NEXT CAPITAL

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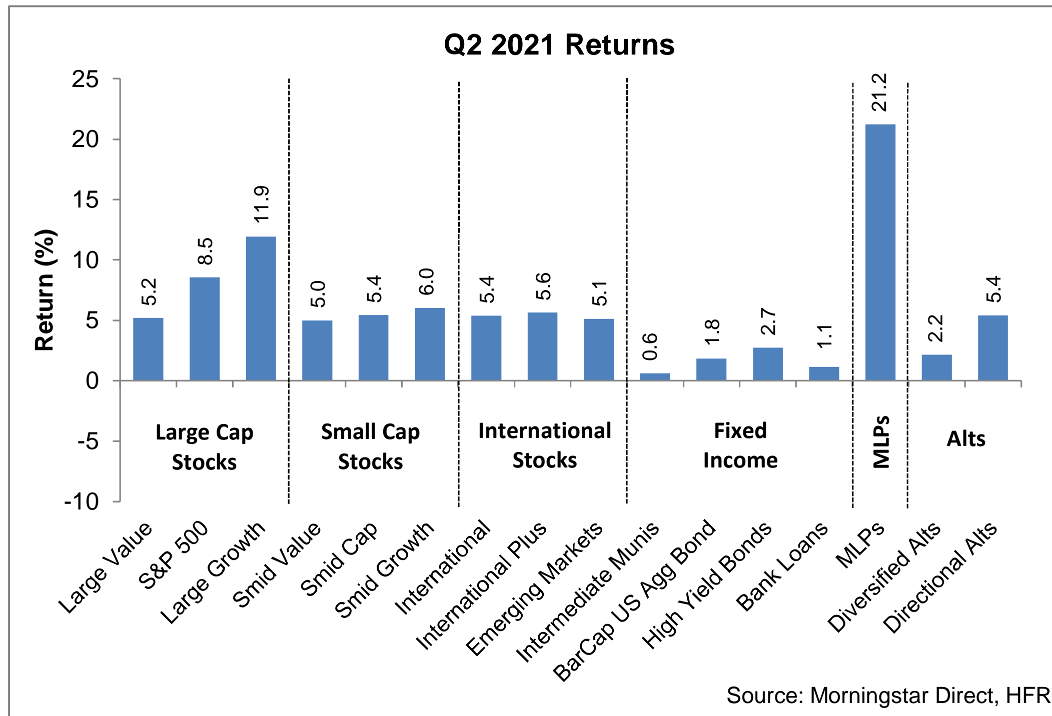
Second Quarter 2021 Investment Review & Outlook



EXECUTIVE SUMMARY

Q2 2021 Recap:

- Financial markets posted gains across the board during the second quarter. The S&P 500 ended the period up 8.5%.
- The re-opening trade took a breather, with large cap growth stocks regaining momentum towards the end of the quarter.
- A sharp downward reversal in US Treasury yields came as a boost to fixed income securities, alleviating price pressures on the Bloomberg Barclays Aggregate Bond Index.

NEXT Outlook:

