



# 2021 Mid-Year Update

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## Unprecedented Stimulus, Economy Rebounds ... Inflation, Interest Rates, Taxes Coming Sharply Into Focus

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## The New Year Delivers a Dramatic Turnaround

The world is not just healing, it's undergoing a burgeoning reinvigoration that's quickly spreading. This time last year, America was in the midst of what seemed to be the beginning of what many thought would be a protracted economic downturn; a disastrous and abrupt end to a record-long

expansion. Last summer, much of our country was in the throes of a lockdown, and many wondered what the future of work, travel and economic prosperity would look like.

In our 2020 mid-year report, we did affirm that the sharp contraction would likely be transitory, and that headlines would probably bring continued, but perhaps overdone volatility as society adjusted to a “new normal,” which has since become one of the most overused cliches of 2020. But growing optimism, swift vaccination rollout and our want and need for a thriving spirit quickly turned one of our world’s darkest hours into a rebirth and reimagination of societal norms. In fact, this new normal might not be as bad as many thought, as our country is not only out of recession, but bubbling with what seems like durable economic growth and bonafide confidence. The question, of course, is its staying power, and how to deal with some of the unforeseen negative effects of the turnaround.

Westwood remains optimistic, in general, and sees continued strength in risk assets driven by several factors including monetary policy, momentum in key global economic sectors and continued government spending. We see continued strength in equities and continued moderation in inflationary pressures and unemployment.

## **Dealing With the Biggest Black Swan Since the Mortgage Crisis**

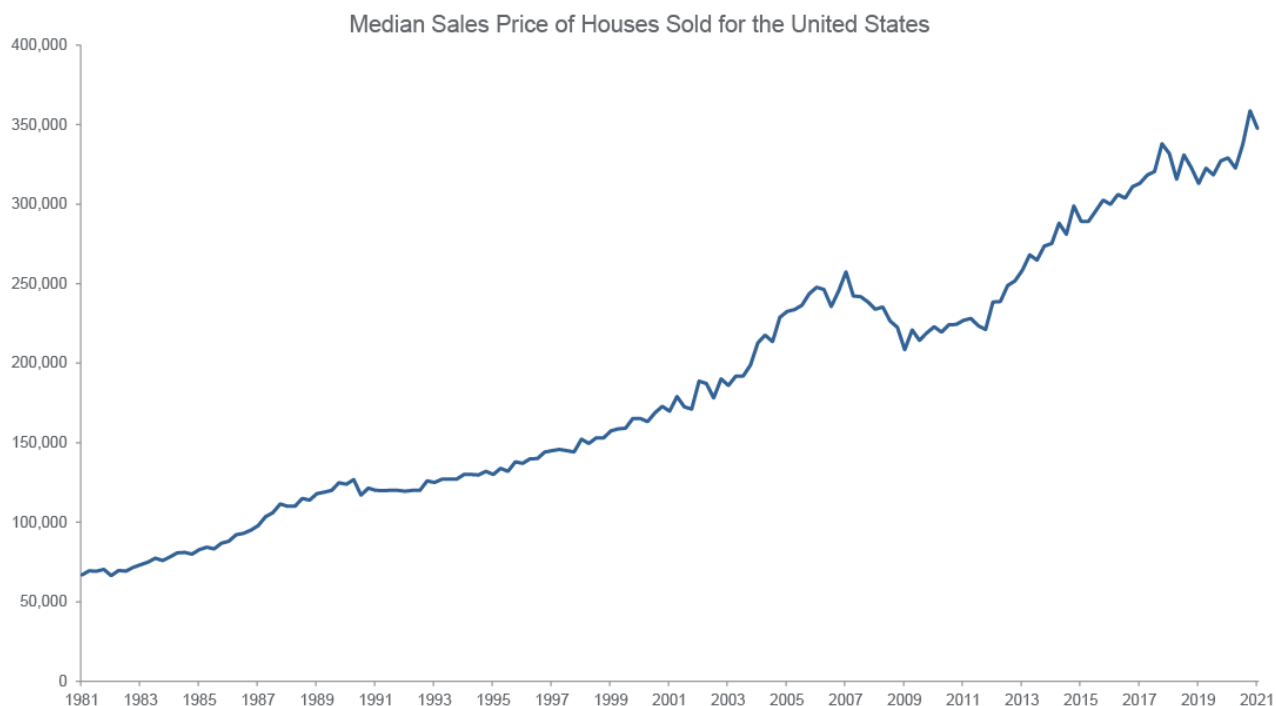
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When “outlier” events like the COVID-19 pandemic occur, it’s perfectly acceptable for the masses to anticipate as many dramatic, pessimistic possibilities as our minds (and models) are simply not accustomed to rationalizing something we haven’t experienced before (i.e., government shutdowns, protruded lockdown orders, mask requirements, mandatory remote work and school, and so on). History can certainly be a guide, but is a limited tool.

