Third Quarter 2021 Investment Outlook

The Beginning of the End

"You can think of this meeting that we had as the 'talking about talking about' [QE tapering] meeting."

– Federal Reserve Chairman Jerome Powell

"I don't think they can tighten without a big negative effect.

– Ray Dalio – Chairman, Bridgewater Associates

"Nothing is over until we decide it is!"

– Bluto - speech to his Delta Chau Ti fraternity housemates after eviction from Faber College

One has to wonder if Jerome Powell has the Bluto speech scene from Animal House shown to his colleagues before every Federal Open Market Committee meeting. Bluto was the iconic movie character played by John Belushi in Animal House, one of the greatest party movies ever made, back when life was way more fun and a lot less PC. Filmed in 1978 at a cost of just $4.5 million, Animal House went on to gross $141 million at the box office, not too shabby for a movie about a bunch of fraternity derelicts. Animal House made college debauchery popular and started the toga party craze. The Otis Day and the Knights hit Shout (You Make Me Wanna) became a playlist prerequisite on the after-hours college party scene and is still popular today, with the Buffalo Bills using a modified version for its stadium theme song. The Bills Mafia is today's Animal House and earned the well-deserved title of the best fans in the NFL.

Powell and his Federal Reserve colleagues (mostly Dean Wormer types) rule the world. Greg and Mandy would definitely hang out in August at Jackson Hole (scene of the Fed's August summer confab) with the Fed crew, where the sweater over the shoulder fashion look is still popular. The plain, hard truth is that central bank policies dominate financial markets and central bankers will decide when the current ultra-accommodative monetary policies will end. For all they care, the rest of us can just keep crushing beer cans against our skulls like Bluto did with exceptional skill. Even though they will forever deny any plausibility, global central banks have created a financial markets environment that is hyper-sensitive to central bank policy actions ever since the Global Financial Crisis hit in 2008. It can also be argued that the Fed's policies have been a major factor behind the widening wealth gap in America. Since the GFC, central banks have aggressively used their policy tool set to micromanage economies. The latest occurred when the C-19 pandemic hit in early 2020 and the Fed acted quickly to help stave off an extended and serious economic collapse. It has largely worked, as the U.S. now finds itself in one of the strongest recoveries of the past 50 years, aided substantially by the successful deployment of C-19 vaccinations and trillions worth of monetary and fiscal policy actions designed to offset the deleterious effects of the C-19 pandemic.

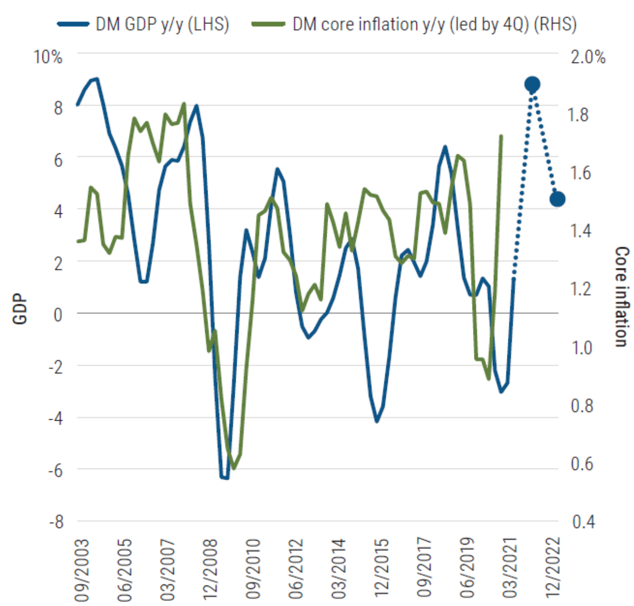
It is the next phase of the post pandemic policy response that will take center stage for the next several years. The $64,000 question today is the telegraphing and timing of the Fed decision to start tapering its ultra-accommodative policies. In other words, the beginning of the end. Although it is still uncertain when it will happen in the U.S., the tightening cycle has started globally as there have been 27 interest rate hikes across 17 central banks so far in 2021. During the last tightening cycle, the Fed moved towards normalizing policy by first reducing, and then ceasing, monthly purchases of Treasuries and agency mortgage-backed securities, while continuing to reinvest the proceeds of its maturing bond holdings. Then the Fed eventually started to raise rates, and then finally began to reduce the size of its balance sheet by not reinvesting maturing bond holdings. Most would agree that the Fed already looks to be behind the curve in some respects as it is still buying $40 billion of mortgage-backed securities per month at a time when the housing market is on fire and there have been strong price increases across most areas of the country and houses for sale often go for above asking price and with an overabundance of bidders. The housing market is clearly not in need of the excessive liquidity support still being provided by the Fed.

