VWG WEALTH MANAGEMENT
A Hightower Company

VWG Wealth Management 2nd Quarter Review

Executive Summary

- The U.S. COVID-19 vaccine mobilization effort yielded impressive results in the 2nd quarter. About 63% of all vaccine-eligible Americans have received at least one dose. In response, the economy continued to reopen, and economic activity strengthened.
- Reflecting this positivity in the absence of meaningful yield in most quality bonds, stocks continued their persistent rise over most of the past 15 months. The S&P 500 Index gained 8.3% in the second quarter. Smaller U.S. stocks as measured by the Russell 2000 Index rose 4.0%.
- International stocks also gained but were hampered by regional COVID-19 hotspots and slower vaccination rollouts. The benchmark MSCI EAFE Index increased 5.3%
- Strong measures of economic output and price inflation were recorded in the quarter. The U.S. PMI Index hit successive new highs in April and May. Inflation fears were stoked as commodity prices and some consumer goods and services spiked, notably restaurant dining and used cars. Curiously, bond yields fell in the face of these developments. Popular media discourse centered around whether

these price rises were due to a rapid recovery from deeply depressed levels amidst temporary supply shortages (transitory).

- Never has the U.S. witnessed its current combination of economic strength and aggressively easy monetary conditions. Price discovery is difficult, and distortions could arise. It is very difficult to separate true signals from noise. Investors need to maintain focus on the big picture and their long-term goals.
- We currently recommend that investors remain positive. Long-term investors should hold diversified, moderately balanced portfolios. It may be prudent for some clients to marginally increase holdings of cash and liquid short-term bonds. We expect occasional periods of volatility as the economy hopefully normalizes.

Review of the Markets

The COVID-19 vaccine rollout garnered momentum in the U.S. in the 2nd quarter. As a result of this and continuing massive Federal Reserve stimulus, the economy continued to reopen, economic output strengthened, and consumer confidence firmed. Stocks gained in sympathy. The S&P Index rose 8.3% for the quarter. It has gained 15.2% for the year. The sector and style rotation witnessed in the first quarter continued, but without causing any noticeable volatility. Small U.S. stocks did not match the pace of large stocks in the quarter but are still this year's outperformers. The benchmark Russell 2000 Index increased 4.0%. It is up 17.3% this year.

The pace of vaccinations lagged in Europe, and some global regions including India and Brazil suffered large setbacks in the fight against the pandemic. As a result, an economic rebound and the demand for foreign stocks was slower. The MSCI EAFE Index, a benchmark for stocks of companies domiciled in developed economies, rose 5.3%. It has returned 9.6% for the year. The MSCI Emerging Markets Index added 3.8% for the quarter and has increased 7.2% this year.

The U.S. economy posted strong measures of output and inflation. The IHS Markit U.S. Manufacturing Purchasing Managers Index (PMI) hit successive new highs in April and May. Headline consumer prices rose 5% year-over-pandemic-stricken-year in May. Core inflation (which excludes food and energy) saw its sharpest year-over-year increase in nearly three decades. Weekly jobless claims hit a new pandemic-era low. Despite this, bond yields fell through the quarter. The U.S. 10-year Treasury closed the quarter yielding 1.45%, after almost doubling in the preceding quarter. Bond prices correspondingly rose, and many yield sensitive assets rebounded after being sold in the 1st quarter. The Barclays Aggregate Bond Index increased 1.7% for the quarter and has paired its loss for the year to -1.7%.

The demand for high yield bonds remained firm amidst the deeply yield-deprived bond environment. The option-adjusted spread (OAS) of indexed high yield bonds has tightened to an all-time low against the spot U.S. Treasury bond curve. Although this is a signal of their being expensive, it is also a positive indication of investor confidence for improving corporate financial health. The Barclays High Yield Very Liquid Bond Index returned 2.1% in the quarter and has earned 2.8% this year. Municipal bonds have been insulated from much of taxable bonds’ losses this year. This is in part due to proposed increased taxes for wealthy households as part of President Biden’s American Families Plan. The S&P National Municipal Bond Index was up 1.4% in the quarter. It has gained 0.7% this year.

