2Q2021 Market Commentary
The Cost of a Rapid Economic Rebound

Just one year ago, it would have been difficult to predict the pace at which the economy would rebound: That by the end of 2Q21 the U.S. GDP would surpass the pre-COVID peak; We would gain back more than 70% of the jobs lost during the pandemic; And job postings would surge to a record high! The combination of accommodative monetary policy and aggressive fiscal stimulus, joined by the rapid enhancement of the vaccine program, all contributed to a more accelerated rebound than was forecasted a few short months ago.

Investors have enjoyed the benefits of the faster than expected rebound in economic activity and euphoric consumer pent-up demand. In the second quarter, equity markets continued to notch fresh record highs with participation across a broad range of global equity markets. Even the broad bond market recovered after a dismal start to the year. In addition, commodities posted their longest consecutive quarterly winning streak (five straight quarters) since 2002-2004 as consumer demand outstripped production and supply.

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As we move into the second half of 2021, we acknowledge that the bulk of the easy rebound in economic and earnings growth is likely behind us, and there is speculation about how much longer the expansion can continue. Especially since we are starting to feel the negative effects from the aggressive monetary and fiscal actions taken during the pandemic (e.g., inflation). However, the supportive factors of growth remain in place (e.g., accommodative policy, strong corporate and consumer balance sheets, and solid vaccination participation). Therefore, we expect the expansion to continue with more reasonable levels of growth that will be slower than what we have seen in recent quarters. We believe the global equity market offers the best return potential but expect more volatility as we navigate through the expansion. Bonds serve as a source of portfolio diversification but return expectations should be put in perspective as yields at historic lows offer little to no upside outside of the coupon.

U.S. Economy – Easy Rebound May be Behind us but Expansion Should Continue

Since the beginning of 2021, estimates for this year's growth have been revised substantially higher **(Chart 1)** and expectations for 2022 have followed the same trajectory. The consumer pent-up demand has been better than predicted with consumers shifting from spending on goods (e.g., furniture, electronics) to spending on experience and leisure. Air travel has returned to levels not seen since March 2020, spending in restaurants has surpassed its pre-pandemic high[1], U.S. hotel occupancy was 65% as of July 3rd[2], the highest since February 2020, and we have finally seen fans pack sport stadiums.

Chart 1

Expectations for 2021 Growth Revised Higher

Estimates are as of July 12, 2021. Source: Bloomberg Finance L.P., Verdence Capital Advisors.

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However, we also acknowledge that the robust economic rebound and the actions taken to combat COVID-19 come with a price tag. Not only has the Federal deficit ballooned to a record high, but because of the mind-blowing amount of fiscal stimulus, the money supply (the amount of money in circulation) is now almost 100% of nominal GDP. **(Chart 2)**. The supply chain continues to struggle to keep up with the surge in demand and wait times for products have soared to record high levels. In addition, the labor market has improved but select sectors (primarily service oriented) have struggled to find workers. In the following, we address three important economic questions as we move past the euphoria-driven rebound and look toward a strong—albeit more reasonable—pace of growth.

1. **How transitory is inflation?** Inflation (as measured by the core Consumer Price Index) is growing at the fastest year over year pace seen since the early 1990s. **(Chart 3)**. Gasoline prices and used cars have increased ~45% over the past year, airfares are up nearly 20%, auto insurance and major appliances are up more than 10% and rental cars are up `90%! Even some day-to-day necessities like clothing, shoes, milk, and fruit are rising at an alarming rate **(Chart 4, next page)**. We can attribute the rise in prices to the massive amount of money that has been printed, surging consumer demand and production disruptions because of COVID. With better economic growth, investors should understand a higher level of inflation usually follows close behind. However, we are not looking for the recent multi decade highs

