MARKET REVIEW & OUTLOOK

July 2021

KEY TAKEAWAYS

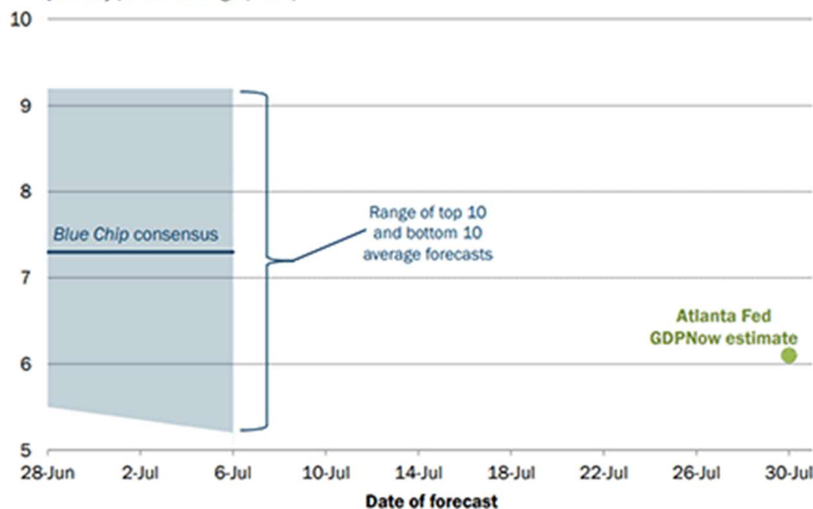
- U.S. Mega-cap Equities, i.e., Technology continues to make new highs, dragging the S&P 500 along for the ride. The rest of the markets are not nearly as sanguine as the "delta" variant is causing some concerns.
- Interest rates again dropped significantly during the month on longer maturities, continuing the trend that began in June.
- The Fed has resumed their confidence that inflation is "transitory", in part taking cover from the emergence of the "delta" variant and renewed calls for masks and lockdowns.

The U.S. Economy

The economy continues to be robust, though as mentioned last month, the results are no longer beating lofty expectations, additional information later. The downward trajectory of last month's forecast proved to be in the right direction as 2nd quarter GDP came in at 6.5%, which was far short of the expected 8.5%. However, a meaningful portion of the miss was attributed to less inventory building than expected and more inflation than expected, which serves to subtract GDP. The initial view is that 3rd quarter GDP will slow modestly from the 2nd quarter, as seen in the chart below.

GDPNow is not an official forecast of the Atlanta Fed. Rather, it is best viewed as a running estimate of real GDP growth based on available economic data for the current measured quarter. There are no subjective adjustments made to GDPNow—the estimate is based solely on the mathematical results of the model.

In particular, **it does not capture the impact of COVID-19 and social mobility** beyond their impact on GDP source data and relevant economic reports that have already been released. It does not anticipate their impact on forthcoming economic reports beyond the standard internal dynamics of the model.



Source: https://www.frbatlanta.org/cqer/research/gdpnow

Stocks and Bonds

The fixed income markets saw another sharp drop in yields for the month on the 10-year Treasury, with a low reached mid-month on “delta” concerns just below 1.15% and a modest rebound to end the month. The strength in the base Treasury rates, which runs contrary to the continued robust inflation reports, resulted in more solid results throughout the fixed income complex, including high quality fixed income. High-quality fixed income, as measured by the iShares US Aggregate Bond ETF, saw positive returns, finishing the month with a gain of +1.12%. The U.S. 10-year Treasury bond yield ended the month near the bottom of the range at 1.24%, down from June’s close of 1.44%.

The Dow Jones Industrial Average rose +1.25%, the S&P 500 rallied +2.27%, and the small cap Russell 2000 dropped -3.65%. The international markets where again bifurcated, with continued “delta” variant concerns. The MSCI EAFE iShares Core International Developed Markets ETF Index had a modest reversal of last month’s decline, climbing +0.91%, conversely the MSCI Emerging Markets iShares Core ETF Index fell -3.55%.

In July, we saw predominately green performance with one extreme outlier, being Energy.

The best performers were…

- Healthcare: +4.92%
- Real Estate: +4.62%
- Utilities: +4.33%

The worst performers were…

- Energy: -8.32%
- Financials: -0.46%

Source: https://www.sectorspdr.com/sectorspdr/tools/sector-tracker

Oil Report

In July, crude oil started out strong on the initial reports that OPEC+ had agreed to continued restraint of supply through the end of the year, but the UAE backed out at the last minute. The result was selling the early gains. The weight of OPEC+ members quarrelling and the resurgence of Corona virus reports around the "delta" variant lead to a big mid-month slump. Though as has been repeated many times, the dip buyers stormed in and took prices back to where they started. The current NYMEX WTI Crude Oil futures settled at $73.81 and posted a gain of 34 cents from the prior month close of $73.47 a barrel. The price for RBOB gasoline had a pretty climb for the month except for the aforementioned "delta" variant drop. RBOB finished higher by almost 4% for the month of July. The strength of the economy and whether the "delta" variant leads the government to lock us down again will have a big impact on the direction of oil and gas prices.