Broad swaths of commodity prices continued to rise in the 2nd quarter. Much of these gains were attributed to rapidly recovering global economies combined with supply lapses and shortages caused by the pandemic’s affliction last year. The NYMEX High Grade Copper continuous futures contract rose 7.3%. It has increased 21.5% this year. Prices of crude oil and refined products rose sharply past pre-pandemic levels. The NYMEX West Texas Intermediate Crude Oil continuous futures contract advanced 24.2% and is now up 59.1% this year. Some experts predict further gains in the 2nd half as demand continues to improve against less responsive increases in supply. The NYMEX Gold continuous futures contract edged 3.3% higher this quarter. It has fallen -6.5% this year.

Attempting to Filter through Confusing, Mixed Messages

Much of the economic expectations and market views we expressed in our last VWG investor letter proved to be correct in the 2nd quarter. The U.S. economy has continued to open. Activity is readily apparent, auto traffic has returned, dining and personal travel have begun to recover. Spikes have been seen in consumer prices (notably, prepared food and used cars) and in certain commodities (copper and lumber). Inflation has become a headline topic in media and client conversations.

We are in midst of a most remarkable period. Never has the U.S. witnessed its current combination of economic strength and aggressive monetary conditions. By many measures, U.S. economic output is already back to pre-COVID levels. Massive liquidity, huge global household savings surpluses, pent-up consumer demand, and depleted inventories, could produce a growth tailwind that could persist for many quarters. Incredibly, Blackrock estimates that U.S. will reach full economic potential output by end of 2021.

U.S. easy monetary conditions are not expected to change anytime soon. In June's FOMC meeting, many members forecasted the Federal Reserve to begin raising interest rates in 2023. This is quite different from previous economic cycles, in which the "Fed playbook" would be to begin raising rates before the economy reaches its potential *(presumably now or very soon).* Rick Rieder, Blackrock's CIO of Global Fixed Income, cautions that "policy which is intentionally late relative to current economic reality can create a broader set of distortions and after-shocks."

It is true that the prices of many personal consumption expenditures (PCE) have risen sharply in the past year. However, it is a stretch to project that a longer-term change in trend is occurring (systemic inflation). It is quite possible that price increases are reverting to the mean, rebounding from depressed pandemic levels (transitory inflation).

