Quarterly Investment Perspective: Q2 2021

Aldo S. Vultaggio, CFA®, CPA, AIF® | Chief Investment Officer

EXECUTIVE SUMMARY

- Global stock markets continued to rally on the recovery in the first quarter, while global bond markets broadly declined amid rising long-term interest rates. There is a long way to go before interest rates threaten stock market returns. Bonds markets will likely be challenged in the short term , but in the long term, higher interest rates will result in better future bond returns.
- The U.S. economy is recovering, but there is still a long way to go until it reaches full health. Abroad, economic growth has been meaningfully divergent across regions. The global economic outlook is brighter now due to additional fiscal (government) support and an anticipated vaccine-powered recovery in the second half of 2021.
- We believe that investors should be prepared for the current challenges and bumps along the road to recovery, while positioning portfolios for the inevitable global acceleration. We outline a few ways we are helping clients position portfolios to reduce the risk of short-term market volatility but remain aligned with our long-term outlook.

MARKET REVIEW

RECOVERY HAS BECOME PREVALENT IN MARKETS

Global stock markets continued to rally in the first quarter, hitting all-time highs. Continued central bank and government support, better-than-expected fourth-quarter corporate earnings, and progress on coronavirus vaccine distributions have improved investor sentiment and aided stock prices overall. Perhaps more importantly, the market rally has continued broadening into areas that have been particularly hurt by the pandemic, including smaller companies, value-oriented stocks, and cyclical (economically sensitive) sectors, such as consumer discretionary, financials, energy, industrials, and materials.

RISING INTEREST RATES HAVE BEEN A SIGN OF AN IMPROVING GROWTH OUTLOOK

Global bond markets broadly declined in the first quarter (see **Figure 1**) amid rising long-term interest rates, particularly in the U.S. However, long-term rates have moved up for the right reasons. Ongoing vaccination, anticipation of reopening, easy monetary policy, and the passing of a $1.9 trillion COVID relief bill have all increased inflation expectations from depressed levels. More recently, “real” interest rates (adjusted to remove inflation effects) have also moved up, which is consistent with more optimism on the outlook for economic growth. Despite these rosier expectations, the Federal Reserve continued to indicate that short-term policy rates are not likely to change until at least 2023.

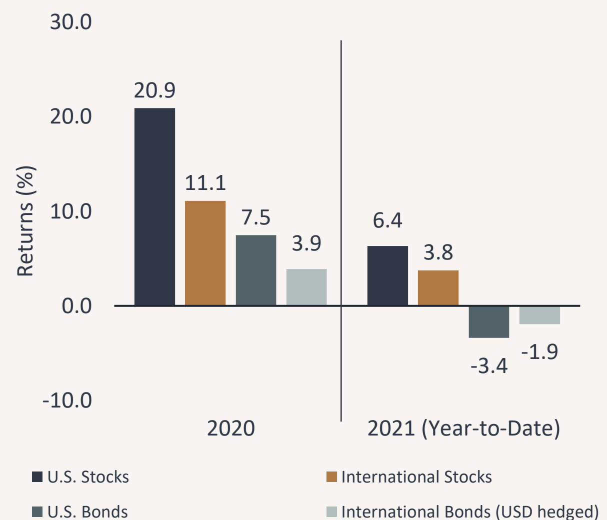

FIGURE 1. U.S. markets continued to outperform international in the first quarter mainly due to the U.S. dollar appreciating versus most foreign currencies amid increased U.S. government spending and rising U.S. interest rates.

Meanwhile, rising rates have put downward pressure on bonds worldwide. The aggregate U.S. bond market declined in the first quarter. International bonds fell less and modestly outperformed U.S. bonds, as interest rates abroad (in aggregate) did not increase as much as U.S. rates did in the first quarter.

SOURCE: MORNINGSTAR, RUSSELL, MSCI, BLOOMBERG BARCLAYS. DATA AS OF 03/31/2021. SEE ENDNOTE 1 FOR ADDITIONAL DISCLOSURES.

MARKET OUTLOOK

INTEREST RATES ARE RISING BUT ARE UNLIKELY TO END THE STOCK MARKET CYCLE ANYTIME SOON

Rising rates have historically coincided with the end of most market (and economic) cycles. However, we believe there is a long way to go before interest rates threaten stock market returns. First, it will likely take time before the Federal Reserve starts hiking rates given their new economic condition criteria (i.e., near-full employment and average inflation above 2%). Second, even though rates have moved up recently, they are still very low by historical standards and are unlikely to choke off borrowing and investment activity. The housing market is a good example of this. (See **Figure 2**.)