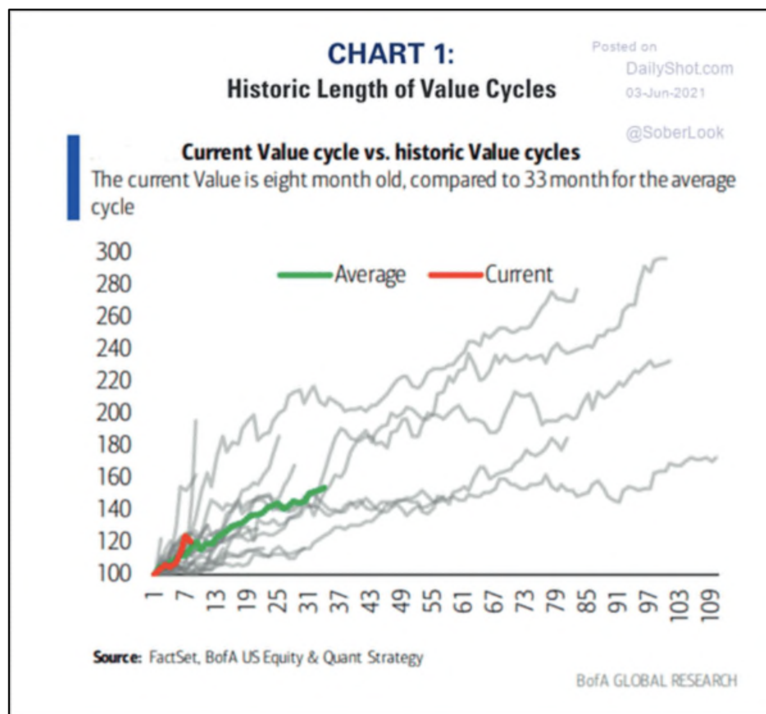
- A scarcity of yield in traditional fixed income securities, along with sustained support from the Federal Reserve will continue to fuel investor appetite for equity market risk.
- Heightened volatility will persist in the intermediate portion of the yield curve. The 10-year US Treasury yield seems to have bottomed after a notable move lower, and one can expect to see it march back up during the third quarter.
- Investors will begin to shift their attention back to tax increases and Covid-19 cases as Fall approaches, providing potential sources for price volatility in the months ahead.

To Our Clients and Friends,

Financial markets advanced for a fifth straight quarter, continuing their climb from the depths of the pandemic in Q1 of last year. The S&P 500's 15.3% return in the first half of 2021 was its second-best start in the last 20 years.

Stock markets reverted to a familiar pattern in the second quarter, as US big tech stocks resumed their market leadership. The large cap growth segment of the market led performance with an 11.9% return, outpacing the S&P 500's 8.5% gain. Meanwhile, the post-Covid darlings – value-oriented cyclical stocks – lagged with "just" a 5.2% return (and indeed, many of the most economically sensitive names declined in Q2).

This marked a quick reversal from a trend that many expected might have more staying power. After years of underperformance against their growth counterparts, it was theorized that a regime shift might be taking root. The massive influx of capital provided by the Federal Reserve, US Treasury, and Congress – along with the expected boost provided by a re-opening economy – created a recipe for stronger economic growth and higher interest rates. These are necessary conditions for strong value stock performance, which are tilted more towards companies like banks, oil & gas producers, manufacturers, and materials producers.



This was not the case, however, in the second quarter, as concerns arose that the Federal Reserve would step away from markets sooner than expected. While one might ordinarily think that the higher inflation we have observed in recent months would correlate to higher interest rates, the opposite took place. The yield on the 10-year Treasury bond sagged throughout the quarter, falling nearly 0.50% from its highs. Today it stands at just 1.25% – the lowest in recorded history outside of the pandemic era of the last 18 months.

We have been asked about this apparent contradiction. One must understand that although the Federal Reserve directly controls the short end of the yield curve (the Federal Funds rate is an overnight interest for

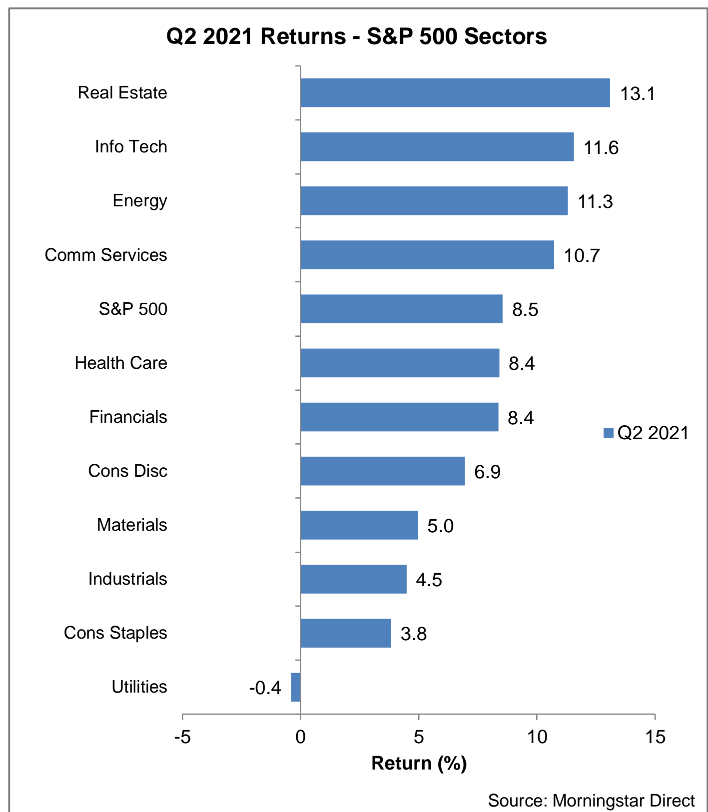
banks that filters through to the rest of the market), its control of longer dated bonds is less clear cut. Yields on bonds such as the 10-year Treasury are a greater reflection of what the market thinks will happen to the economy and inflation several years into the future. Today, therefore, bonds markets are telling us that they are concerned the Fed will hike short term rates too fast and that it will snuff out the fragile recovery we are currently witnessing.

