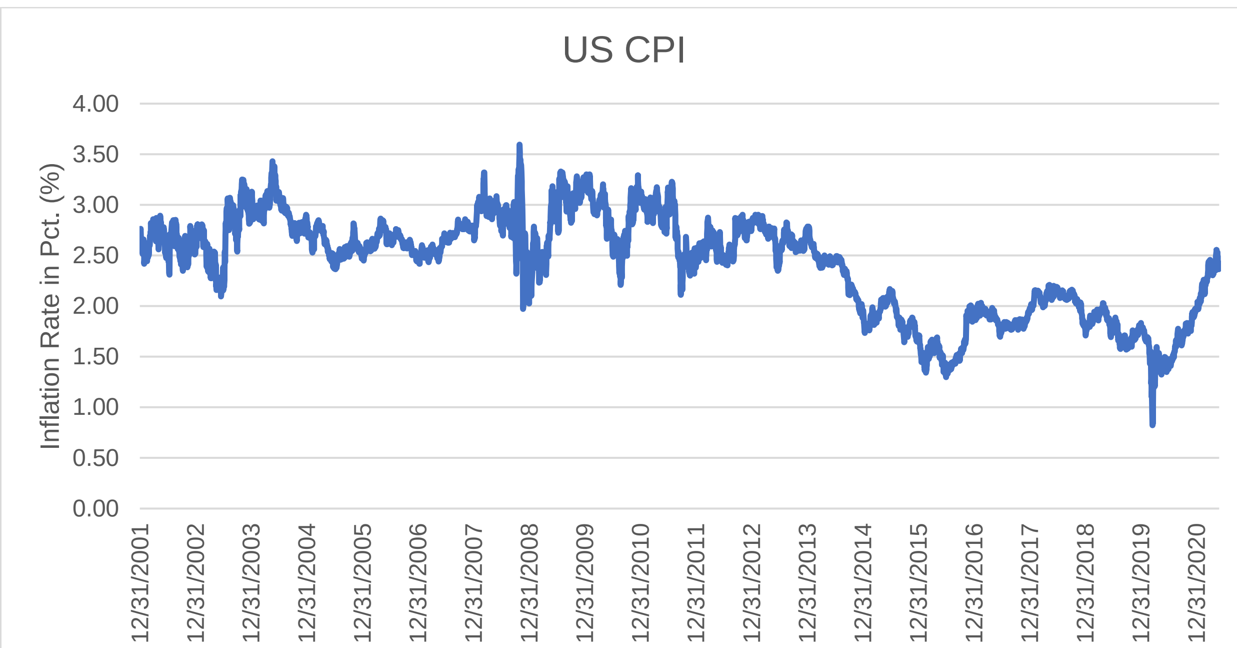
File# 210262

AndCo's Monthly Market Update

June 2021

THE ECONOMY

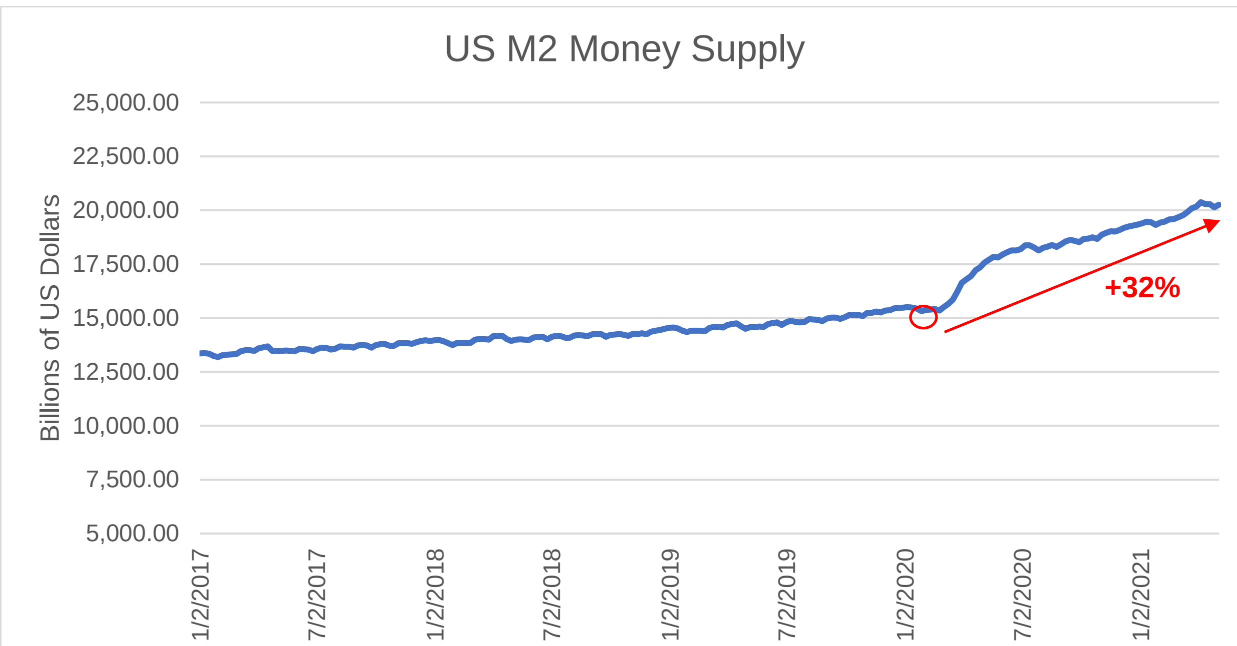
The global reflationary theme we have been experiencing for more than a year remained broadly intact during May. As a result of this continued strong growth, concerns over the potential for rising global inflation grabbed most of the headlines. Evidence of rising inflation was seen in the release of the US Consumer Price Index (CPI), which rose 4.2% annualized through April.[1] While some of the recent increase in inflation can be attributed to the base effect created during the pandemic when prices collapsed, we believe the reflation of the economy is only part of a much larger story.