If interest rates unexpectedly increase quickly, we could see some volatile movements lower in the stock markets. However, if rates slowly move higher — the more probable scenario going forward — it would likely coincide with falling unemployment, more labor force participation, better earnings, and higher stock markets.

Bond markets will likely be challenged in the short term particularly in the scenario (like the first quarter of this year) where stock market volatility remains low while interest rates move higher. However, in a scenario where stock market volatility picks up materially, high-quality bond returns will likely be positive, as investors flee stocks to buy bonds for portfolio protection. Regardless, in the long term, higher interest rates will result in better future bond returns.

ECONOMIC REVEW

U.S. ECONOMIC GROWTH IS ACCELERATING, BUT EMPLOYMENT WILL TAKE MORE TIME TO HEAL

The U.S. economy is recovering, but there is still a long way to go until it reaches full health. On one hand, consumer confidence and spending have been improving, supported by higher income and a declining savings rate (after reaching an all-time high in the second quarter of 2020). On the other hand, the labor market is still severely damaged with nearly ten million fewer jobs than pre-pandemic levels. The ratio of prime-age employment to population is now only slightly above the level after the global financial crisis. (See **Figure 3**.)

INTERNATIONAL ECONOMIC GROWTH IS DIVERGENT ACROSS REGIONS

Economic data continues to show that China is furthest along in the recovery process, so much so that its policymakers are slowly removing government support. Many other countries in Asia, mainly raw materials producers, have been buoyed by strong export demand by China. Meanwhile, Eurozone labor markets are still deeply depressed, and vaccination programs are lagging the U.S. and the U.K. Latin American export-oriented economies have broadly benefited from higher commodity prices; however, many countries in the region are the furthest behind for vaccine delivery.

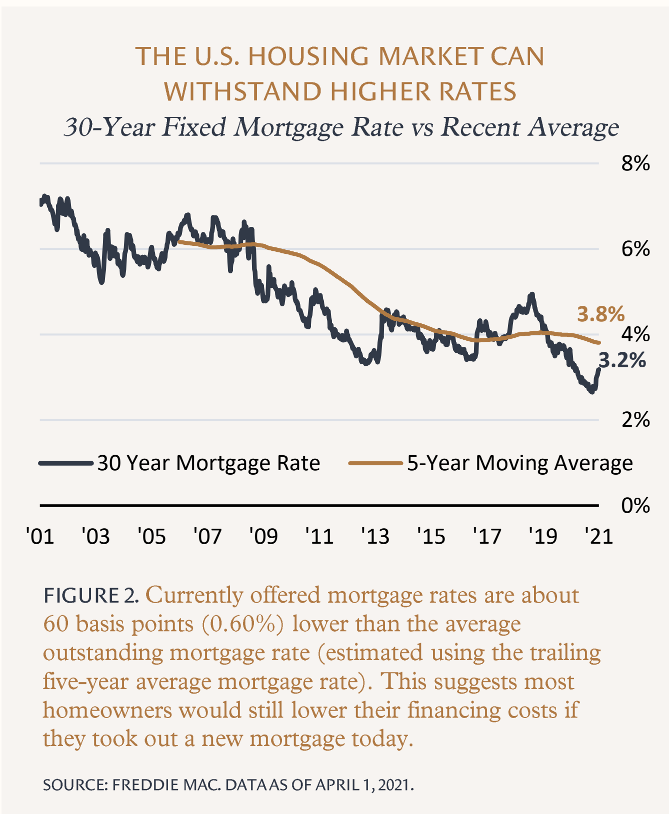

FIGURE 2. Currently offered mortgage rates are about 60 basis points (0.60%) lower than the average outstanding mortgage rate (estimated using the trailing five-year average mortgage rate). This suggests most homeowners would still lower their financing costs if they took out a new mortgage today.

SOURCE: FREDDIE MAC. DATA AS OF APRIL 1, 2021.