Chart 2

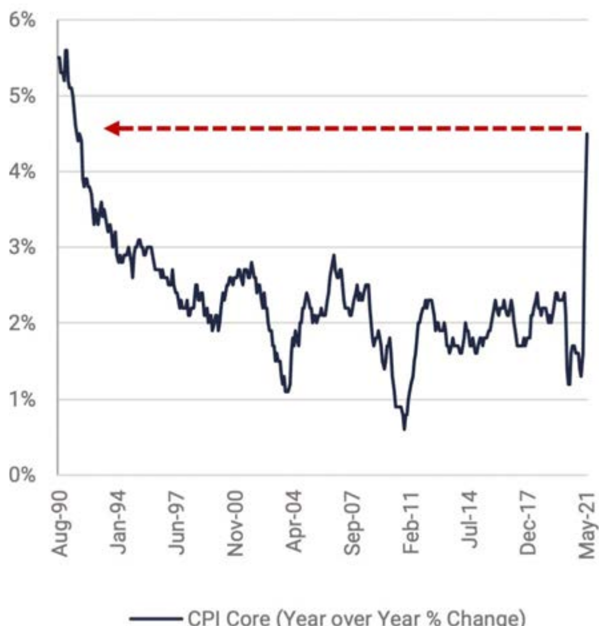
Money Supply Nearly as Much as Nominal GDP

Data is quarterly and as of 2Q21 (using 1Q21 GDP).
Source: Bloomberg Finance L.P., Verdence Capital Advisors.

Chart 3

Inflation Rising at the Fastest Pace Seen in 30 Years

Data is as of June 2021. Source: Bloomberg Finance L.P., Verdence Capital Advisors.



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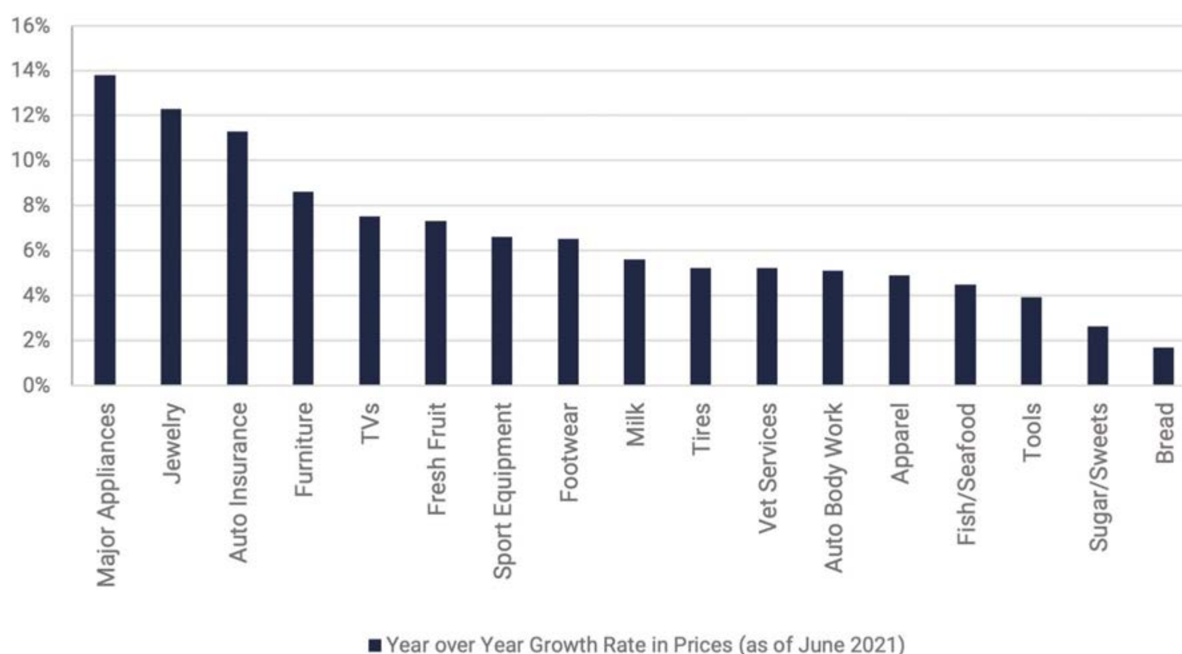
in inflation growth rates to be sustainable. In fact, we are beginning to see some inflation indicators turn over, especially as we start to scratch the surface on returning to normal levels of production of goods. Lumber prices, which rose 550% (from April 2020 to May 2021) have wiped out all the 2021 gains. There are signs that used car prices (which made up ~30% of the rise in prices in June) are beginning to descend back to reality. The Manheim Used Vehicle Index, which is considered an indicator for pricing in the used car market, saw its first monthly decline this year in June. Even some food categories that skyrocketed in recent months dipped lower in June (e.g., meat, chicken, baby food). This does not mean that we are going to instantly see a lower bill for goods and services. It will take time to work through the supply bottlenecks, labor shortages and consumer demand that have all been contributing to higher inflation.

