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Todd Asset Management

Shouldn't Earnings Leaders Lead an Earnings Driven Market?

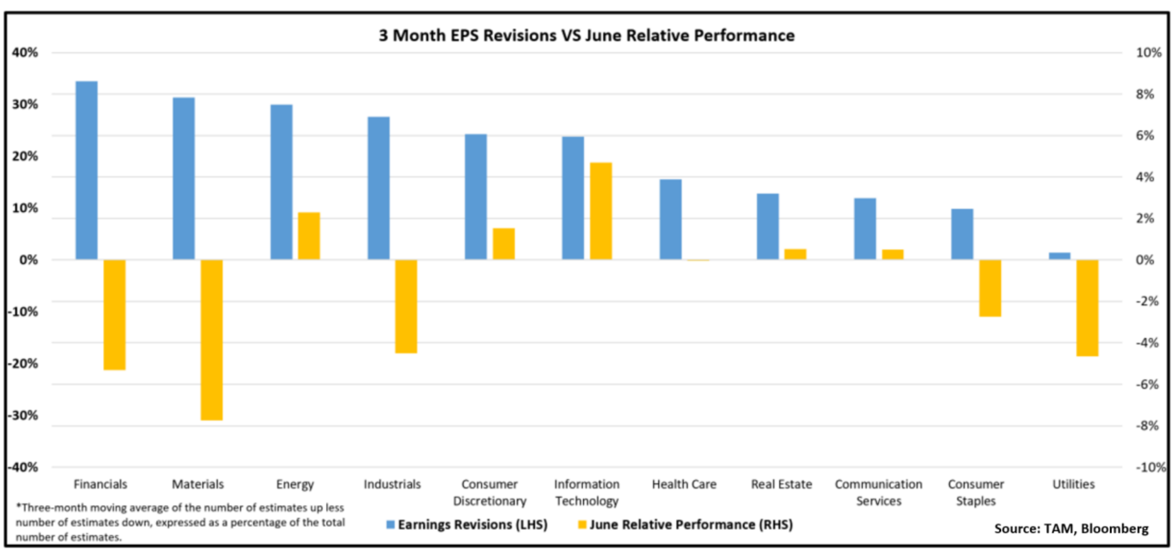
Todd Asset Management Q2 2021 Review and Outlook for US Markets

	2Q 2021	YTD	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
S&P 500	8.6%	15.3%	40.8%	18.7%	17.7%	14.1%	14.8%
Russell 1000 Value	5.2%	17.0%	43.7%	12.4%	11.7%	9.4%	11.6%

* *Annualized Total Returns.*

At the end of June, the S&P 500 wrapped up a good month and quarter, with returns of 2.33% and 8.55% respectively. During the quarter, the S&P hit many new highs and was the leader of all major markets, as most international indexes posted lower returns. Growth trounced Value, as many of the big tech beneficiaries of Covid-19 caught a strong bid while interest rates fell from almost 1.75% to 1.25% recently.

Earnings and P/E multiples drive market returns, and when index earnings decline and markets increase (like 2020) it is because multiples expand. When earnings growth is higher than market appreciation, then multiples contract and the market is earnings driven, like 2021. Interestingly, the groups with the largest earnings revisions over the past three months were the market laggards during June and the second quarter. Shouldn't earnings leaders lead an earnings driven market? We think so, and anticipate they are likely to resume their leadership as the year goes on.