Source: Bloomberg as of Bloomberg May 31, 2021

Inflation generally rises when the supply and demand of goods and services is not in equilibrium. The pandemic threw the global supply chain into a state of chaos as businesses were shuttered. In isolation, the shutdown alone caused shortages for certain goods and services which resulted in rising prices. However, as businesses come back online, the lack of available goods and services should recede, and an equilibrium price should be re-established. What is different this time is the role that global Central banks played in supporting the economy as it emerges from the pandemic.

Central banks, led by the US Federal Reserve (the Fed), significantly increased the money supply to provide liquidity to the economy. Looking at the chart below, the money supply has increased in absolute terms by more than 32% since January of 2020.[2.] The reason this is important is this liquidity will eventually flow into the economy. When we look at the impact of increased money supply on inflation, there is a roughly 91% correlation between the two statistics which would suggest that as long as the Fed continues increasing the supply, inflation should continue to rise.[3] We have already seen signs of excess liquidity in items such as residential real estate, real assets, and commodities, all of which have all experienced significant price increases. Moving forward, as the global supply chain is untangled, the excess liquidity created by the central banks will need to be effectively removed from the system to avoid continued price increases.



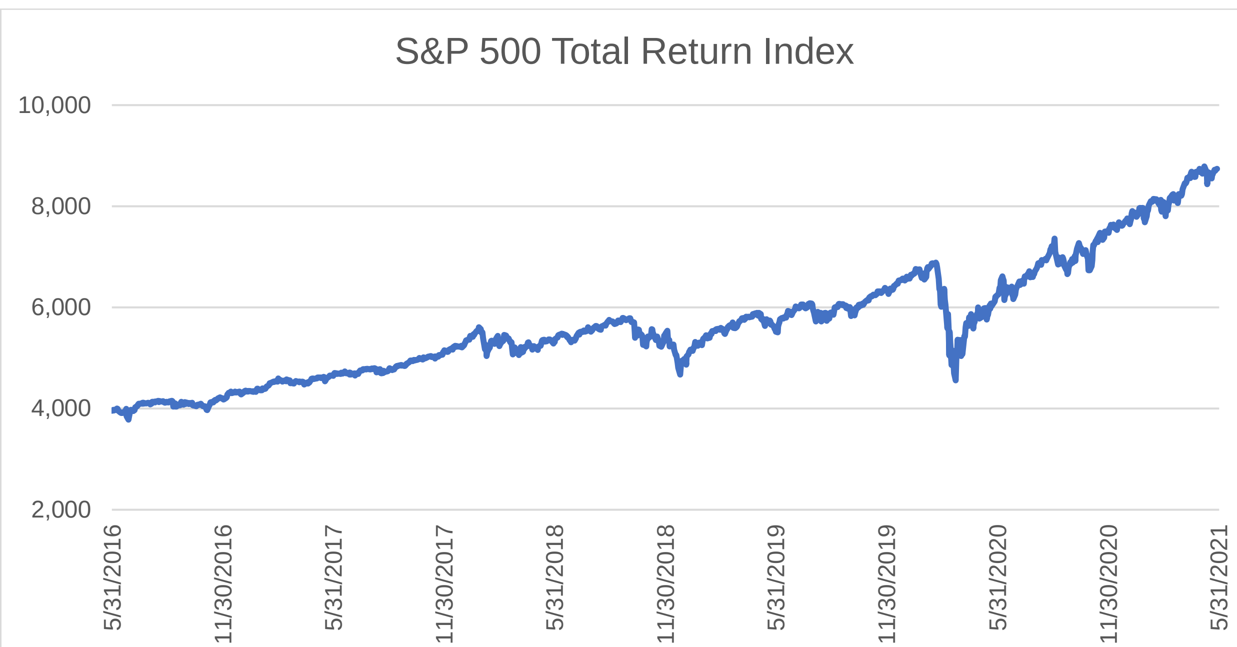
Source: https://fred.stlouisfed.org/series/WM2NS