2. **Are there signs that the supply chain disruptions are abating?** To understand why we are experiencing such a breakdown in the supply chain, one must understand how businesses have operated for decades prior to the pandemic. "Just in time" manufacturing was a phenomenon that global companies could utilize given the rapid advancements in manufacturing and globalization. This allowed companies to cut costs by limiting inventories and source products by the click of a button. Well, introduce a global shutdown to "just in time" manufacturing and you have a recipe for disaster! Products could not be manufactured or even shipped, and that dilemma collided with a surge in bottlenecks. The result has been nothing short of chaotic. Lead times for raw materials have been running at a record high, the backlog of manufacturing orders topped a record high and inventories are running at record lows. The products that could get manufactured faced shortages of port workers

Chart 4

Prices Rising Across a Variety of Items

Data is as of June 2021. Source: Bloomberg Finance L.P., Verdence Capital Advisors.



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to unload ships and truckers to transport them, leaving ships idle in the ocean. The answer to fixing the supply chain disruption is more workers and time for manufacturers to clear the backlog of orders and replenish the already depleted inventories. However, there are some small signs of optimism appearing in select data. In June, manufacturing inventories rose for the first time this year and the backlog of orders dropped by the most since April 2020. **(Chart 5)**. At one point 40 container ships were anchored outside one of the U.S.'s busiest ports (Los Angeles – Long Beach), but that has been cut by more than 50% suggesting we are getting goods out into the economy.

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Chart 5

Supply Chain Destruction Turning Around?

Data is as of June 2021. Source: Bloomberg Finance L.P., Verdence Capital Advisors.

