Argent Wealth Management, LLC

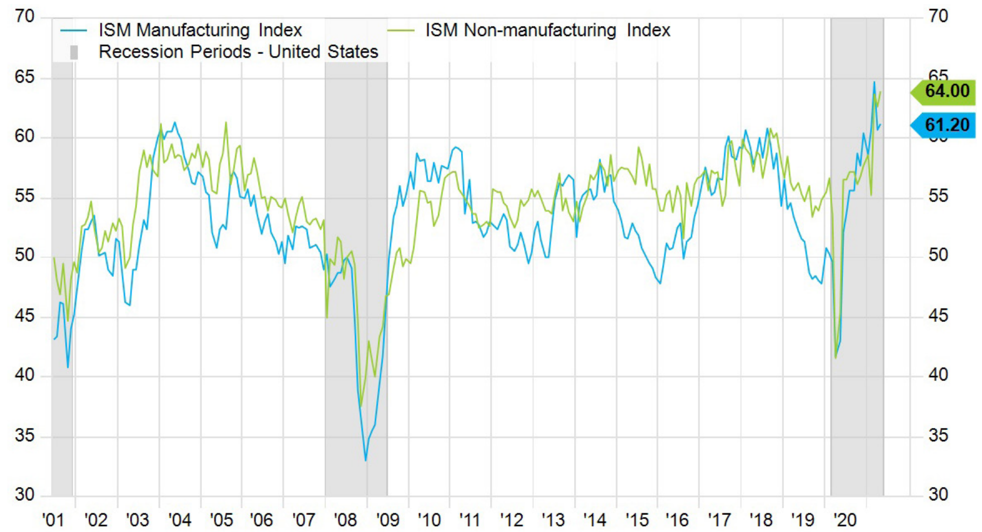
Investment Outlook
Summer 2021

Reasons for Optimism, but All Bull Markets Eventually End

Second Quarter 2021 Review and Third Quarter 2021 Outlook

Investors have good reasons to be optimistic. The economy has recovered at a pace faster than experts predicted. For example, on May 31 the U.S manufacturing and services (non-manufacturing) PMI, a reliable forward economic indicator that surveys purchasing managers' plans, are both at 20-year highs. According to the OpenTable Seated Diners index, more people are sitting down for a restaurant meal in the U.S. than the average of January and February 2020 before the COVID-19 pandemic caused many states to enact stay at home orders. The lodging occupancy rate is up 9.7 percentage points more than in January and February 2020 according to Ned Davis Research. People are dining out and traveling again, sooner than most predicted at the beginning of the year.