The past has shown that times of chaos are often followed by periods of lower volatility as civilization generally prefers calm and happiness over stress and unpredictability. Obviously, the outcome of this global incident was predicated on how deep and long the pandemic’s painful side effects would persist. Fortunately, swift (and sometimes frustrating) actions by governing bodies and the public at large minimized the effects of this crisis, and most global metrics for public health and economic trends point to sustained positive trajectories, with limited areas still grappling with the virus.

Unlike the financial stresses of the housing crisis, the dramatic and dynamic cultural, social and psychological effects of this deadly pandemic arguably had a deeper effect on a larger swath of people and surely made many rethink their hierarchy of values. Business owners in nearly every sector and size have also had to modify structures, some temporarily, others forever. At a minimum, the crisis has changed a portion of our social fabric forever. Investment strategies should account for these alterations and portfolio rebalance to account for opportunities and/or shortfalls in companies that fail to adapt.

Dramatic modifications in commerce and work patterns have put a heavy demand on technology and e-commerce solutions, which are likely to persist for some time. These trends should fuel digital media, online retail, delivery services, automation and other sectors for the remainder of 2021 and beyond. We've also seen an exodus from some of the most dense urban areas as Americans sought comfort and better places to work and live. These trends will impact certain commercial and residential real estate markets and could amount to budget deficits in some cities. Some rural areas and suburbs may also struggle with infrastructure and traffic, despite tax windfalls.



Source: Federal Reserve Bank of St. Louis, Census, HUD. As of January 2021.

On a positive note, the world witnessed one of the greatest efforts in medical research and development. In less than a year's time, three separate vaccines were given emergency approval domestically, followed by a subsequent distribution of historical proportions beginning in late 2020. As it stands today, more than 54% of Americans have received at least one dose of a COVID-19 vaccine, and the rates of infection and mortality continue to plummet in most areas. We believe there's a high probability that vaccine creation and distribution channels continue to improve, despite political differences.

