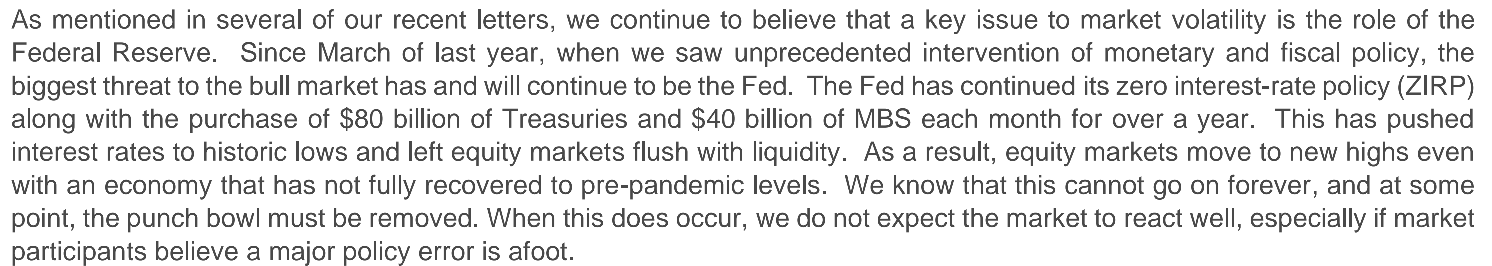

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Market Update
August 19, 2021

As mentioned in several of our recent letters, we continue to believe that a key issue to market volatility is the role of the Federal Reserve. Since March of last year, when we saw unprecedented intervention of monetary and fiscal policy, the biggest threat to the bull market has and will continue to be the Fed. The Fed has continued its zero interest-rate policy (ZIRP) along with the purchase of $80 billion of Treasuries and $40 billion of MBS each month for over a year. This has pushed interest rates to historic lows and left equity markets flush with liquidity. As a result, equity markets move to new highs even with an economy that has not fully recovered to pre-pandemic levels. We know that this cannot go on forever, and at some point, the punch bowl must be removed. When this does occur, we do not expect the market to react well, especially if market participants believe a major policy error is afoot.

Yesterday, the Fed released minutes from their July meeting and, as we expected, they deliberated over how and when to start pulling back their support. From the report we garnered that most participants believe “substantial further progress” has been met when it comes to their price stability mandate. This should be quite obvious as inflation is running hotter than anyone expected. However, their mandate on maximum employment has still not been met. This, I believe, will continue and if they deem in necessary, give them cover to continue their current accommodative stance into 2022. However, it seemed most participants believed tapering of asset purchases should begin sometime in the 4th quarter if the economy continued on its current path. Since this meeting occurred, economic numbers have been weaker as inflation and worries over the Delta variant have increased uncertainty in consumer confidence. We currently believe the variant will follow the same path as it did in the UK and India and start to ease over the coming weeks. Inflation, on the other hand, seems to be quite sticky in our opinion. Prices increasing at their current rate weighs heavy on growth because of the service nature of our economy. If we don’t see growth pick back up and inflation ease, stagflation becomes a real worry.

On a brighter note, earnings have been nothing short of excellent. So far, 91% of companies in the S&P 500 have reported and 87% of these companies have beat expectations on the top and bottom line. This is well above historical trends. We are also seeing the strongest year-over-year earnings growth since coming out of the financial crisis in 2009. However, valuations continue to be elevated. The forward P/E on the S&P 500 is around 21.1x, which is above both its short- and long-term trends. We haven’t seen valuation metrics this high since the Dot-com bubble in the late 1990s.

We still believe there are pockets of value in the market. Cyclical sectors are trading at discounts relative to their historical means vs themselves in some instances and relative to the market in all instances. We still believe favoring quality is the right strategy, along with sticking to our strict fundamental discipline. There are major pockets of excess and we are avoiding them. We believe the rest of the year will be volatile and our thoughts will evolve as we gain a clearer picture on the economy, the Fed, and other factors such as the Delta variant.

Some of the most surprising market action has come from interest rates. Two years ago, it would have been difficult to envision that GDP growth would be 6% and CPI would be above 5%, while the 10-year Treasury yield is 1.2%. We continue to believe there are technical issues strongly influencing rates. Supply and demand are out of balance with the Fed buying $120 billion a month of bonds. There was also a record volume of short selling in Treasuries heading into the summer, which mostly has been worked through. The debt ceiling is another major issue that is largely under the radar. The US Treasury is undertaking extraordinary measures as congress missed the deadline to raise the debt ceiling. This means no new issuance which is weighing on the supply of debt. We believe most of these factors will be resolved by the end of September. However, if rates are still trending down by then, we are going to have to rethink our position on higher rates going forward.

We will continue to navigate this difficult environment to the best of our ability. As always, we at AMB thank you for your support and for allowing us to partner with you in reaching your financial goals.

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