Retirement Market RECAP Q2 2021

HANYS Benefit Services

Despite inflation, investors are bullish on growth, betting on bigger earnings

The U.S. equity markets delivered exceptional performance again in the second quarter of 2021, with the S&P 500 Index returning 8.55%. Investor preference favored larger capitalization segments, with the Russell Midcap Index returning 7.50% and the Russell 2000 Index (small cap) posting a 4.29% return in the quarter. U.S equities extended a lengthy run of outperformance versus international, with the MSCI EAFE Index reporting a 5.17% gain in Q2.

As indicated on the accompanying chart, the three- and five-year annualized performance differentials between the S&P 500 and the "EAFE" indexes each exceed 700 basis points. A traditional hedge against inflation, real estate outperformed all other asset classes, with the S&P United States REIT Index posting an 11.94% gain in Q2. Fixed income recovered from a painful Q1 as yields moved lower across the yield curve. For example, the yield on the benchmark 10-year U.S. Treasury Bond decreased 0.31% during Q2 from a rate of 1.75% on March 31. Some of the relief for fixed income came at quarter's end, with investor expectations for future inflation easing somewhat. The BBgBarclays US Aggregate Bond Index of investment grade, intermediate term bonds returned 1.83% in Q2.

On June 16, in reference to monthly purchases of $120 billion in U.S. Treasury and mortgage-backed securities, the Federal Reserve stated purchases would continue until "substantial further progress" is made on goals for maximum employment and price stability. The Fed's purchases are intended to hold interest rates down, thus stimulating borrowing and economic activity. The Fed makes purchases at varying maturities to influence the shape of the yield curve according to the present and expected state of the economy and the credit markets. The U.S. economy is rebounding from the pandemic more powerfully than expected. Also on June 16, the Fed raised its Central Tendency Projections for GDP growth and inflation. The Fed is now calling for GDP growth in 2021 in the range of 6.8% to 7.3%. The U.S. economy has not grown at that rate since the early 1980s.

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The Fed acknowledges that inflation is rising and changed its projection for the Personal Consumption Expenditures deflator (used by the Fed to track inflation, instead of the Consumer Price Index) to a range of 3.1% to 3.5% in 2021. The Fed believes the current round of price increases is mainly caused by disruptions in supply. This is seen as a temporary condition that will ease when production rises to meet powerful demand as Americans return to their pre-pandemic lifestyles. The Fed believes that powerful secular factors in place pre-pandemic will ultimately keep inflation at bay: aging populations, global competition, the "Amazon effect" and advancements in technology/productivity.

The bond market agrees with the Fed, pricing in inflation at 2.34% over a 10-year period (breakeven rate of inflation: yield on the nominal U.S. Treasury minus the U.S. Treasury Inflation Protected Securities at 10-year

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maturities). Most importantly, regarding inflation, there was no spike in the Federal Reserve Bank of Atlanta Wage Growth Tracker (June 1, 2021). As opposed to supply and demand imbalances, wage inflation is generally believed to be less responsive to changes in monetary policy and therefore presents challenges for central banks.

The Fed is not alone in a bullish economic forecast. The consensus forecast of 66 economists in a *Wall Street Journal* survey (July 2021) calls for the economy returning to the long-term 2.2% annual growth trend (since 2009) by the fourth quarter of this year, making up the all economic activity lost during the pandemic.

In the five quarters since the pandemic panic and the bottom of the market, securities of most types have become expensive — with challenges for investors putting "new money" to work. According to economist Ed Yardeni (Yardeni.com), as of July 2, the forward price/earnings ratio for the S&P 500 Large Cap Index was elevated to 21.5x. This compares to the five-year average P/E of 18.1x. The market has not been this expensive since 2000. Inflation is a consideration when analyzing P/E ratios. Historically, elevated P/Es have been more sustainable during periods of low inflation; not the current environment.

What is driving equities to a series of record highs? The best answer may be strength in corporate earnings.

What is driving equities to a series of record highs? The best answer may be strength in corporate earnings. In Q1 2021, earnings for the S&P 500 Index re-gained the $180/share level from before the pandemic. More important, earnings forecasts well into 2022 are very strong. With "earnings season" in full swing, as of July 16, 8% of S&P 500 companies reported Q2 earnings and 85% have reported an upside earnings surprise; 90% reported an upside revenue surprise (FACTSET). The year-over-year earnings growth for those companies is 69.3%. If this holds for the remaining reporting companies, it will mark the highest YOY growth since 2009 (109.1%). Optimistic investors are buying on the belief that companies will grow earnings into the share price. Said another way, the market is a little ahead of itself.

EQUITY INDICES	3 MO	1 YR	3 YR	5 YR
S&P 500 TR USD	8.55%	40.79%	18.67%	17.65%
Russell 3000 TR USD (Broad Market)	8.24%	44.16%	18.73%	17.89%
Russell 1000 TR USD (Large Cap)	8.54%	43.07%	19.16%	17.99%
Russell Midcap TR USD	7.50%	49.80%	16.45%	15.62%
Russell 2000 TR USD (Small Cap)	4.29%	62.03%	13.52%	16.47%
MSCI EAFE NR USD (Int'l Equity)	5.17%	32.35%	8.27%	10.28%
MSCI Emerging Markets NR USD (E.M. Equity)	5.05%	40.90%	11.27%	13.03%
S&P United States REIT TR USD (Real Estate)	11.94%	37.82%	9.95%	6.13%

FIXED INCOME INDICES	3 MO	1 YR	3 YR	5 YR
ICE BofA 3M US Trsy Note TR USD	0.02%	0.13%	1.40%	1.20%
ICE BofA 1-3Y US Trsy TR USD	-0.03%	0.07%	2.68%	1.60%
BBgBarc Long-term US Treasury TR USD	6.46%	-10.58%	7.99%	3.13%
BBgBarclays US Aggregate Bond TR USD	1.83%	-0.33%	5.34%	3.03%
BBgBarclays US Treasury US TIPS TR USD	3.25%	6.51%	6.53%	4.17%
BBgBarclays High Yield Corp TR USD	2.74%	15.37%	7.45%	7.48%
BBgBarclays Global Aggregate TR USD (Global Bond)	1.31%	2.63%	4.23%	2.34%

ICE BofAML – Intercontinental Exchange Bank of America Merrill Lynch; BBgBarc – Bloomberg Barclays; S&P 500 - Standard & Poors; MSCI – Morgan Stanley Capital International | Sources: Morningstar as of June 30, 2021

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