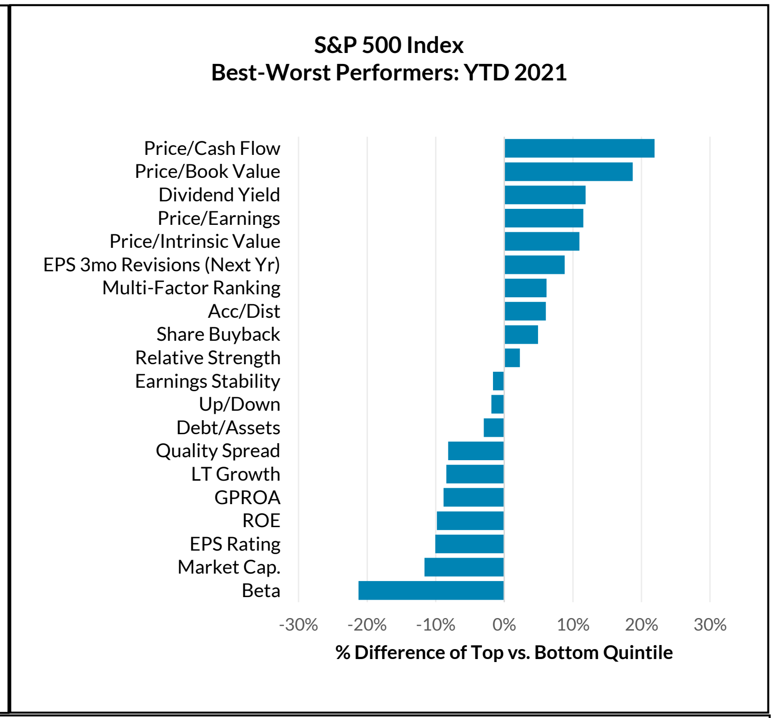
Four interesting points to think about:

- The Covid-19 Delta Variant has investors worried about renewed outbreak and the potential for a slowdown from currently elevated economic growth rates. Vaccines are effective at preventing the most severe outcomes, and we believe growth should remain strong.

- The June Fed meeting advanced expectations of tapering bond purchases and increasing short term rates to 2022 or 2023, earlier than prior meetings. Despite this bond yields plunged over the following weeks. We think rates probably increase from here.
- A safety trade occurred in stocks, with the pandemic growth darlings recovering lost ground during the quarter. Economic worries grew as Jobs and Retail Sales numbers were below expectations.
- Inflation is here, with June CPI at 5%, and oil surging. It's tough to reconcile bond rates declining on economic worries with re-opening driven inflation and recent Fed comments.

The recent rotation to bonds, and safety growth stocks does not "feel" right to us as we look at anticipated economic growth rates. We think investor psychology is still scarred from ten years of subpar growth and the recent Covid-19 depression. Second quarter earnings reports during July could change investors' perception and allow the economically sensitive sectors that we favor to get reinvigorated. Consumers have savings and pent up demand. Companies have the ability and need to spend on capital equipment, thanks to support they received during the Pandemic. Inventories are low and bottlenecks are holding up production of consumer goods, a precursor of better sales in the future. There are currently over 9 Million job openings and 9 Million unemployed. In May, nearly 4 Million people QUIT their jobs, presumably to move to another job for higher pay. The services side of the economy is opening so we believe many of the unemployed are likely to get re-employed. These are all good things, and point to economic recovery being young, reopening occurring and stimulus programs working. We believe the S&P is beginning the second half of a secular bull market that probably lasts years. With that said, we are passing peak growth rates in earnings, GDP growth and many other economic measures. Markets advance as long as earnings are growing, but the period where markets pass peak growth rates is normally accompanied by volatility and market indigestion for a few months. While pullbacks can occur at any time, we like the long term outlook for stocks.