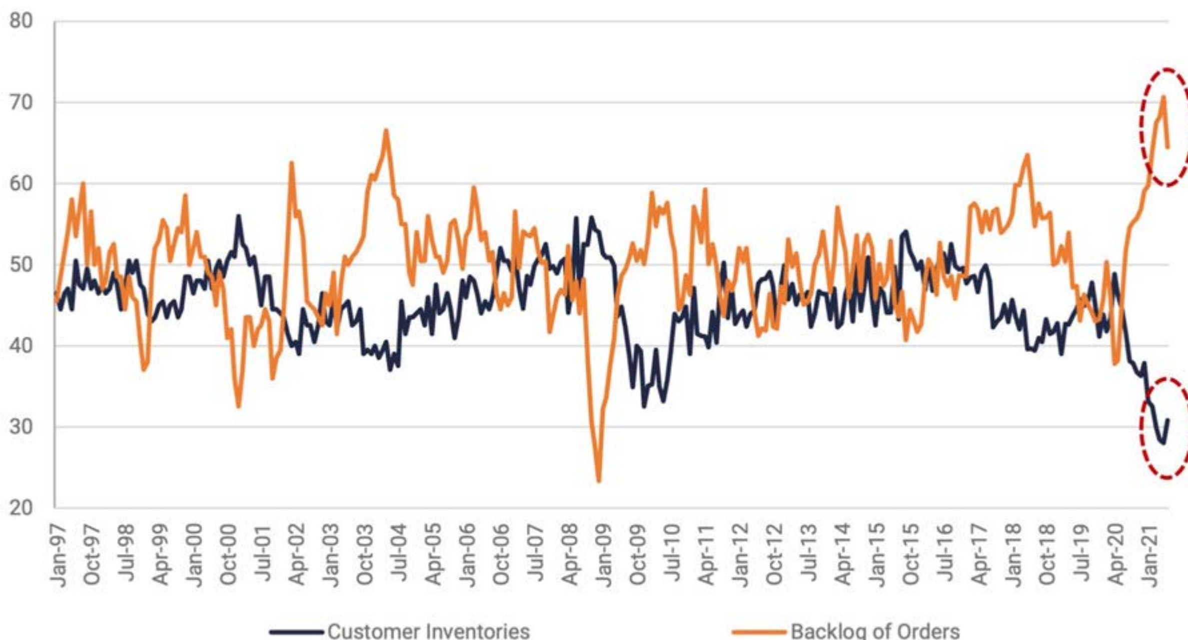

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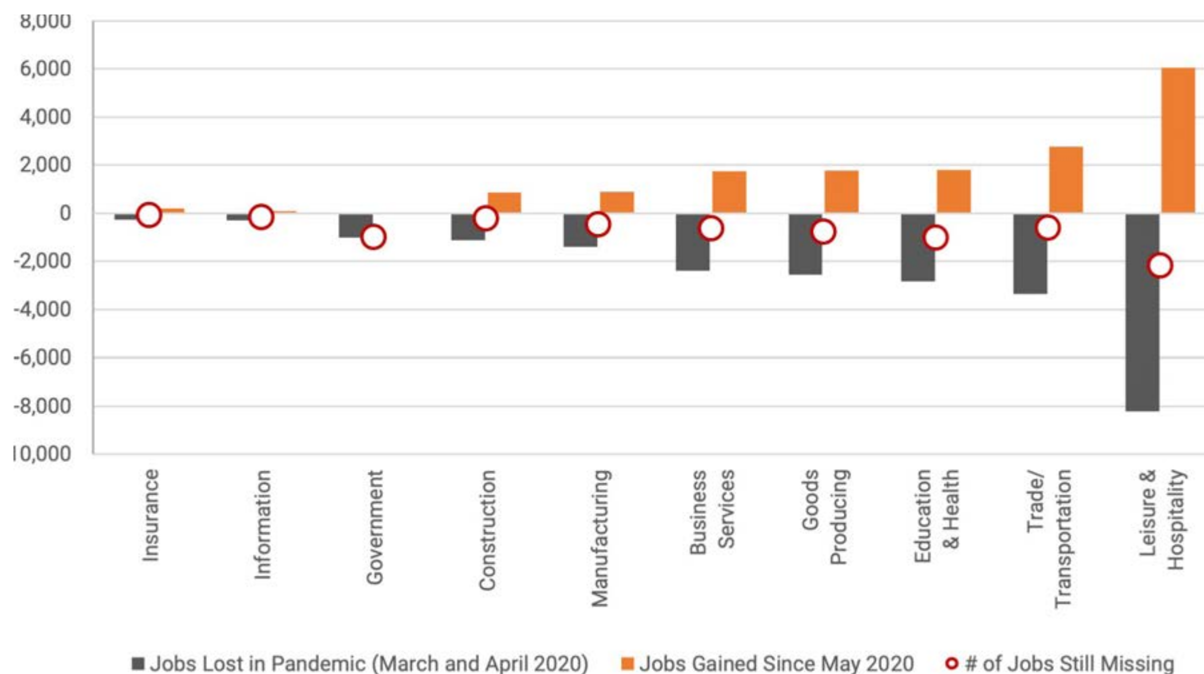
Chart 6

Several Areas of the Labor Market Still Suffering

Data is as of June 2021. Source: Bloomberg Finance L.P., Verdence Capital Advisors.



