Quarterly Market Review

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Maybe it's just me but these signs don't seem all that clear…

Market Review: Stocks ride the wave of uncertainty to strong gains

A reversal of a reversal of a reversal of style leadership in the second quarter made the markets as tough to follow as the beginning of this sentence. The S&P registered its fifth consecutive quarterly gain as growth and value stocks alternated leadership each month. After digesting a bevy of economic reports, Fed speak, and corporate earnings commentary, the market seemed committed to grinding higher despite doubts arising on the durability of the economic recovery. Vaccine progress, strong earnings, and improving economic fundamentals helped growth stocks lead an April rise to start the quarter. Persistent headlines about inflation worries in May led to a rotation back into value stocks with the added volatility restraining market gains to a modest 0.7%. Signs that inflation pressures were beginning to ease emerged in June triggering a depression in bond yields that boosted growth stocks, namely the tech and communications sectors, to impressive late quarter gains.

Inflation sprints out the blocks but has yet to go the distance

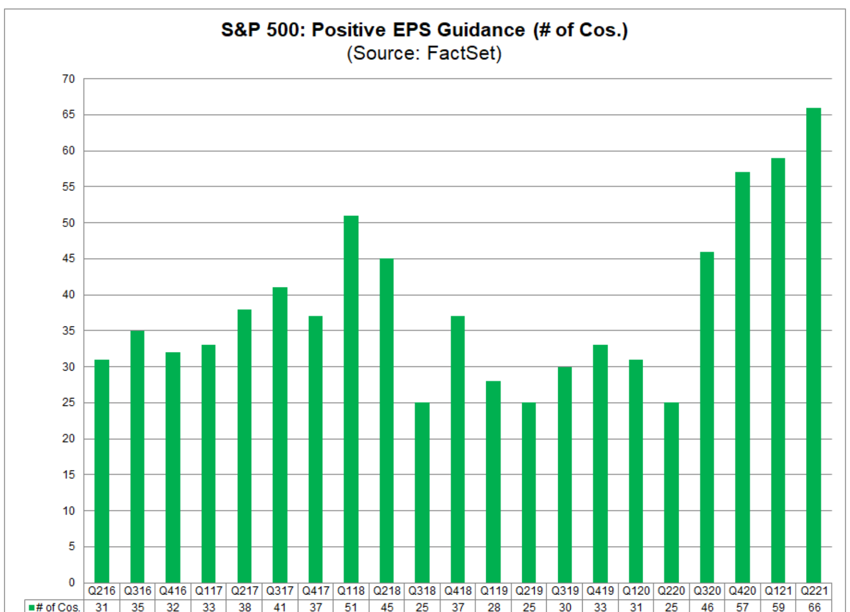
The primary reason for the flip flop in leadership between growth and value stocks during the quarter was the uncertainty surrounding inflation. Headline Consumer Price Index numbers for May came in at a much-greater-than-expected 5% year-over-year rise – the largest such gain since summer 2008. A tightening labor market, supply chain issues, and skyrocketing raw materials costs were all (rightfully) lobbed out as reasons for the spectacular upward pressure on prices. However, debate soon ensued over the sustainability of such pressures. The coming end of enhanced unemployment benefits, positive corporate commentary on supply chain management, and late quarter declines in prices of lumber all suggested that Fed Chair Powell's consistent 'inflation is transitory' soundbite is actually more bite than bark.

Market Performance

Index Returns (%)	1M	QTD	YTD
S&P 500	2.33	**8.55**	15.25
S&P MidCap 400	-1.02	**3.64**	17.59
S&P SmallCap 600	0.33	**4.54**	23.56
Factor Returns (%)			
S&P Momentum	7.18	**12.07**	12.28
S&P Growth	5.68	**11.93**	14.31
S&P High Beta	-1.06	**9.28**	34.08
S&P Value	-1.17	**4.99**	16.30
Top 3 Sector (%)			
Real Estate	3.19	**13.09**	23.30
Information Technology	6.95	**11.56**	13.76
Energy	4.61	**11.30**	45.64
Bottom 3 Sector (%)			
Utilities	-2.17	**-0.41**	2.38
Consumer Staples	-0.18	**3.83**	5.02
Industrials	-2.21	**4.48**	16.40

Fed finally thinking about thinking about being hawkish

Speaking of the Fed, the most powerful gang of economists in the nation surprised everyone by throwing up hawkish signs during the June FOMC meeting. The number of participants expecting hikes of the federal funds rate in 2022 jumped from four in March to seven in June. Thirteen of the total eighteen members envision two hikes in 2023, up from only seven in March. Certain regional bank presidents were outspoken on the potential for currently observed inflation stats to force the Fed to alter its monetary policies sooner than expected. Even Chair Powell, the adopter of the ‘not even thinking about thinking about raising rates’ catchphrase, admitted that discussions about tapering have logically begun among committee members. Despite the slightly hawkish takeaway from the Fed meeting, longer-term yields sold off suggesting that investors still have concerns over economic growth.