The Rest of the Data

The June ISM Manufacturing Index decreased 0.6 points to 60.6 from May's reading of 61.2. Additionally, the ISM Services Index dropped to 60.1 from 64.0 in June, falling from all-time high. The prices paid component remains very elevated in both surveys and continues to signal strengthening inflation pressures. Any reading above 50 generally indicates improving conditions. Consumer confidence increased modestly to 129.1 in July, which compares to an upwardly revised figure of 128.9 in June. The unemployment rate rose slightly, coming in at 5.9%, as the economy added 850,000 jobs in June, handily beating expectations of 720,000. The Consumer Price Index for All Urban Consumers (CPI-U) was up +0.9% in June, erasing the first relative monthly decline seen last month, on a seasonally adjusted basis. Over the last 12 months, the All-Items Index increased +5.4% on a non-seasonally adjusted basis, which continues to be the highest reading since 2008. The CPI ex Food and Energy was 4.5% and the largest 12-month increase since November 1991. Overall, these numbers show that the economy is experiencing robust growth that will probably continue into the near future. The Fed is going back and forth on whether inflation is "transitory" or not. The data is starting to suggest as is the commentary from corporate America, that inflation is not "transitory". The question remains, if the stimulus continues to roll off, does that have a one two punch of stopping inflation, but also returning the economy to the standard 2% growth rate?

Summary

Does a watched pot boil? That's what the last several months feels like, the economy is strong, and unemployment is falling, but inflationary pressures are stubbornly high, and the government stimulus packages are rolling off. First is the eviction moratorium and 5 weeks later the balance of the extended unemployment benefits. We keep waiting for something material to change, but we just keep chugging along. We had to mid-month asset swoon attributed to the "delta" variant scare, but many asset classes shook off those concerns and recovered most if not all those losses. Last month, the Fed sort of backed off the inflation is "transitory" but jumped back on that bandwagon with the "delta" variant as their cover. The Fed continues to be more scared of economic growth than inflation, or is more scared of the equity markets declining?

As mentioned in the GDP discussion, the economy has continued its strong growth, though as the chart below shows, economic surprises continue to be to the downside. The other aspect of the chart is the close correlation of the Fed's balance sheet and the trajectory of the stock market. Even with all the great economic news that has been coming out for months, the Fed is still too scared to even start reducing some of the emergency measures that were taken as the pandemic started 18 months ago or really even 12 years ago.

Source: https://www.zerohedge.com/markets/july-jolt-small-caps-bond-yields-plunge-most-march-2020-covid-crash

Maybe the "independent" Fed is more beholden to Wall Street than they will ever care to admit. So will inflation scare the Fed into action or will things return to the "normal" sub-2's. Less than 2% inflation and economic growth. Maybe the next few months will reveal some answers, though we have been saying that for months and it seems we are still in limbo.

With all the aforementioned uncertainty, whatever do we do? We retain our focus on what we can control, which is the amount of equity risk that is taken in a clients' portfolio in concert with the clients' risk tolerance and long-term goals. The markets will always face different "worries", today it is sustained vs. transitory inflation, tomorrow it will be something else. We have built our asset allocation models with dynamic features and quarterly rebalancing, both in fixed income and equities. If the markets continue to march higher, we will capture some of those gains and reallocate to less volatile high-quality bonds. If the equity markets enter a period of negative performance, we have dynamic investment vehicles that utilize rules-based defense mechanisms to reduce the risk of the portfolio. Further, if the market gets too extended on the upside, some of the vehicles will capture partial gains and wait for the extension to correct.

If you have specific questions about your portfolio or financial situation, we are here to help. Long-term financial planning is designed to deal with uncertainty like those we discussed above. Our portfolio management process is to design a prudent allocation across many asset classes. Equities are for long-term growth and several vehicles that we utilize offer defensive mechanisms to mitigate equity market declines.

Kevin Churchill, CFA®, CFP®
Chief Investment Officer
WaterRock Global Asset Management

Institutional Asset Management adapted for Private Wealth™

WaterRock Global Asset Management, LLC
Scottsdale, AZ 85260
(623) 252 – 1356

WaterRock Global Asset Management, LLC. ("WaterRock Global") is a Registered Investment Advisory Firm regulated by the State of Washington and the Securities Exchange Commission under the Investment Advisors' Act of 1940 and in accordance and compliance with applicable securities laws and regulations. Investing in the stock market involves risk, including the risk of principal loss. Information in this newsletter is in no way intended as personalized investment advice and should not be interpreted as such. Past performance is not necessarily indicative of future results.