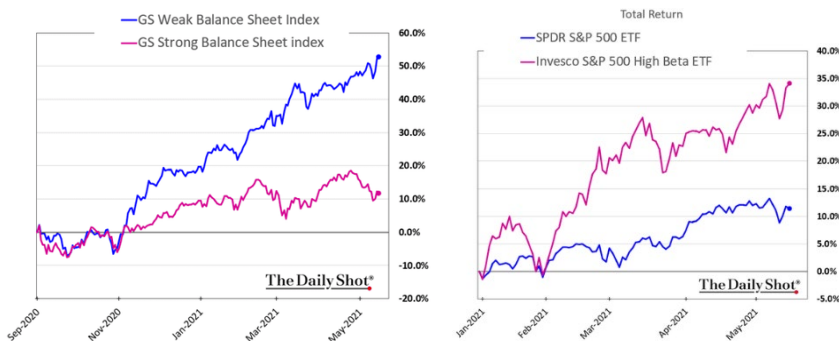
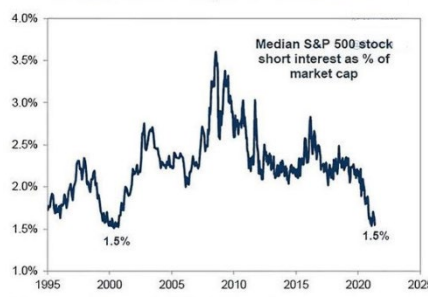
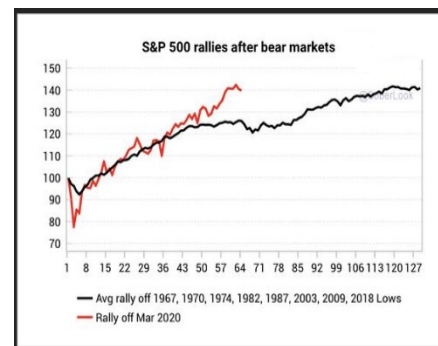


Exhibit 4: Short interest for the typical stock is extremely low



Source: FactSet, Goldman Sachs Global Investment Research



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