Since the Fed was forced to move to an ultra-accommodative policy stance in March 2020 due to the C-19 pandemic, financials assets have soared, and the U.S. economy is now experiencing robust growth. Second quarter real GDP is expected to be above 9% and 2021 real GDP growth is forecast to be near 7%. The Fed raised both its 2021 inflation and real GDP growth forecasts at its June FOMC meeting. In addition, more Fed Board members raised their 2023 interest rate forecasts, which made the stock market nervous given that the market advance since March 2020 has been supported by the excessive liquidity and zero interest rate policies supplied by the Fed. The market is now starting to think harder about the beginning of the end and when the Fed will start to taper. It will create more volatility and the upside case for stocks will become more challenging even as the U.S. economy continues on its path to fully recover from all of the C-19 pandemic declines.

Since the positive vaccine news from Pfizer and Moderna occurred last November, the global economy is experiencing a rolling recovery. China led the global recovery starting last summer (due to more immediate and stringent lockdowns, not vaccination related), then the baton was handed to the U.S. late in 2020 and the baton will next pass to Europe and the emerging markets. European countries are quickly catching up on vaccination rates and starting to ease their restrictions on economic activity. In addition, like the U.S, the eurozone passed one of the largest-ever fiscal stimulus plans, which is about to be deployed. Eurozone growth is still several quarters from peaking, which should provide a tailwind to risk assets outside the U.S. and similar to what the U.S. stock market experienced since last November. Business and consumer confidence should help cushion the European markets against any soft spots in jobs or manufacturing output. Asian and South American markets have also been laggards as C-19 cases have remained problematic with India in particular suffering a large economic setback from its recent major C-19 outbreak. If vaccine availability can be accelerated (western countries are now sharing excess supplies), as we have seen with the U.S., it should be just a question of time before more economies regain their footing and experience above average economic growth due to pent-up demand.

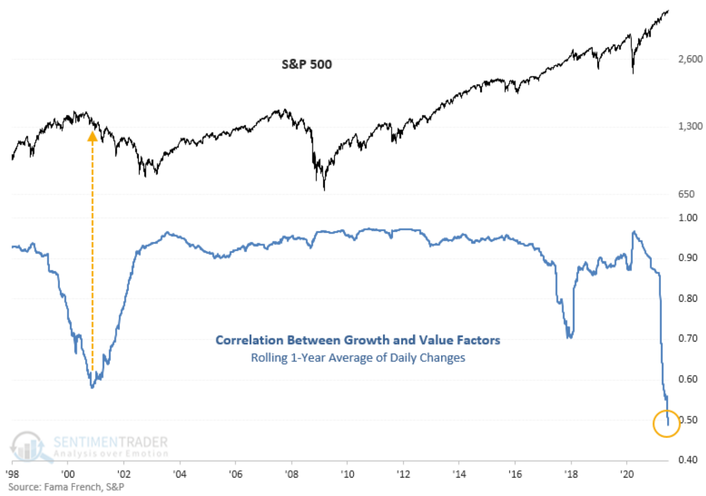
The rapid U.S. economic recovery and acceleration of demand for goods and services has created one major negative side effect. As shown in the next chart, inflation levels have seen a large increase. Goods are seeing the largest price increases, as the C-19 lockdowns initiated a home improvement wave and low mortgage rates created by the Federal Reserve's Zero Interest Rate Policy created a mini building boom. Materials like steel, plastics, lumber, chemicals, packaging, and semiconductors are all seeing supply shortages and price increases as a result. It will take time for the global supply chain to return to normal. The major debate in financial markets today is if the current elevated inflation levels will persist or, as the Federal Reserve believes, elevated inflation levels will be transitory. Persistent levels of high inflation may force the Fed to act and reduce its accommodative policies sooner than it expects. The market is biased towards the Fed's transitory inflation view but this could change depending on the macro data in the months ahead. In particular, employment is the key focus of the Fed and the jobs data for July, August, and September will be very important to the timing of the Fed's next policy move.