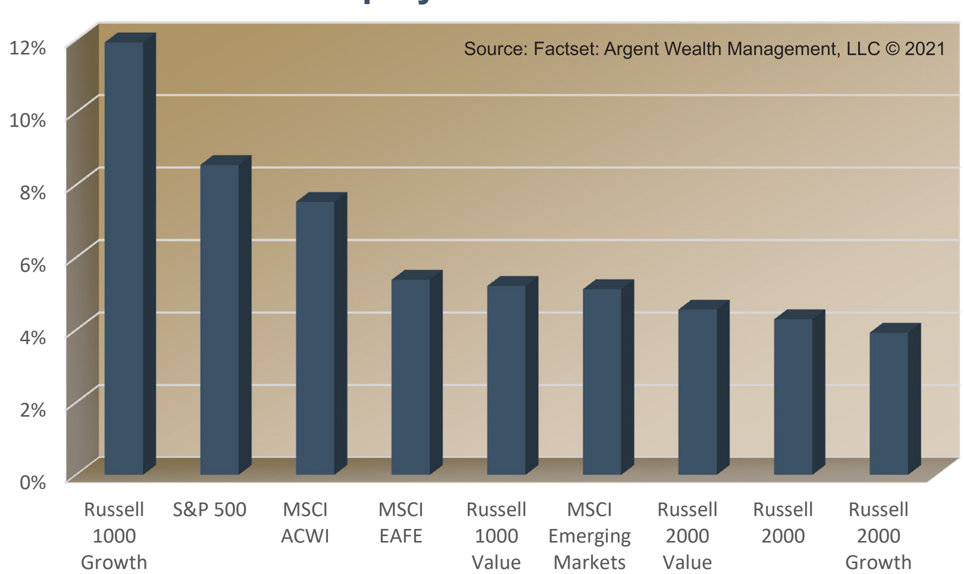
US ISM Report on Business



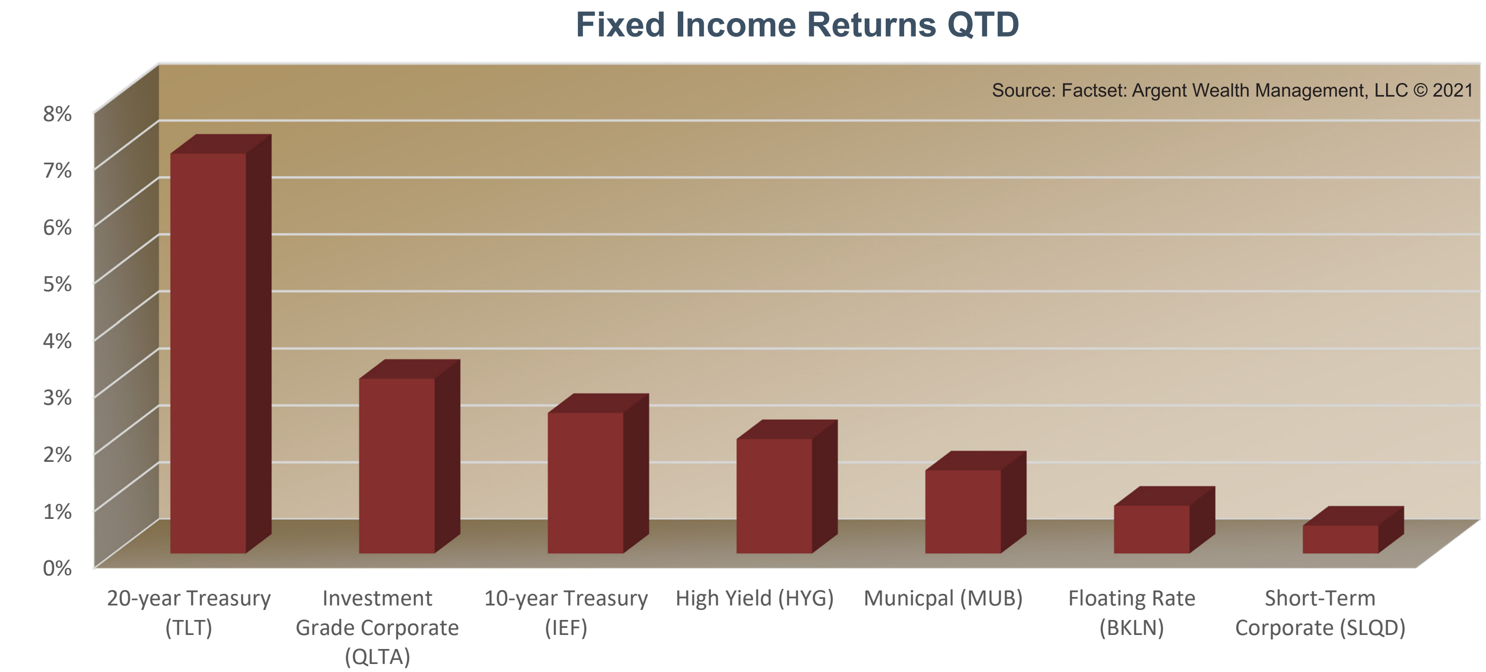
Source: Factset: Argent Wealth Management, LLC © 2021

On the back of this news, equity markets have continued to make gains. Growth stocks outperformed value stocks in the second quarter. The one-year trailing returns of the iShares Russell 1000 Value Index is now 43.5%. The one-year trailing return of the iShares Russell 1000 Growth Index is now 42.5. Large cap U.S. stocks outperformed international stocks in the second quarter and have now outperformed them over the last year. The SPDR S&P 500 Index (representing large cap stocks) returned 40.90% over the last year compared to 32.63% for the iShares MSCI EAFE Index ETF (representing international stocks). The iShares MSCI Emerging Markets Index ETF returned 39.95%. The S&P 500 also outperformed small cap stocks in the second quarter. However, the iShares Russell 2000 index ETF returned 61.87% in the last year, outpacing large cap and international stocks. It is important to stay diversified.

