PDS Wealth Management

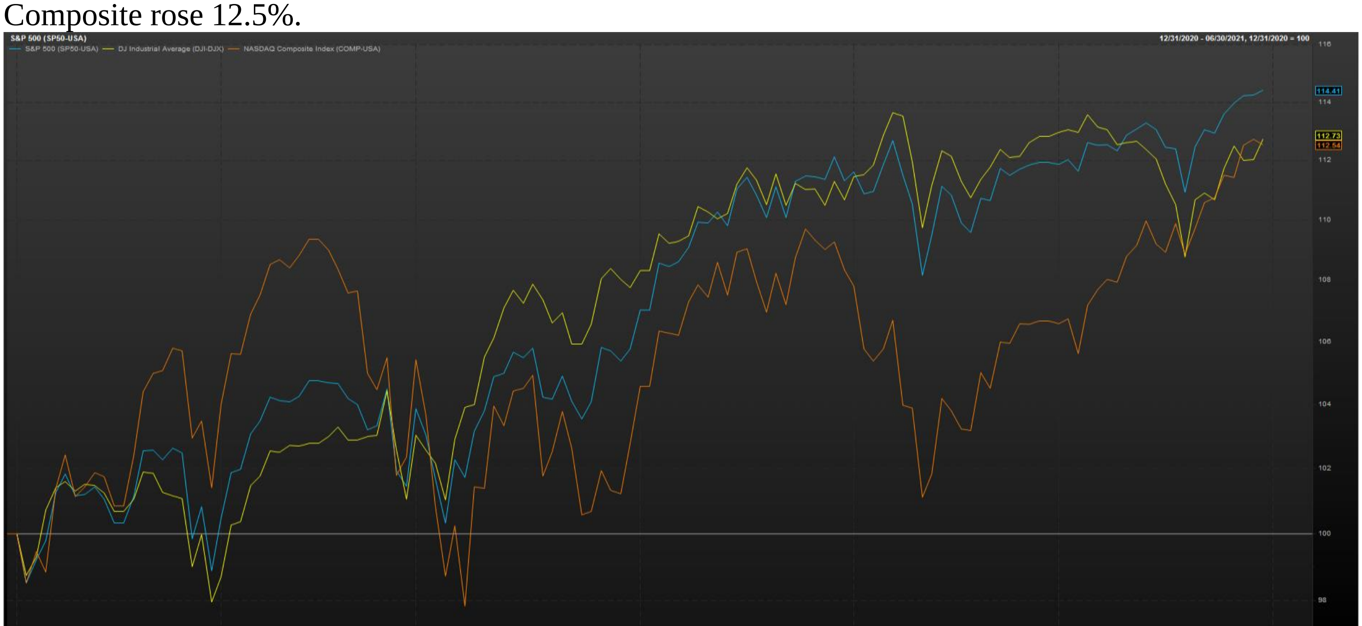
Quarterly Investment Report - Q2 2021

Welcome to the first edition of the PDS Wealth Management Investment Report. In the report, we highlight relevant data regarding the economy and markets that influences our portfolio management decision-making. As usual, we will refrain from predicting the future. Instead, we will focus on where things stand and from where we've come. At PDS Wealth, we are proud of our "durable, not predictive" approach to portfolio management which has served our clients well through market cycles. If any topic herein leads to any questions or concerns, don't hesitate to reach out to us to discuss. Thank you and enjoy!

Market Review

Stocks

Following the rollercoaster ride that markets experienced in 2020, 2021 has been easygoing by comparison. The S&P 500 finished the first half of 2021 up 14.5%, the Dow Jones Industrial Average gained 12.7%, and the Nasdaq Composite rose 12.5%.



Source: FactSet

For the S&P 500, 2021's largest year-to-date peak to trough decline stands at ~5%. Here's hoping that the smooth sailing continues. According to JP Morgan, since 1980, that compares with average intra-year drops of 14.3% and last year's dramatic 34% COVID-induced decline.

Despite the relatively calm ride investors have enjoyed thus far in 2021, there have been meaningful rotations and divergences between sectors and styles underneath the surface. Following years of underperformance, value stocks have staged a comeback versus growth stocks. The Vanguard Value Index is up 15.5% year-to-date compared with the Vanguard Growth Index's 13.2% gain. That may not look like much of a difference, but in 2020 growth outpaced value by over 35%!

The growth/value dynamic is reflected in sector performance. The energy and financial sectors have led the charge higher in the first half, up 42% and 24.5% respectively, while technology is "only" up 13.6%. Staples and utilities, often seen as safe-haven sectors, were the worst performing groups in 1H with respective returns of +3.7% and +0.85% year-to-date.

The small-cap Russell 2000 Index jumped 17.1% in the first half of 2021 and international markets also rose to varying degrees - the FTSE All-World ex-US Index gained 9.6%.

Bonds

The yield on the 10-year treasury note started the year at 0.93%, touched 1.78% on March 30th, and closed June out at 1.46%.

Source: FactSet

The US Aggregate Bond Index is down 1.6% on the year through June 30th. The S&P 500 Investment Grade Corporate Bond Index fell 1.4% in 1H and currently yields ~2% with a duration approaching 9 years. The S&P 500 High Yield Corporate Bond Index returned +2.6% in the first half of 2021. High yield spreads over Treasury notes are at their lowest levels since 2007 (see chart below), currently yielding ~3.4%.

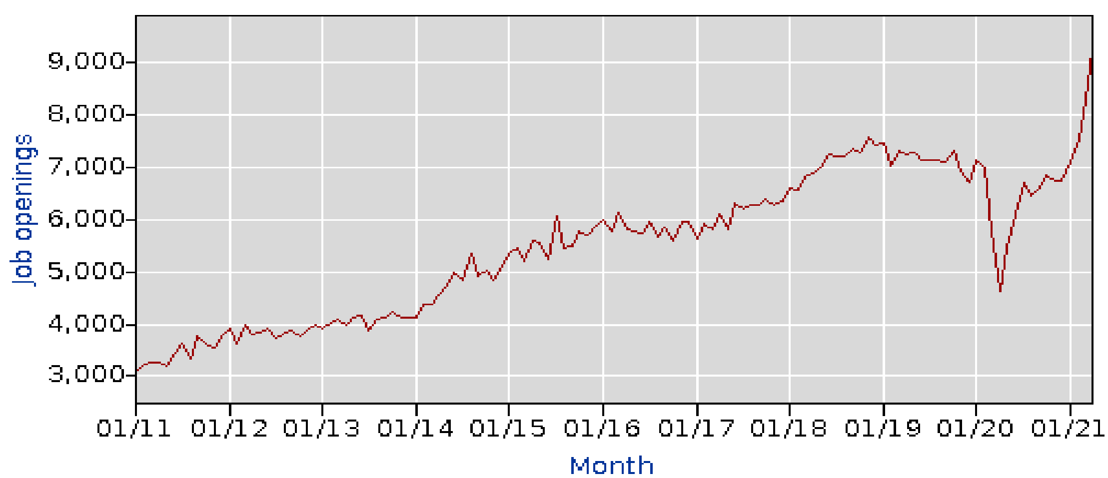
Source: Strategas Research Partners

Economic Review

US and global economies continue to rebound, albeit at varying rates, as the post-COVID world takes shape. Boosted by a flood of liquidity from the Federal Reserve and fiscal stimulus, Q1 2021 GDP in the US grew at an annualized rate of 6.4%. Q2 is forecast to grow 9.8%. Current forecasts for the full year are currently for 8-10% headline (pre-inflation) growth. The OECD forecasts global GDP growth of 5.8% for 2021.

Employment

June's employment report, released last week, showed continued strong job gains with nonfarm payrolls increasing by 850,000. Employers continue to report a shortage of available workers, as evidenced in the number of job openings shown in the JOLTS survey:

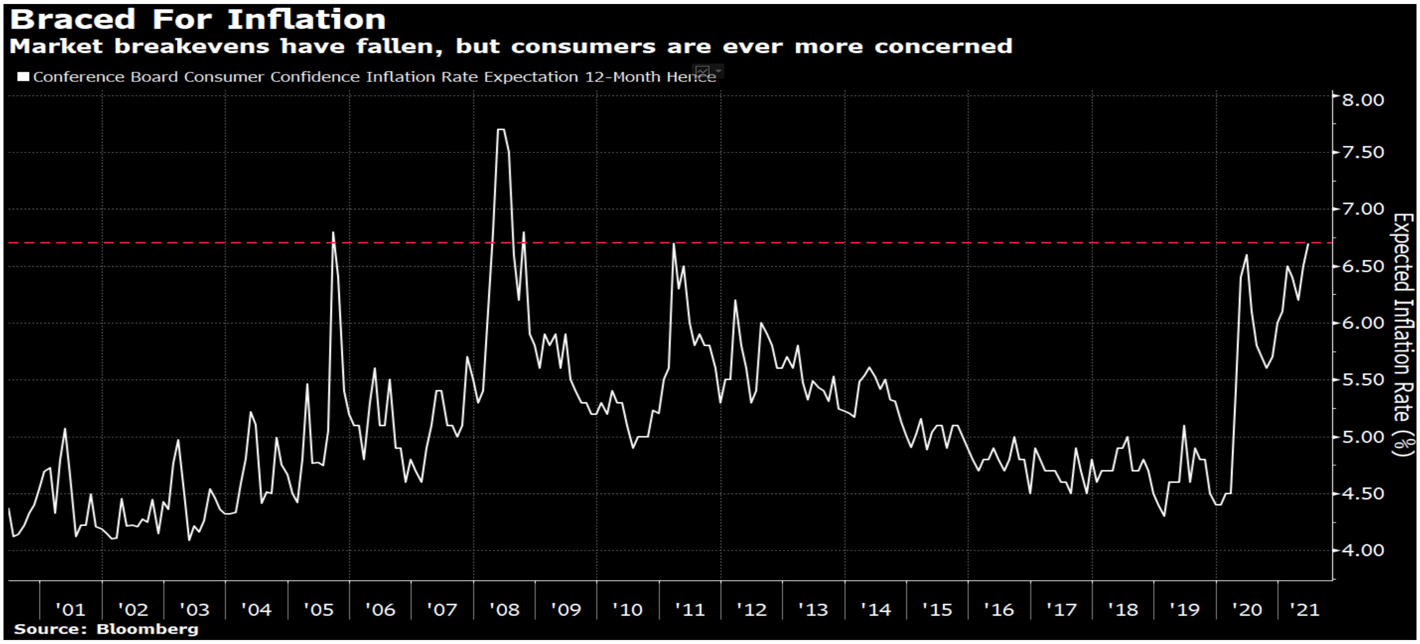


Source: Bureau of Labor Statistics

The unemployment rate ticked up to 5.9% in June as more individuals entered the labor force. However, the broader measure of unemployment, which includes those "marginally attached" to the workforce (referred to as "U6" by the statisticians), remains elevated at 9.8% compared to just under 7% pre-COVID. The Fed is focused on this metric and uses it as cover to maintain their loose policy stance.

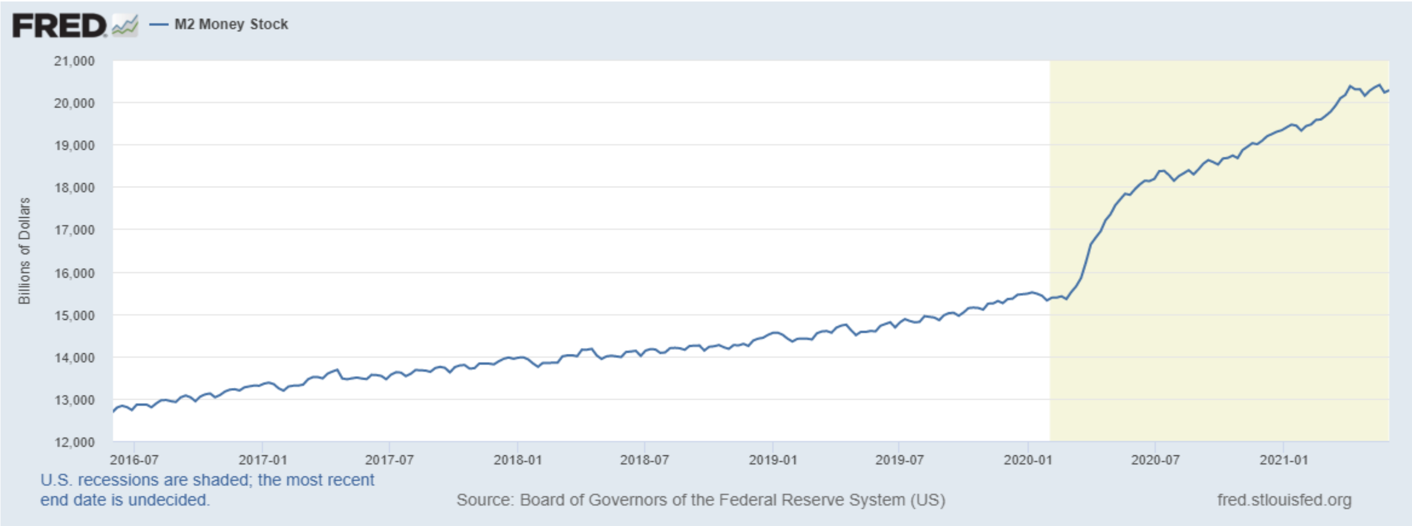
Inflation

Inflation is one of today's hottest topics and one the Fed is watching closely. Chairman Powell and other Board members have indicated a desire to let the economy run hot and indicated their comfort with inflation running at over 2% for a reasonable period. Fed speakers view the recent spike in prices at "transitory," which may or may not prove correct. The bond market has begun to moderate long-term inflation expectations, but consumers have not…



