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Dueling Narratives

In the July installment of CAPTRUST's Investment Strategy, Sam Kirby shares a market recap for the second quarter of 2021 and reviews the case for continued economic recovery and expansion into the second half of this year and beyond. Also included is a look into the powerful forces that shape capital and global markets—including how those forces work in tandem, and which is the most difficult to measure and predict.

Global capital markets are dynamic, driven by the actions of millions of participants of all shapes and sizes, and with different motivations. These markets are formed by a trio of powerful forces: fundamentals, technical factors, and investor sentiment. Let's dig in on these for a moment.

The fundamentals represent market and economic conditions and profits. Technical factors show the state of liquidity and the flow of assets being bought and sold. The third force, investor sentiment, reads the general mood among investors regarding a particular market or asset—and could possibly be the most difficult to measure and predict—but we'll get into that a little later.

The beauty of well-functioning markets is that they can somehow distill this complexity into a single value: the fair price of exchange for an asset between willing parties.

In normal economic conditions, these three forces participate in a game of tug of war. Fundamental conditions and sentiment may signal that all is well while some technical anomaly appears out of nowhere—and a flash crash might ensue. At other times, widespread optimism and technical momentum can push prices higher despite weakening fundamentals.

But these three forces can also work in tandem, with powerful reinforcing effects. In March 2020, pandemic restrictions severely disrupted economic activity (fundamentals), liquidity issues emerged in the bond market (technicals), and the fear of an unknown health threat dealt a blow to sentiment.

This perfect storm triggered the fastest bear market in U.S. history as the S&P 500 Index plummeted by 34 percent in just 23 trading days. Not long after, the forces swiveled in tandem as the pandemic's fundamental impact to most businesses and households proved not to be as severe as initially feared, and aggressive fiscal stimulus and support programs effectively bridged the lull in private sector activity. Technicals were supported by the massive liquidity injected by the Federal Reserve and other global central banks, while sentiment was buoyed by vaccine progress and rising levels of household wealth. The resulting market recovery was every bit as breathtaking as the decline.

Narrative-Driven Markets

Of these three forces, sentiment may be the most difficult to measure and predict. In his 2019 book, *Narrative Economics: How Stories Go Viral and Drive Major Economic Events*, Nobel Laureate economist Robert Shiller concludes that the stories we tell each other are the most powerful force in economic behavior. Yet, they are frequently overlooked. In a seemingly prescient analogy, Shiller explains that narratives, like viruses, are contagious, spreading from person to person and amplified by social media and the press.

Over the past year, markets have been driven by a powerful and unified narrative of rapid recovery, with asset prices marching higher to the drumbeat of improving virus and economic conditions. Recovery indicators compiled by the Oxford Economics U.S. Recovery Tracker show a nearly complete recovery across a wide range of measures, including health and mobility, supply and demand dynamics, and financial conditions.[1] By virtually any measure, the pace of economic recovery has surpassed expectations. The S&P 500 Index added more than 15 percent to its 2021 returns through the end of June as the 10-year U.S. Treasury's yield nearly doubled during the first half of the year.

But as we neared and passed the mid-year milestone, the mood suddenly shifted. The straight-line increase in stock prices paused, and Treasury yields declined, suggesting more muted growth expectations. Suddenly, a competing narrative with a more cautionary tone emerged, leading some to question whether our V-shaped recovery will be an upper- or lower-case letter.