Equity Returns QTD

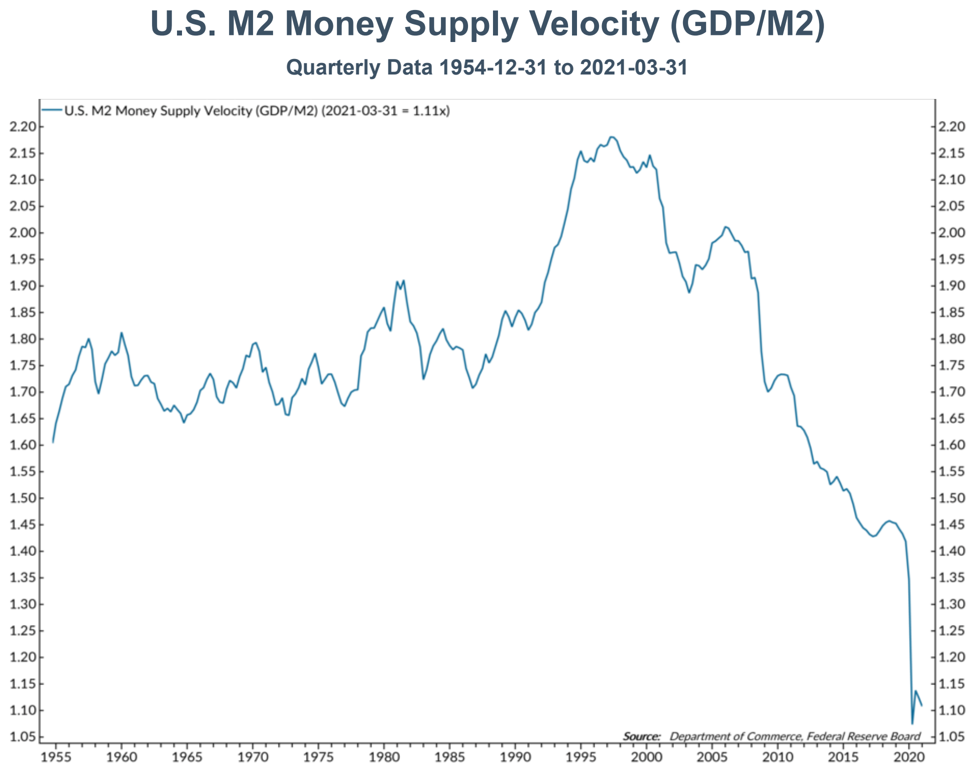


Bonds indices were mostly positive in the second quarter as yields came down after spiking earlier in the year. When yields come down bond prices go up, and vice versa. This reflects investors' expectations that the year-over-year Consumer Price Index (CPI) inflation readings of 5% we saw in May are likely to prove temporary.

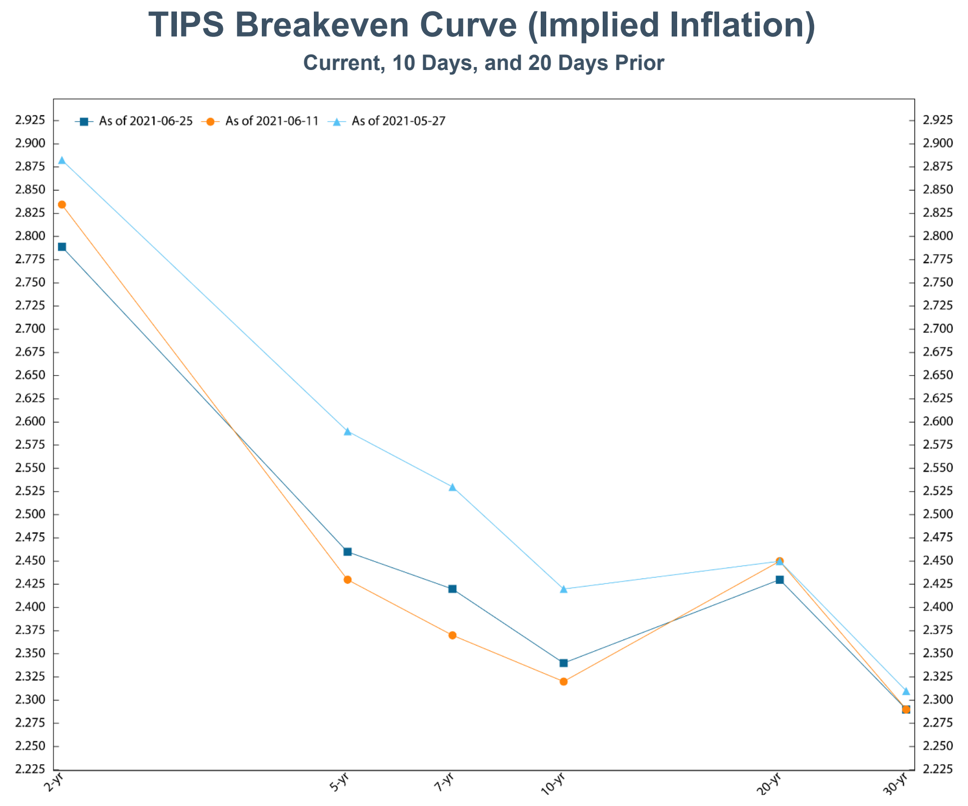


The Inflation Debate

On a year over-year-basis through May 31, CPI (Consumer Price Index) increased 5%, the most since August 2008. If 2020 were an ordinary year, this would be an extraordinary reading. However, a year ago there were stay at home orders, many schools were remote, camps were not operating, and most restaurants had limited occupancy if not completely closed. Only a fraction of people who were traveling pre-pandemic by plane were booking flights. Ned Davis Research estimates that 1% of headline CPI inflation was due to these base effects. In addition, CPI for used vehicles surged 29.7% year-over-year as temporary factors like semiconductor chip shortages and a faster than expected pickup in economic growth caused significantly more demand than supply for new vehicles. Suppliers in general were caught off guard causing a temporary imbalance of demand versus supply in transportation services, which was up 11.2% year-over year, and in gasoline, which was up 56.2% year-over-year. Food, however, was only up 2.2% year-over-year, and shelter was only up 2.2% year over year. The question becomes, will spikes in areas like energy, transportation, and cars continue over the next year as much as they did over the past year causing persistent inflation readings? This is highly unlikely as suppliers will have time to catch up and more accurately forecast demand as the economy normalizes.



The inflation narrative above does not, however, account for the record amount of stimulus that has been injected into the economy. The Federal Reserve remains high accommodative. We estimate that the U.S. Government has injected the equivalent of about 25% of GDP (Gross Domestic Product) of stimulus into the economy since April 2020 (more on this in the final section). This could cause demand-pull inflation (as opposed to supply-push inflation that is causing the temporarily high inflation readings as noted above). Many cite this as a reason to be more concerned about inflation long-term. However, since 2008 the Fed has been highly accommodative with short-term interest rates near zero, yet the economy was consistently below the Fed's goal of under 2% annualized core inflation. There is not a direct link between the amount of money printed and inflation, as many believe.



Many factors play into inflation. Technology, for example, is often cited as a reason we have not seen strong wage gains over the past ten years. Technology makes companies more efficient and less reliant on human capital to complete tasks. This puts downward pressure on wages. There is another factor that is less frequently cited that relates to inflation: The Federal Reserve has been highly accommodative, but that does not necessarily mean that the dollars it is printing are circulating in the real economy.