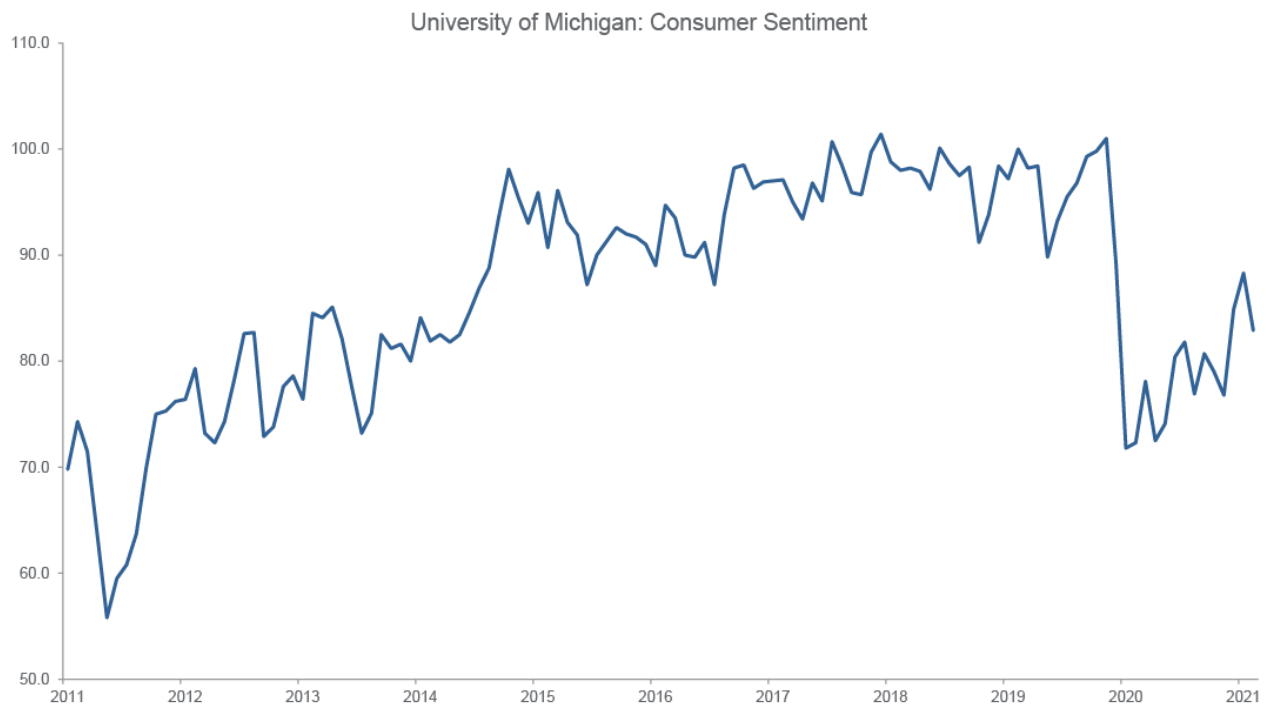
The new administration, which promised a more conservative approach to opening the country, seems to have taken the cue from the Centers for Disease Control and Prevention to allow life to return to normal. Many states had already begun to relax social distancing and masking requirements, but as of June 1, the vast majority of the country is getting back to business as usual.

## Consumers Confident, Ready to Spend More: Are Companies Able to Deliver?

As restrictions fall, individuals and businesses alike have already begun to show their post-lockdown spending prowess, along with their excitement to reconnect and resume a more normal life. Some things are certainly different. Many restaurants have streamlined their menus, shifted to all-digital menu systems (which also allow for quick changes), and utilized other means to deal with the deluge of traffic amid thinner staffs and higher wholesale prices for foods, disposable items and employees.

This cost-saving, smart approach to reopening is also being utilized in many other sectors. TSA travel data shows increasing traffic at checkpoints, but traveller counts are still down about 20% from 2019. Of course, much of this data is skewed as airlines don't have the staff or same amount of routes operating versus two years ago. A lack of available workers could create a sticking point for earnings growth as corporate America continues to scale. One solution may be to increase wages, but with other input costs rising, either margins shrink or goods become more expensive. The latter is likely to win the war in many cases.

The two most popular domestic consumer confidence metrics are both showing a sharp rebound, and both are indicating future optimism, with the University of Michigan CSI slightly less optimistic.



Source: Federal Reserve Bank of St. Louis, University of Michigan. As of May 2021.



The good news is that demand is likely to remain elevated and consumers should be able to digest minor price hikes. Americans have been not only socking away savings at a record pace, but also have been essentially “shut in” for a year. Many of us have been paying premiums for delivery services or have even lost touch with what “normal” costs used to be. In other words, most of us are just happy to get out, enjoy a good time with friends or loved ones, and socialize.

Real, disposable income is also rising, which helps to buffer increased costs. And the continued boom in the housing market has also created an immense amount of wealth and equity for homeowners, which is likely to be tapped, especially if interest rates continue to creep higher, which could, in turn spur more activity in the real estate market.



Source: Federal Reserve Bank of St. Louis, U.S. Bureau of Economic Analysis. As of May 2021.