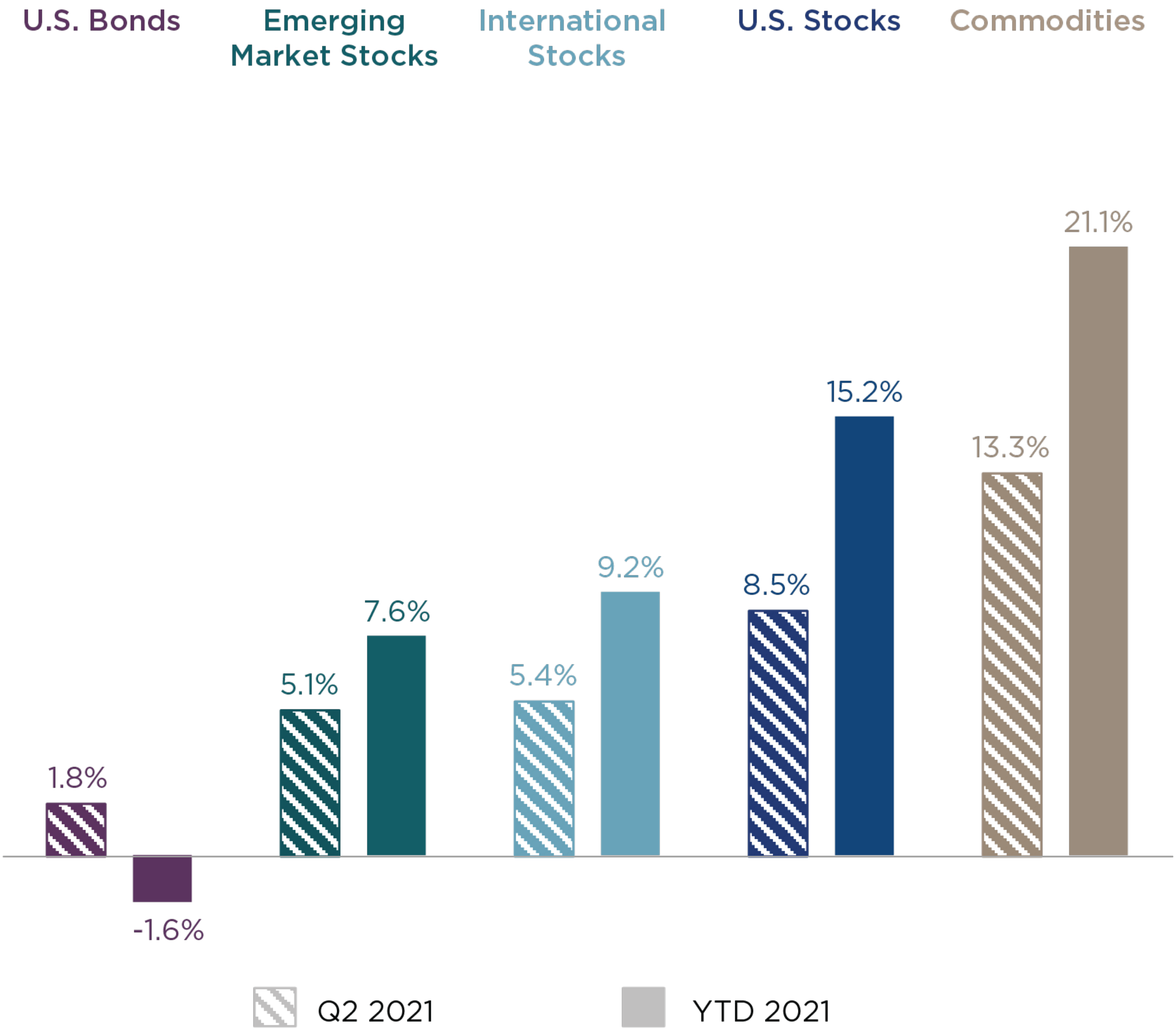
Market Recap—Second Quarter 2021

As the global recovery and growth expectations accelerated through the spring, equity markets advanced, with the S&P 500 Index posting an 8.5 percent gain as it marked new all-time highs. Gains were broad-based, with 10 of 11 S&P 500 sectors delivering positive results as strong earnings growth boosted cyclical sectors, while a late-quarter pullback in interest rates provided support to growth sectors. Only the utilities sector (often viewed as a bond proxy) finished in negative territory, with a slight decline of 0.4 percent. And, although they lagged behind 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.