As shown in the next chart, there is a typically a tight correlation between year-over-year GDP and inflation with a lagged effect. The chart shows that when GDP growth (green line) on a year-over-year basis peaks, then inflation (blue line) also peaks afterwards. With second quarter real GDP growth expected to be around 9%, it will be the peak level for year-over-year GDP growth. As the previous chart showed, inflation is currently running hotter than the Fed's 2% target, but as GDP growth decelerates (but still stays strong) this should eventually translate into inflation levels peaking on a year-over-year basis and then also start to decelerate. That being said, the situation today is fraught with outlier possibilities (the dreaded tail risks) given the trillions of the monetary and fiscal stimulus that have already been pumped into the U.S. economy over the past 15 months and the Biden Administration is trying to pass another multi-trillion "infrastructure" spending bill.



Source: Haver Analytics, PIMCO calculations as of March 2021. Developed market (DM) core inflation is the GDP-weighted aggregate core inflation of Canada, euro area, Japan, U.K., and U.S. DM GDP growth is calculated from the aggregate value (in U.S. dollars) of GDP of Canada, euro area, Japan, U.K., and U.S.

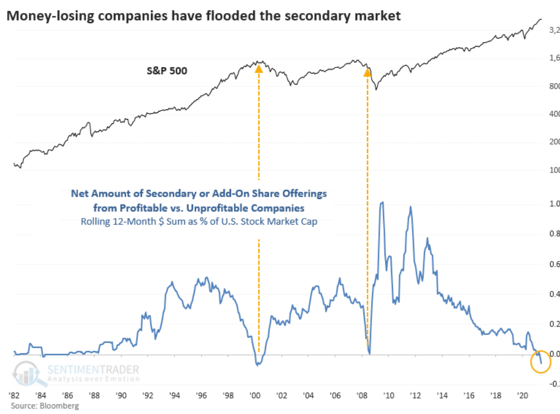
As it relates to the current stock market setup, the next two charts represent the most interesting market dynamics in play right now and both are related to the timing of the Fed's next policy move and inflation. The top chart shows how the correlation between growth and value factors has plummeted this year. The yo-yo effect of growth vs. value stock performance is playing out almost daily in the stock market. If longer maturity bond yields move higher because of strong inflationary data or the market perceives the Fed may have to act sooner rather than later to reduce its monetary policy accommodation, value stocks outperform and growth stocks lag. Conversely, if long maturity bond yields move lower because inflation or economic data is softer than expected and it pushes out the market's expectation of the timing of when the Fed will begin QE tapering, then growth stocks outperform and value stocks lag. This low correlation setup between growth and value factors last occurred when the U.S. was coming out of the 2000 recession.



A related chart below shows the correlation between moves in the 10-year U.S. Treasury yields and the S&P 500 Information Technology Index. The correlation has also collapsed, which means as yields decline, tech stocks go up. Normally, tech stocks are more economically sensitive to GDP growth changes such that when economic growth improves, bond yields usually rise and so do tech stocks and the relationship is more positively correlated. Now, tech stocks are acting more like bond proxies and acting less sensitive to economic growth and more sensitive to the market's whims about the Fed's next move in reducing liquidity through QE tapering or raising interest rates.

