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Wealth Management

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Can Stocks' Second Half Performance Equal their Stellar First Half?

By David G. Dietze, JD, CFA, CFP™
Managing Principal, Senior Portfolio Strategist
ddietze@pgbank.com
908-598-1717

Just about every asset class put a smile on investors' faces for the first six months of 2021. Stocks gained 12% or more, as measured by the three leading stock indices, completing their fifth quarter in a row of gains. Indeed, the market had its best first half of the year since the Dot Com days.

Only fixed income disappointed, as a sharp rise in interest rates crimped bond values, primarily high credit quality bonds of longer duration. An ETF targeting long dated US Treasuries has slipped nearly 9% this year, as the ten-year US Treasury's yield climbed from less than 1% to end the quarter just shy of 1.5%.

The primary reason for stocks' success was the continued retreat of the pandemic. The United States has been a global leader in rolling out vaccines, with nearly half of Americans having gotten the jab. Masks have by and large come off, and Americans are once again venturing out.

The continued monetary accommodation has also spurred risk assets. With the Federal Reserve continuing to pin the benchmark Federal Funds rate at close to 0%, while still buying $120 billion monthly of Government and mortgage backed securities, TINA, an acronym that stands for There Is No Alternative to stocks, continues.

Two big stimulus packages helped line consumers' pockets and propel spending. One package, valued at $920 billion, was passed into law just before the start of the year and a second, under the Biden administration, provide an additional $1.9 trillion in direct assistance to the unemployed as well as support for state and local jurisdictions and stressed industries.

Corporate earnings surpassed all expectation, with Q1's profits up nearly 50% from the prior year, while by all accounts Q2's will outshine last year's second quarter by an even greater extent.

However, amid all this positive news, investors are growing increasingly uneasy. Several readings on inflation came in quite hot. That's set off a debate: Are the price increases a temporary bump due to the depressed activity last year or something longer lasting? That answer will help determine monetary policy. Expectations for the first rate hike to occur in 2024 have now given way to some seeing hikes as early as next year. The Fed's bond buying may be tapered before any hikes occur, perhaps before the end of this year.

Bottom Line

Stocks are poised to continue to drift higher for the balance of the year. Historically, outstanding first halves are followed up by solid second halves. The low interest rate environment incents investors to continue buying on the dips.

Inflation and higher rates are indeed potential headwinds. However, at the end of the day Fed Chief Jerome Powell is unlikely to risk repeating the mistakes following the aftermath of the Great Recession and tighten monetary policy too quickly.

Corporate earnings may not increase at quite the same rates in Q3, but Q2 earnings will benefit from easy comparisons from last year. Expectations for 2022, while not quite as heady as 2021, will be sufficiently ebullient to support stock prices.

Valuation are high. However, valuations have become more reasonable so far in 2021, as earnings have grown even faster than stock prices. Valuations of course must be seen in the light of fixed income yields. Nevertheless, with stock price valuations full, the market is more vulnerable should unforeseen headwinds arise.

Fiscal stimulus continues. While not quite the shot in the arm of the earlier pandemic relief packages, passage of an infrastructure bill is highly likely. There appears to be bipartisan agreement on a skinny traditional infrastructure spending proposal, and it's free of any new taxes.

Inflation/Interest Rates

Nearly two thirds of investors see inflation and or rising interest rates as the number one headwind. The bearish argument is that over generous monetary policy and profligate fiscal spending, without any material offset via higher taxes, have lit a match to higher prices. Inflation, once out of the bottle, is hard to contain, as inflation expectations become embedded. Money has sat in bank accounts, but with the pandemic waning consumers are starting to spend. Bottlenecks, labor shortages, and higher wholesale prices are the catalysts for higher prices.

The bullish pushback is that any inflation is temporary. Prices are jumping, but were bound to given the comparison is against the pandemic induced lockdown. As time passes, comparisons will be against a more normalized backdrop. Any pricing surge will be transitory.

The number one arbiter of the debate as to whether the recent hotter than expected inflation readings are temporary or longer lasting is the Federal Reserve. The Fed's views matter because it is more likely to start tapering down bond buys and ultimately starting hiking interest rates if it sees a more permanent inflation problem. Higher interest rates make stocks a tad less compelling versus bonds, plus make borrowing costs higher for consumers and corporations alike.