In Europe, vaccination progress and an ambitious $900 billion stimulus plan drove the reopening forward, paving the way for robust corporate earnings. Emerging market stocks also added to gains as they benefited from accelerating vaccine rollouts and strong commodity prices despite a late-quarter pullback driven by concerns of slowing growth in China.

As shown in Figure One, core U.S. bonds also posted positive returns during the second quarter, with the Bloomberg Barclays U.S. Aggregate Bond Index posting a 1.8 percent gain that cut its year-to-date deficit nearly in half. Bond prices benefitted from falling interest rates during the quarter as the 10-year U.S. Treasury's yield dipped from 1.74 percent to 1.47 percent, while investor appetite for credit remained strong.

Figure One: Second Quarter Performance by Asset Class



Source: CAPTRUST Research

Asset class returns are represented by the following indexes: S&P 500 Index (U.S. large-cap stocks), MSCI EAFE Index (international developed stocks), MSCI Emerging Markets Index (emerging market stocks), Bloomberg Barclays U.S. Aggregate Bond Index (U.S. bonds), and Bloomberg Commodity Index (commodities).

In short, the second quarter was a period of exceptional economic recovery and market performance, particularly within the corners of the market more tightly linked to levels of economic activity. The second half of the year, however, has gotten off to a rockier start, with both equity and fixed income prices signaling a less-linear recovery from here. A more cautionary tone has crept into the narrative.

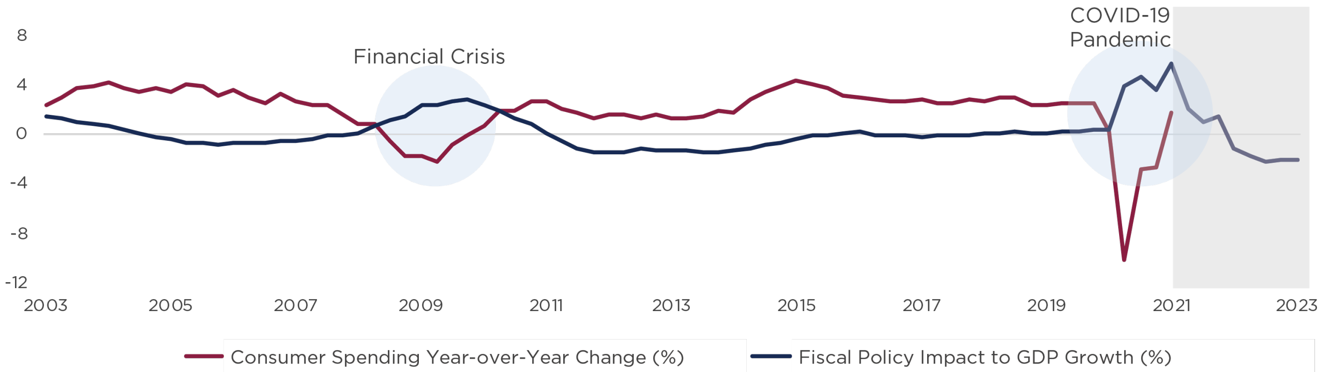
The Continuing Recovery Narrative

The case for continued economic recovery and expansion into the second half of this year and beyond, which remains our base case, is that many of the tailwinds described above remain firmly in place. Record levels of household wealth, strong fundamentals, extraordinary policy support, and growing vaccine availability across the globe set the stage for continued strong growth.

Corporate earnings are a key measure of the fundamental health of the economy and, thus far, results have not disappointed. In fact, earnings surprised to the upside during the second quarter as more than 85 percent of companies included in the S&P 500 Index beat their earnings estimates. Profitability also surged as changes required to adapt to the pandemic and rapid technology adoption boosted productivity. These results have allowed stocks to begin to grow into the elevated valuations reached during last year's rapid recovery.