Source: Bloomberg as of June 30, 2021

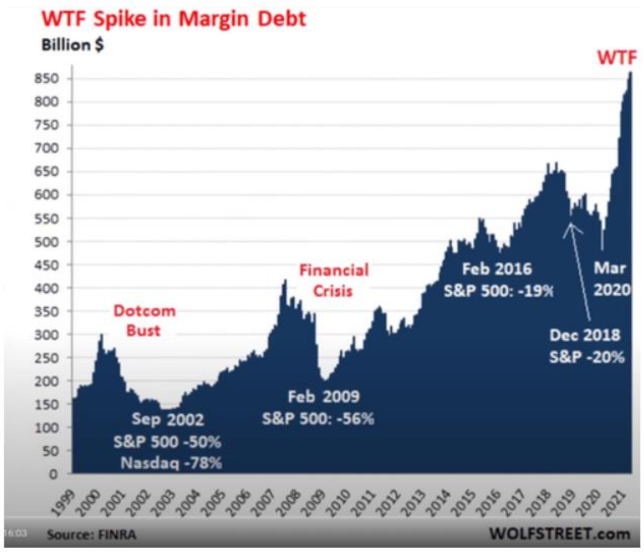
There is some anecdotal evidence that the stock market rally from the March 2020 lows is getting long in the tooth, and we are drawing closer to the beginning of the end. The left chart below compares the net stock issuance of profitable companies compared to unprofitable companies. The dramatic decline in the lower (blue) line indicates that more unprofitable companies are issuing stock today than profitable companies and at historically wide margins. In the past when the net issuance setup was like it is today, the stock market experienced a healthy sized decline in the period ahead as noted by the two vertical yellow arrows lines.



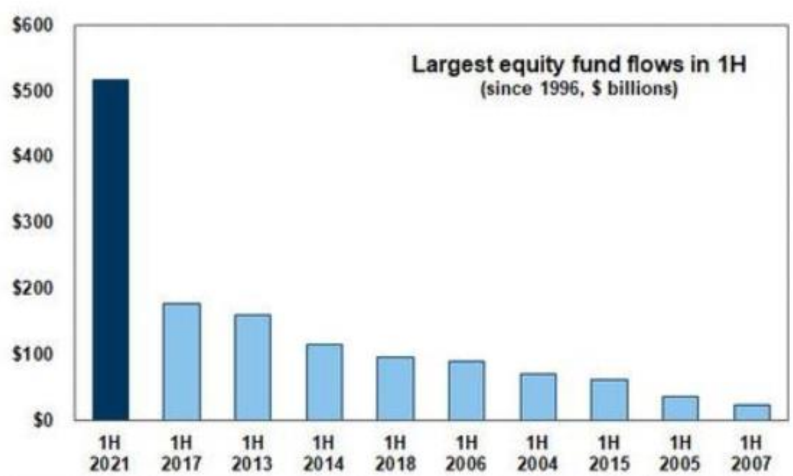
When the stock market continues to hit new highs and the stock prices of many companies also trade at elevated levels, company executives are incentivized to raise more capital while investor demand is strong. This is especially true for young but unprofitable companies because they need capital to fund operations until the company (hopefully) turns cash flow positive. The right side chart above captures this trend and shows a dramatic increase in IPO issuance the past 12 months with over 1200 companies coming public. With the U.S. stock market hitting all-time highs, IPO and secondary stock offerings are at all-time highs and helped by how much liquidity is sloshing around the financial system. While it may be a great time for companies to raise capital, it may not necessarily be a great time for investors to be offering it to them. When the quality of the companies issuing more shares into the market are poor, then the overall quality of the stock market declines over time and the broad stock market becomes more susceptible to larger pullbacks because when bad news hits, the lowest quality companies decline the most. As the economic cycle ages, it becomes more prudent to move up the quality curve as opposed to continuing to chase the IPOs or secondary offerings of loss making companies.

Some more anecdotal evidence of a peaking stock market is shown in the next chart. Margin debt levels have exploded higher over the past year. Margin debt is a loan that an investor gets from their broker, and then they use the borrowed money in their brokerage account to buy financial assets like stocks. WTF is an acronym that basically means, wow, that is crazy! The large spike in margin debt starting in early 2020 was brought about by two factors. The first factor was the Fed cutting interest rates to 0%, which makes borrowings of any kind very cheap including margin loans. When it becomes much cheaper to borrow, people will take on more debt. The second factor is that post C-19, as more people were laid off or working from home and with many receiving multiple government support checks or generous unemployment benefits, more non-traditional investors (using that term loosely here) began to invest or speculate in financial assets. The meme and SPAC stock (or stonks as Reddit crowd calls them) craze over the past year are two examples where cheap money combined with a new generation of neophyte "investors" are creating distortions in some segments of the stock market. According to Bloomberg Intelligence, retail trading volumes have increased from 15% in 2019 to 24% of total trading volume today. 10 million new online brokerage accounts opened in 2020 and 10 million more have already opened in just the first six months of

2021. When the Fed finally decides it is the beginning of the end of its easy monetary policy stance, these extreme setups now in place will begin to reverse and tailwinds will turn into headwinds for the broad stock market. That may not be today's business, but the Defcon level procedure has started.

