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## July 2021

### 3rd QUARTER OUTLOOK

#### Reopening Leads to Strong First Half

The first half of 2021 was exceptionally good for the stock market. Regardless of which way interest rates swayed day to day, stocks continued to forge higher attaining new record highs for the market averages. The first quarter of the year saw a powerful move higher in value stocks, shares of companies that had not only been left behind since the beginning of the pandemic, but one could argue have been left behind for more than a decade. In the first quarter shares of banks, energy companies, industrials and materials led the way and created a healthy rotation that is the hallmark of a strong bull market.

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But as we moved through the second quarter of 2021 value stocks paused and gave back some of their gains only to be replaced in this continuing rotation by a move higher in the large growth names. Many of last year's darlings such as Apple, Microsoft, Google, Facebook and Amazon had been somewhat dormant throughout the first part of 2021. But as interest rates moved back down in the second quarter (we will talk at length about the bond market

and interest rates in a moment) the large growth names regained their mojo and aided in the market averages attempts to push to more new highs late in the second quarter.

We talked about the great reopening of economies around the world and how markets were responding to the massive uptick in economic activity. Sure, shortages were bound to occur as supply chains around the world had been disrupted by the pandemic. This and massive pent-up demand have led to inflation and the debate on Wall Street as to whether this inflation is temporary or more permanent in nature. But suffice it to say, the stock market remained impervious to the gyrations of the bond market and other than momentary lapses continued higher throughout the first half of 2021.

As we enter the second half of the year analysts are expecting blow out corporate earnings. Comparisons are extremely easy year over year given last year's economic shut down, and companies have been operating lean and mean as business booms. As always, we will see if share prices are already reflecting the expected good news in corporate earnings. But regardless of how stocks react in the short run, corporate earnings continue to strengthen.

## Inflation and Interest Rates

As the stock market continued to make new highs throughout the first half of 2021, the bond market continued to confuse market participants. After touching 1.70% in the first quarter, the yield on the 10-year Treasury Note fell back to under 1.30% in recent days. Now, this might not sound like such a big deal, but many market mavens had been predicting that rates on the 10-year were going to 2% and likely higher in the second half of 2021. The retreat in yields seems to have caught many of the big players off-sides which likely added fuel to the move.

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The narrative is that with inflation as strong as it is, the Fed is going to have to change course on monetary policy sooner than later. That should mean higher interest rates, the tool most used to fight inflation, in the coming months and possibly years.

So, despite hot CPI numbers and numerous other inflationary signals, interest rates in the second quarter started to retreat. Instead of pushing up towards 2% the yield on the 10-year tumbled. This was very confusing to pundits and market participants alike. Despite signs of inflation everywhere interest rates had begun to head back down. What could possibly explain this phenomenon?

Well, one school of thought, promoted by the Fed Chair Powell, is that the inflation we are seeing at the moment is transitory (the Fed's term). The feeling is that you only "reopen" the economy once and that the supply shortages and pent-up demand, though certainly real, will be resolved over time.

Another, somewhat convoluted argument, was that higher rates would in effect slow the economy back down, decreasing inflation, and thus rates would fall eventually anyway and maybe folks were buying bonds (forcing rates down) in anticipation of all of this.

The more likely explanation for rates moving back down in yield is that the combination of the Fed bond buying program and foreign demand for bonds has simply been dwarfing the supply (as great as it is) of U. S. Government bonds. More than a call on inflation or the direction of interest rates, the move back down in yields might have been a supply shortage of a security that some simply have to buy.

From late last year into early this year the move up in interest rates was not having a negative effect on stock prices. Indeed, the market averages continued to push to new highs. This did confuse some market participants who were sure that a move up in interest rates would be the death knell for stocks. On the positive side it was reasoned that interest rates were going up for the right reason- the economy was improving. Remember, the Fed has wanted to see some inflation for years, so again the reasoning was that if the economy is improving and some inflation is occurring then interest rates normalizing is a good thing, thus not detrimental to stocks.

So, when rates began to fall in the second quarter that argument started to take on water. If rates are falling because the economy might begin to stall, then that would not be particularly good for stocks. Au contraire mes amis. Despite rates falling stocks have continued to push, albeit more deliberately, to new highs.

The takeaway for now is that stocks appear to be letting the bond market sort itself out and not reading too much into it all. The economy looks to be strong in the second half and despite the “warnings” of the bond market, the bulls continue to push stocks higher.

As for inflation, it would be hard to argue that we are not dealing with an inflationary spike at the moment. Will it last? Will equilibrium be found between supply and demand in the near future? Or are we just beginning an inflationary period that will be long lasting and damaging to the economy and people’s wallets? As mentioned, the Fed has sought some inflation, especially when it comes to peoples’ wages, and we are finally seeing that occur. But wage inflation, while good for the worker can be tremendously damaging to the small business owner. Inflation and the direction of interest rates will be a huge story to watch in the second half of 2021.

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## **The Fed**

Every six weeks and often in between there is much hand wringing about the Federal Reserve and future monetary policy. We know that the Fed has been overwhelmingly accommodative since the pandemic took hold and been firmly in an emergency stance with regards to policy. Pundits and market participants now spend endless amounts of energy wondering when the Fed will lessen its accommodation (end asset purchases) and begin to tighten (raise interest rates).

Fed Chair Powell has made it clear that the Fed will give markets plenty of advance notice when they decide that a change in

policy direction is warranted. But traders are obsessed with gaming the Fed and being out in front of their actions. Instead of taking the Fed Chair at his word, they continuously try to parse every sentence and read every tea leaf to decipher when the Fed will change course.

As mentioned, the Fed Chair has indicated that they are in the camp that the spike in inflation that we have seen is transitory. They have recently acknowledged that the inflationary environment is a bit more intense than they expected, but still have not changed their basic position. The question is will they change that stance sooner than they have been signaling, especially if inflationary pressures continue to mount? Instead of rate hikes in late 2022 or early 2023 will the Fed be forced to begin tightening sooner. The asset purchase program has flooded the system with trillions of dollars of liquidity. If that is discontinued sooner than expected will markets be able to absorb the “shock”?

These are all questions that market participants will be pondering as the second half of 2021 unfolds.

## **Summary**

The stock market has had a great beginning to 2021. Often a great first half of the year for stocks is followed up by a good second half of the year. So, momentum and history are on the side of the bulls. But we have to keep an eye on inflation and consider how the Fed will react if inflationary pressures continue to build. If Fed policy changes sooner rather than later, it likely would cause disruption in the markets. Of course, there is a school of thought that says that the markets may actually applaud the Fed for attempting to get in front of a potential inflation problem before it would get out of hand. The takeaway is that all eyes will be on

the Fed in the second half of 2021. What exact reaction there would be to a sooner than later Fed policy change is hard to call, but it is pretty clear that there will be some disruption in the short run.

In the meantime, if Fed Chair Powell stays true to his word, the markets should be given adequate advance warning to any change in Fed policy. In the meantime, the economy's great reopening remains on track as long as Covid variants do not rear their ugly head and throw a monkey wrench into the proceedings.

As always, we appreciate that you entrust us to manage your money and guide you on your road to financial success. We strive to keep you informed and to provide you with the best service in the industry. Remember, do not hesitate to contact us with any thoughts or questions. If you feel that we can help someone that you know and love, we would be honored to try to help them find their path to financial success. Stay safe as we continue the road to normalcy.