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Steven Elwell:

Hi everyone. This is Steve Elwell, Chief Investment Officer of Level Financial Advisors and this is your second quarter 2021 market review. Another good quarter for the stock market in the US, international, emerging markets, global real estate, all of which were positive for the quarter. Even the bond market rebounded after a pretty rough first quarter in 2021. Specifically, US stocks are up about 8.24% for the quarter. Global real estate actually led the way at up 10.17%. It was a nice rebound or leadership by global real estate and growth stocks for the second quarter, particularly because interest rates came back down. Interest rates shot up in the first quarter and they cooled off and came back down in the second quarter, which is what really helped the bond market do well, helped global real estate do well and helped tech stocks and growth stocks do well for the second quarter.

If we look a little deeper, like I said, real estate leads the way, but not a bad quarter by any measure for basically any asset class that you're looking at from the stock side ranging anywhere from about 4% return up to as much as about 12% depending on which category you're looking at. But all in all, the recovery continues to happen economically. The world's economies continue to reopen, and the stock market is responding positively to surprise corporate earnings that were better than expected for the first quarter. And for continued support from the Federal Reserve. They're still indicating that they're really not going to raise interest rates in any material way for probably at least a year and a half if not longer. Obviously inflation is one thing that could change that and we're going to talk about that in a minute here, but we're kind of hearing a lot on the sidelines here from people that are sort of saying, well, the stock market's hitting all-time highs.

We're still not really economically fully recovered, at least from a job standpoint and a GDP standpoint. Not fully recovered from the damage that was incurred last year. How is it that the stock market can be at new all-time highs and setting new records despite those things? And it's a little more nuanced than that. This chart from JP Morgan we think does a pretty good job of breaking it down. So remember of course that the stock market is forwards looking not backwards looking, and the stock market is predicting that earnings from corporations, which is ultimately the bottom line when it comes to stock valuations, earnings are going to be pretty good. On this chart here on the left, it's showing the S&P 500 earnings per share. And last year, of course, there was an earnings recession where earnings go down for the S&P 500. And that's pretty obvious as to why that happened, but the projections for 2021 and 2022 and 2023 are very optimistic and positive.

And so far in 2021, we have seen that come to life better than expected. The first quarter was fantastic. Expectations for the second quarter are very high and positive for a rebound of earnings growth. In fact, when you look at the chart here on the right, the earnings growth year-

to-date is 19.7%. That's obviously pretty good. And to fill in sort of the rest of the information on this chart, the earnings growth is this gray line which looks great so far for 2021. The multiple expansion is simply what is the price that people are willing to pay for a dollar of earnings. Obviously, in some moments, people are willing to pay a high price. In other moments, people are willing to pay a lower price. The ultimate driver in the long run for stock market returns is earnings growth and profitability, as it should be. That should be the bottom line.

But obviously in certain moments, people are willing to pay a higher or lower price for different stocks despite whatever the underlying profits are. What we've actually seen is earnings growth grow quite a bit this year. And the multiple that people are willing to pay has actually gone down, which actually is somewhat tied together. If the earnings growth is faster than anticipated and the prices of stocks stayed the same, then there is a negative effect on the multiples of what people are willing to pay for those profits. And so they're always somewhat connected, but ultimately those two things make up what the S&P 500's return ultimately is for the year is, are the prices being paid for each dollar of profits going up or down and are the actual profits going up or down? So, like I said, they're interconnected, but the bottom line is companies in the S&P 500 and throughout the world in the first quarter and second quarter are looking like they're making a lot more money in profits than originally anticipated. And so the stock market valuations have gone up to respond to that as they normally would.

So that's been good information on that front, good news on that front, positive surprises on that front. The expectation is that we'll continue as the second quarter earnings are announced here in the first few weeks of July through the end of August as companies come out and say, well, here's how we did in the second quarter. But bottom line, if you want a simple answer as to why the S&P 500 and stocks throughout the world are going up and going up quite a bit this year, it's because profits have been better than expected. And that's a fairly simple statement and fairly easy for most of us to understand as to why prices would be higher. Well, profits are higher.

