INVESTMENT STRATEGY UPDATE

MARKET REPORT
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ASCENTIAL WEALTH ADVISORS

RETURN TO NORMAL FUELS RECOVERY

Global equity markets continued to climb higher in the first half of 2021. Vaccines have allowed a return to normal for many countries, creating a boom in economic activity. The global economy is projected to grow by 6.7% this year accompanied by double digit corporate earnings growth. (JP Morgan, June 2021) However, access to vaccines and the loosening of pandemic restrictions is proving critical to the recovery.

Within the US the economy is hot – as pent-up demand, an abundance of government stimulus, and low interest rates are causing a spike in everything from travel and entertainment to construction and real estate transactions. The unemployment rate fell to 5.9% at the end of June, and the current 9 million job openings are equal to the 9 million Americans that remain unemployed. If more workers can be placed back into the workforce, the economy could grow even stronger. Inflation has now become a focus for markets, and the debate about whether it is temporary or not is weighing on policymakers.

US equity markets have posted five consecutive quarters of positive returns, the longest stretch since 2017. Through the first half of 2021 the worst pullback in US stocks was only -4%, far below the average -14% that drop equity markets typically experience in any given year. While we expect US stocks to continue to benefit from a strong economy, we would not be surprised to see a normal market correction in the second half of this year.

Outside of the US, vaccine distributions and economic recoveries are mixed and as a result, foreign equity markets have underperformed the US year-to-date. As vaccines become more widely available, foreign stocks should benefit and could outpace US stocks during the latter part of 2021 going forward.

Bond markets struggled in the first half of the year due to concerns about inflation and its potential effect on interest rates. The 10-year US treasury yield started the year below 1%, and after rising above 1.7% at one point this spring, closed the second quarter at 1.5%. When inflation came in higher than anticipated in May, the Federal Reserve signaled it is watching carefully for signs that inflation is more than "transitory." If that turns out to be the case, it is likely we could see rising interest rates sooner than previously expected, putting additional pressure on bonds.

Index	*2021 (through 6/30)*
S&P 500	+15.3
DJIA	+13.8
EAFE (Int'l)	+8.8
BC Ttl Bond	-1.6

Dow Jones Relative Risk Benchmarks	
Conservative	+0.1
Moderate	+7.3
Aggressive	+14.1

INFLATION 101

Inflation concerns have been making headlines, with prices for some goods soaring as the economy rebounds. Worries are not totally unfounded, although we have not seen persistent high inflation in the US for decades and the Federal Reserve believes these increases will be temporary. While it is easy to get wrapped up in the hype, it is helpful to re-visit the basics of inflation for some perspective.

What is inflation? Inflation is the general rise in prices in an economy over time. The average rate of inflation in the US since 1958 has been 3.6% (JP Morgan). This includes a period of hyperinflation in the 1970s-1980s where prices rose by double digits for many years. However, for many years inflation has been below average, under 2.0% until recently. Some inflation is a good sign that an economy is prosperous and growing. The Federal Reserve maintains a target of 2.0% average inflation for the US economy.

What causes inflation? At the most basic level, inflation is caused by demand for goods and services outpacing supply. Demand is influenced by general economic conditions and the availability of capital that can be spent. The fiscal stimulus that has been distributed by the US government over the past year has increased the amount of money available to spend, which could be inflationary. Supply can be affected by a wide range of factors as well, including supply chain disruptions and labor shortages like we have seen since the start of the COVID-19 pandemic.

What does inflation mean for financial markets? Inflation can affect financial assets in different ways.

The Federal Reserve tries to control inflation by adjusting interest rates, raising them if inflation rises above their 2.0% target for an extended period of time. Rising interest rates can be bad in the short-term for bonds, as the market re-prices existing bonds lower based on the new, higher level of interest rates in the market. Generally, stocks perform better than bonds in an inflationary environment. As long as the rate of increase in prices is moderated so that they can pass on higher costs to consumers, companies can do well and stock prices rise. However, if the Fed raises interest rates too quickly, it can slow the economy too much and unintentionally cause a recession. In that case, stocks would likely fall.

What does inflation look like today?
Inflation ticked up recently, rising 5.0% on a year-over-year basis in May. This figure could be somewhat distorted by the absence of inflation last spring with most economies paralyzed in COVID-19 lockdowns. Time will tell whether some of the issues creating these price increases are temporary or more lasting. Therefore, we will continue to monitor inflation data and its impact on investment strategy.

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OUR VIEW

FIXED INCOME — With fears regarding inflation and rising interest rates mounting, we are in favor of slightly lower traditional fixed income exposure. In order to maintain an adequate level of risk management in portfolios, we are recommending an increased allocation to alternative strategies. We expect the combination of active fixed income and alternative strategies to help manage overall portfolio volatility and equity risk with less interest rate risk overall.

US EQUITIES — US stocks have been the best performers, and should continue to benefit from the recovery. Although stock prices have risen, earnings have grown more (up 19.7% this year) leaving stocks less expensive. With value stocks cheaper and more cyclical compared to growth stocks, we are recommending a slightly higher allocation to value. Although we remain positive on US equities, their outperformance thus far in 2021, has led to most portfolios to be overweight. A re-balancing may be in order, delivering profit while also decreasing overall risk.

INTERNATIONAL EQUITIES — Foreign stocks have lagged year-to-date, but are less expensive with the MSCI All Country World Ex-US Index now at a price-to-earnings discount of -27.3%, relative to the S&P 500. (JP Morgan, June 2021) Foreign equity markets are more heavily weighted to cyclical sectors which look attractive in a sustained recovery, and consensus projections are for earnings growth in both developed and emerging markets to outpace the US for this year. As foreign countries catch up to the US in recovery pace, investors in foreign markets should be rewarded.