3. **Getting America back to work.** The U.S. economy has recouped ~16 million of the 22 million jobs that were lost during the pandemic and the unemployment rate has dropped from 14.8% to 5.9%. In addition, with the faster than expected reopening of the economy there are more than 9 million jobs that need to be filled, a record high. There are areas of the economy that are struggling more than others to get workers. The leisure and hospitality sector lost more than 8 million jobs and is still struggling to get back to pre-pandemic levels. **(Chart 6)**. There are several factors that have contributed to sidelining some workers. First, there is no denying that the additional unemployment benefits have made it uneconomical for some to return to work, especially to some of the lower paying, service-oriented jobs. The additional $300 Federal weekly unemployment insurance along with each state's benefits have some employees making 80% to more than 100% of the state's average weekly wage. For example, in 2Q21 an unem-

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ployed resident of Texas or Pennsylvania was making almost 80% of the average state's weekly wage by staying on unemployment. In Ohio it was more than 80%![3] This is unlikely to continue. Especially since more than half of the U.S. states ended the additional Federal unemployment insurance prematurely. The rest of the states will see their citizens lose that extra $300/week in September and the Biden Administration has signaled they do not plan on extending it beyond its expiration (September). Second, is the health factor as some are uncomfortable returning to work because of COVID. Lastly, childcare has been an issue, especially for women and minorities, as schools have yet to normalize their schedules. The end to emergency unemployment benefits along with schools reopening, COVID vaccinations continuing and wages rising should help to incentivize employees back to the labor force.

Economy bottom line: We believe that the peak economic GROWTH rates are likely behind us. It is not realistic to assume the economy can post the same quarter over quarter growth rates that we saw coming out of the depths of the pandemic. Instead, we see a more sustainable growth trajectory that is supported by accommodative policy, healthy consumer, strong corporate balance sheets and the ongoing clean up from the 2021 pent-up demand.

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Global Equities – Remain Patient and Liquid to Take Advantage of Opportunities

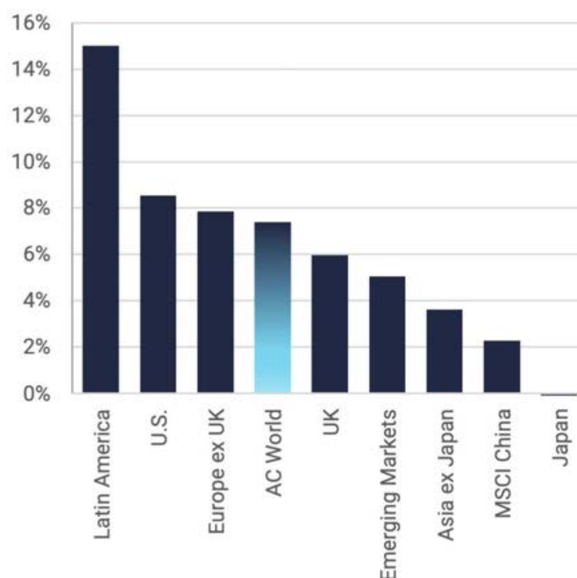
Global equities rose for the fifth consecutive quarter in 2Q21 as many major Indices notched fresh record highs. The world reopening and speed up in vaccinations led to solid returns across a range of global equities. However, there was a clear distinction between some of the countries that have been slow to vaccinate, faced renewed lockdowns and/or struggled to get COVID variants under control. For example, the Asian region underperformed the U.S. and the developed economies as variants and lockdowns became a concern. **(Chart 7)**.

Given our expectation of an ongoing global economic expansion and accommodative monetary policy, globally, we favor global equities over bonds. However, it is important to be patient and have liquidity to take advantage of opportunities. Many global Indices are trading at or near their record highs and valuations look stretched. As we move from the recovery phase to the expansion phase, investors will demand a robust level of earnings growth to warrant these high valuations. In addition, we are closely watching the effect that higher input costs and a tight labor market may have on operating margins, globally. Discipline and due diligence will be important at the company and the regional level.

Chart 7

Global Equity Returns in 2Q21

Data is for 2Q21. U.S. is S&P 500. Source: Bloomberg Finance L.P., Verdence Capital Advisors.



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Currently, we recommend the following allocation:

- **International developed equities attractive:** We continue to favor developed international equities over U.S. equities. Developed international equities have more attractive valuations and are historically cheap relative to U.S. equities. **(Chart 8)**. In addition, international equities stand to benefit more as global economic trade accelerates. Germany, Spain, France, United Kingdom, and Italy are just a few international developed countries that see a larger portion of their GDP made up from exports relative to the U.S. As a result, in Europe, the sector breakdown leans more cyclical and should benefit as the world continues to expand.

- **In the U.S., still favor reopening trade:** We have seen a tug of war over value versus growth sectors in the first half of 2021 at all market cap levels. While value surged out of the pandemic, the expensive growth and tech areas resumed leadership in 2Q21 as interest rates declined and investors turned defensive. Given our view that the level of interest rates is unsustainable at these low levels, this presents a headwind to expensive growth sectors. Therefore, we recommend a modest tilt towards value sectors that can benefit from the ongoing economic expansion and not be hampered by the resurgence of higher yields. In addition, history suggests that small and mid-cap stocks outperform large cap stocks in the

Chart 8

International Developed Equity Valuations Historically Cheap Compared to U.S.
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two years after a recession ends **(Chart 9)** as the economy moves through the expansion phase. Given that the recession ended in April 2020, we are officially in the second year of the expansion, so we believe there is room for small and midcap to outperform large cap stocks.

- **Patience in emerging market equities:** We continue to believe that emerging markets can benefit more than the U.S. from a return to more normal levels of global trade. However, there is currently more appetite in the emerging market economies for rolling lockdowns and they have less control over COVID variants. This puts their manufacturing and potentially economic growth at risk. Lastly, we have not seen valuations fall to levels that account for this added economic risk. We will continually assess the situation and look for potential opportunities.

Chart 9

History Gives Us Guidance Where to Invest in the U.S.

Data reflects last five recessions from 1980 to 2009. Source: Bloomberg Finance L.P., Verdence Capital Advisors.

Equities Bottom Line: After the record rally we have seen from the depths of the pandemic, valuations are looking stretched globally. However, we continue to believe that equities offer the best return potential for investors, especially compared to bonds. As we navigate from the recovery to the economic expansion, we expect volatility will be heightened. Due diligence and patience are crucial at this stage of the economic cycle. There is nothing wrong with holding excess cash to be able to take advantage of opportunities.

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Fixed income – Yields at Current Levels are Unsustainable

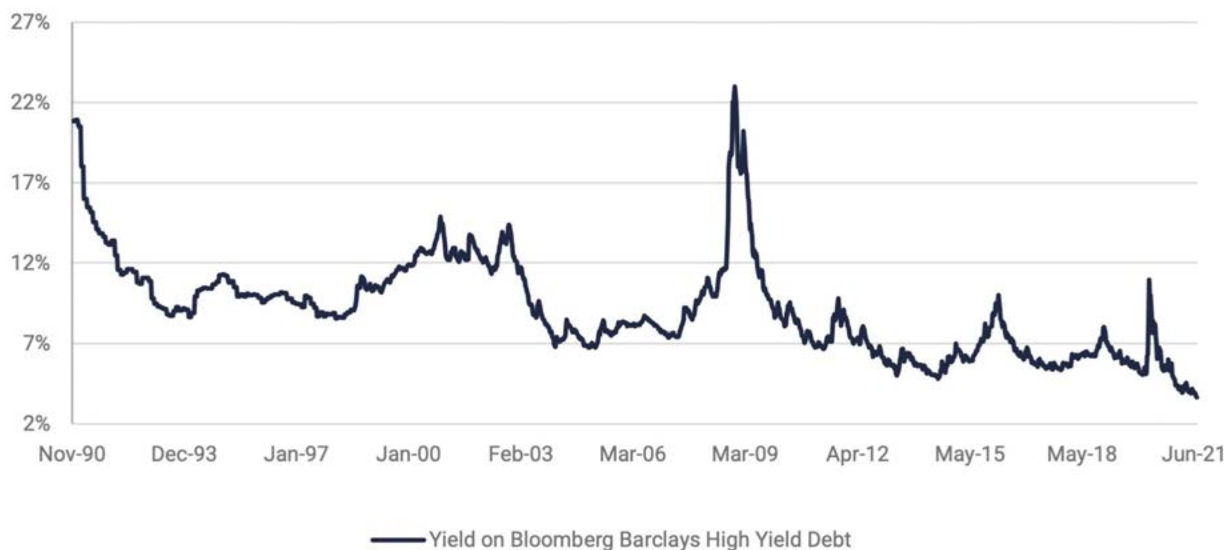
After posting the third worst quarterly drop in history in 1Q21, bond investors were offered reprieve in 2Q21 as the Bloomberg Barclays Aggregate Index posted its best quarterly gain in a year. Despite some discouraging inflation data and some members of the Federal Reserve calling for a plan to remove emergency monetary policy, the selloff in bonds stalled. Investors fled to corporate bonds with the yield on a high yield debt index dropping to a record low. **(Chart 10)**. Even long-term bonds rallied (10YR and 30YR Treasuries) as global investors struggled to find debt with any yield even if it offered less than inflation expectations.

Fixed income bottom line:
The economic expansion has room to run and interest rates at current levels appear to be unsustainable. Fixed income generally offers value as a portfolio diversification mechanism, but we see little return potential over the coupon. We would consider remaining defensive and invest in short maturity or floating rate bonds.

Chart 10

High Yield Debt Yielding a Record Low

Data is weekly and as of July 9, 2021. Source: Bloomberg Finance L.P., Verdence Capital Advisors.



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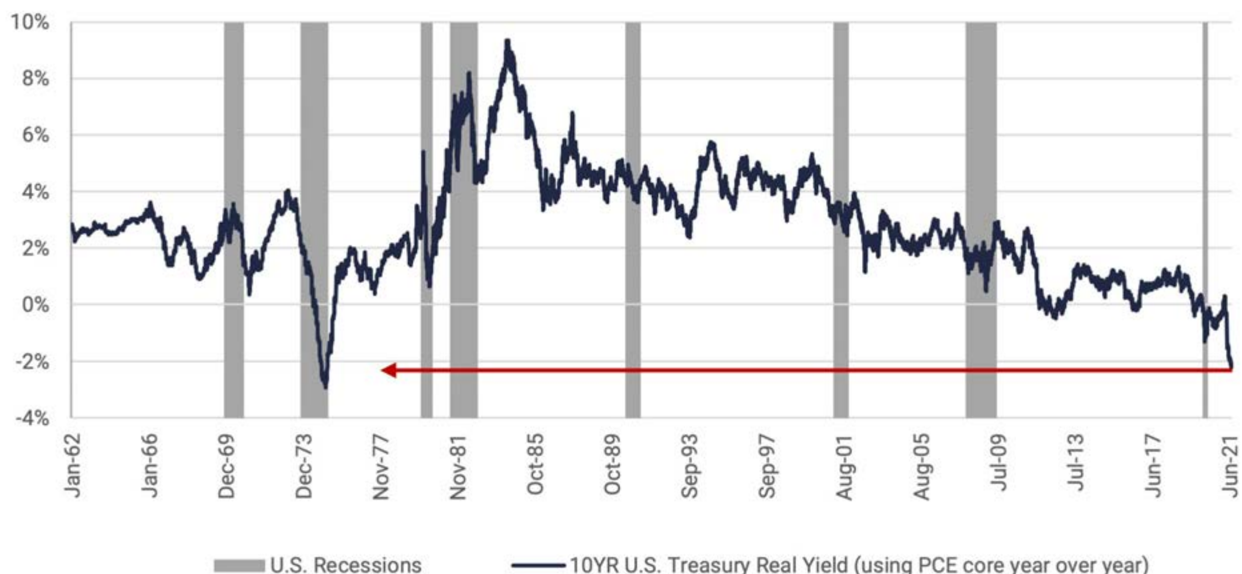
We believe there are many more supportive factors for rates to move higher from current levels as opposed to many realistic options that could drive them lower from here. The expectation for economic growth and inflation do not justify interest rates at current levels. In fact, when looking at real long-term yields (10YR U.S. Treasury yield minus inflation), they are sitting near the lowest level seen since the 1970s. Which also so happened to be the start of a painful bear market in bonds. **(Chart 11)**. While we will always view fixed income to add diversification and potentially hedge if economic growth takes an unexpected turn lower, we would be defensive with our bond allocation and recommend the following:

- **Short duration is the key to being defensive in a rising rate environment:** While the Fed remains committed to keeping the rise in interest rates orderly, the reality is that over the next 12-18 months interest rates across a variety of maturities are likely to rise. Therefore, investors may want to be defensive with their bond exposure and focus primarily on short duration fixed income. In addition, we believe that floating rate notes offer an opportunity for bond investors. As the Fed begins to raise rates (likely 4Q22 or early 2023) these bonds should adjust to reflect the higher interest rate environment.
- **Do not reach for yield; risk/reward minimal:** While higher yielding fixed income carries a lower duration given its high coupon, we would exercise caution. The extra yield investors gain to buy high yielding debt compared to a Treasury bond is at the lowest level seen since before the Great Recession and yields are a record low. This offers little reward for the additional risk when investing in high yield bonds.

Chart 11

Real Yields Have Fallen to Lowest Since Early 1970's

Data is as of July 19, 2021. Source: Bloomberg Finance L.P., Verdence Capital Advisors.



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Alternatives: Looking Beyond the 60/40 Portfolio When Traditional Assets are Over Valued

As we navigate through the economic cycle, experience stretched valuations in the public market and witness speculative investments (e.g., SPACs, Cryptocurrency, MEME frenzy) come back to earth, it reminds us of the importance of alternative investments in portfolios. We are in a period where equity markets are stretched globally, volatility is expected to remain high, Governments must pay for records amount of debt, Central Bank intervention has resulted in a substantial amount of negative yielding debt and many public inflation hedges (e.g., TIPS) look expensive.

Therefore, the traditional benefits one may receive from a simple 60/40 portfolio of stocks and bonds may not offer the same diversification or return opportunities as has been experienced historically. It is also likely to produce much more volatility than an investor is accustomed to. In contrast, for qualified investors, investing in the private market removes the daily volatility, typically offers low correlations, and attractive risk adjusted returns, and may be a better way to hedge against inflation.

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The Verdence View

It is important for investors to decipher between an economic slowdown and a contraction. It is true that the easy rebound after a record decline in economic growth and earnings is behind us. However, that does not mean that the expansion is coming to an end. There are many forces that should continue to support the economic expansion. These include monetary policy, solid corporate balance sheets, a healthy consumer, a prolonged manufacturing expansion to clear up the surge in pent-up demand and our expectation that we can get more Americans back to work in the second half of 2021. This does not mean that we are not closely monitoring the risks of inflation and new COVID variants. These factors can weigh on sentiment, spark short term volatility but also present opportunities to adjust asset allocation. While we favor an overweight to global equities, it may be prudent to hold excess cash with valuations at current levels. Having the flexibility and liquidity offers investors the chance to take advantage of volatility that is likely to arise as we move into the economic expansion phase.

If you have any questions or comments, please feel free to reach out to your financial advisor.

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1.According to the May retail sales report and it is considered spending in food services and drinking places.

2.str.com as of July 3, 2021

3.https://www.businessinsider.com/unemployment-benefits-versus-average-wages-across-the-us-2021-5

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