# The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets July 2021

From: *Philadelphia* Investment Management Group

## OVERVIEW

- ***The Wide Divergence of Sector Performance in the First Quarter Narrowed in the Second.*** *Growth led the way with stronger-than-expected earnings.*

- ***The U.S. Economy is Widely Expected to Outpace the Rest of the World for the Foreseeable Future.*** *The dollar's long slide may have run its course, with further dollar strengthening as a result of the Fed's announcement of the cooling off of economic activity.*

- ***The Interest Rate and Inflation Questions Continue to Concern Investors.*** *The worry over a return to the double-digit inflation days of the 70s and 80s was further exacerbated by the positive numbers for April, May and June of 0.8%, 0.6% and 0.9%, respectively, for the Consumer Price Index.*

## THE ECONOMY

Business investment is emerging as a powerful source of U.S. economic growth that will likely help sustain the recovery. Companies are ramping up orders for computers, machinery and software as they grow more confident in the outlook. The recovery in business is shaping up to be much stronger than in the years following the 2007-09 recession. Orders for non-defense capital goods are near the highest levels for records dating back to the 1990s. Consumer spending, which accounts for about two-thirds of economic output, is also driving the early stages of the recovery. Americans, flush with savings and government stimulus checks, are spending more on goods and services, which they shunned for much of the pandemic.

Manufacturing is a particularly capital-intensive industry. It requires more spending to build a car than serve a restaurant meal. Production should remain strong for several quarters as companies rebuild inventories. The longer-term outlook for capital spending is bright. Yes, there are supply hindrances, and the pandemic is to blame for the disruption. Supply versus demand unequalness can cause price increases, and we are seeing this. However, it should be short-lived as these pockets of supply problems are filled and business gets back on track.

## FINANCIAL MARKETS

### EQUITIES

Stocks rose in the quarter and bond yields continued to decline as investors propelled the major stock indexes into record territory. Gains among shares of large U.S. companies were broad-based, with ten of the eleven S&P sectors advancing. Earnings season has begun as we write this commentary, and investors will be watching to see if companies' results are justifying the high valuations being placed in the equity market.

While the S&P 500 and NASDAQ reached new highs, the Russell 2000 index of small companies, after advancing 62% for the past one-year period, took a breather during the quarter, as reflected in the following chart. However, all indexes finished the first half of the year on a strong positive note.

| | Equity Returns* | | |
|---|---|---|---|
| **Index** | **2nd Qtr** | **1st Qtr** | **YTD** |
| S&P 500 | 8.55% | 6.17% | 15.25% |
| Dow | 5.08% | 8.29% | 13.79% |
| NASDAQ | 9.49% | 2.78% | 12.54% |
| Russell 2000 | 4.29% | 12.70% | 17.54% |

*Total: price change + reinvested dividends

Analysts are expecting that S&P 500 profits rose 64% in the second quarter from a year earlier. This growth rate would be the highest in more than a decade; however, we must keep in mind that these numbers are coming off of upended business conditions caused by the pandemic.

As shown in the following chart, with the exception of Utilities, all sectors of the S&P 500 had positive returns for the second quarter, and all except Consumer Staples and Utilities had double-digit returns for the first six months of 2021. After pulling back somewhat in the first quarter, Information Technology companies picked up again with the rotation back into growth, and ended the quarter with a return of 11.56%, trailing only the Real Estate area. Like the first quarter, Energy remained one of the strongest performers for the second quarter, making it the highest performer for the first half of the year, followed by Financials.

| Sector | Weight | 2nd Qtr | 1st Qtr | YTD |
|---|---|---|---|---|
| | S&P 500 | Returns* | | |
| • Energy | 2.8% | 11.30% | 30.85% | 45.64% |
| • Materials | 2.8% | 4.97% | 9.08% | 14.50% |
| • Industrials | 8.9% | 4.48% | 11.41% | 16.40% |
| • Cons. Discretionary | 12.1% | 6.95% | 3.11% | 10.27% |
| • Consumer Staples | 6.0% | 3.83% | 1.15% | 5.02% |
| • Health Care | 13.0% | 8.40% | 3.18% | 11.85% |
| • Financials | 11.9% | 8.36% | 15.99% | 25.69% |
| • Info Technology | 26.2% | 11.56% | 1.97% | 13.76% |
| • Communication Svcs | 11.1% | 10.72% | 8.08% | 19.67% |
| • Utilities | 2.6% | -0.41% | 2.80% | 2.38% |
| • Real Estate | 2.5% | 13.09% | 9.02% | 23.30% |

06/30/21
*Price + income
Source: S&P Dow Jones

Equity performance continues to shift from value companies to growth companies and then back to value. A lot of this change is the result of Washington's inability to reach an agreement on infrastructure spending. While it is mainly cyclical companies that will benefit the most from infrastructure spending, investors at times feel more comfortable with growth issues and the thought that these companies will continue to do well regardless of what Washington agrees to or does not agree to with their spending option.

## FIXED INCOME

The big news surrounding the fixed income markets in the past quarter was the big drop in Treasury yields followed by a yield retreat for corporate bonds. What we believe has precipitated this move is a Federal Reserve that is readying the markets for the tapering of its bond purchases. However, of interest with the move by the Fed, is the fact that the tapering also sends a signal about future moves in interest rates.

One theory is that we will see the first rise in rates by December and that the early increase will slow the economy and inflation. And then this would mean the Fed needs to raise rates less in the future. It appears the basic model of lower rates leading to higher inflation has not really worked. Globalization, online competition and weak worker employment have ensured prices stay under control.

All major fixed income sectors posted positive returns in the second quarter of 2021, as reflected in the following chart. Corporate credit spreads declined across the board and credit, in general, benefited from an improving economic outlook. Although rebounding in the second quarter, long government bonds were the worst-performing category in the first half of the year due to rising inflation expectations.

**Fixed Income Returns**

| Index | 2nd Qtr | 1st Qtr | YTD |
|---|---|---|---|
| Corp/Govt | 2.57% | -4.43% | -1.97% |
| Int. Corp/Govt | 1.03% | -1.80% | -0.79% |
| Long Corp/Govt | 6.71% | -10.79% | -4.80% |
| **U.S. Government** | 2.02% | -4.61% | -2.68% |
| - Intermediate | 0.67% | -1.73% | -1.07% |
| - Long | 6.61% | -13.24% | -7.50% |
| **Corporate** | 3.60% | -4.50% | -1.06% |
| - Intermediate | 1.76% | -2.06% | -0.34% |
| - Long | 7.03% | -8.73% | -2.31% |
| - **Quality** | | | |
| - AAA | 4.84% | -7.39% | -2.91% |
| - AA | 3.74% | -5.29% | -1.75% |
| - A | 3.36% | -4.91% | -1.71% |
| - BBB | 3.73% | -3.96% | -0.38% |
| **Municipal** | 1.72% | -0.36% | 1.36% |
| - Intermediate | 0.65% | -0.25% | 0.41% |
| - Long | 2.42% | -0.43% | 1.98% |

Source: ICE BofA

As further shown in the chart, municipal bonds were the only positives for the year to date. The first half of 2021 continued to provide strong cash flows into the muni market. With the combination of federal stimulus for municipal issuers and sectors, increased comfort in municipal credit fundamentals, increased vaccination rates and the reopening of the economy, demand remained strong.

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In conclusion, we expect further moderation of the ill effects on the economy caused by the pandemic. Business will continue to slowly get back to normal. Inflation pressure will prove transitory and slow to 2-2½% by mid-2022. The Fed will not need to slam on the policy brakes to halt the economic cycle. This is all a recipe for an extended global economic recovery.



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