What we've also heard a lot about and is grabbing the headlines all throughout the country here is inflation. And so we have another nice chart here from our friends at JP Morgan, which if you look all the way to the right with this gray and blue line, you can see both the headline CPI, which is the consumer price index, and the core CPI, which strips out some of the more volatile categories to see exactly what has inflation been here. And it's been running hotter than what it's been the last 10 years. So if we look specifically in April, 2021, the headline CPI was 4.2%. In May it was 4.9%. In June it was around 5%. That obviously is quite a bit higher than the traditional two, two and a half percent we've been seeing for the last 10 years. The Federal Reserve continues to argue that this is a result of the transition from a shutdown economy to a reopened economy.

As you might imagine, you can't just snap your fingers and restart a factory or restart a saw mill or restart all these different things. People have to be trained. Machines have to be picked back up to gear. Supply chains are sort of, depending on where you're getting your stuff from, either running as normal or not running as normal. So there's sort of all these unique things happening

when it comes to creating goods and services that are having an effect on the price. The most common things that are being talked about are used cars because of course new cars, the manufacturers have a shortage of chips. They need those chips to make the new cars. If they can't get the chips, then they're making less new cars, which for someone who wants to buy a car, if you can't get the car you want from the lot as a brand new one, then you might turn to the used car market to go find what you're looking for. So there's a little extra demand in the used car market.

But also you look at the car rental companies, which basically had to sell their inventory of cars last year just to survive because no one was traveling and renting cars. Well, now they have increased demand because everyone wants to take a vacation now after dealing with the last 16 months and they want to rent cars and they don't have enough cars to rent. So they're buying a bunch of cars, a bunch of used cars. So that creates just all sorts of unique things happening on that front. And then many people have heard a lot about what's going on in the lumber markets. Saw mills were shut down and they needed to reopen them and they couldn't get people to go back to work and they needed to train them and it's a dangerous job. It takes time for a lot of these things to really get back to where they were under normal conditions. And this has caused some dislocations in different areas of the economy.

But it's really been pretty phenomenal sort of watching real time. I think we'll all be able to kind of remember this moment and how sort of odd all these dislocations were, but as it pertains to our clients and our portfolios and retirement and all these moving pieces, we're getting a fair amount of questions that say am I properly prepared if inflation continues to run hot here? What happens if inflation keeps running at 5% a month or 5% a year? The Federal Reserve responds or they don't respond, how is that going to affect my portfolio, which is such a natural question to ask because inflation, particularly for retirees, has a real effect. You're not in the job market receiving a 5% raise in your salary because you had 5% higher costs for all the goods and services you buy due to inflation.

You have a portfolio of investments, which fortunately this year have done well and have grown more, for most of you more than what inflation has been. But we obviously need to make sure that we keep up with inflation. Otherwise it eats into the real money that we have, the real money that we have to spend on things. So, some of the things we like to look at on both sides of the portfolio, first I'll take a look at the bond side, which traditionally is the side of the portfolio that people are most concerned about when they talk about inflation for two reasons. Obviously, as an example, if you own a bond that pays 3% interest, but inflation ends up being 4%, you are -1% and you are actually losing money in real terms. So that's a pretty obvious concern. The second side is generally the way that the Federal Reserve has fought inflation has been to raise interest rates.

And a lot of people are well aware that if interest rates go up generally for long-term and intermediate term bonds, and even some short-term bonds depending on how much interest rates go up, interest rates going up generally is bad news and can be very bad news for the bond market. That was the story of the first quarter. That's why the bond market had such a bad first

quarter is because interest rates shot up very quickly as the market anticipated higher inflation and anticipated some of that inflation coming from the economy reopening, but doing it in this really dislocated way from a supply chain standpoint. So this chart shows year-to-date for 2021, the first six months of the year, several different categories as we think about, well, how are our bonds positioned in these portfolios?

This orange-ish marker at the bottom shows the US bond market, the aggregate bond market is down 1.6% for the year. We tend to lean our bonds towards shorter term bonds. And so I've included two of the funds that we generally use to cover that category; Vanguard short-term bond ETF and Vanguard short term treasury ETF. Both of those are down for the year, but much less than what the US bond market is. And that's to be expected. Interest rates going up will be worse for longer term bonds than they will be shorter term bonds. And so our focus on shorter term bonds has helped protect us against losing more money on the bond market side. So that is one thing in its own right that has been helpful is our focus on shorter term bonds.