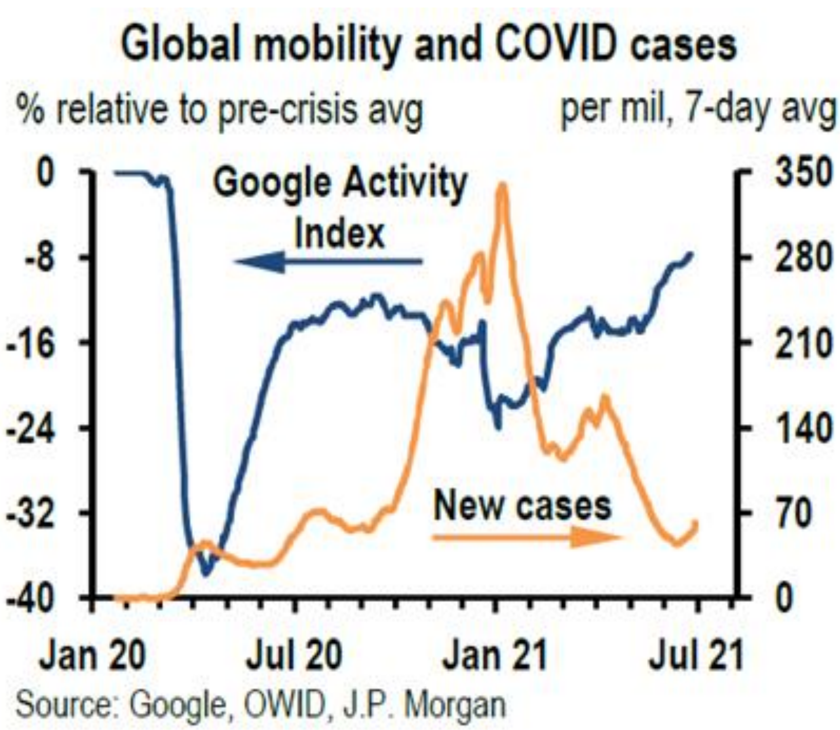
Factors



Source: Bloomberg, William O'Neill + Co. and Todd Asset Management

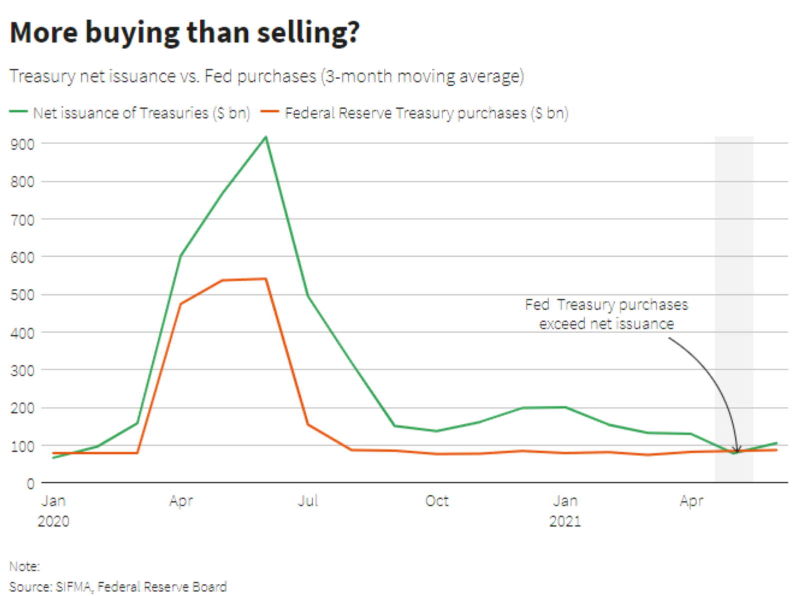
We present our customary factor analysis for the second quarter (chart left) and year to date (chart right). There is a stark difference between these two charts, as the nascent shift towards value factors that was evident in the first quarter reversed in the second quarter. Bond rates collapsed, and investors seemed worried about the economic outlook for the latter part of the year. In hindsight, after the surge in first half stimulus spending, we probably should not be surprised that markets seem worried about a second half disappointment since it appears Washington may not have a follow up stimulus program. During the quarter, Value factors fell to the bottom of the pack as Growth and Quality factors improved. Year to date, Value factors remain favored. We suspect the value weakness in the second quarter should prove temporary as the economy continues expanding in the second half.