The chart to the left shows M2 money supply velocity. This is the frequency at which one unit of currency is used to purchase domestically produced goods and services. It is measured by taking GDP and dividing by M2 (M2 is a measure of money supply that includes cash, checking deposits, and easily convertible near money). According to the quantity theory of money, inflation = (M2 x Velocity)/Real GDP. To get inflation, velocity must increase. Currently, velocity is near an all-time low since measurement began. There are other newer theories as well. Modern Monetary Theory (MMT) would state that the more we import from overseas the more money we must print just to keep the amount of actual money supply the same domestically. For example, if we import $100 of goods from China, that money sits on China's balance sheet stagnant and is not being used to purchase domestically produced goods. This might help explain why we have seen persistently low inflation over the past 12 years despite a highly accommodative Fed. MMT would state that this is one reason fiscal policy makers must get more involved with stimulus and tax policies to control inflation.

At Argent we are watching velocity indicators and bond market indicators to give us a sense of when we should expect more persistent inflation. Bond yields will start to rise, and the TIPs breakeven curve, a measure of investors' expectations of inflation, will start to increase well ahead of CPI data (which is backward looking).

Equities in Bull Market. How will it End? Watch Inflation!

Near Term Expectations

Putting aside the acute and unexpected pandemic of 2020, we have been in a long-term or "secular" bull market since March of 2009.

Near-term risks include COVID-19 variants and potential tax law changes. The biggest risk is always the one no one sees coming so it is important to stay diversified. In addition, investors are unsure what new fiscal policies will be enacted. Recently a stimulus bill in the $1 trillion dollar range garnered support by both democrats and republicans, but it will take more negotiation for it to pass. With the Fourth of July and August recesses, we may not get clarity on this until the fall. The other wild card is what democrats, who have a majority in the house and a narrow majority in the senate, might do with reconciliation, a process they can use one more time this year to extend law provisions that would otherwise sunset. The uncertainty around potential new tax laws and stimulus, will likely lead to volatility in the coming months. We do not expect this to derail the bull market as earnings are predicted to be 50% higher in 2022 than they were over the past 12 months, according to FactSet. We believe that a correction in the 5-10% range quickly makes equities more attractive on a valuation basis.

SPDR S&P 500 ETF Trust (SPY-USA)

Source: Factset: Argent Wealth Management, LLC © 2021

Long-term Expectations

Over the past five years the S&P 500 has returned ~18% per year annually. This is ~8 percentage points over the long-term average. Over the next 3-5 years investors should expect equity returns to revert towards 8-12% annually.

Despite reasons for optimism, investors should be aware that eventually all secular bull markets end. They tend to last about 20 years. Secular bear markets tend to last about 10 years. We are about 12 years into this secular bull market. How does it end? This secular bull market has been supported by accommodative monetary policy that has been fighting deflationary forces such as technology. Interest rates have remained low. This allows individuals and businesses to borrow at low rates to finance homes, cars, boats, or take loans to start or grow their businesses. The economy as we know it today is built on low interest rates. If rates remain low, investors can expect the long-term bull market to continue.

Over the past year the U.S. Government has enacted stimulus measures that, by our estimates, amount to ~25% of GDP. More stimulus is likely by year end in some form. The Federal Reserve is not expected to raise rates for at least the next one and half years. As discussed, it is likely the recent uptick in inflation is transitory, but all this stimulus could be planting the seeds for inflation to occur along with an economy that is growing faster than is sustainable. Until that point, which could be three to five years from now, equity returns are likely to be in line with historical averages if not better. Eventually the Fed will be forced to raise rates to combat inflation. This will change how today's economy functions. The economy will need to reset, and this will be an uncomfortable adjustment. It is likely that the secular bull market will come to an end and we will enter a bear market where equity returns are flat to slightly positive. In these environments it pays to be more tactical. Unlike bull markets, where a rising tide lifts all boats, there will be areas of the stock market that do well while others suffer. Argent and Argent clients will be positioned and prepared for this shift. For now, stay cautious in your fixed income exposure and be at least at target weights in your stock portfolio. Have some cash on the sideline to take advantage of near-term volatility.

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