In our opinion, the market's concern is overblown. Both short term and long-term rates are effectively at all-time lows. A healthy economy can absorb modestly higher rates, and it is all but clear that the Fed will continue its historically accommodative stance years into the future. If not for the distorting effects of the Federal Reserve – and increasingly petulant financial markets – we are certain that rates would be materially higher than they are today.

Market Recap…

As noted above, the second quarter provided a return to pre-covid trends: US outperformed International, Growth outperformed Value, and Large Cap stocks outperformed Small Caps.

At a sector level, growth-oriented technology and communication services (Facebook and Google comprise nearly half of this sector) stocks were among the best performing in the quarter. Both sectors posted double digit gains, outperforming the S&P 500. This was in stark contrast to traditional defensive sectors such as utilities and consumer staples, which now lag the broader market by more than 10% on the year after another tepid quarter.

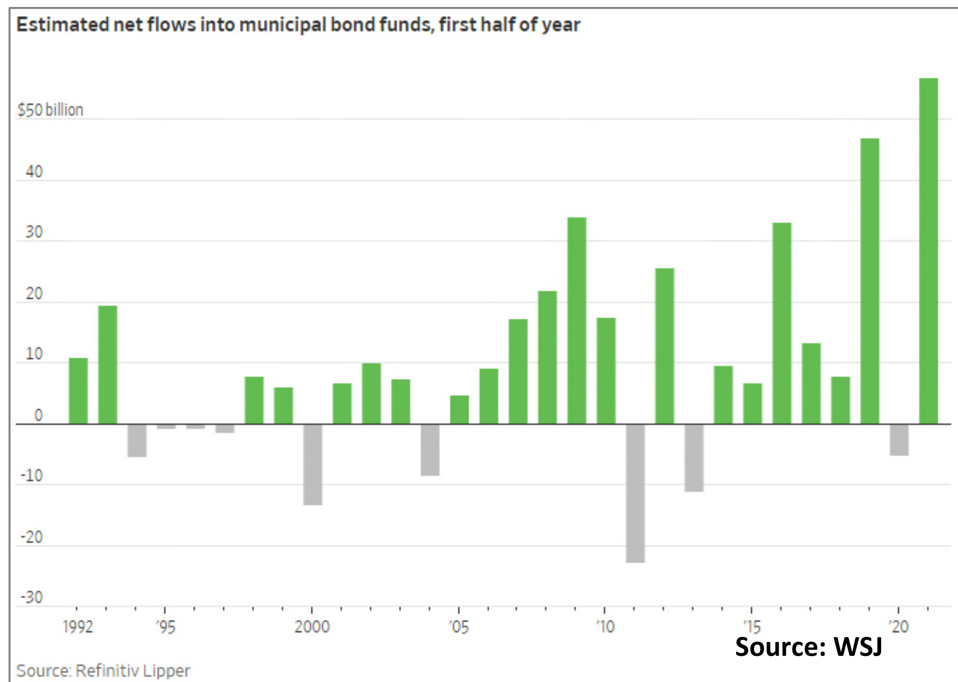


Non-US equities continued their lackluster start to the year, with developed international stocks and emerging markets underperforming the S&P 500 by more than 3% on the quarter and 6% for the year. The combination of a stronger than expected dollar, lower covid-19 vaccination rates, and China's unexpected crackdown on its multi-national companies have been a headwind to performance, despite more attractive valuations relative to the US. These markets have been a large disappointment, as many market pundits expected non-US stocks to deliver more robust performance this year amid a cyclical recovery.