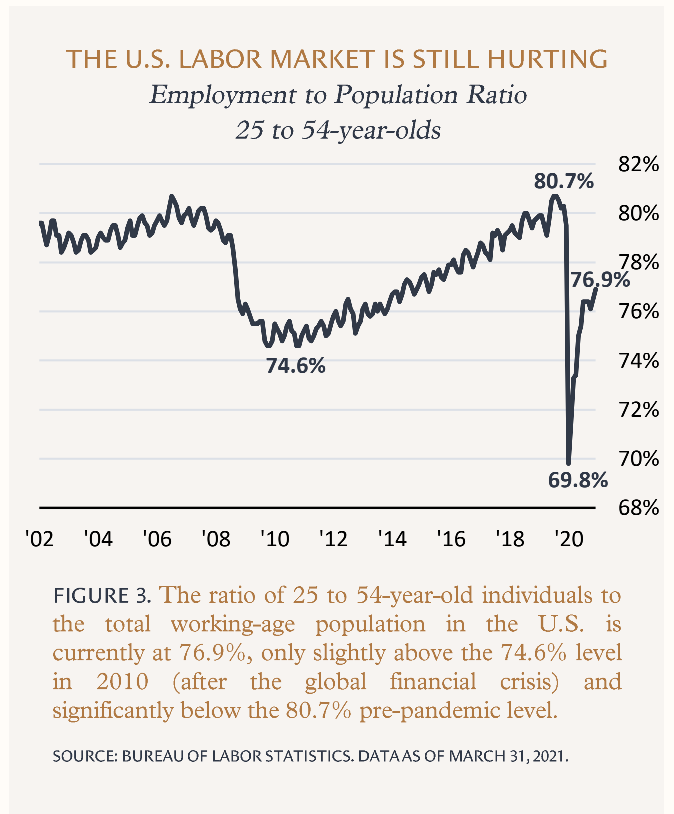

FIGURE 3. The ratio of 25 to 54-year-old individuals to the total working-age population in the U.S. is currently at 76.9%, only slightly above the 74.6% level in 2010 (after the global financial crisis) and significantly below the 80.7% pre-pandemic level.

SOURCE: BUREAU OF LABOR STATISTICS. DATA AS OF MARCH 31, 2021.

ECONOMIC OUTLOOK

GLOBAL GROWTH IS PROJECTED TO INCREASE

The International Monetary Fund (IMF) recently raised its projections for global growth to expand by 6% in 2021, up from their January estimate of 5.5% and in stark contrast to 2020's -3.3% contraction.[2]

The brighter outlook for the worldwide economy is mainly due to additional fiscal support implemented in some larger economies (particularly in the U.S.) and an anticipated vaccine-powered recovery in the second half of 2021. In the meantime, economists expect economic activity will continue to adapt to limited mobility and the current country-specific lockdowns.

A SURGE IN PRICE INFLATION IS EXPECTED BUT IS LIKELY TO BE TEMPORARY

Pent-up demand, together with the U.S. government's new stimulus spending, could produce undesirably high inflation by pushing up prices for some goods and services (e.g., gas, airline tickets, hotels) as pandemic-related restrictions end. However, persistent year-over-year price inflation across most goods and services is unlikely to happen for a while.

A surge in consumer buying and an influx of government stimulus money are one-off dynamics that are not likely to result in long-lasting spending and output. More importantly, there is a lot of slack in the economy, particularly in the labor market, as noted earlier. It will take a high amount of spending and hiring over many months before we run out of workers and the economy reaches capacity.

ON THE MINDS OF INVESTORS

HOW TO DEAL WITH INEVITABLE MARKET VOLATILITY

It has been more than a year since the last time we experienced a significant stock market decline. Markets (both in the U.S. and abroad) have recovered quickly from the March 2020 lows and are hitting new record highs once again. For many investors, this long and nearly uninterrupted winning streak raises concerns that a major decline is forthcoming.

Downside market concerns are valid, because big selloffs are common and should be expected periodically regardless of the environment. (See **Figure 4**.) However, simply acknowledging that selloffs are common is only part of the battle. Living through big market corrections and the scary and fear-inducing news headlines that accompany them can be downright painful.

Watching account balances fall — even while acknowledging that the declines will be temporary — is not for the faint of heart. But the biggest challenge in long-term investing may not necessarily be witnessing violent stock market declines but rather keeping these all-too-common fluctuations from affecting your financial plan and mental health.