Interesting Charts We Saw This Quarter

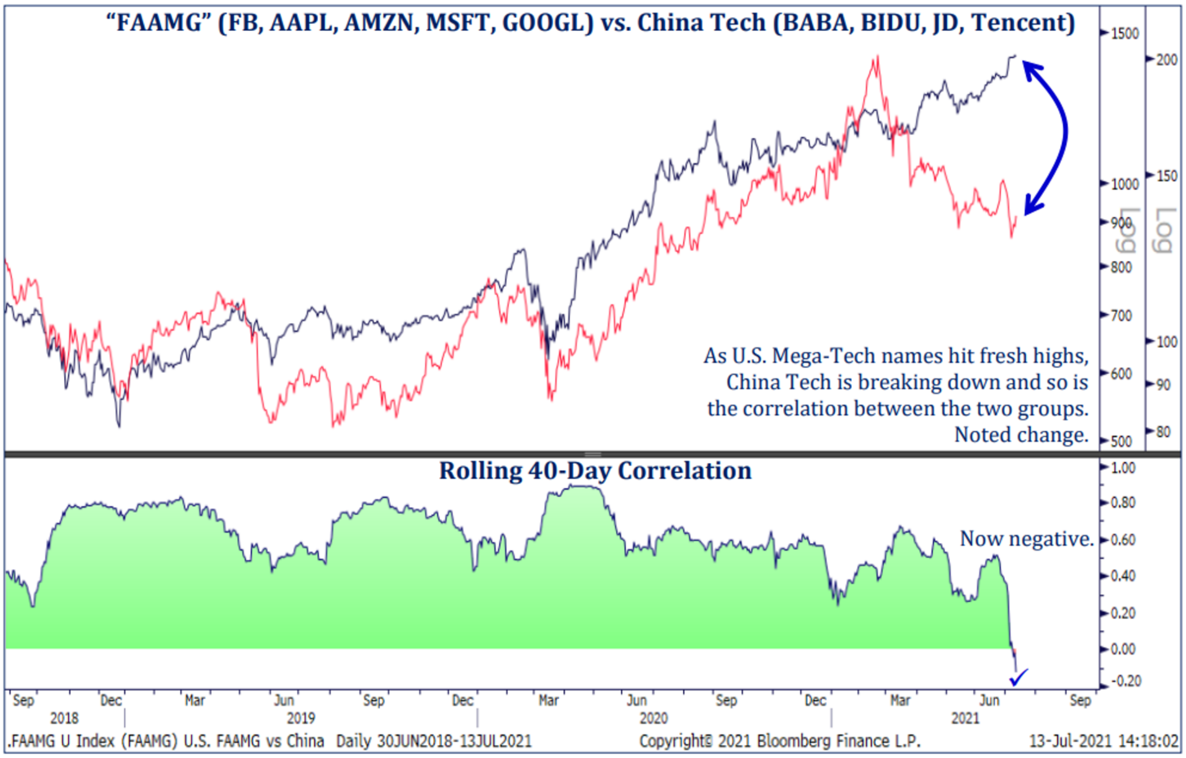


The Google activity index monitors consumers' everyday mobility, i.e. leaving the house for shopping or dining out. As new cases receded from the January peak, mobility picked up globally, though it is still not at pre-pandemic levels. Assuming new cases remain constrained as vaccinations roll out, this activity should bode well for the service sectors of economies that have been lagging in the overall recovery. We are seeing an uptick in cases recently (led by Asia) but most countries are aggressively ramping up vaccine distribution.

US Ten year bond yields have declined from 1.75% to 1.25%, while economic fundamentals have been very strong. Many strategists are chalking it up to technical factors including the Treasury issuing less debt due as they draw their cash balances down, and the Federal Reserve purchasing bonds. This chart shows the Treasury issuances (in green) and Fed Purchases (in orange). In May, The Fed bought more Treasuries than were issued, driving yields down.