Another important component of the growth story is illustrated in Figure Two: the all-important handoff from public sector stimulus and support back to private sector economic activity. During the pandemic, consumers amassed an estimated $5.4 trillion of excess savings, and low interest rates have reduced household debt service to the lowest levels of the past 40 years.[2] This suggests that household financial strength and consumer spending may be more sustainable over the long term, rather than a temporary sugar high from pent-up demand.

Figure Two: Impact of Government vs. Consumer Spending



Sources: *The New York Times*, Federal Reserve Bank of St. Louis, The Brookings Institution, Hutchins Center

The Case for Caution

Despite these significant economic tailwinds, the market's tone has shifted in recent weeks. Within equities, the smaller and more cyclical corners of the market have taken a breather as larger companies and more defensive sectors have outperformed. And perhaps most telling, the yield of the 10-year Treasury slipped back to levels not seen since February.

While divining the reasons for such shifts is never easy, a changing narrative almost certainly plays a role. As we move from the initial reopening boom to a more uncertain next phase, a number of wildcards have emerged, resulting in a wider range of potential outcomes and, perhaps, the introduction of more volatility.

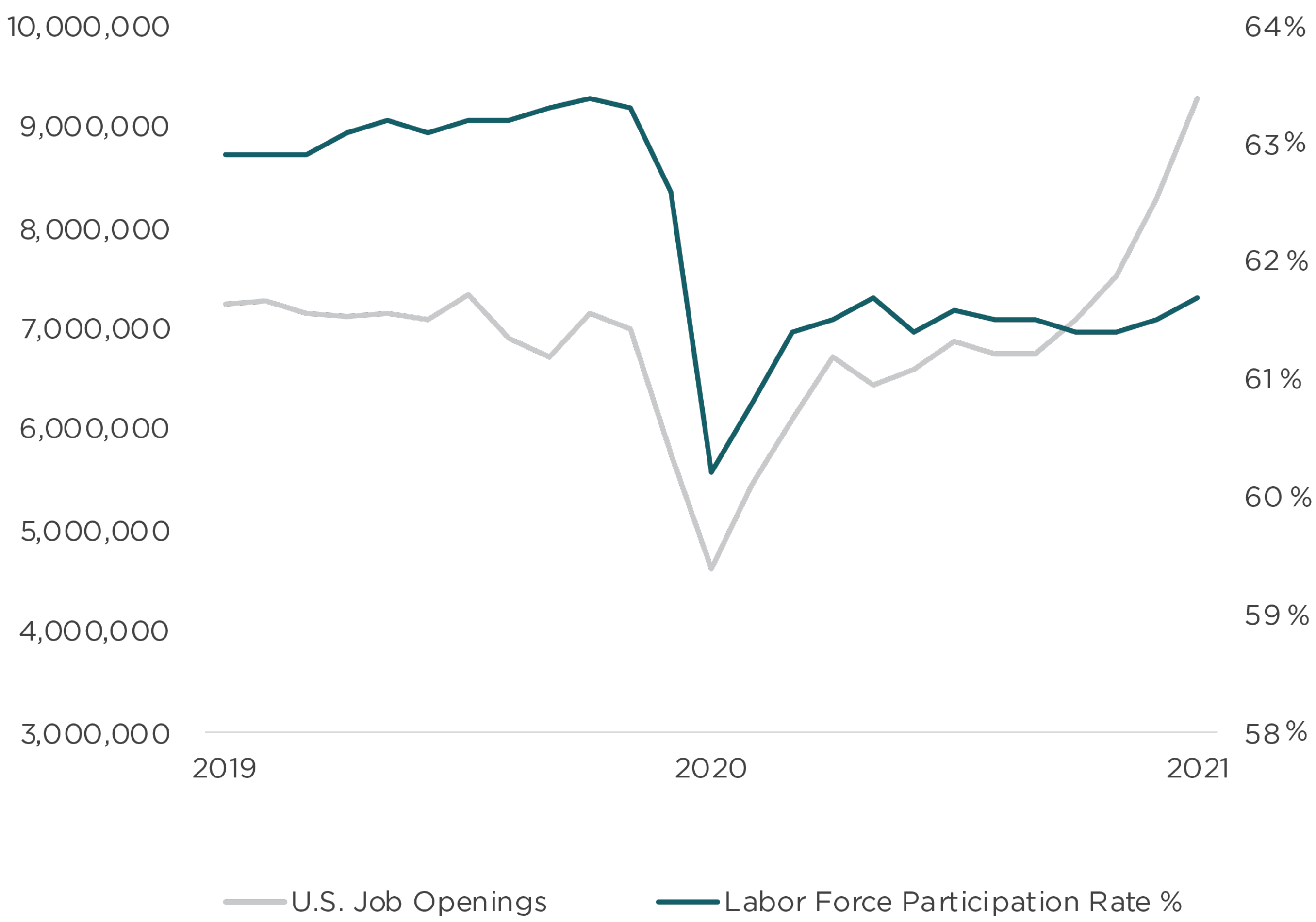
Over the past year, investors have been rewarded as markets priced in economic recovery and growth that was far better and swifter than expected. Surprises have been more or less unanimously to the upside. We may now be nearing (or past) the point of peak recovery optimism. Even if economic trends continue a strong upward trajectory, the growth curve will likely be flatter during the next phase, and this downshift in the growth rate may temper investor sentiment.

