Zacks
INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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3 Key Factors for Investors in the Second Half of 2021

In many ways, the first half of 2021 has played out as largely expected. Here's a quick list of forecasts made at the beginning of the year that I think are largely running their course:

- ✓ Rising vaccination rates were expected to give way to loosened and eventually removed economic restrictions;
- ✓ The economy was expected to surge on the heels of returning demand and a spending boom;
- ✓ The "reopening trade" was expected to favor companies that suffered most during lockdowns but could benefit most from re-engaged consumers;
- ✓ Surging demand would generate strong growth rates along with inflationary pressures.

The first six months have gone fairly close to script, in my view, which tees up a few key factors to watch in the second half. Here are three factors that investors should keep an eye on.

Factor #1: Will Inflation be "Transitory"?

The consumer price index jumped 5.4% in June – its quickest increase in 13 years – and has been trending firmly higher. Globally, inflation measures in 49 countries have also been tracking higher.[1]

The inflation debate continues to center around whether these price pressures will be transitory or more nefarious and long-term. In Q2 earnings calls and reports – both of which we monitor closely here at Zacks Investment Management – we noticed a majority of CEOs referencing inflation. Here are a couple of examples that stood out:

From the massive consumer packaged goods company, Conagra: "*We expect the negative impact of the cost inflation to hit our financials before the beneficial impact of our responsive actions, including our pricing*."

From PepsiCo: "*We're seeing inflation in our business across many of our raw ingredients and some of our inputs in labor and freight and everything else*."

Early on, it appeared price pressures were largely being driven by energy, reopening categories like restaurants and travel/hospitality, and big-ticket categories like used cars and housing. But we're seeing inflationary pressures in much broader categories this summer, and many producers are indicating continued firmness in commodities and other input costs. Continued supply chain bottlenecks aren't helping.

For investors, inflation will be a key metric to watch in the second half, but there are a few things to start thinking about now. For one, history tells us that stocks do better during flat or disinflationary regimes, versus periods of higher inflation. This does not mean stocks should be avoided if inflation is expected – rather, it means investors should be more selective during inflationary periods. A pivot to value could be a play – data dating back to 1927 indicates that value stocks have tended to outperform growth during periods of moderate to high inflation.

If inflation does indeed prove sticky, we'd generally want to favor companies with strong pricing power, i.e., firms that can pass along rising costs to consumers without losing market share.

Factor #2: Will Leadership Continue to Shift Between Cyclicals (Value) and Growth?

We have seen quite a bit of style rotation year-to-date so far, namely as capital moved between cyclical (value) stocks and secular growth stocks. From the beginning of the year through the middle of May, value outperformed—the Russell 1000 Value index rose +15% compared to just +2% for the Russell 1000 Growth index. From mid-May to the end of the second quarter, however, U.S. Treasury bonds have rallied alongside growth stocks (+12%), while value stocks have lagged (+2%).

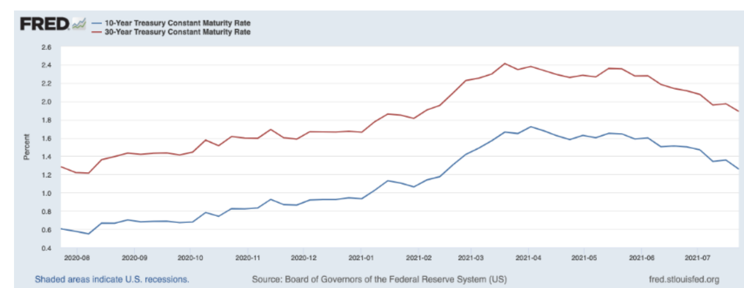
There are some logical explanations for the rotation year-to-date. When vaccines were announced to be effective in November, economically sensitive cyclical stocks started to outperform as investors anticipated the economic reopening. Some of the most beat-down stocks during the pandemic started to rally strongly.

But the rapid surge in demand gave way to what is largely considered peak growth in Q2, which has caused investors – in my view – to rotate into growth names expected to perform better as the U.S.'s pace of growth moderates. Concerns over rising inflation have also nudged capital back to secular growth names.

The key question from here is whether this rotation continues or if the value will start to lead again. In my view, economic growth has likely peaked, but I think will it continue at a faster pace than many expect. In other words, cyclicals likely have some room to run, but quality growth names should also do well in an expanding economy. I expect leadership to shift quite a bit, which favors a broadly diversified approach to equity investing.

Factor #3: Are Interest Rates Poised to Move Higher?

Interest rates in the U.S. – as measured by the 10-year and 30-year U.S. Treasury bond yield – moved higher in the second half of 2020 and throughout Q1 2021. However, as you can see in the chart, yields have slipped back over the last quarter:



Source: Federal Reserve Bank of St. Louis [2]

There could be a few reasons for this fluctuation in rates. Yields may have pushed higher in

anticipation of higher inflation and economic growth, and we may have seen some retracing as investors started to shift expectations to moderating economic growth and inflation that may indeed be transitory. Going forward, I'd expect better-than-expected economic growth and an eventual reduction in the Fed's bond purchases to put upward pressure on rates, both of which I could see playing out by the end of the year.