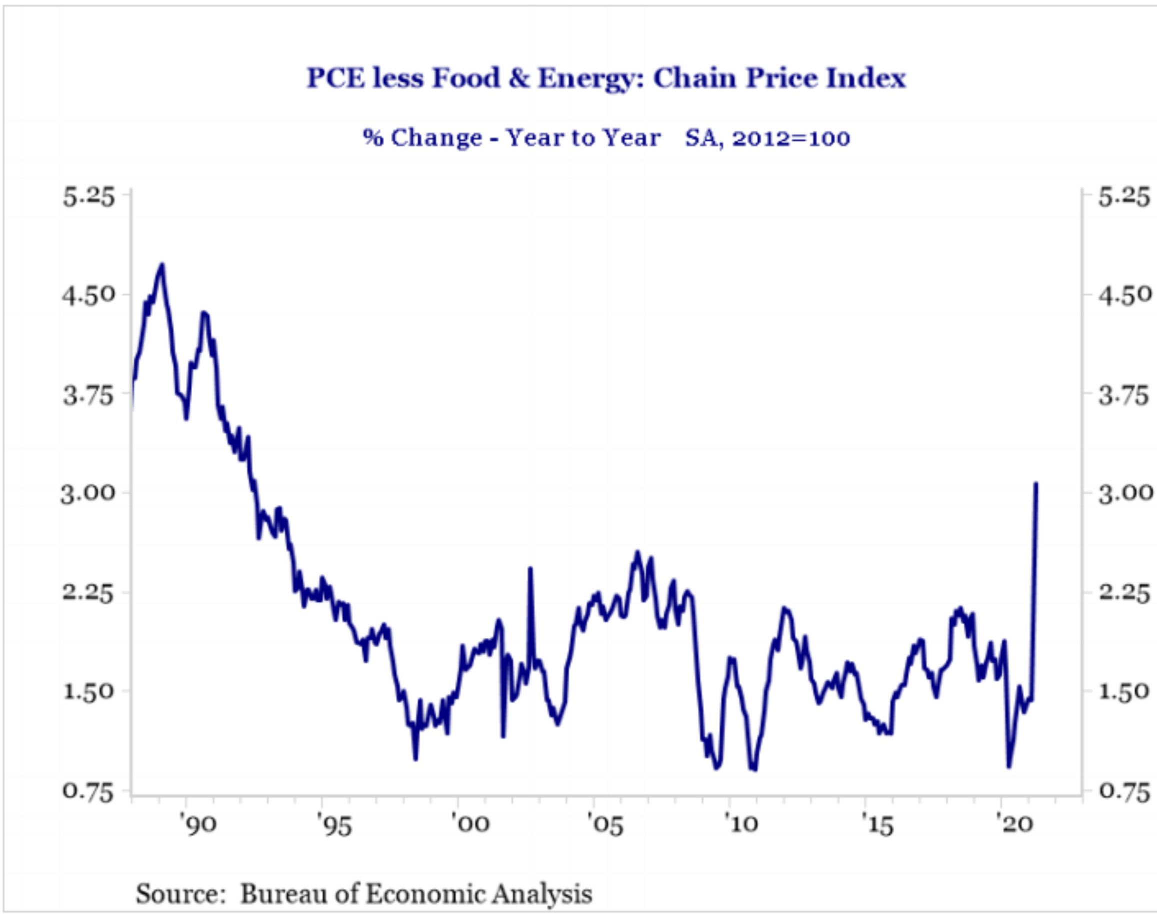

Chart courtesy of Strategas Research Partners

The current intense debate around inflation – whether it is transitory or systemic - could well be an example of the "availability heuristic," a subconscious cognitive shortcut first researched by Amos Tversky and Daniel Kahneman. It portends that humans tend to judge the likelihood and significance of things based on how easily they come to mind. We overstate and misjudge the magnitude of recent events. We remember things better that are packaged in vivid narratives. In "Thinking Fast and Slow," Kahneman states that:

"People tend to assess the relative importance of issues by the ease with which they are retrieved from memory - and this is largely determined by the extent of coverage in the media."

Succumbing to "availability" causes us to overestimate the likelihood of unlikely events and to underestimate the likelihood of likely events. It diverts our attention, making it very difficult to discern true signals from noise. Social media, news outlets, and one's firsthand pocketbook experiences are all currently reinforcing the immediacy of the inflation. Longer-term fears could well be exaggerated.

The bond market has often proved to be a reliable leading signal for future economic growth, inflation, and interest rates. Quite surprisingly, the yield of the 10-year U.S. Treasury Note began falling in early June. This occurred simultaneously with the reporting of May's extremely strong readings in U.S. and Eurozone Manufacturing PMIs, the U.S. Consumer Price Index, along with highs in copper, lumber and many grains and foodstuffs. At least on the surface, the bond market appears at odds with strength in the economy and prices. Particularly when only four months ago pundits were calling for a 2.00% yield on the U.S. 10-year when 1.70% had been reached.

