Rising inflation and rate hike concerns may have made headlines several times in the first half of 2021, but investors pushed past the speculation and the equity markets posted record highs. At the midway point of the year the three major US indexes were up by double-digit percentages – the Nasdaq was up 12.5%, the Dow Jones Industrial Average added 12.7%, and the S&P 500 surged to 14.4% since Dec. 31, 2020.[1] Optimism for economic recovery was strong amid increased vaccinations, reopening of businesses, and consumer spending on the rise. The Federal Reserve also came out with an optimistic assessment of the economic recovery estimating growth to hit 7% this year, which would be the fastest calendar year expansion since 1984.

Enclosed our team shares insights on the developments over the second quarter and more broadly the first half of 2021 in the markets and economy. For additional in-depth analysis and to view recordings of our team on various local and national media outlets, visit our website RocklandTrust.com/Wealth&Investments.

Key Takeaways from Q2 2021:

- Inflation is present but the Fed expects an evening out – whether it is transitory or long-term is still to be determined
- Record highs across all major US indexes with Real Estate, Information Technology, and Energy sectors leading the way
- Better than expected jobs report reflecting a rapid economic recovery

US Economy

The US economy began to fully reopen during the 2nd quarter as nearly half of the US population is now fully vaccinated. Many economists are predicting that Q2 real GDP will rise above the levels they were expecting before the pandemic. The Conference Board, a leading provider of economic indicators, predicts that US Real GDP grew 9.0% annualized in Q2 2021 and, will grow 6.6% for the full year 2021. This follows a strong 6.4% annualized increase in Q1.

The Consumer Confidence Index, a survey that reflects consumer attitudes and buying intentions, further improved in June and now stands at the highest level since the onset of the pandemic's first surge in March of 2020. This is in spite of increased inflation expectations. The survey showed a healthy appetite for long-lasting manufactured goods, such as motor vehicles and appliances. In addition, consumers are showing a continued willingness to purchase homes which could push home prices even higher as demand continues to outpace supply. Consumers have also indicated strong desires to go on vacation over the next six months which should boost demand for in-person services.

Consumer spending, which accounts for two-thirds of economic output, may be underpinned by a strengthening labor market and an elevated personal savings rate that was derived from three rounds of fiscal stimulus checks disbursed over the past year. Furthermore, in July the government will launch a new wave of monthly child tax credit advances to families with children which should strengthen spending into the back half of this year.

Business investment is also helping to sustain the economic recovery as companies continue to pour money into productivity-enhancing digital technology such as computers, machinery, and software. The pandemic forced companies to minimize contact and interact with consumers in ways they hadn't planned for many years to come. Many past recessions had financial causes which forced businesses to take time to rebuild their balance sheets. However, this pandemic was different in that the government stepped in meaningfully and left businesses ready and willing to spend once they felt it was safe to do so.

[1] Washington Post, June 30, 2021

Lastly, government spending could continue to help boost economic growth if progress is made on an infrastructure bill. The current $1.2 trillion Bipartisan Infrastructure Framework could result in significant investments in our transportation, water, cybersecurity, and the national electric grid, over the next decade.

Despite this optimistic spending outlook for the back half of the year, investors will continue to weigh whether the recent acceleration in inflation will prove to be transitory in nature or whether it is the start of a long-term trend that could force the Federal Reserve to raise rates faster than anticipated. A sharp and unexpected rise in inflation and rates, increases the cost of doing business, which could lead to lower corporate profits and thus lower economic growth.

Traditional Asset Class Returns Q2 2021

Asset Class	Benchmark	Q2
US Stocks	S&P 500	8.55%
US Gov't Bonds	BbgBarc US Govt Intermediate	0.62%
Cash	BbgBarc US Treasury Bill 1-3 Mon	0.00%

US Stocks

The S&P 500 continues to climb to record highs. The index was up another 8.55% in Q2, bringing the year-to-date return to 15.25%. This quarter marked the fifth consecutive quarter of gains. These year-to-date gains are on top of a 31.49% return in 2019 and an 18.40% return in 2020. The S&P 500 has now compounded at an astonishing 18.67% and 17.65% per year over the past 3 and 5 years, respectively.

10 out of 11 sectors in the S&P 500 posted positive returns for the quarter. The Real Estate (+13.09%), Information Technology (+11.56%), and Energy (+11.30%) sectors were the top performers, while the Utilities (-0.41%) sector was the only sector with a negative return. The Information Technology sector saw little negative impact from the pandemic as demand for technology hardware and software increased as companies were forced to quickly adapt to work-from-home and rapid changing consumer behaviors. The Real Estate and Energy sectors have also benefitted greatly as a re-opening economy has increased demand for both real estate and oil/gas.