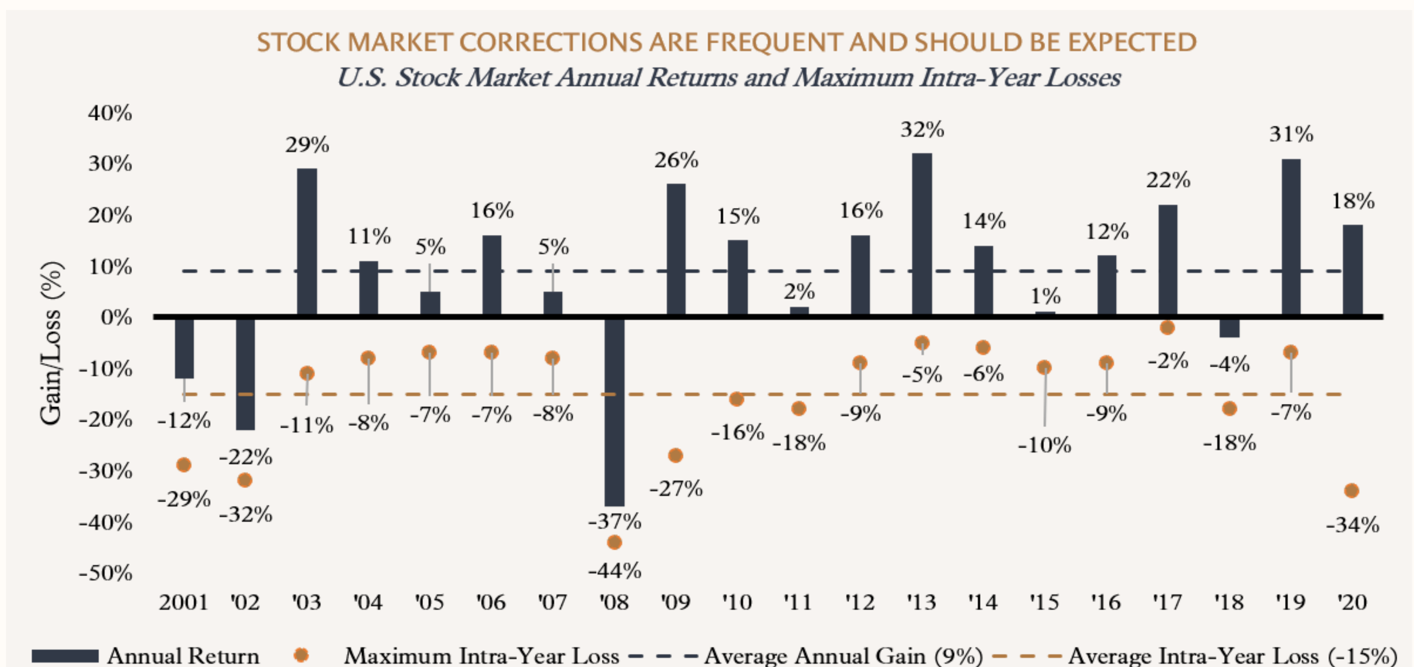

FIGURE 4. Over the last two decades, the U.S. stock market has experienced an average -15% drawdown within each year, with five years featuring -20% (or worse) bear markets. However, the U.S. stock market has averaged an annual gain of 9% over the entire period. Stocks perform well for investors over the long run if one can tolerate the volatility risk associated with them.

SOURCE: STANDARD AND POOR'S. DATA AS OF 12/31/2020. U.S. STOCK MARKET REPRESENTED BY THE TOTAL RETURN OF THE S&P 500 INDEX.

We believe investors with a financial plan and a corresponding diversified investment portfolio are more likely to make better decisions and are more confident about reaching their goals. Ultimately, this confidence is our best defense against the temptation to change things when markets go crazy. A robust financial plan, a balanced portfolio, and a disciplined investment management process are tried-and-true tools to help you survive and even thrive in the inevitable volatility to come.

PORTFOLIO MANAGEMENT

RISKS REMAIN TO THE OUTLOOK

Although the general market and economic outlook is currently positive and improving, there is still relatively high uncertainty surrounding both. Risks to the outlook are related to the pandemic's path, virus variants, vaccine distribution setbacks, and the ongoing effectiveness of policy support. Although we are in a much better place than we were in last year, the pandemic is still raging in many parts of the world. Additionally, the necessary preventive measures are still negatively impacting many economies, business sectors, and people.

PORTFOLIO POSITIONING TO REDUCE THE RISK OF MARKET VOLATILITY

We believe that investors should be prepared for current challenges and bumps along the road to recovery.

To help defend against potential stock market turbulence, we are maintaining broad diversification within client stock allocations. This diversification helps to avoid concentration risk in areas of the market that are very expensive or hurting amid the pandemic. Additionally, we have been rebalancing client portfolios that are overweight in stocks due to their significant appreciation and adding back to bonds that have recently declined in value due to rising interest rates.

