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INVESTMENT MANAGEMENT, INC

Disciplined Value Investing

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Q2 2021 Commentary: Carry on, but keep an eye on inflation…

Carry on Mr. Market, carry on. What we got in the second quarter, was more of what we got in the first quarter. The S&P 500 advanced 8.5% in the three months ending June 30th, which built on the 6.2% gain in the first quarter. Put together, the 15% gain in the first half of the year was among the best in decades. Not only has the stock market performed well, but it has done so with little volatility. We have not yet had even a five percent correction this year. Fueling the rise, in part, was a benign interest rate environment. There was much wringing of hands earlier in the year when long term interest rates moved higher. However, the 10-year US treasury yield fell in the second quarter to 1.48% from 1.68%. Long-term rates have fallen further in July. Due to falling rates, the aggregate bond index gained 1.83%, helping it recover from first quarter losses.

The hot topic of the moment is inflation and whether its recent surge is transitory as Fed chairman Jay Powell maintains. There is a lot of debate, back and forth. We are inclined to believe current inflation will subside as the economy continues to normalize. The components of the price index whose prices have spiked higher are chiefly pandemic specific and caused by unexpected demand from the strong economy. As supply catches up with demand, prices should settle back to earlier levels. We are already seeing the type of adjustment we can expect in the price of lumber which is now down 65% from its high price on May 10 and back to last November's level.

That stock prices are driven by what happens to earnings is a foundational belief. We need look no further than the earnings picture to understand what is going on in the stock market. In January, earnings for the S&P 500 companies in 2021 were expected to rebound to pre-pandemic levels in the $165 neighborhood. Six months later, those expectations have ballooned to $193 according to FactSet Research. Second quarter earnings reports are trickling in this month and in aggregate are blowing away the estimates despite higher expectations. All indications are the growth trend will continue in the third quarter which is broadly supportive of stock prices.

Of course, regarding stock market levels, the second part of the equation is how much are investors willing to pay for earnings. Currently, the market appears comfortable at a price to earnings ratio at the historically high level in the low twenties. This P/E level may well be as high as can be expected. It appears that investors are unwilling to pay much higher multiples for stocks. The evidence is in the response, to date, of second quarter earnings reports. Despite companies posting numbers at a rate well above estimates, the stock market response has been disappointing and reporting companies have struggled to move higher indicating valuations are reaching their limit.

The good news is that the low interest rate environment will not change any time soon. Fed chairman Powell has emphasized in congressional testimony that Fed rate policy will not change until the labor market recovers. The unemployment rate is currently 5.8% and there is plenty of room for that rate to improve. The Fed will hold steady until the unemployment rate falls significantly from here. That time is well into the future. An accommodative Fed and a strong economy means there is still room for the stock market to move higher.

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