Perhaps no theme has dominated the narrative more than concerns that temporary price pressures could bloom into more problematic, long-term inflation. The much-anticipated inflation readings for June revealed a 5.4 percent year-over-year increase in prices, the sharpest increase since 2008.

While some view these numbers as welcome evidence of economic healing, others fear a return to economy-crippling 1970s-style inflation should these price pressures become sticky and begin to alter behavior. The University of Michigan Consumer Sentiment Index suggests this may already be happening; the index unexpectedly dipped by nearly 6 percent in July as consumer complaints of rising prices for homes, cars, and durable goods reached all-time highs.

The slowing pace of recovery within the labor market is another headwind. In May, the number of job openings reached an all-time high of 9.3 million as the labor force participation rate shrank, as shown in Figure Three below.

Figure Three: Jobs Are Back—But Where Are the Workers?



Source: Bloomberg

The scarcity of qualified workers has affected all sectors 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 may trigger a return to the workforce for some, others may have used their time at home to reconsider their career plans or opt out altogether.

Another source of uncertainty, as mentioned earlier, is the transition of the growth baton from the public to the private sector. While this handoff is always important, the unprecedented magnitude of fiscal and monetary support deployed during the pandemic crisis magnifies the risk. The recovery could stall if support is removed too soon. And too much stimulus could cause the economy to overheat or introduce market excesses.

Without a doubt, the greatest wildcard is—and will continue to be—the virus itself. The more-contagious Delta variant now represents the bulk of new cases across the globe, posing risks of uncontrolled spread in less-vaccinated areas and serving as a difficult-to-assess economic threat as we enter the fall.

The Stories We Tell

Investors rely on narratives to make decisions with imperfect information. In that way, they're like heuristics or *rules of thumb* that can simplify an incredibly complex real world into more manageable stories we can use to guide our actions. They are imprecise by necessity. And, as we are now seeing, they often come into conflict, contributing to ambiguity and, perhaps, higher levels of market volatility.

These stories are critically important because they can change the way we think, which can, in turn, affect the way we act as consumers, business leaders, policymakers, or investors.

The second phase of an economic recovery is often bumpier than the first. While it's impossible to tune out the deluge of narratives in our always-connected digital world, it's more important than ever to seek out trusted sources with balanced perspectives and make well-informed decisions in support of long-term goals.

Author(s)

Sam Kirby, CFA®

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