From an inflation perspective, particularly if interest rates go up, I would almost argue in the long run that that's not even bad news for our shorter term bonds because think about what most of us might be familiar with, something like CDs, a certificate of deposit. If I buy a six-month CD, I get my money back in six months. So if interest rates go up over that period, I get my cash back pretty soon and I get to reinvest that at the new higher interest rate if I so choose. If instead I had bought a six-year CD and interest rates went up right after I bought it, I have to wait six years or pay a penalty to cash out that CD and get my cash back to feel the effect of re-investing at the new higher interest rate.

So clearly inflation and increasing interest rates is a bigger problem for longer-term bonds than it is short-term bonds. This year's returns have shown that. That would be our expectation going forward if interest rates continue to creep up or the Federal Reserve forces interest rates up, that I would expect short-term bonds to continue to do better than intermediate and longer term bonds.

One other category of bonds that we are using that many of you are aware of are the inflation protected bonds, which we have, depending on what your portfolio looks like, three different versions of funds we use to cover that category; one from DFA, one from Vanguard, and then a shorter term one from Vanguard. And those funds for this year not only have done better than the US aggregate bond index, but are fairly positive for the year, particularly the short-term inflation protected bond ETF from Vanguard for the first six months of the year was up 2.75% while the slightly longer term Vanguard and DFA versions were up 1.44% of 1.7% for the year.

And my point is not to say, well, which of these funds is better than the other, but simply that our bond strategy of remaining shorter term and having some exposure to these unique government bonds that have inflation protection where when inflation goes up, the value of the bonds are automatically adjusted to reflect that amount of inflation increase, those unique features of those particular bonds have done their job this year and have worked very well relative to the US aggregate bond index by itself.

And if I go on the stock side of the portfolio, we have another chart here that shows the first six months of the year for 2021. And it shows three things. It shows the S&P 500 sort of as a barometer or a benchmark that many people might use, which has had a great year by any measure, I mean, up 15%. Nobody's going to complain about that for the first six months of the year. But what I want to highlight is several of the asset classes that we use that we think traditionally have been well-positioned to defend against inflation if inflation does run hotter than expected. And those two categories particularly are global real estate, which many people are well aware is generally a pretty good asset class to own when inflation is running hot. Many of us have seen that in our own local real estate market.

But global real estate is up about 17.3% for the year, which is better than what the S&P 500 has done. And then value stocks. I have a line here for DFA US large cap value, which is one of the main funds we use to cover that category, and value stocks have done better than the S&P 500 so far this year. And traditionally we view those as two asset classes that would perform well should inflation run faster or hotter than unexpected, and they have done their job as well this year.

So on the front of are we well-positioned should inflation continue to run hot, the evidence so far looks pretty good. I think we're in good position to deal with inflation should it happen based on our short-term bonds, our treasury inflation protected bonds, the way we allocate the stock side of our portfolio. But I would also caution people to say just because inflation has run hot for the first six months of this year does not mean that it'll last. Trying to predict something like inflation is just as hard as trying to predict something like which stock will do best or which investment category will do best. In the short term, anything really can happen.

We've even seen, as we noted in the quarterly letter, certain areas that were running very hot inflation wise like the lumber market have recently seen dramatic declines in the last couple of months, May and June particularly. Well, June particularly for the lumber market where lumber futures lost something like 40%, the biggest drop month-over-month like in history for the lumber market. And so we're all going to kind of get to wait and see exactly what happens on this front. Is the Federal Reserve right that this inflation that's showing up is temporary and simply just due as a result of the economy reopening and people going back to work and factories reopening, or is it something that's going to last for a longer period of time? And that of course is something that we will keep a very close eye on as we monitor and rebalance our clients' portfolios.

But I thought we would cover really those two main topics, which was what we have heard the most over the last three months is how is it that stocks keep hitting new highs? And the bottom line generally is profits have been great. And are our portfolios well positioned to deal with inflation both on the bond and the stock side of the portfolio? So this has been the second quarter 2021 market recap. I thank you guys for tuning in and playing along as I walked through the charts and provided some commentary about what's happening out there. And as always, if you have any questions for us about your portfolio or any financial planning items or anything else like that, please reach out to us, shoot us an email or give us a call or schedule a meeting.

We're happy to have any conversations about any questions that any of you might have, and until next time, enjoy the summer.