Many of the recent price hikes are clearly a short-term phenomenon. For example, higher rental car rates reflect that a year ago the car rental market came to a near standstill, prompting a rate decrease to match reduced demand.

To gain insight on how likely inflation is to be more than temporary, look at wage increases. Wages tend to be sticky, but once they start to float up, they are not easy to restrain.

Pandemic Resurgence

Just when we thought we were out of the woods, the Delta variant has surged. Lockdowns have been reimposed in places like the UK, while such organizations as the World Health Organization and the County of Los Angeles counsel a return to mask wearing, even for the vaccinated.

No question this is disturbing. 27% of Wall Streeters cite this as the biggest risk facing the markets. This may explain why US Treasury interest rates have declined in recent weeks, as a hedge against another material slowdown or worse in the economy.

While few can accurately predict the path of this variant, we counsel not to let its threat derail your long-term investment plans. Remember, the original rationale for the first lockdown was to avoid having an overflow of patients in the hospital or worse. However, epidemiologists note that while the vaccinated may still get sick from the variants, the incidence of hospitalization or death is far lower. Further, while vaccination rates have slowed, there is significant room to increase the percentage of the population that's been vaccinated and indeed this variant may spur those on the fence.

Retail Speculation

10% of the financial community cites market speculation as the biggest near-term risk. Meme stock investing, research via chatrooms, the spiking of companies with little fundamental support, all suggest a retail investing public that's infatuated with investing.

A recent study indicated that the small investor crowd is now anticipating a 17% per annum return from stocks. This is totally inconsistent with history, which counsels an 8 to 10% yearly profit. Further, those expectations have steadily increased over the years, despite rising valuations.

An over-enthusiastic public has long been, in a contrarian fashion, associated with an over loved market. Over loved markets can be ripe for a pullback, or worse, as too many people are over invested, allowing for little additional buying power to propel stocks higher, and perhaps vulnerable to panic should the market retreat.

Back in 1929, legend has it that Joe Kennedy, JFK's father, knew it was time to get out of the market when his shoeshine boy was offering up stock tips. This underscores that extreme retail participation has been associated with market tops in the past.

While we acknowledge that this overenthusiasm of the crowds for stocks is not a positive, we don't think that by itself it's a call to deviate from your long-term portfolio plan. Trying to time the market is not easy, and many have sat on the sidelines for years waiting for a correction.

Investment Ideas

Energy Stocks: These were the best performing industry group in the first half of 2021. There could be more room to go. First, while they have performed well recently, over a multi-year period they have been the biggest laggards. For those with fearing stocks are too high, these companies may be the antidote.

Second, energy demand is surging, as worldwide people want to get out of their homes and travels. Some call it revenge travel, as there's a desperate desire to do what you could not do during the throes of the pandemic.

At the same time, globally societies are doubling down on discouraging fossil fuel usage and development. The problem results in that fossil fuel developers are projected to reduce production far faster than consumers can wean themselves off oil and gas. As demand outstrips supply, prices are poised to rise.

There's also a new mindset among energy companies and their investors. A few years ago, the mantra was to spend all the money you had to develop new supplies; returning money to shareholders was not a priority.
Today, investors insist that energy companies use all free cash flow to reward long maligned shareholders with dividends and stock buyback. Just recently both **Exxon (XOM)** and **Chevron (CVX)** have announced plans to sell portions of their business. Undoubtedly, the proceeds will be returned to shareholders. We recommend investments in both companies.

Financial Stocks: Inevitably, interest rates will rise. When is not clear, but with the monetary and fiscal stimulus being applied, plus the resurging economy creating more loan demand and transactional activity, the outlook for lenders and insurance companies appears bright. Too, these companies have not regained all time valuation levels.

In short, as rates rise, net interest margins for banks are poised to increase, while the float of insurance companies, meaning the amounts paid in as premiums before being paid out for claims, can be invested more profitably.

Wells Fargo (WFC) may well benefit from this improving environment. Up already 51% in the first half, this bank enjoys an enviable coast to coast franchise. Its focus on middle market lending and retail accounts allows it to avoid the volatility associated with banks focused more on trading. Its traditional strict underwriting standards may serve them well when the current cycle changes. The bank has had its share of miscues and scandals in the past, but new leadership seems to be righting the ship. The bank came through the recent stress tests with as much excess capital as anyone; it promptly announced a doubling of its dividend and a stock buyback totaling nearly 10% of the bank's capitalization.