Bottom Line for Investors

I think worries over sticky inflation, peaking economic growth, and rising interest rates are together contributing to a wall of worry over the durability of the economic expansion – and by extension, the bull market. But in my view, the worries may inspire investors to start moderating expectations for sustained economic growth and profitability, and falling expectations could give way to positive surprises. And stocks tend to love positive surprises.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Black Rock. July 15, 2021. https://www.blackrock.com/us/individual/insights/insights-for-equity-investors

[2] Fred Economic Data. July 23, 2021. https://fred.stlouisfed.org/series/DGS10#0

IN FOCUS THIS WEEK

- U.S. GDP growth surpasses pre-pandemic size. Is it enough?
- Is the Fed tip-toeing closer to monetary tightening?
- Businesses adapt to rising cases of the Delta variant

The U.S. Economy Grows to Pre-Pandemic Size, and Then Some

The U.S. economy posted another stout quarter of GDP growth in Q2, though the first estimate came in fairly far below expectations. The Bureau of Economic Analysis reports that the U.S. economy grew 6.5% in Q2, well below the 8.4% consensus estimates. This GDP growth puts the country back above its pre-pandemic size, and more growth is expected in the second half of the year. The expansion continues to be driven mostly by consumer spending, which rose at a firm 11.8% pace in the three months ending June 30 – the second-best performance since 1952. Consumers are still spending more on goods than services, but in recent months services started to catch up as Americans re-engage with the physical economy, i.e., with more travel, trips to salons, restaurants, and the like. Importantly, business investment was also a big contributor to growth in Q2, as businesses increased spending on technology upgrades, equipment, software, and R&D. The labor market is tight and wages are being pressured higher, which has arguably pushed businesses to invest more in technology and other means of boosting productivity. Even with the strong growth rebound, the U.S. economy is still about 2.4% smaller than it would have been (estimated) had the pandemic never happened. The labor market has not caught up to pre-pandemic levels, either – there are still 7 million fewer jobs today than before the pandemic. Other detractors from GDP growth in Q2 were inventories and trade. As consumer demand outstripped supply, businesses sold down inventories and struggled to bring more goods back online.[1] On the trade front, since imports detract from GDP, the U.S.'s trade deficit pulled down growth in Q2.

Is the Fed Tip-Toeing Closer to Monetary Tightening?

Most readers are aware of the Federal Reserve's extraordinary measures to stimulate the economy in the wake of the pandemic. Rates were lowered close to the zero bound almost immediately, and monthly Treasury and mortgage bond purchases to the tune of $120 billion have been 'designed' to further boost the economy. The jury is still out on whether these bond purchases actually work effectively, but that is another topic for another day. This week, the Fed's meeting was as closely watched as any, as market watchers were looking for even the slightest hint that the Fed would start to back off its stimulative measures/programs. And they got a strong hint: the Fed said "the economy has made strong progress" towards the goals set early in the pandemic, which could be an indication that the bond purchases can be wound down. In our view, this Fed action would be a good thing – bond purchases have the effect of holding down the long-end of the yield curve, keeping it relatively flat. A steeper yield curve is better for the economy, in our view, as it gives way to a more profitable environment for bank lending. As for raising short-term interest rates (Fed funds), don't count on it – Federal

Reserve Chairman Jerome Powell said there are no plans for rate increases anytime soon.[2]

Economically Adapting to Covid-19 and Its Mutations

News of rising cases of the Delta variant is increasing around the world, but in Western countries, each successive wave has been causing less and less economic damage. Vaccines have been a key factor in avoiding the most deleterious of economic impacts, as Western countries have relatively high vaccination rates and have not needed to resume lockdowns, as we're seeing in countries like Australia, Vietnam, and Indonesia. But improving economic outcomes with each new surge of cases is also tied to businesses and governments adapting to doing business and living with the pandemic. Businesses have developed new protocols for keeping workers safe, including distancing and spacing out worker shifts, and allowing for more remote work capabilities. Some are taking even more drastic measures as we saw at Facebook and Google this week, where vaccinations would be required to return to campuses. All this to say, the threat of another economic lockdown – and associated recession – appear low even as new cases rise.[3]

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[1] The Wall Street Journal, July 29, 2021. https://www.wsj.com/articles/us-gdp-economic-growth-first-quarter-2021-11627508180?mod=hp_lead_pos3&mod=hp_lead_pos1

[2] The Wall Street Journal, July 28, 2021. https://www.wsj.com/articles/fed-says-economy-has-made-progress-toward-its-goals-teeing-up-bond-taper-11627495233

[3] The Wall Street Journal, July 28, 2021. https://www.wsj.com/articles/covid-19-keeps-resurging-but-western-economies-are-adapting-11627491835

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