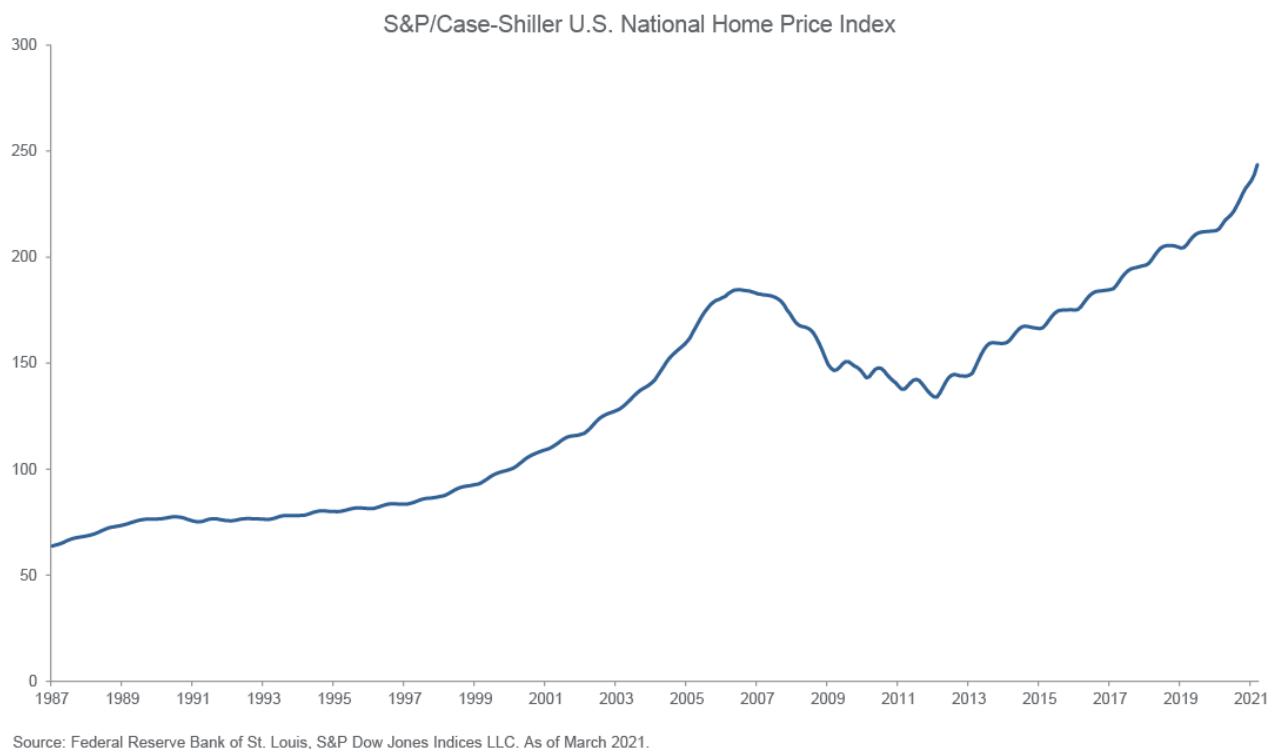


Source: Federal Reserve Bank of St. Louis, U.S. Bureau of Economic Analysis. As of May 2021.

Cash-infused consumers were forced to change their spending habits and put abnormal strains on certain sectors like tech, furnishing and home improvement items. So, what started as a pricing collapse in many commodities, services (labor) and finished items has quickly turned into a parabolic “re-flation” that has driven the costs of just about everything near all-time or multi-year highs. This jump in prices has acted as an added tax on consumers and comes congruent with a

sustained rise in average home values, which gained more in 2020 than in any year since 2005. While housing is expected to remain strong in 2021, our view is that most areas of hyper-inflation will be transitory, while some could see more sticky or structural price increases.

Another risk to corporate profits is the fact that the labor market is extremely tight (a factor that contrasts headline labor data). Companies big and small are facing labor shortages and are having to either pay up to get employees to work, or even shut down portions of their business, as we saw with American Airlines in late June as hundreds of flights had to be cancelled due to staff shortages. On the flipside, consumers' compensation may finally get a boost that has been lacking for years.