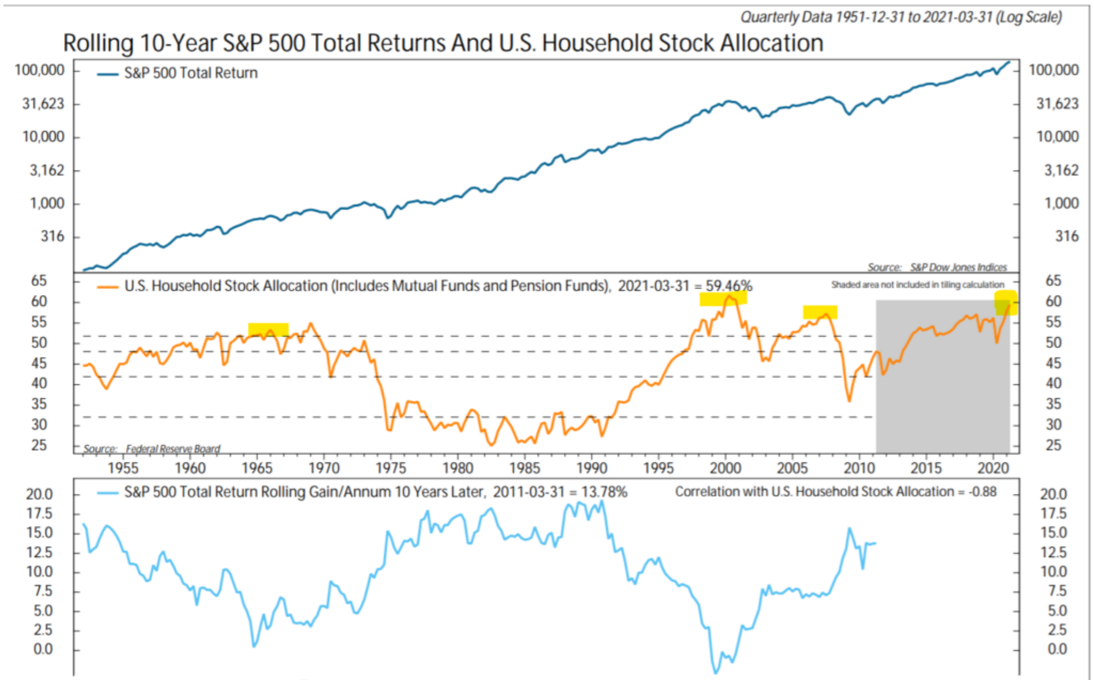


How much are investors chasing stocks higher? The next chart shows that flows into equities in the first half of 2021 were over 2X higher than any previous six month period since 1996.



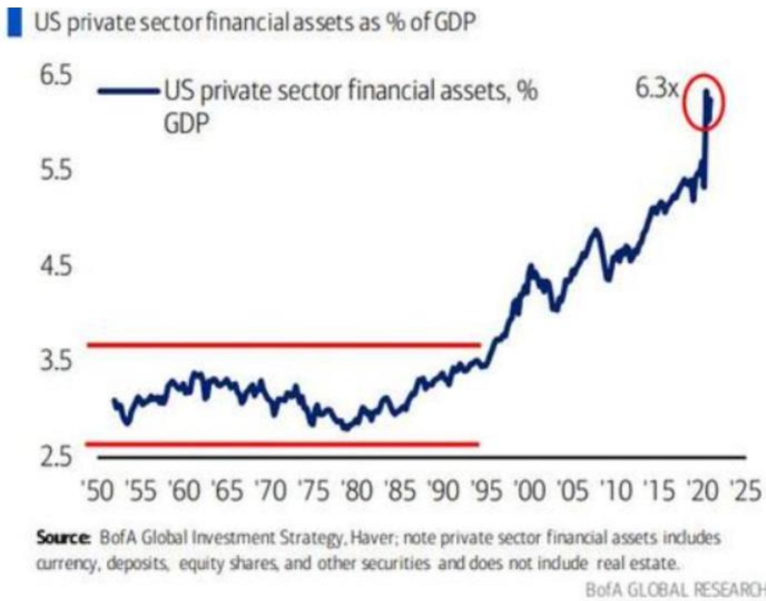
Source: Goldman Sachs Investment Research Division, Cormac Conners, as of 7/6/21. Past performance is not indicative of future returns.