From a market capitalization standpoint, Large and Mid-Cap Stocks (Russell 1000 +8.54%) significantly outperformed Small Cap Stocks (Russell 2000 +4.29%).

From a style perspective, Growth stocks (Russell 3000 Growth +11.38%) regained interest and significantly outperformed Value stocks (Russell 3000 Value +5.16%). However, Value stocks are still outperforming Growth stocks by nearly 5% year-to-date as a re-opening economy has caused investors to flock towards sectors that are more sensitive to the pace of economic growth.

US Bonds

The first and second quarter of 2021 can be described as a tale of two quarters across the fixed income markets. In the first quarter, we saw a sharp rise in rates which many expected to continue. However, over the last 3 months we've seen US interest rates decline in the intermediate to long end of the curve. With investors considering whether the US economy has cooled off in terms of growth and recovery, the 10 year treasury declined .29% during the quarter to end at 1.45%.

One of the biggest headlines throughout the quarter was inflation with the May Consumer Price Index (CPI) ex-energy and food logging its biggest gain year-over-year since 1992. Inflation was also discussed at length during June's Federal Reserve (Fed) Meeting and post conference, raising the expected measure of inflation (CPI) to 3.4% in Q4 2021 versus a forecast in March of 2.4%. The Fed did strike a more hawkish tone stating it would address inflation if the expectations of higher prices affected consumer and business behavior. Chairmen Powell reiterated the Fed's belief that current inflationary pressures are transitory.

In the days following the June 16th meeting, we began to see the yield curve flatten indicating for now the Treasury market seems to concur with the Fed's belief that inflation will likely subside as soon as the supply of goods catches up with consumer demand. Increased demand for longer dated treasuries brought the yield gap between the 2 to 10 year and 2 to 30 issues to their tightest levels since February.

Corporate bond spreads tightened to a post-2008 financial crisis low during the quarter fueled by a strong economic backdrop and high demand. With declining rates and tightening corporate spreads, bond returns across the fixed income spectrum were positive for the quarter helping to offset some of the negative returns of the first quarter.

As we begin the second half of 2021, Inflation will continue to be a widely discussed topic and investors will look to see when the Fed will begin to unwind some of its accommodative policy such as asset purchases.

Diversifying Asset Classes

Equity diversification was a mix bag in the quarter. Mid Cap Growth stocks, Real Estate, and MLPs all outperformed the S&P 500 in the quarter, while Mid Cap Value stocks, Managed Futures, Precious Metals, and Dividend Stocks all underperformed.

Fixed-income diversification was beneficial in the quarter. High Yield, Floating Rate, TIPS, Convertible Bonds, and Emerging Market bonds all significantly outperformed the Bloomberg Barclays US Government/Credit Intermediate index, while Short-Term Bonds, International Bonds, Mortgage-Backed Securities and Catastrophe Bonds all underperformed.

Asset Class	Benchmark	Q2
Foreign Stocks	MSCI EAFE	5.17%
Emerging Markets Stocks	MSCI Emerging Markets	5.05%
US Mid Cap Stocks	Russell Mid-Cap	7.50%
US Small Cap Stocks	Russell 2000	4.29%
REITs	MSCI US REIT	12.00%
Commodities	Bloomberg Commodity	13.30%
MLPs	Alerian MLP	21.23%
Managed Futures	Credit Suisse Mgd Futures Liquid TR	7.80%
Foreign Bonds	FTSE WGBI Non-USD	0.45%
Emerging Market Bonds	JPM EMBI Global	3.93%
US Inflation Protected Bonds	BbgBarc US Treasury TIPS	3.25%
Floating Rate Loans	Credit Suisse Leveraged Loan	1.44%
US High Yield Bonds	BbgBarc US Corp High Yield	2.74%
Convertible Bonds	ICE BofAML Convertible Bonds	3.92%

Conclusion

As we move through the second half of the year, two major concerns – inflation and potential tightening policies of the Federal Reserve – will continue to be watched closely. Stocks are coming off highs in the first half of the year and are expected to continue to feed off the accelerated economic growth and strong earnings gains. The summer months may slow down, but as September nears and unemployment benefits run out, children go back to school, and some offices re-open we may see positive changes in the labor market and with supply shortages.

As always, our team is available to answer any questions and we remain committed to keeping you informed and ensuring your investments are appropriately positioned and well-diversified so you can meet your financial goals.

Sincerely,

David B. Smith, CFA
Chief Investment Officer
Investment Management Group