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Q2 Market Review and Outlook

Executive Summary

- The "everything" rally resumed in the second quarter. For the time being, market participants are looking through various risks, many of which appear to be on the rise.
- These risks include but are not limited to: (1) rising inflation, (2) tightening monetary policy, (3) unprecedented fiscal stimulus policies, (4) higher taxes and regulatory oversight, (5) expanding inequality and global social unrest, and (6) rising cyber-attacks impacting US-China tensions.
- We are not turning bearish but have concluded it is prudent to slowly begin preparing for a day when equity investors, who are known to be a manic group, think everything is wrong.

Cash

Cash continues to be abundant and earned nothing in Q2. At today's 0.05% 3-month T-bill rate, investors will need 1,387 years or until the year 3048 to double their money even before considering inflation and taxes. Yields on cash after inflation are the lowest on record since 1830 outside of our three major wars. This is in accordance with the Federal Reserve's plan to stoke the economy and bring the jobless back to work. Consumers and corporations are flush with cash and searching for yield. While we know that the real, post-inflation return on cash is negative, we continue to believe that cash serves a purpose in client portfolios and can be used opportunistically when market participants are more fearful. Given the risks noted throughout this piece and a growing "goldilocks" euphoria, we believe it is appropriate to begin to rebuild our defensive cash balances slowly back to above neutral.

Bonds and Inflation

One risk, inflation, jumped and exceeded expectations throughout the quarter but bonds generally rallied with the broad-based Barclays US Aggregate up 1.8% in Q2. For now, market participants seem to believe the Federal Reserve's assertion that high inflation will be transitory and easily quelled. Despite some of the highest inflation prints in decades, investors actually pushed the 10-year US Treasury yield down on the quarter from a high of 1.74% on March 31st to a low of 1.45% by quarter-end. The Federal Reserve itself continues to be one of the biggest "investors" in Treasuries and continues purchasing $80 billion each month, effectively soaking up all of America's net issuance of debt. The Federal Reserve has just now "started to start talking" about tapering down these purchases (in addition to $40 billion of mortgage-backed securities each month). Again, for now, market participants seem to believe the Federal Reserve will be able to taper their $120 billion of monthly purchases at a pace that will be "just right." We hope this is the case but we maintain an underweight position to taxable bonds. Today's 1.2% yield on 10-Year Treasuries is no compensation for historically average inflation of 2% let alone the recent 4+% prints seen in Q2.

We do remain relatively neutral, however, to investment grade municipal bonds and both US high-yield municipal and corporate debt. We continue to believe that owning relatively short-dated investment grade municipal bonds is more attractive than holding cash. While we are cognizant of the flood of money that has pushed high yield spreads and yields to record lows and bond covenants to record weakness, we also continue to believe that active, patient, and discerning managers can find money-good credits at attractive yields. We continue to eschew most emerging market debt and our reticence has only grown following the delta variant outbreaks coupled with social unrest across the emerging world.

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Public Stocks

The United States, despite some of our own issues, was relatively calm in Q2 in terms of social unrest and relatively immune to the delta variant so far. Thus, the US continued to be a desirable destination for capital and US stocks gained over 8% on the quarter. Investors focused on the following positives: a reopening economy, continued share repurchases, and record earnings growth. Q2 earnings, especially compared to this time last year, may show their best year over year growth on record. Plans to drastically increase taxes and social spending appear to have moderated for the time being but are likely to resume. Lower yields on bonds along with growing earnings made the relative earnings yield on stocks all that more attractive. We have maintained a near-neutral stance to US stocks for some time based on this relatively attractive earnings yield but believe the time has come again to move to a slightly underweight position to the space. We have not seen a 10% correction since the pandemic outbreak last March and such corrections should be expected in normal times. With US stocks at some of their most expensive absolute levels in history and investors largely optimistic, we plan to trim US stocks in the near-term.

International stocks joined the "everything" rally with a 5+% gain in Q2. This gain occurred despite risings risks in many ways. Europe struggled with its reopening as the delta variant gained hold. Japanese markets largely fell on the quarter and Japan's struggles to control the coronavirus will likely contribute to an Olympics without spectators and spectator-related consumption. Emerging markets turned in small positive returns in Q2 despite significant social unrest from Latin America to South Africa. US-Russian relations remained cold following continued cyber-attacks. Finally, and likely most importantly, US-China relations continued to ratchet up with President Biden recently warning US businesses about doing business in Hong Kong. While international stocks remain relatively cheap to their US peers on an absolute basis, we recently began paring back exposure given higher stock prices and rising risk factors.

Alternative Assets

Hedge funds as a complex also gained ground in Q2 with asset-weighted indices up 3% but there was wide dispersion with many funds struggling to navigate these unprecedented times. We continue to pare back our exposure to the space in general while focusing our investments on a select group of partners that truly warrant the fees and illiquidity. We continued to shrink our uncorrelated hedge fund and focus the philosophy on investing in strategies that seek to make money no matter what. As we finish constructing a portfolio of select managers we believe can accomplish this task, we are likely to add to the space for the first time in years. Even a small return, if it can be achieved in the face of these rising risks, will likely be attractive versus cash and bonds.

While we strategically favor private equity and its ability to add value despite relatively high fees and illiquidity, we have begun to tread with more caution here too. We intentionally slowed our commitments to new funds while we benefit from realizations into a strong IPO market. The rise and fall of SPACs like Lordstown Motors and the flood of investor capital into larger deals at higher prices warrant more caution rather than less. We are excited to be rolling out our next vintage of private equity funds this summer but will be highly selective and patient in putting this capital to work.

Real estate and real assets were the sole asset class we tactically added to on the quarter. Global listed real estate gained over 9% on the quarter and broad commodities were similarly strong. Investors facing low yields and concerns with supply shortages and rising inflation were keen to bid up the space. While we are not anticipating runaway inflation any time soon, we do think the risk of sustained higher inflation has grown and that real estate and real assets like gold are useful potential hedges and have added exposure.

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Conclusion

In conclusion, the "everything" rally resumed in Q2 as investors appear to think everything is "just right" with the world. The Federal Reserve continues to flood the world with cash and guarantee that this cash will lose money after inflation for the foreseeable future. This continues to push investors into riskier assets at lower and lower yields. The Federal Reserve's continued easing and reassurances that they can slowly reduce accommodation without major shocks has helped to instill investors with perhaps an overconfident sense that everything is just right. With numerous threats on the horizon, we think it is prudent to begin to be a bit more cautious and slowly build up our defensive positions.