The next chart from Ned Davis Research shows the typical U.S. household is all-in on the stock market. The orange line in the middle chart shows the average allocation that households have in equities going back to 1950. The most recent reading near 60% on the far right shows that we are now at the same household equity allocation level that hit right before the tech bubble burst in 2000 and right before the Global Financial Crisis hit in 2008. The blue line in the bottom part of the chart shows what the rolling forward 10-year return was for U.S. stocks once the household allocation to stocks previously reached these high levels. The table at the bottom shows that when household equity allocations exceed 54% or the highest 20% of history, the forward 10-year annualized return at its worst was -3.0% (circled) while the average outcome was +4%. The table also shows that when the average household despises stocks and only has about a 30% allocation to equities (lowest 20%) the "worst" 10-year annualized return for investors under that setup was +13% while the average was +16%. In other words, when everybody has already boarded the stock market boat, the forward return outlook is sure to disappoint.



Stock Allocation Quintile	Average Stock Allocation	Low GPA% 10 Years Later	High GPA% 10 Years Later	Average GPA% 10 Years Later
Highest 20%	54.57	-3.03	8.43	4.09
2nd Highest 20%	49.98	2.78	13.78	7.12
3rd Highest 20%	45.81	5.46	16.35	10.66
4th Highest 20%	36.74	8.48	18.13	13.18
Lowest 20%	29.08	13.24	19.36	16.32

As the chart above indicates, the importance of the stock market to the net worth of the average American household cannot be understated. Financial asset values and their potential impact on the U.S. economy cannot be understated either. The next chart shows the massive growth of financial assets relative to U.S. GDP. The Federal Reserve adopted a more activist monetary policy mentality starting with Alan Greenspan's term in the 1990s. Since the Global Financial Crisis hit in 2008, the Fed's monetary policies have become even more extreme. As the Fed has maintained a long period of easy monetary policy, financial asset values have soared, even though those policies have not generated a higher level of real GDP growth. Importantly, with financial assets representing a much larger portion of the U.S. economy and also overly dependent on Fed policy support, financial asset declines now have much greater potential to have an outsized impact on the U.S. economy. Such was the case in the February/March 2020 market collapse, until the Fed once again had to step in and provide extraordinary monetary policy accommodation to stave off a depression like outcome. The chart can also be considered an indicator of how overly sensitive financial markets will be to a reversal in the Fed's current accommodative policy stance. When the Fed finally decides the beginning of the end has arrived, it has the potential to be a very important event for financial markets and the economy.



Summary

The C-19 post pandemic period has been a difficult time for many but with one major exception. It created an outsized increase in the financial wealth of most investors. Once again, we have central banks to thank for coming to the rescue and bailing everyone out. No one should argue it wasn't necessary because the C-19 pandemic was a once in century event that required extraordinary measures to offset the extremely dire and negative economic consequences of the C-19 pandemic. However, that was then, and this is now. Global economies are staging a robust and rapid recovery and financial markets have fully recovered and then some. Today, global financial markets are at an important crossroads. The U.S. economy has experienced a strong recovery, but inflation has accelerated as demand for goods and services spiked and supplies of both materials and labor remain constrained. Yet, the Fed is resolved to keep its foot on the accelerator until the jobs market shows further improvement. When the Fed finally decides to start to reverse its ultra-accommodative policies, it will be a very important change to the dynamic of financial markets. A few more months of strong job gains may be the tipping point and the beginning of the end. For a stock market trading at rich valuations where both institutional and retail investors are already all-in, a move in the other direction by the Fed may be difficult news for financial markets to take, like when the Delta Chau Ti fraternity found out they were all expelled from Faber College. When it happens, investors may begin to hate the Fed as much as Bluto and his Animal House fraternity brothers hated Dean Wormer.

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IMPORTANT DISCLAIMER: