May 17, 2021

Weekly Viewpoint

Are Inflation Expections Too Inflated?

Performance for Week Ending 5.14.2021

The Dow Jones Industrial Average (Dow) finished down 1.24%, the Wilshire 5000 Total Market Index℠ (Wilshire 5000℠) fell 1.52%, the Standard & Poor's 500 Index (S&P 500) dipped 1.39 and the Nasdaq Composite Index (NASDAQ) lost 2.34%. Sector breadth was negative with 8 of the 11 S&P sector groups closing lower. The Consumer Discretionary sector (-3.69%) led the way lower followed by Technology (-2.23%) and Communication Services (-1.95%).

Index*	Closing Price 5/14/2021	Percentage Change for Week Ending 5/14/2021	Year-to-Date Percentage Change Through 5/14/2021
Dow	34382.13	-1.14%	+12.34%
Wilshire 5000	43415.80	-1.52%	+10.03%
S&P 500	4173.85	-1.39%	+11.12%
Nasdaq	13429.98	-2.34%	+4.20%

Market Observations: 5/11/21–5/14/21

The major market indices finished the week lower, in very choppy trading activity, as solid gains in the latter half of the week were outweighed by broad losses during the early part of the week. Triggering the volatility was an uptick in pricing pressure that, in turn, prompted fears that the Federal Reserve will have to tighten monetary policy to cool prices. Since the bottom reached in March of last year, easy monetary policy—the combination of very low interest rates and balance sheet expansion through bond buying activity—has been a key driver of demand for stocks. While the Fed has argued that the rise in inflation will prove transitory, investors appeared to head for the exit in the event they are wrong. If that proves to be the case, and inflation is longer lasting, the Fed would have to remove the proverbial punchbowl, which could lead to a temporary lull in the bull market.

The good news is that many of the factors applying upward pressure on prices, like supply bottlenecks, are likely to prove temporary. In addition, the so-called 'base effect" that is currently exaggerating prices following the year ago plunge, could result in a high base effect, that leads to downward pricing pressure during the quarters ahead. Fed officials continue to shrug off the uptick in prices with Fed Governor Christopher Waller saying the uptick in prices appears "temporary." The comments from Waller, one of three Fed governors to speak last week, echoed those by Lael Brainard and Vice Chair Richard Clarida. Officials are trying to drive home the message that inflation spikes are transitory to counter criticism their ultra-easy monetary policy is making matters worse. Waller added that policymakers will need to see several more months of economic data -- including the May and June labor-market figures --before being able to fully judge the strength of the recovery. The comments suggest it would be premature to discuss scaling back the Fed's massive bond-purchase program at its June 15-16 meeting, as the June employment report won't be released until July 2.

While inflation has been much higher than expected, so has earnings and economic growth, which continues to provide a favorable backdrop for the equity markets. Adding to the positive tone late in the week was the CDC's new guidelines on masks and social distancing. In what could equate to be the most significant decision of the pandemic yet, the U.S. Centers For Disease Control and Prevention said that fully-vaccinated Americans no longer need to wear masks in public spaces, citing data that indicates little chance of infection from new variants and little or no chance of passing on the virus.

A Mixed Bag of Economic Data: While both the Consumer Price Index (CPI) and Producer Price Index (PPI) came in at much higher than forecast levels, the overall trend for data reports suggests the economic recovery remain solid. Last week, the Labor Department reported that initial jobless claims in the week ended May 8 fell 34K to 473K, the lowest level since the start of the pandemic and a sign the labor markets continue to heal. April retail sales were flat during the month but followed an upwardly revised 10.7% surge during March due to the American Rescue Plan. On a three-month average basis, which helps smooth the month to month volatility, retail sales were up 2.6%, still showing considerable strength. On a year-over-year basis, retail sales surged by nearly 29%. While this partly reflects the base effect from the collapse in sales during the lockdown last spring, it also shows strong consumer demand, which remains the underpinning of the current recovery.

Solid Q1 Earnings Season: First quarter earnings season continued to wind down with overall results significantly better than expectations. Through Friday, 457 members of the S&P 500 have released results with nearly 87 percent surprising to the upside. Aggregate earnings growth is up by just over 47%, more than double the 22% gain that analysts were forecasting at the end of March. Sector wise, the biggest gains in aggregate earnings growth has come from Consumer Discretionary, Financials, Materials, and Communication Services. Looking ahead, growth in the second quarter is forecast to be even stronger than the first quarter with the Bloomberg consensus currently estimating growth of 57.9%. While strong growth is always welcome, the bar seems to be set very high, which leaves plenty of room for negative surprises – stay tuned.

Bullish Narrative Intact: We maintain a constructive view on risk assets and believe the macro environment provides a sturdy backbone for additional gains over the course of the year. The economic recovery has solid momentum and is likely to pick up steam as we approach the Spring and Summer months. Importantly earnings expectations continue to trend higher and based on consensus expectations from Bloomberg, earnings are forecast to grow by 31 percent this year followed by over 13 percent in 2022. Monetary policy will remain accommodative for the foreseeable future with Fed officials pledging at the conclusion of the April Federal Open Market Committee (FOMC) to keep interest rates at record lows for at least the next two years. While a near-term period of consolidation cannot be ruled out, we would view pullbacks as corrective and not the start of a broader move lower. Hence, periods of weakness would be viewed as a buying opportunity as the return profile over the next 12-plus months favors additional upside.

The Week Ahead: Highlights of this week's data calendar include; the May Empire Manufacturing Index, April Housing Starts and Building Permits, the Philly Fed Index for April, the April Leading Economic Indicators report, the Markit Manufacturing Index for May, and April Existing Home Sales. On Wednesday the Federal Reserve will release the minutes from the April meeting. The Fed speaking calendar will be relatively light with just 5 Fed officials scheduled to present. Earnings season will continue to wind down, with more than 90% of the companies in the S&P 500 having now reported. There are still a few companies left however next week, including 20 from the S&P 500.

Definitions

The Dow Jones Industrial Average is a price-weighted average of 30 blue-chip stocks that are generally defined as the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

Wilshire 5000 Total Market IndexSM represents the broadest index for the U.S. equity market, measuring the performance of all U.S. equity securities with readily available price data. The index is comprised of virtually every stock that: the firm's headquarters are based in the U.S.; the stock is actively traded on a U.S. exchange; the stock has widely available pricing information (this disqualifies bulletin board or over-the-counter stocks). The index is market cap weighted, meaning that the firms with the highest market value account for a larger portion of the index.

Standard and Poor's 500 Index is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Nasdaq Composite Index is a broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market. The index was developed with a base level of 100 as of February 5, 1971.

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