To help defend against bond market turbulence due to rising interest rates, we are maintaining broad diversification within client bond allocations which has helped during the recent rise in long-term U.S. treasury rates. Client bond allocations are diversified across maturities (short, intermediate, and long-term bonds), sectors (treasury, corporate, securitized, and municipal bonds), and geographies (U.S. and international bonds).

PORTFOLIO POSITIONING TO ALIGN WITH THE LONG-TERM MARKET OUTLOOK

We believe that investors should position portfolios for the inevitable global acceleration.

As we get closer to moving past the virus, the recovery in stocks will continue broadening out to other areas of the market, many of which have started to outperform in recent months. As such, client portfolios continue to be positioned to underweight technology and more growth-oriented stocks trading at higher valuations amid lofty expectations. In turn, we favor more value-oriented (cheaper) stocks and cyclically oriented sectors[3] that should continue outperforming as the recovery accelerates.

For the same reasons — significantly cheaper valuations and a more cyclical sector exposure — we are evaluating a potential increase to international stocks. In late March 2020, we increased client allocations to U.S. stocks given their significant discount after declining 35% in just over a month.[4] Since then, U.S. stocks have significantly outperformed due to a faster recovery and a more technology-heavy market relative to international markets broadly.

On the bond side of client portfolios, we are evaluating ways to potentially enhance returns during the next couple of years of low interest rates and to mitigate the impact of unexpected future rate increases. Enhancements may include increasing allocations to credit (i.e., non-government bonds) and expanding the opportunity set to include a certain amount of the highest quality bonds within the non-investment grade (high-yield) sector.

OUR INVESTMENT DECISION-MAKING PROCESS

When it comes to making client portfolio changes, we are very deliberate with the investment decision-making process.

We thoroughly research and evaluate data and available investment options. We also consider clients' tax situations to ensure that a portfolio change's potential benefit will be worth the cost within a reasonably short breakeven period.

Ultimately though, we make investment decisions that we believe will benefit clients in the long run, by increasing the diversification and the risk-adjusted returns of their portfolios. As always, when we move forward with any changes, we will communicate more details about them. In the meantime, please do not hesitate to reach out to us should you have any questions.

SOURCES & ENDNOTES

[1] U.S. stock returns are represented by the Russell 3000 Index. International stock returns are represented by the MSCI ACWI Ex USA IMI. U.S. bond returns are represented by the Barclays Aggregate Bond Index. International bond returns are represented by the Barclays Global Aggregate Ex USA Hedged Index.

[2] International Monetary Fund. https://www.imf.org/en/Publications/WEO/Issues/2021/03/23/world-economic-outlook-april-2021

[3] Cyclical sectors include Consumer Discretionary, Financials, Industrials, Energy, and Materials.

[4] U.S. stock represented by the Russell 3000 Index, fell 35.09% from February 19, 2020, to March 23, 2020.

Past performance does not guarantee future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

IMPORTANT DISCLOSURE INFORMATION

Please remember that different types of investments involve varying degrees of risk, including the loss of money invested. Past performance may not be indicative of future results. Therefore, it should not be assumed that future performance of any specific investment or investment strategy, including the investments or investment strategies recommended or undertaken by Capstone Financial Advisors, Inc. ("Capstone") will be profitable. Definitions of any indices listed herein are available upon request. Please contact Capstone if there are any changes in your personal or financial situation or investment objectives for the purpose of reviewing our previous recommendations and services, or if you wish to impose, add, or modify any reasonable restrictions to our investment management services. This article is not a substitute for personalized advice from Capstone and nothing contained in this presentation is intended to constitute legal, tax, accounting, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. Investment decisions should always be based on the investor's specific financial needs, objectives, goals, time horizon, and risk tolerance. This article is current only as of the date on which it was sent. The statements and opinions expressed are, however, subject to change without notice based on market and other conditions and may differ from opinions expressed by other businesses and activities of Capstone. Descriptions of Capstone's process and strategies are based on general practice, and we may make exceptions in specific cases. A copy of our current written disclosure statement discussing our advisory services and fees is available for your review upon request.

CAPSTONE
FINANCIAL ADVISORS

Capstone Financial Advisors, Inc.
2001 Butterfield Road, Suite 1750
Downers Grove, IL 60515
Phone (630)241-0833
Fax (630)241-0834