U.S. Bonds Not Responding to Further Global Inflation Data … Yet

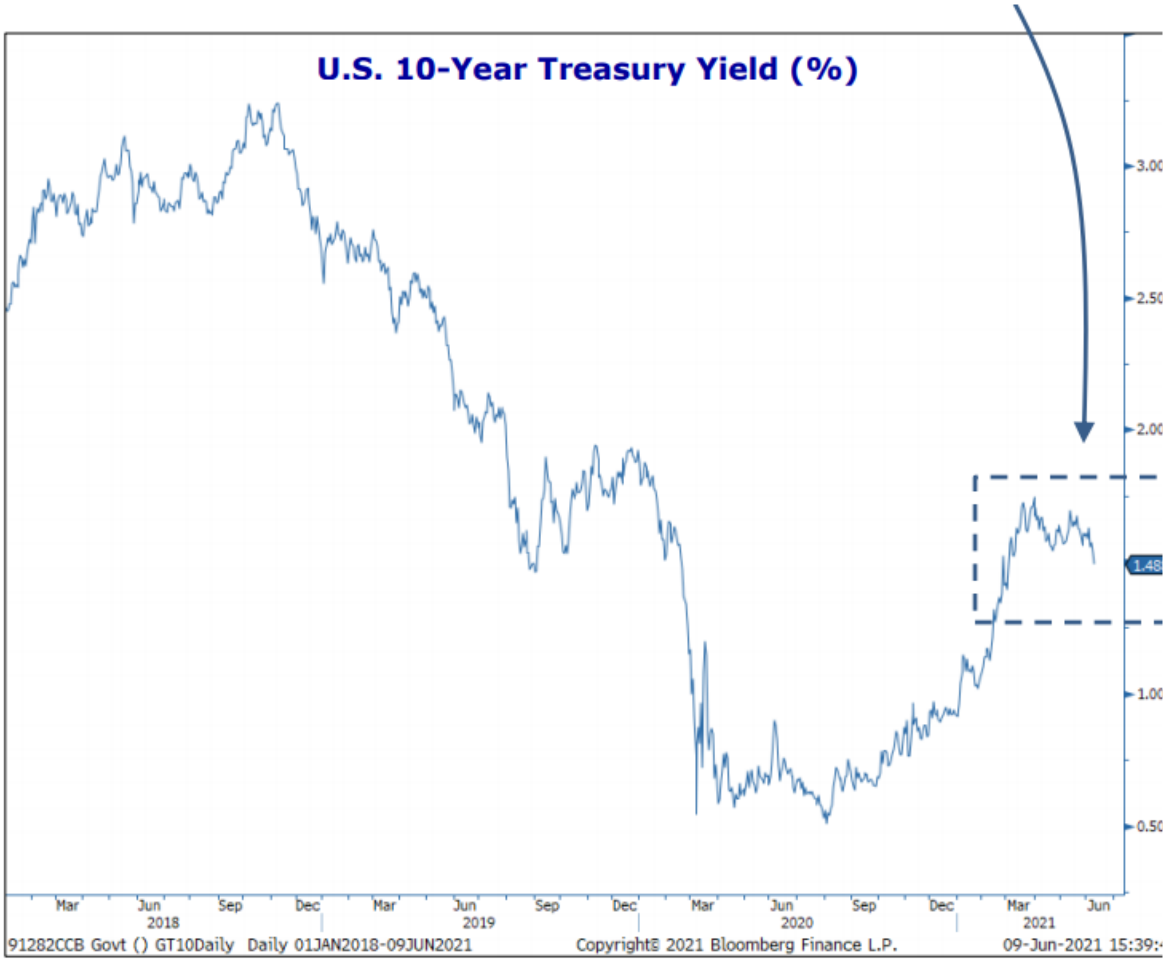

Chart courtesy of Strategas Research Partners

Portfolio Strategy and Asset Positioning

Maintaining focus on the big, longer-term picture is critical to the success of individual long-term investors. The last eighteen months has proven to be harsh and challenging. It has been extremely difficult to remain focused on one's long-term goals, and to attempt to properly filter out extreme noise and confusion. Although things appear calmer today, we are nowhere near a state of equilibrium. The global economy has witnessed perhaps the most calamitous decline and swiftest rebound ever seen. The Federal Reserve, central bank to the world's reserve currency, has and continues to take massive actions which surely are clouding price discovery in many assets. Our culture is undergoing dramatic, rapid behavior changes in life and work.

VWG Wealth Management recommends that long-term investors maintain diversified portfolios. They should be tilted toward assets and strategies seeking appreciation and total return. We caution that valuations of many assets appear rich. These include some sectors within public and private equities. Due to this, it is possible that forward returns could be lower than those enjoyed over the previous five- and ten-year periods. Even If this proves correct, it does not by itself call for overt defensiveness. It does mandate diversification and the avoidance of excessive risk taking.

VWG expects higher interest rates in the 2nd half. We see such a move as a natural response to economic normalization, not to the expectation of systemic inflation. The preceding chart of the U.S. 10-Year Treasury yield tells the story. If the current strength in the economy persists, and the recovery broadens, rates should rise. With current yields deeply depressed, bond duration should be kept short.

We do expect to see some periodic bouts of volatility entering the picture. This is only to be expected after the tremendous, smooth rise that has been enjoyed in equities and other “risk-on” assets. Rising interest rates, potentially rising oil prices, and geopolitical unrest could all play a part. Raising some cash and increasing allocation to liquid short-term bonds may be prudent.

VWG will remain on watch and will communicate to you if our *(longer term, hopefully noise-filtered)* views change. We wish you a fun summer, with plenty of time to relax and enjoy the company of family and friends.

Regards,

VWG Wealth Management

Suzanne, Ashley, Rashmi, Kay, Lynette, Ona, Michelle, Ryan, Ryan, Susan, Marnie, Justin, Elana, Patricia, John, Rick and Jeff

[Who we are](#)

**** Index Data and Charts Sourced from FactSet Research, Morningstar, Blackrock Investment Management, Strategas Research Partners.***

Please reach out to us if you have any questions or comments.

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