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Should Investors Stay the Course Despite the Surging Delta Variant?

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Many investors feel they're at a crossroads. They saw the stock market drop precipitously last year, by as much as 35%, amid the surge in Covid 19.

Since then, on the back of extreme monetary and fiscal stimulus, together with the development of several vaccines, the market has snapped back. Indeed, we've seen 49 new all-time stock market highs this year. This is even though millions of Americans who were working pre-pandemic are not employed today. Wide swaths of the economy remain underutilized.

Now, what was an overseas virus mutation, the so-called Delta variant, has fully hit our shores, and threatens again to lock down areas of the economy. Travel plans, back to office hopes, even return to in-class learning, are all threatened by this new strain.

Investors, like many Americans, feel at a loss to plan effectively in the face of this new health risk. We have been told to trust the science, but the science is constantly changing. For example, Pfizer, the maker of one of its vaccines, has now shared that the vaccine's immunity can drop 83% in as little as four months.

The nation has carefully watched the percentage of Americans that are fully vaccinated. Yet, now we are being told that the true number to watch for may be the number of Americans that have taken a third shot, a booster, as only with the booster will we be truly safe from waning efficacy and the new Delta variant. Yet, that booster has not been approved yet, and is unlikely to be available until late September.

Investor sentiment has started to wane. The creeping uncertainty has been compounded by news that the Federal Reserve is on the cusp of pulling back monetary assistance. Compounding the uncertainty are the sad images and stories coming from Afghanistan. That is causing worries over leadership in Washington. Finally, concerns over inflation remain; the latest figures indicate consumer prices rose 5.4% in the last year.

As a result, many investors are bracing for a correction or worse, and wonder how to position their portfolio.

In a Nutshell

Investors need to check again on their time horizons. If those remain long term, they should resist any urge to time the market or to bet on any market correction.

There are good reasons to be skeptical that stocks will underperform longer term. First, interest rates remain low; indeed the yield on the ten year Treasury remains below the dividend yield on the overall stock market. Second, the Delta variant, while very serious, is unlikely to deliver the knockout blow to the economy that the first wave of Covid did, if only because we are far better positioned to handle this threat. Third, corporate earnings have been very strong. Expectation for future profit growth may continue to underestimate corporate performance ahead. Finally, additional fiscal stimulus is undoubtedly on the way.

Delta Variant

By far the most important factor affecting the economy and the market is the Delta variant. While so-called breakthrough infections are most disturbing, the science indicates that if fully vaccinated, those infections are much milder. Over half of all Americans meet that criteria and vaccination rates are rising significantly as the unvaccinated better appreciate the risks.

Before long, we are likely to be able to vaccinate children, a major source of transmission and vulnerability today. Full approval for those vaccines now simply labeled "for emergency use" is expected in a matter of days; that will encourage more to get the jab and support employers and others who wish to mandate vaccination.

Booster shots are under development now and could be available by late September, offering critical protection against a waning of protection from the first vaccine doses. It hopefully will also bolster protection against the Delta and other variants.

In all events, a second economic shutdown is unlikely, no matter what the Delta surge brings. Politically, those that have been vaccinated are unlikely to submit to being locked down to the extent the problem is due to the unvaccinated. We've got the masks, the social distance protocols, the strategies to reduce risk. It is unlikely to be as bad as the first wave.

Investors are best advised to ride out the Delta variant and look for opportunities presented by others overreacting.

Federal Reserve Taper?

The release of the minutes of the Federal Reserve's July meeting brought panicky selling. The minutes indicated increasing acceptance of the idea of reducing monetary accommodation, particularly scaling back the monthly purchases of $120 billion of Treasury and mortgage-backed bonds.

The bear case is that this policy action could be announced very soon, with buys scaled back before year end. That might cause a run up in interest rates. That could result in stock market volatility and a less economic optimism.

We don't think that scenario is the most likely. First, those minutes involve a meeting that was conducted before a recent surge in Delta cases. The Federal Reserve is unlikely to change course amid grave virus uncertainty.

Of course, at some point there will be a taper, most likely after epidemiologists provide the all clear signal. Stock market investors must remember the reason why the Fed would execute the taper is that the economy is strong. That provides a tailwind behind stocks, particularly cyclical ones.

Another reason to be skeptical that a major shift in monetary policy is near is that there is uncertainty as to who will lead the Federal Reserve come next year. Current head Jerome Powell's term ends this year and whether he will be asked to continue is unclear. The Fed may well want to postpone any shift in strategy until it's clear what leadership will be in place.

Corporate Earnings Remain Strong

US companies just reported the strongest year over year earnings growth in over a decade. Average gains neared 90%, with 87% of corporations reporting positive profits and revenue surprises.

Many strategists warn that we've seen the peak in economic and earnings improvement, and that further gains will be of a much lower magnitude. However, due to the pandemic and the resulting limited visibility, it would not be surprising if current expectations remain too low, and companies can continue to power past estimates.

Further, we have seen analysts estimates continue to rise for third quarter results. Usually, estimates come down in the first month of the next quarter, so it's telling that's not happening now. Energy and materials are seeing the best estimate improvements, increasing by double digit percentages.

Wither Emerging Markets?

We continue to advise broad diversification over stock market sectors, reasoning that it's just as difficult to time industry groups as it is to time the overall market.

However, the emerging market investments are worthy of consideration. This sector is down for the year, despite having lower valuations and superior growth prospects compared to our own markets.

There are several culprits, including greater vulnerability to Covid 19 and the Delta variant. Recent US Dollar strength makes repayment of their US Dollar debts more difficult and reduces the value of earnings in foreign currencies. Recent commodity weakness, a major part of many lesser developed countries' economies, also weighs.

However, the most important recent factor pushing down emerging markets has been Chinese weakness. Chinese equities constitute around 44% of emerging market stock indices, so they have significant influence

Chinese stocks have by some measures entered a bear market. Although resurging Covid 19 is a key factor, recent steps by the Chinese government to impose much greater regulations have created panicky sell offs.

Unfortunately, there's no reason to think that there'll be any near-term change in the Chinese government's campaign to tighten regulation of industries and companies. This may be motivated by a desire to deflect attention from perceived failings by their government over resurging Covid. Others suggest it may reflect leader Xi's political calculus to enhance his power.

One diversified way to play the Chinese market is via the $4.6 billion exchange traded fund **Ishares China Large Cap ETF (FXI)**, now trading some 30% off its February high. Top holdings include Alibaba, Tencent, and other world class Chinese techs.

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