C Y P R E S S

Asset Management, Inc.

MARKET COMMENTARY **July, 2021**

The bellwether S&P 500 index finished the first half of 2021 at a record high, rising almost 15%. It was the second best 1H performance for stocks in the past 22 years. A reopening economy and unprecedented monetary expansion have created a favorable environment for equities and asset prices are surging across the board. GDP, inflation, corporate earnings, consumer net worth and consumer spending are all increasing at the fastest pace in years. The rebounding U.S. economy is likely to remain very strong for some time and we believe growth will continue to exceed expectations. There is the potential for a historic multi-year upturn in consumer spending – a Roaring Twenties style boom as pent-up demand and animal spirits are unleashed, fueled by the wealth effect from the rise in asset prices and net worth and by government largesse. Moreover, reopening around the rest of the world is continuing to unfold and a global recovery is finally underway from Europe to Japan, setting the stage for self-reinforcing synchronized global growth.

The Surge in Corporate Earnings

Earnings are the dominant influence on the stock market and equity performance. In the past, the S&P 500 has peaked roughly in line with peaks in corporate earnings. And fed funds have been at much higher levels than now. We believe that with the fed funds rate at zero and $120 billion per month in ongoing QE (Quantitative Easing is the introduction of new money into the money supply, primarily through Fed bond purchases), the current surge in profits will outweigh tapering and a hike in fed funds. They are coming, but the peak in earnings is probably years out.

Market valuations are supported by low rates and the growth in earnings. ISI Research expects S&P operating earnings to surge to $235 this year, a record, and then move up by mid-single digits to $250 next year. This puts the market PE at roughly 18 times estimated forward 12-month earnings.

Second half earnings are set to be some of the strongest in memory. Coming out of the pandemic demand has outstripped the ability of suppliers to meet demand. This has led to shortages and higher prices from semiconductor chips to lumber to beef. New home prices have increased at double digit rates, and prices have risen sharply for gasoline, copper, lumber, and other commodities. This may prove transitory when supply is able to catch up over the next few months, but is actually leading to record revenue growth, profit margins, and corporate profits. Machiavelli and later Churchill famously said never let a good crisis go to waste. For better or worse the pandemic was the opportunity of a lifetime for big corporations to restructure and rethink business practices, and to downsize and cut costs with a breadth and speed unthinkable in normal times. Big corporations have strengthened their hold on markets and emerged more dominant than ever, and profits margins are robust, at the highest level since the financial crisis. As our reopening economy takes off, corporate revenues and profits are booming like perhaps nothing we have seen since the period following WWII. Stay tuned.

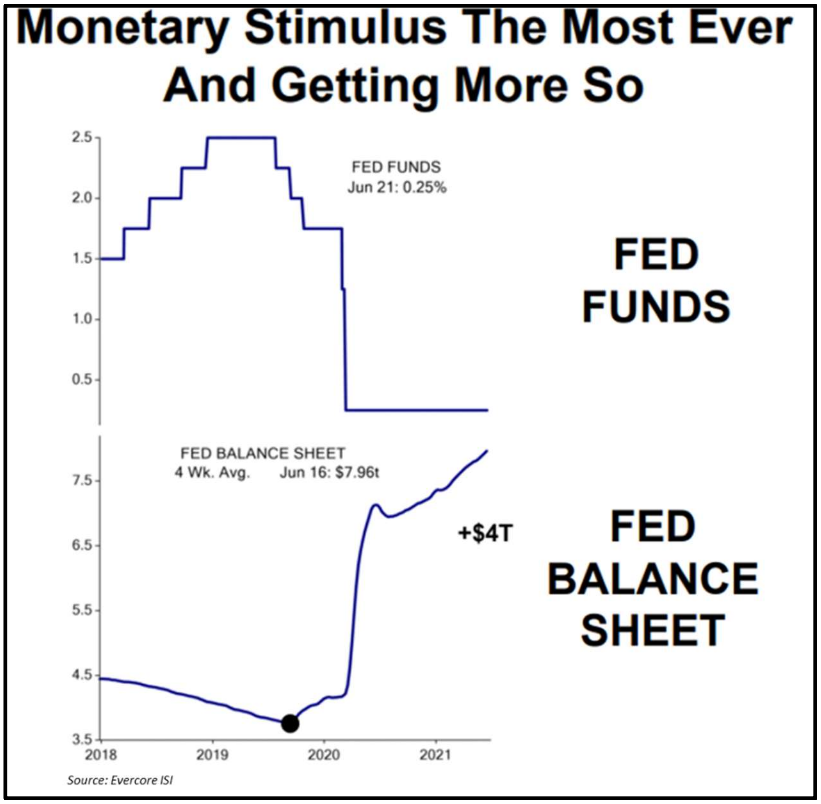
The Treasury Mystery

A prolonged drop in U.S. Treasury yields during the second quarter caught most economists and investors by surprise. Despite lingering fears over rising inflation and a gradual removal of Fed stimulus (i.e., a tapering of its bond purchases), the 10-year U.S. Treasury has dropped 50 basis points over the last 3 months to 1.25% from a high of 1.75% at the close of March.

If rates should begin to normalize as the economy recovers, why have they fallen? There are some plausible explanations: investors are more comfortable with the idea that the pick-up in prices is a temporary phenomenon and not long term, and concern that the spread of the Delta Variant is a threat to the global recovery and could cause new lockdowns. Certainly, these are unprecedented conditions. If it is uncertain whether increasing price pressures are transitory, maybe too some of the growth is transitory. The only certainty is easy money and unprecedented monetary stimulus. Until QE is actually removed and rates move up to a more neutral level –a process that plays out over time – the environment remains favorable and the bias for markets is upward.

Treasury yields play an important role in the economy, affecting borrowing costs on everything from mortgages to corporate bonds to credit card rates. It is also a key valuation metric for the stock market and gauging PE levels. The lower the 10-year rate, the higher the multiple the market is theoretically willing to pay for earnings and the lower the discount rate used to determine the present value of those earnings.

Perhaps, however, the movement in interest rates is simply much ado about nothing. It may very well be a byproduct of the unprecedented liquidity awash around the world and distorting rates, overwhelming traditional correlations between growth, inflation, and interest rates. Likewise, QE (central bank bond purchases) is distorting the bond market and the Fed is still purchasing a significant amount of government debt. Ben Bernanke, Bill Dudley and other Fed economists have said that this scale of QE is the equivalent to a cut in short term rates of 3% or so. The Fed balance sheet, the instrument for QE, has increased by over $4 trillion and counting since the onset of the pandemic in spring 2020. This is a doubling (yes, a doubling) and the Fed balance sheet now represents a previously unimaginable 35% of GDP.



And a similar story is playing out in Europe, Japan, and with other central banks around the world – it is a decidedly global phenomenon. We can't just single out a few countries and say they are pursuing an aggressive reflationary monetary policy and do not practice "sound money" (e.g., as we used to say about Argentina or pre-Euro Italy and its forever depreciating lira) – the whole world has fallen in love with using monetary policy to solve problems. This is putting downward pressure on global yields and inflating assets everywhere. There is a level of insanity to all this (remember the Fed is saying that the tapering process, or gradually reducing the purchase of bonds, will not even begin until further economic progress is made) and even the policy experts don't know how it will end. Stay tuned but for now, "don't fight the Fed".