One reason why the Fed has been slow to begin the process of draining liquidity is the continued slack visible is the labor market. Non-farm payrolls rose only 559,000 in May which was well below the forecasted rise of 650,000.[4] While the unemployment rate fell to 5.8%, the labor force participation rate remains stubbornly low at 61.6%, down from 63.4% prior to the pandemic.[5] Some of this slack can be attributed to government transfer payments established under the

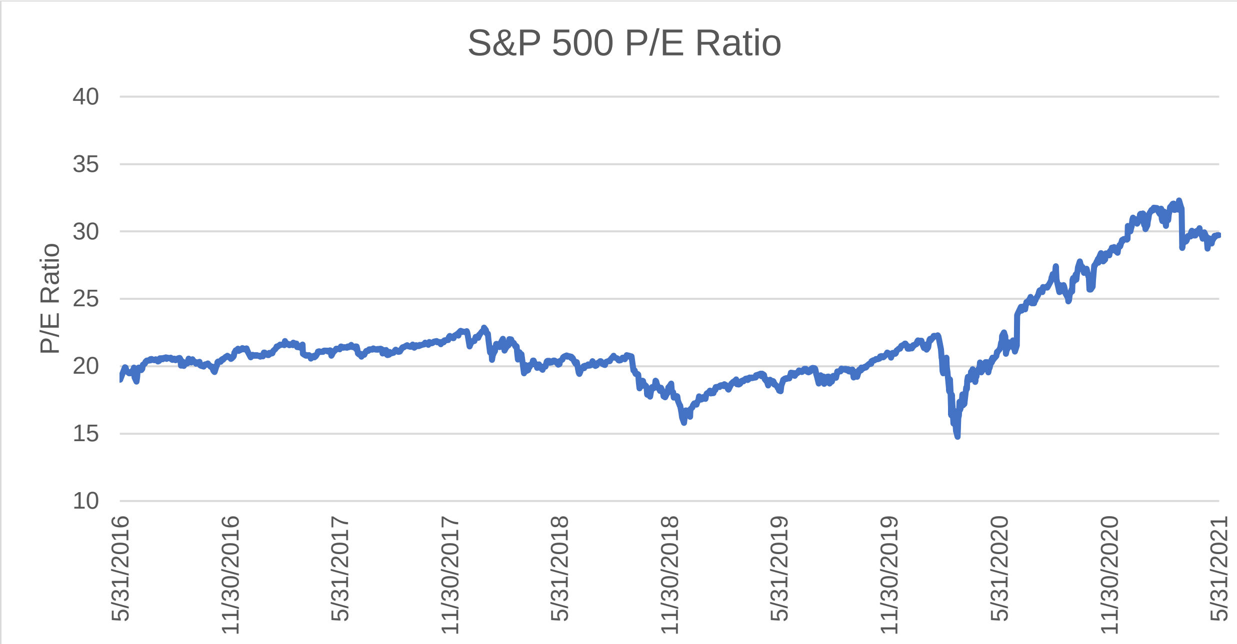
Coronavirus Aid, Relief, and Economic Security Act (CARES). However, as local economies have begun to re-open, labor markets have tightened due to a lack of supply. Despite the shortage of workers, there has not been broad signs of wage inflation. In an effort to encourage workers to return, several states have moved to end extended federal unemployment benefits. Only time will tell if the decision to end benefit payments results in an increase in the labor force participation rate. In the meantime, the Fed will most likely remain accommodative and risk the potential for overshooting on its inflation target rather than choking off potential job growth.

EQUITIES

Equity returns were largely positive across most geographies, market capitalizations, and styles during May. The return outlier during the period was growth stocks, which suffered declines as investors continued to rotate into cyclical and value-oriented stocks based primarily on valuations and improving economic conditions. For the month, US stocks were led higher by the small cap Russell 2000 Value Index which rose 3.11% while the large cap S&P 500 Index returned 0.70%.[6] Overall corporate fundamentals continue to improve as the economy recovers as evidenced by the estimated earnings growth rate for the S&P 500 Index (61%). This is the highest year-over-year growth rate reported for the index since 2009.[7] Despite the positive earnings growth trend, the index's price to earnings (P/E) ratio of 29.7x remains high relative to its trailing five-year average of roughly 21.1x.[8] However, if earnings growth continues, the P/E ratio should be expected to moderate towards its historical level of roughly 18x.