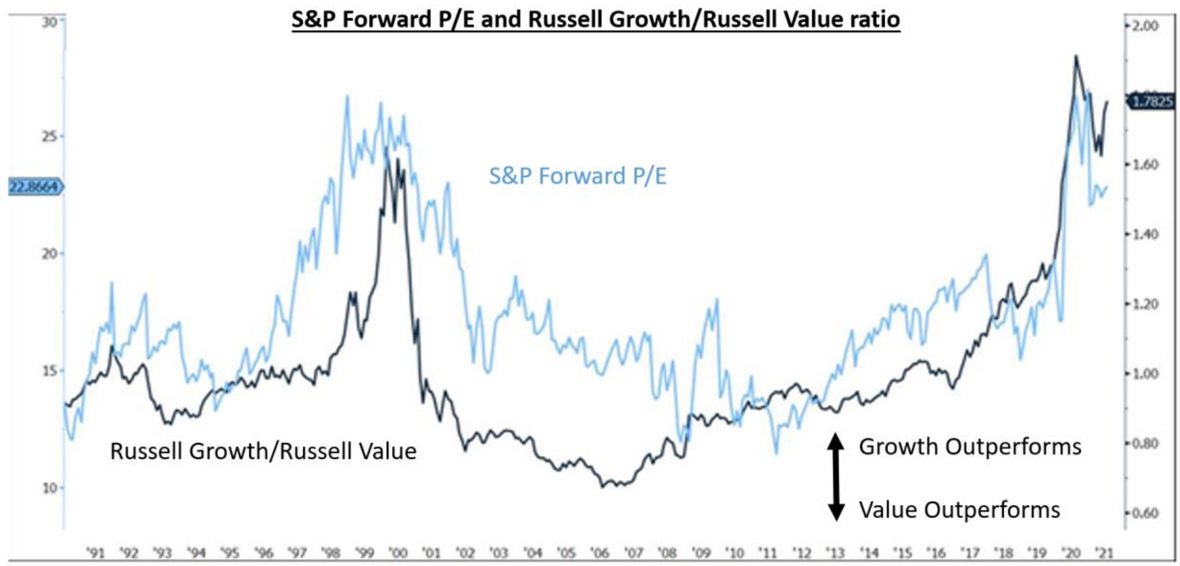


Given the size of our Federal Deficit, we expect Treasury issuances to skyrocket. If the Fed tapers purchases, then supply and demand probably drives rates back up again.



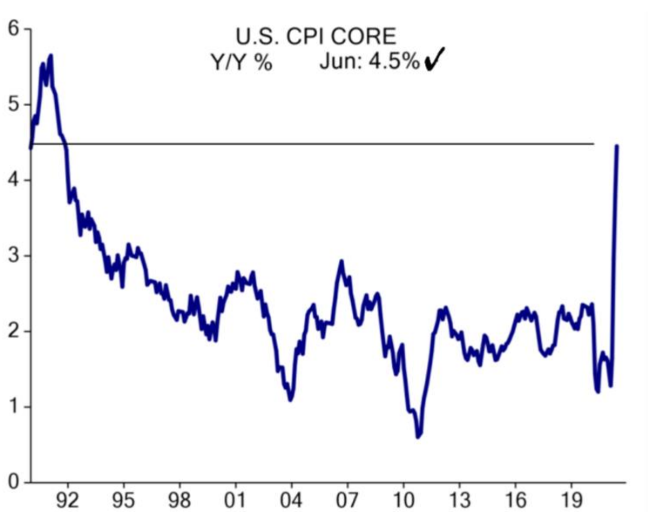
Source: Strategas

U.S. and Chinese tech leaders saw a divergence in performance recently after trading in lockstep for quite some time. All of the companies in the chart above benefitted from the pandemic inspired movement to online activity. Recent regulation changes in China have pressured their stocks, while lower rates in the US have prompted a surge in these higher multiple growth names. Correlations between the two groups have actually become negative over the past month (bottom panel of chart above), where they had been very positive for many years. We think things probably normalize between these sectors, and some combination of the US names weakening and Chinese strengthening should even out performance.



Source: TAM and Bloomberg

Markets go through long periods where multiples expand, followed by long periods where multiples contract. Interestingly, the Growth versus Value cycle is correlated to that. As seen in the chart above, when market multiples are rising, Growth generally outperforms Value. When multiples are declining Value tends to lead. Multiples recently peaked out following the surge in expensive stocks and earnings downdraft suffered during the Covid depression, and are now declining. This should favor Value oriented companies tied to the economic cycle.