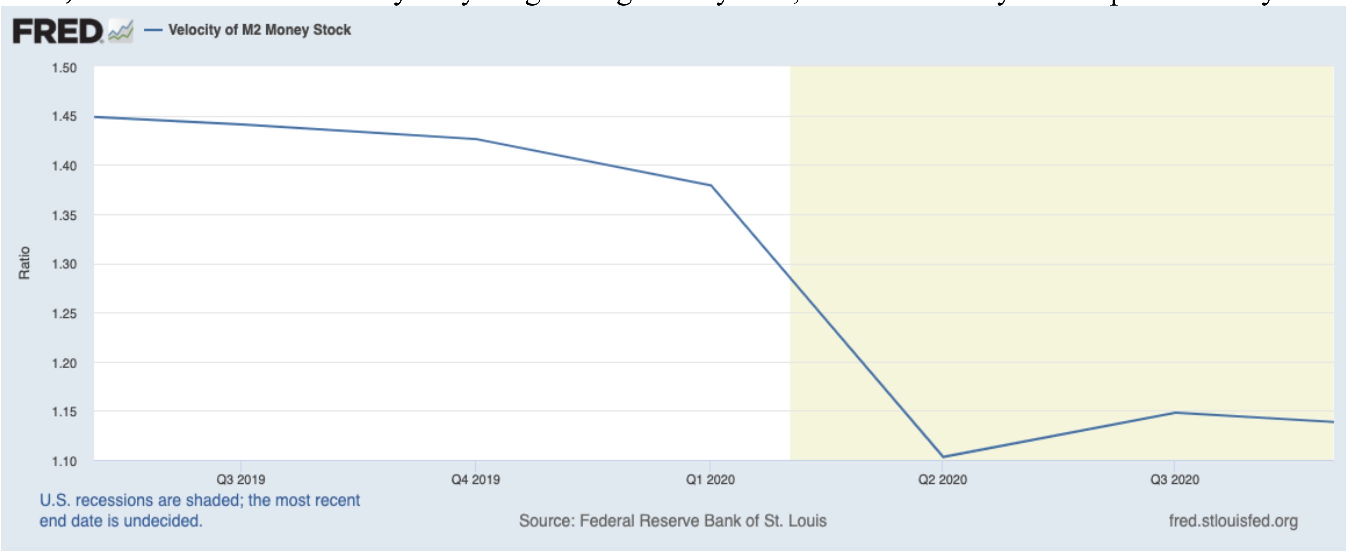
Source: Bloomberg

Looking at the sheer volume of money creation, one could conclude that significant inflation is inevitable. The chart below charts the growth of the money supply, as measured by M2. The highlighted area marks the beginning of the COVID pandemic and shows an exponential increase in supply driven by substantial asset purchases by the Fed.



Source: St. Louis Federal Reserve

BUT, not all of that new money is cycling through the system, as evidenced by the drop in Velocity…



Source: St. Louis Federal Reserve

And there are signs that some inflation spikes driven by supply/demand imbalances are starting to ease, as evidenced by the 50% drop in the price of lumber. Evidently money does grow on trees….

Source: CME Group

Summary & Outlook

As we head into the back half of 2021, there are several issues which have our attention. As usual, we make no predictions, but among the factors we are closely watching are:

- **When will the Fed announce and begin their taper of asset purchases, and secondarily, when will their first rate hike occur (current consensus is for the first hike(s) to occur towards the end of 2022)?**
- **Related to the above, how "transitory" is the recent spike in inflation; are production bottlenecks (semiconductors, automobiles) unclogged?**
- **How much, if any, fiscal stimulus will ultimately make its way through Congress (infrastructure bill?) and will Democrats push through corporate and/or personal income tax increases through the reconciliation process? What new regulations will the Biden regime impose on big tech, energy, other industries?**
- **Will new COVID variants emerge that evade vaccination immunity and bring back lockdowns?**
- **Will cybersecurity attacks continue, potentially striking critical infrastructure? Will these exacerbate already fragile geopolitical relationships?**

All the best for the rest of 2021!

Paul Spencer, CFA®

Director