Source: Bloomberg as of May 31, 2021

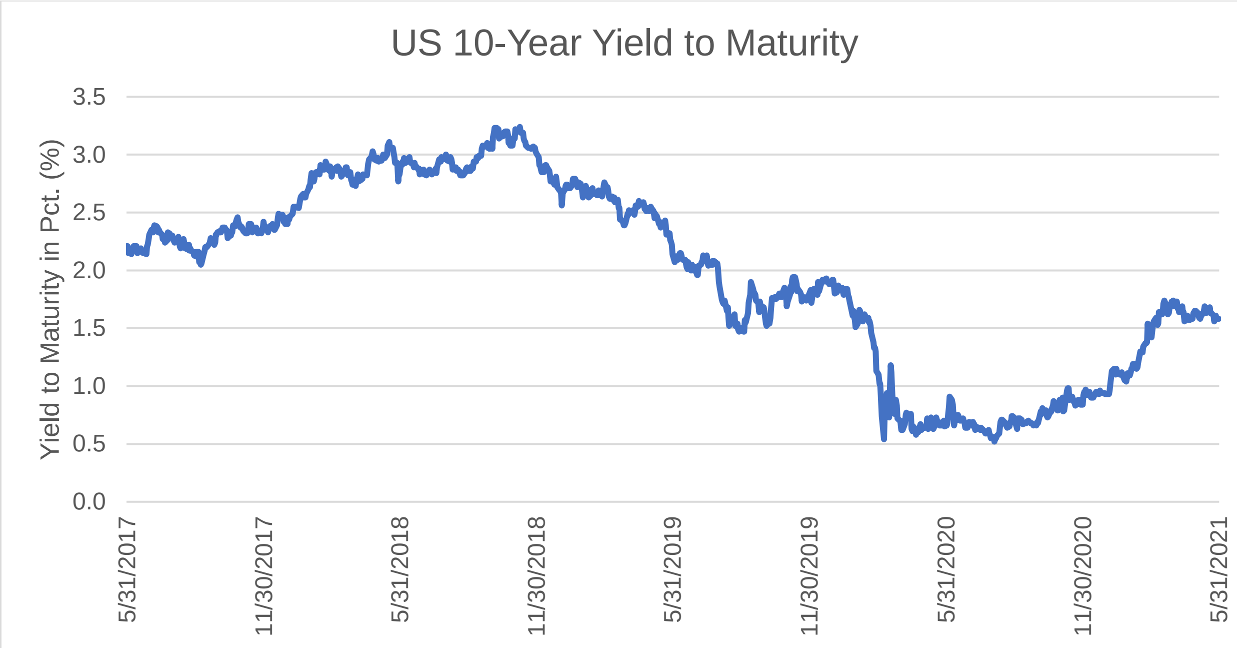


Source: Bloomberg as of May 31, 2021

Foreign stocks outpaced their US counterparts, primarily due to the continued decline in the US dollar (USD). The developed market MSCI-EAFE Index returned 3.26% while the MSCI Emerging Market Index returned 2.32% in USD.[9] Global stocks, especially those in Europe and the UK which have lagged relative to the US, are increasingly being seen as a potential opportunity as those regions begin opening their economies as the pandemic recedes.

FIXED INCOME

Fixed income markets were generally benign in May. Despite higher-than-expected inflation reported during the month, yields across the US Treasury curve were modestly lower. As a result, performance of both US Government and investment grade corporate bonds were positive in May. For the month, the Bloomberg Barclays US Aggregate Bond Index returned 0.33% while the Bloomberg Barclays US High Yield Corporate Bond Index returned 0.30%.[10] Overall, credit spreads narrowed slightly during the period and remained near their all-time lows.[11] Finally, despite concerns over rising inflation, the break-even yield for Treasury Inflation Protected securities (TIPS) moderated during the month with the 5-Year rate closing at 2.60%.[12]



Source: https://fred.stlouisfed.org/series/DGS10 May 31st, 2021

APPENDIX

1. Bloomberg, May 2021
2. https://fred.stlouisfed.org/series/WM2NS
3. https://fred.stlouisfed.org/series/CPILFESL#0
4. Bloomberg, May 2021
5. Bloomberg, May 2021
6. Morningstar, May 2021
7. https://www.factset.com/hubfs/Website/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_060421.pdf
8. https://www.cnbc.com/2021/02/23/powell-says-inflation-is-still-soft-and-the-fed-is-committed-to-current-policy-stance.html
9. Morningstar, May 2021
10. Morningstar, May 2021
11. Bloomberg, May 2021
12. https://fred.stlouisfed.org/series/T5YIE

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