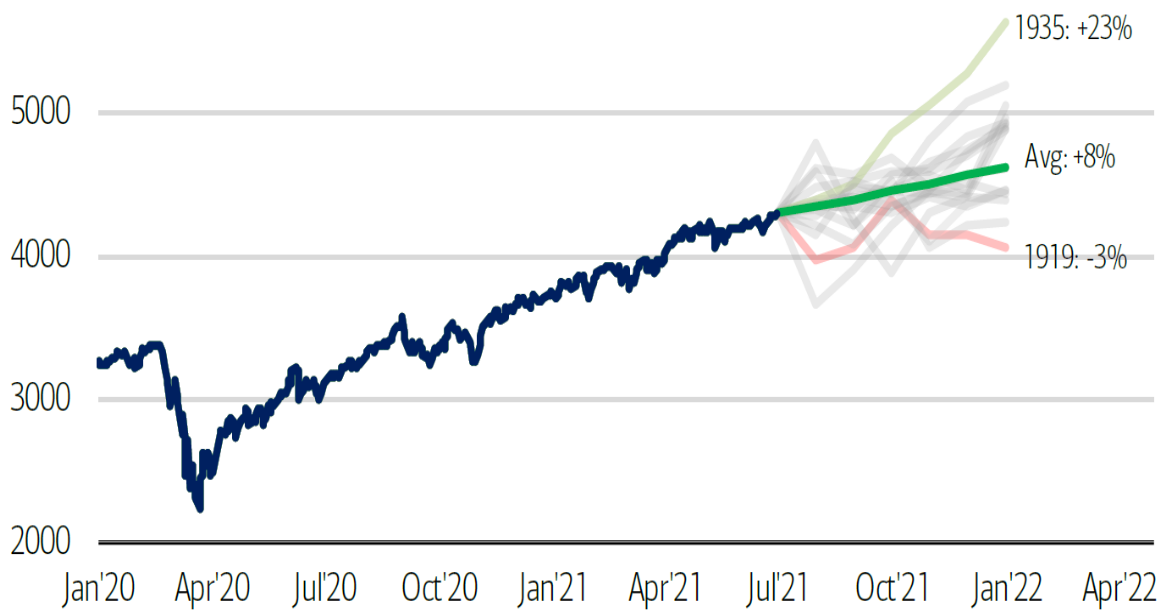


Source: Evercore ISI

Core CPI is running at 4.5% year over year, the highest level in 30 years. Overall CPI increased 5.4% y/y. The Federal Reserve believes this is temporary because much of the increase reflects higher used car prices due to bottlenecks in new car production. Investors' still worry inflation might remain higher than prior levels. Regardless, the Fed has signaled they do not intend to reduce their stimulative policies until they see employment gain or inflation sustainably above their targets.

After similar first half gains, the market historically added another 8%

S&P 500 2020-2021 total returns and historical H2 returns



Source: BofA Research Investment Committee, Bloomberg, Global Financial Data

This chart speaks for itself. After similar first half gains, the average gain in the second half is 8%. We would point out that in general, the second half results tend to be more volatile than the results from this year's first half. Given inflation readings are up, and investors are acting worried about the expansion, more volatility is likely over the summer.

Summary

We got mixed messages through the quarter as equity markets made new all-time highs, yet bond yields (particularly 10yr treasuries) collapsed in June. The dramatic move in interest rates signaled that investors were increasingly concerned about resurging Covid cases, led by the more transmissible Delta variant. Data continues to show that vaccines are very effective at protecting from all variants, however investors clearly began to question the reopening/reflation narrative that persisted since last November. Falling rates and increased economic uncertainty fueled a rebound in Growth names, specifically the FAAMGs, which came at the expense of Value. We think this dynamic is likely transitory for a few reasons. First, the rotation to Value since late last year was probably due for a pause, given that the Russell 1000 Value outpaced the Russell 1000 Growth by more than +20% in just 8 months through mid-May. Second, the cautious stance investors seemed to embrace in June didn't show up in traditional defensive sectors as Utilities and Consumer Staples continued to underperform. Also, despite the rush into US Treasuries, credit market also weren't signaling any impending trouble brewing. High yield spreads are currently trading at their tightest levels since the Great Financial Crisis. This all suggests to us that the sharp reversal we saw in the markets during the quarter was more positioning and technical in nature and not a sign of a larger problem that would derail the economy.

As always, if you need any additional information, please feel free to contact any of us.

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07/19/21
S&P 500 – 4,258
Russell 1000 Value – 1,521

Refer to the following page for more information on the commentary presented. This is pertinent to this letter and should not be reproduced or duplicated without this disclosure.

TODD
Asset Management

Disclosure

The indexes used in this letter are unmanaged, and not available for direct investment. They do not include the reinvestment of dividends, nor do they reflect management fees or transaction costs.

S&P 500 Index is a widely recognized index of market activity based on the aggregate performance of a selected portfolio of publicly traded common stocks. The performance data was supplied by Standard & Poor's. It is included to indicate the effect of general market conditions.

Russell 1000 Value Index is a widely recognized index of market activity based on the aggregate performance of common stocks from the Russell 1000 Index, with lower price-to-book ratios and lower forecasted growth values. The performance data was supplied by Frank Russell Trust Company.