## Economic Performance by the Numbers

While the U.S. economy will likely be the dominant growth driver for the next few months, global economies should also see improving conditions. After recording its first economic contraction in 2020, the Chinese economy has already fully recovered, with gross domestic product (GDP) growth expected to return to a rate of 5% to 6% by the end of the year.

Domestically, GDP growth was only negative for the first and second quarters of 2020 at -5.0% and -31.4%, respectively. And while this technically counts as a recession, positive growth returned in Q3 and gained back all it had lost, and then some, by Q4 2020. Growth in first quarter 2021 clocked in at a strong annualized rate of 6.4%. We expect this momentum to continue and see real domestic GDP readings of +7.0% versus the current consensus for 6.5%.



Obviously, government intervention via direct consumer stimulus, business bailouts, unemployment forgivable loans and outright bond and exchange-traded fund (ETF) purchases have most certainly distorted what would have otherwise been a more protracted recession. That said, the Federal Reserve (Fed) is unlikely to take a dramatically hawkish turn and rush its forecast to begin raising rates in 2023. The near-term demand that has driven prices higher should subside as the excitement around America (and the world's) reopening dissipates. Growth rates have likely peaked, but that doesn't mean corporate earnings and economic growth cannot continue. We do see the Federal Funds Rate at near zero for the rest of 2021, but also see potential for a hike by late 2022. Core inflation should moderate by year end at or very close to the Fed's target of 2.0%.

With congressional control by the Democrats, large fiscal impulses are likely to continue, and should they come without tax increases, or with less severe tax implications, a major headwind currently contemplated by investors would be removed. Regardless, we believe 2021 will continue to be a constructive year for risk asset returns, particularly those more equity-oriented. However, we remain fully aware of the potential for further disruptions and continued uncertainty across asset classes and geographies.



Source: Federal Reserve Bank of St. Louis. As of June 2021.

## Equities

Major indexes already made their V-shaped recovery during summer 2020. Momentum has continued for the S&P 500 and NASDAQ, driving many stocks higher without much pause since bottoming last May. Sectors such as consumer discretionary, tech, autos and housing/construction all had tremendous showings in the first half of the year. But while indexes might continue to make

records, this is not a “tide that will lift all boats.” Big tech names may also be deceptively attractive, especially following blockbuster earnings from many of the top stocks in the space. First quarter earnings growth for the S&P 500 looks to be as much as 80% year over year. Backing that growth data is the fact that the vast majority of S&P 500 earnings (and revenue) results are handily beating analysts’ consensus expectations. And since market participants tend to set their market health barometers against these forecasts, price trends should continue higher. Smaller companies (and some larger names as well) are attracting the attention of small-scale, individual investors who tend to move in unison. We expect to see some increased volatility as “trading culture” gains even more traction. This theory is further supported by record stock option volume in the second quarter.

## Credit Markets/Fixed Income

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Global credit markets recovered from a massive selloff in the first half of 2020, and continue to improve slowly, but asset selection is likely to be much trickier moving forward. Default expectations soared last March with cumulative five-year implied defaults on U.S. high yield breaching above 50%. Those expectations have come down dramatically, and we believe they will continue to do so, as companies raise capital at a break-neck pace, while terming out maturities. Of course, not all sectors or firms will have that ability. We do see investors continuing to dip their toes (or more) into riskier corporate debt such as lower-quality single-B- and triple-C-rated bonds.

If you’re a believer in The International Monetary Fund’s call for dollar weakness against other reserve currencies like the Euro or Yen, we could see investors turning to “carry trades” where one borrows in a low-yielding currency and then invests in a higher-yielding, emerging market asset to capture the difference.

The bottom line is that the corporate bond market outlook is certainly positive, but with low yields everywhere, investors will have to get creative on strategy, all while balancing out risk. Higher coupon investments could offset price risks, but again should be approached with skill and tact.