Within the fixed income markets, the reversal in interest rates brought some relief to conventional bond holders. The Barclays Aggregate Bond Index, the general proxy used for broad bond market performance, gained 1.8% in the second quarter after losing more than 3% in Q1. The latter figure represented the worst start to a year for the bond market in 40 years.

Credit oriented sectors continued to perform well, with high yield bonds gaining 2.7% and bank loans rising 1.1%. Both of these market segments are significantly outperforming the investment grade bond market on a year-to-date basis, as credit spreads have tightened and corporate defaults have been extremely low. While yields on high yield bonds have reached all-time lows, their premium over Treasuries is still above record levels – suggesting there may still be some room for performance in this sector. Nevertheless, we have rotated away from much of the riskiest directional corporate credit in favor of securitized bonds and more flexible strategies that are less exposed to a risk-off environment.

Municipal bonds have fared well this year, outperforming their taxable investment grade peers by 2.0%. Despite long maturities and significant interest rate sensitivity, these bonds have seen record inflows from investors concerned about higher income tax rates. It's not so obvious to us that the expected outcome – an increase from 37% to 39.6% in the top marginal bracket – would make muni bonds that much more valuable, but these days we seem to live in a world driven more so by narratives than fundamentals. We continue to believe that 1% yields (even tax-free) with five to seven years of duration are highly unattractive. If interest rates move higher by a point, it would wipe out five or more years of yield from these bonds.

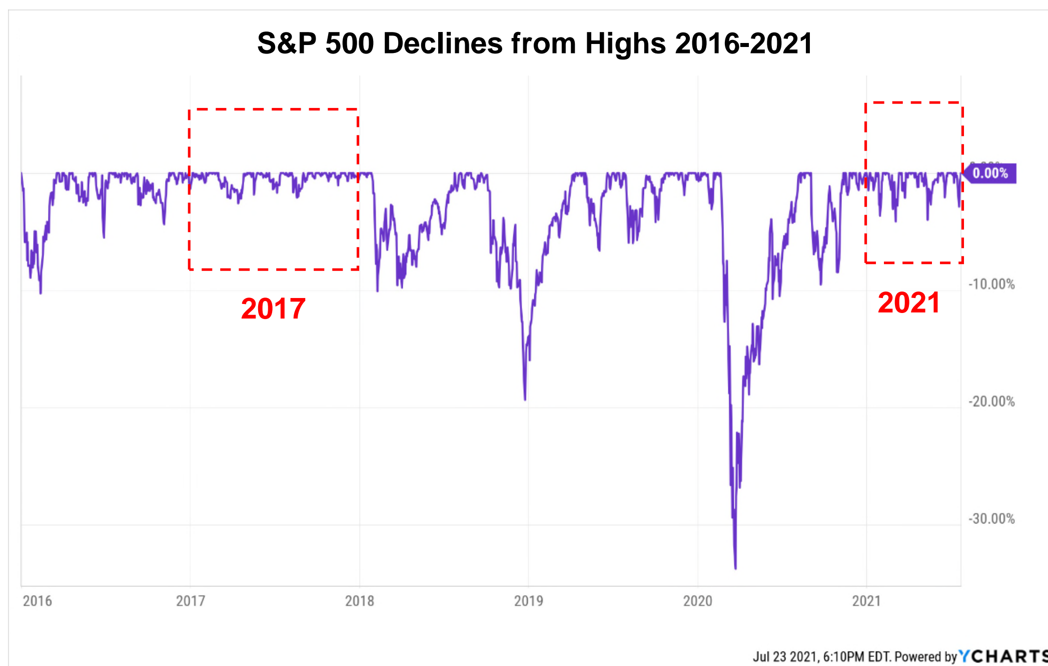


The hedge fund industry continued its rebound from the bizarre "meme-stock" declines from January (whereby retail owners of companies like GameStop and AMC drove up stock prices, hurting many professionals who were short the same names). Diversified hedge funds strategies rose 2.2% in the quarter. Meanwhile, their more directional peers, long/short equity strategies, gained 5.4%. That puts these two approaches up 4.0% and 12.7%, respectively, for the year. Volatility has been relatively limited this year, but emergence from the current liquidity fueled rally should provide a more conducive environment for these funds to make money for investors.