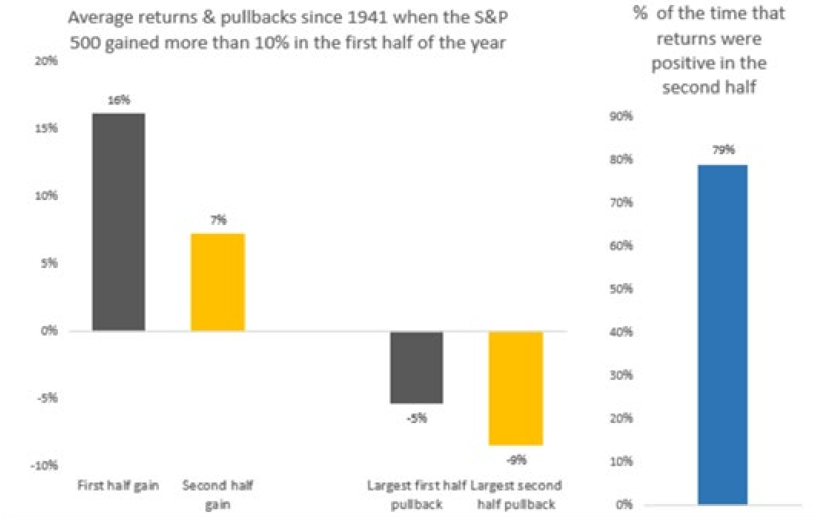
Your enthusiasm for Casual Friday is admirable but some might say your outfit seems a bit inappropriate…

Peak growth or a peek at potential growth?

Discussions about economic growth during the quarter centered on whether the US had achieved peak growth from the lows of the pandemic or if the economy has further to run once the labor market and supply chains normalize. Corporate commentary supported the latter notion as conference calls relayed expectations for continued growth based on pent-up consumer demand. As an exhibition of their faith, 66 S&P 500 companies issued positive guidance – the highest amount in 5 years. On the other side of the growth debate, multiple research firms pointed out that peak growth usually occurs 12-18 months after a recession. Supporting this notion is data from the Bureau of Economic Analysis showing that Consumer Durables spending is already 120% of pre-covid February 2020 levels. Both sides of the peak growth debate could be right if growth were to slow but still remain elevated relative to historical trends.

Modest gains are possible, less modest volatility is likely

Setting aside fundamentals for a brief moment, the strength of the market during the first half of 2021 suggests that more gains could be in store. Barron's research shows that when the S&P gains more than 10% in the first six months, its chances of making second half gains are nearly 80%. However, those gains tend to be more modest than the first half (6% on average) and the market has yet to experience its historically annual 10% pullback. Bringing fundamentals back into the conversation, peak growth and inflation concerns are legitimate issues that the market will need to digest in the second half. The Fed's reaction to either of those issues is likely to introduce significant amounts of volatility into the market no matter how well they telegraph their actions. Investors will need to be comfortable in a persistent haze of uncertainty if they commit to riding the market higher for what will likely be muted gains.



Source: FactSet

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Portfolio Leaders

NVIDIA (NVDA) started its **50% quarterly rise** with a sizable boost in April thanks to a pre-announcement of a coming revenue beat by the CFO at an industry conference. In addition, the company relayed their intentions to get into the central processing unit (CPU) market which would make them more competitive with rival chip maker Intel. The stock encountered one last jolt forward in June as rival semiconductors, Broadcom, Marvell, and Mediatek endorsed NVDA's proposed merger with ARM Ltd.

Adobe (ADBE) enjoyed a **23% advance** on the strength of earnings results that exceeded already elevated expectations. While the company reported robust growth across all product lines, the standout was the 25% YOY growth in its Digital Media segment which includes its Photoshop, Acrobat, and Illustrator product lines. Investors were also pleased with the reported progress of its newest acquisition, Workfront which should help attract companies that need all-inclusive project management.

Eli Lilly (LLY) received a string of good news in June regarding its potential blockbuster Alzheimer's drug that helped propel the stock to a **23% gain** for the quarter. In early June, the FDA issued accelerated approval for Biogen's Alzheimer drug which uses the same methodology of plaque removal thought to slow down the progression of the disease. Later in the month, LLY's drug, Donenamab, was designated as a 'breakthrough therapy' by the FDA paving the way for accelerated approval and an accelerated move in its stock price.

Portfolio Laggards

Caterpillar (CAT) was **down nearly 6%** despite reporting a sizable revenue and earnings beat in late April. Concerns arose over the ability of CAT to replicate such great numbers (and justify its now loftier valuation multiple) going forward. Indeed, most of the stock's decline came from a general pullback in Industrial stocks as the threat of rising inflation, constrained supply chains, and a labor shortage provoked doubts about the durability of the massive year-to-date rally in cyclical stocks.

Fluor Corporation (FLR) **tanked 23%** during the quarter effectively erasing all of the stock's gains for the year. In mid-May, the engineering and construction firm announced a $600 million convertible preferred offering which represented nearly 20% dilution of current shares. Investors soured on the idea likely frustrated that management failed to mention their intentions on the recently completed earnings call. FLR stock fell dramatically that day and was never able to gain momentum back for the remaining weeks of the quarter.