Inflation risk is certainly real as consumers are hoarding relative war chests of savings and are itching to get their “groove” back. The 10-year Treasury yield has been creeping higher as the Fed is getting moderately more hawkish and bullish on growth. But, as much as we hear a modicum of inflationary caution, the economic dynamics that lay ahead of us are far from simple. Unless prices continue to skyrocket (which we don’t think most will), it would behoove the Fed to keep the “punch bowl” filled with a serving spoon in hand.

## Commodities

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Most soft and hard commodities continued their upward trajectories in the first half of the year. Eighty percent of this marketplace were trading above pre-pandemic levels by the end of the first quarter. Like other sectors, these usable and durable essentials encountered a perfect storm as much of the developed world recovered in unison, driving real growth. Speculators also jumped in as future growth prospects improved, in-turn triggering more buying (in some instances) by

companies who needed to lock in prices. This was evident in many of the metals, crude oil and meats. The swift jump in demand was also met with tempered supply and/or logistical challenges that added to price appreciation in many areas.

According to [The World Bank](#), “shocks” in metals and lumber created significant impacts for all, but especially developing and emerging nations. While many of these markets have already begun to correct, we see continued moderation in the prices of most commodities, with crude oil ending the year around \$64 a barrel.

Since most globally traded commodities are denominated in U.S. Dollars, they tend to have an inverse correlation to dollar movements. We do expect general dollar stability and even moderate strength into the back half of the year, which should help further moderate commodities prices (obviously predicated on Fed and other central banks’ actions). Prices should also see bearish pressure as production, shipping and demand balance out over the next three to eight months.

## **Broad Outlook**

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We have a positive outlook for economic and business conditions — the backdrop for markets. Equity markets have roared back as volatility has subsided while consumer confidence is turning the corner with increased vaccination rates.

Several trends that are providing tailwinds include a re-emerging consumer as quarantine is in the rearview mirror. Additionally, the services-space will benefit as reopening continues, bolstered by high savings rates and renewed spending. Global central banks have continued to keep policy rates low, providing extraordinary market support, which will likely remain, keeping the economy hot with inflation and low unemployment. Fiscal spending is driving strength as we reopen. Confidence continues to increase as the virus seems to be more in control domestically. Increased corporate earnings are offsetting concerns around increased taxes. Ever-present risk includes potential for supply-constraint impacts such as inflation and extended sales cycles. Uncertainty in new administration policy on taxes and regulation remains a watch point.

In other words, much of the worst should be behind us. The COVID-19 vaccine will continue to trigger a “release” of formerly quarantined populace from self-imprisonment to spend. Global central banks of developed nations are likely to keep policy rates low for extraordinary market support for an already strong economy with rising inflation prospects and falling unemployment. Fiscal spending, combined with businesses resuming more normal operations, are driving a strong reopening; expect these trends to continue into the back half of 2021. After confidence restarts (with virus control), pent-up demand will help earnings realization so long as companies can continue to meet consumer demand. Increased tax rates on corporations are a risk factor but should be offset by increased earnings and incremental government spending.

## **How We Are Augmenting Portfolios**

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- As a result of the market conditions and our expectation that equity markets are likely to reflect continuing growth in economic output, which should positively impact corporate earnings growth, we will maintain an overweight position to equity exposure.
- In addition, we expect intermediate maturity interest rates to rise given the accommodative Fed, fiscal stimulus and subsequent reopening economic activity. This should push up near-term inflation and growth; therefore, we will remain underweight fixed income and hold our exposure to the Alternative Income product as an income-like, market neutral exposure that should outperform fixed income in this environment.
- We acknowledge the potential for inflation to become a long-term concern and will continue discussing inflation metrics as a key watch item.
- Over the quarter, Emerging Markets (EM) has underperformed domestic equity markets, primarily given the impact of China, which represents nearly 40% of the EM index, underperforming from tightening financial conditions and regulations on large technology companies. Secondly, the worsened COVID-19 numbers in India have led to concern for lengthened closure there. The impacts of reopening, including increased import demand and rising prices of raw materials (particularly copper and oil), lead to outperformance in the near and medium term, therefore, we will maintain a 10% position to EM equities.
- Finally, we made a small rotation from a Growth-equity exposure to Value-equity exposure to reflect our view that Value will outperform the Growth factor at this point in the economic cycle. We will reduce our AllCap Growth exposure from 16% to 10% and increase our Value exposure by 6%.