Finally, we have observed strong performance in 2021 from other non-traditional strategies including private equity, private credit, and private real estate. While second quarter performance will not be available for several weeks, many of the strategies we track have posted meaningful performance this year, particularly those that are still experiencing a recovery from pandemic-related mark downs. In the first quarter, private equity strategies rose 10.0%, private real estate rose 2.3%, and private credit strategies rose 3.2%. We continue to favor these areas for diversification against elevated stock and bond market valuations.

Outlook…

Our opinion of the market environment has not changed significantly since last quarter. While we are seeing some sector rotation within stocks, the broader reality remains the same: with a backdrop of robust monetary stimulus and fiscal spending, there remains an enormous technical bid for this market. Brief declines have been met with voracious buying from investors, such that the S&P has not declined more than 4% all year. This is an unusual lack of volatility that is emblematic of the market we live in today. Until there is a fundamental shift in government support of the economy and financial markets, it is difficult to see investors' mentality changing.



Interestingly, the lack of volatility this year echoes 2017, when volatility collapsed and markets marched higher amid strong Fed accommodation and expectations for a tax cut from a new Trump administration. Some may recall the market finished that year up over 20%.

This time around it appears that tax *hikes* are the likely outcome, yet that has not deterred markets. We can only speculate that investors believe an associated uptick in spending will accompany these tax increases, or that the fiscal drag will not be significant enough to offset the current strength in corporate earnings. What we do know, however, is that analyst earnings estimates rarely incorporate changes in corporate tax rates until said changes are actually signed into law. Thus, what are already high price-to-earnings multiples could look even more elevated should Congress move forward on currently proposed legislation.

Some may also note the looming similarity in Federal Reserve policy. The market rally in 2017 was ultimately derailed by the attempted withdrawal of Federal Reserve stimulus. In 2018 the bank started shrinking their massive balance sheet (reducing market liquidity) and increased short term rates to 2.25% by year-end. Stock markets were choppy throughout the year before falling nearly 20% in the fourth quarter. It was not until Fed Chairman Jerome Powell acquiesced to the market's desires – signaling a shift back towards accommodation in a January 2019 speech – that markets reversed course.

In the shorter term, the Fed will surely do everything in its power to avoid a repeat of this episode. Chairman Powell has repeatedly emphasized accommodation will remain in place until 2023. However, high inflation numbers have brought that commitment into question. One of the Fed's two primary mandates is to control inflation; if price increases continue at the current pace, they will have no choice but to restrict monetary policy.

Inflation, therefore, will be one of the most important data points to watch as we move later into the year. Recent inflation prints have been the highest of the past decade, but the figures are highly distorted by transitory factors like used automobiles and something called "base effects" – the simple math of comparing today's prices to year-ago levels that were depressed during the heart of the pandemic. We should have a much better sense of inflation in late 2021 or early 2022 as we move away from these temporary issues.

Final Thoughts…

As long-term investors, of course, focusing more on durable portfolio construction – rather than market timing – is paramount. We therefore continue to advocate the following:

- Avoiding low coupon, interest rate sensitive bonds which appear to have much more downside than upside potential in this environment
- Adding exposures to help mitigate risk during a potentially inflationary environment – namely, real estate and floating rate investments
- Reducing equity market volatility risk through the use of alternative investments, where appropriate
- Taking advantage of the premiums afforded by private markets, where appropriate

As always, if anything has changed in your financial life, or you feel that your tolerance for risk has changed, please call or email us at your earliest convenience.

Sincerely,

Your Investment Team

7/23/2021

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