## Outlook Positives

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- Vaccine Rollout Strong – America has vaccinated at a record rate and leads most with an unprecedented economic rebound. Most states and businesses have returned to relatively normal operations, save remote work and elevated precautions in some areas. Most developed nations are following suit.
- Inflation Should Cool, Dollar Stable – Record bouts of inflationary pressures have hit many sectors including commodities, foodstuffs, services and housing. Although a fair amount should dissipate, some experts see inflationary pressures remaining and will also watch the U.S. Dollar for a rebound after what was a flat first half for the greenback.
- Fed “Punch Bowl” to Stay Full – The Federal Reserve remains in a highly accommodative state. Rates are expected to remain near zero until 2023. The central bank has begun winding down several of its stimulative programs already.
- Short Recession, Growth to Continue – The official recession lasted only two quarters. The following two quarters of growth more than offset the drop in GDP. While momentum seems to be on our side, expect lower growth rates in the back half of the year. , versus consensus expectations of 6.5%
- Equity Earnings Momentum – Full-year earnings estimates for the S&P 500 continue to see an upward trajectory after exceptional first quarter results. Second quarter earnings are now expected to go up nearly 61% compared to Q2 2020 and full-year estimates now stand at \$183.68 on a “per index share” basis.

- Labor Market Tight, Consumer Confidence Rising – Headline unemployment numbers still remain relatively high, but gig-workers, under-the-table laborers and other groups may not be fully represented in government data. Extended and added unemployment funds have also allowed many workers to stay home. When benefits run out, expect businesses (many running on less than optimal staffing) to have a more diverse labor pool to pull from; this should help with longer-term growth and employment data.
  - The World is Open! – Travel restrictions have eased across much of North America, while Europe and Asia continue to relax flight and tourism constraints. Expect standout revenues from travel-related stocks, but realize that much of the anticipated rebound has already been baked into valuations.
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## What to Watch for in the Back Half of the Year

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- Accommodative Policy Shifts – As countries around the world reopen and look to normalize commerce, inflation and distorted post-pandemic economic trajectories, we could see shifts to less-supportive monetary and fiscal policies. Momentum is strong at the moment and should be able to accommodate a moderate pivot to this type of environment, but since not all areas/countries will recover at the same pace, we could see large discrepancies in growth trajectories as progress and goals vary. Large imbalances or crises abroad could create market disruptions and impact prices and/or domestic growth.
- Interest Rates and Inflation – The Federal Reserve and policymakers seem to be accepting of the current spike in prices. It seems that the surges noted are mainly due to supply chain constraints and limited capacity at a time when demand is abnormally high. We expect short term rates to remain relatively low (for the time being), along with a steepening of the yield curve (long-term rate assumptions rising). A sharp improvement in labor markets (combined with stubbornly high prices) could shorten the Fed's 2023 target for a rate-rise, but any announcement to that effect would be unlikely until later in the year. And if domestic inflation rises substantially, the fiscal spigot could be turned off (low probability).
- Equities Strong Now, but Future Strength Will Be Nuanced – Stocks around the world are enjoying near-record performance, but the bulls are not as resolved and widespread as demonstrated in mid-June after a subtle hint by the Fed that rates could go higher, sooner. In addition to consumer prices, investors will turn to looming tax hikes that could throw cold water on an all-around equity extravaganza. Opportunities will come in the form of more precise stock and sector selection that best capitalizes on this nuanced cyclical momentum with a keen eye on valuation and upside potential.
- Vaccine/Disease Progress – Vaccine rollout slowed by politics, logistics and/or safety concerns. A new strain presents itself and surges out of control. We see continued improvement in the global fight against COVID-19, but surprises, like what India experienced this year, are certainly a risk that shouldn't be ignored.

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