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Second Quarter 2021 Market Letter

The great awakening continues in the second quarter of 2021. Earnings expectations continue to improve. Since last December, earnings expectations for the full year 2021 S&P500 Operating Earnings have increased 21%, from $166.19 per share to today's $182.30. This improvement of 21% has been accompanied by a YTD rise in the S&P500 of 15%. Since earnings expectations have increased more than the market, one could argue that valuations have decreased. While that is true, they remain much higher than average. Other markets were less robust. International stocks rose 8.9%, bonds fell 1.6% and gold fell 7%. (as measured by the iShares EAFE ETF, iShares Core U.S. Aggregate Bond ETF and iShares Gold Trust)

To put current earnings and earnings expectations in perspective, consider the following: The 21% increase in earnings expectations since last December reflects and estimates the excitement around current economic growth. The result, though, is that it means corporate earnings would have increased by 8% per year on average over the last three years. Not bad, but maybe not a level deserving of a premium multiple. This higher level of earnings expectations would result in average annual earnings of 7% per year over the last 7 years. But wait, current expectations call for another 12% earnings growth for 2022. If that happens, then average annual earnings growth would increase to 8% per year, on average, over the previous 8 years. Can longer term annual earnings growth of 8% maintain a historically high market multiple? This is one of the reasons we feel that returns of large cap domestic stocks will be low over the next few years, and why diversification into other asset classes remains important.

In the last quarterly note, we commented on inflation showing up in various places except for the official inflation statistics. Well, that changed during the second quarter. It is clearly reflected now in what are considered traditional price measures, such as the CPI and PCE index. (Consumer Price Index and Personal Consumption Expenditures). Now the argument has shifted into whether the current inflation and inflationary pressures are transitory, and likely to reverse, or are more permanent. The latter would require the Federal Reserve to begin raising interest rates sooner and would begin to reduce the liquidity that is helping maintain high financial asset prices.

What is the difference between transitory and non-transitory inflation? An employer paying $18.00 per hour is having a hard time finding employees. Paying a $1,500 signing bonus is transitory inflation. This is where we are now. If employers shift and begin raising hourly wages, then the labor price increase is more permanent. General Mills has been absorbing the commodity price increases so far (transitory) but has announced that they will begin raising prices on products (non-transitory). It has been decades since inflation escaped control of the policy makers. We may find out if they have the control that they think they have.

On a separate topic, we wanted to discuss ESG investing as it has been gaining a lot of press lately. What does it mean actually? The E in ESG stand for Environmental, the S for Social, and the G for Governance. ESG investing means to invest in things that are good for the environment, good socially, and good from a governance standpoint. These things sound nice, and investors around the world are clamoring for such investments. The marketing machine of the investment world has taken notice. If you can gather billions and even trillions of assets by saying that you are a good ESG investment, whatever that really means, then the industry will position its products to do so.

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There is some value in ESG investing and also a lot of noise and hype. The SEC, which regulates larger investment advisors, have put firms on notice if they advertise that they are ESG managers, or use ESG products. They want to make sure that there is substance behind the advertising hype.

Are ESG investments good investments? It is not an easy question to answer. The Department of Labor implemented a new rule earlier this year which caused much concern over whether 401k plan fiduciaries could consider including ESG investments. The initial belief was that the rule prohibited them. What the rule actually says is that fund selection should be made on a risk/return basis, not other factors such as benefits to others. The concern seems to acknowledge that ESG funds would not make the cut if one only considered risk/return. In other words, because everyone knows that ESG funds will have lower returns. While that might not be the case for every ESG investment, the concern over the DOL rule shows that lower returns are the assumption. Consider also that there are some bonds being issued now that get to reduce the amount of interest paid to investors if they meet stated ESG goals. In these cases then, you are hoping to make less of a return. And what are the future expected returns of assets that are being bid up today through intense demand for all things ESG? Financial theory would say that expected future returns are lower for these assets.

And who decides what the E, S and G really stand for? There are firms like Morningstar and MSCI that have come up with their interpretation of all the things that the E, S and G could stand for, and a system for measuring how companies measure up. It is a huge business. But these ranking systems are not the same. A company can have a high rating from one provider, and a low rating from another provider.

Is ESG even needed? Are our companies really running amuck, and in need of reining in through ESG pressure? Does the amount of hype relate to the incremental benefit achieved?

Consider to whom a corporation is accountable already, absent ESG. Shareholders own the company, but management runs the company. Management, specifically the CEO, answers to the Board of Directors. The Board is elected by the shareholders and represents their interest. In addition to having the Board oversee management, shareholders can submit items to be considered during annual meetings.

In addition to Boards and shareholders, companies are also subject to regulation by various government agencies, including the Occupational Safety and Health Administration, Consumer Product Safety Commission, Department of Labor, Environmental Protection Agency, Securities and Exchange Commission and various state regulatory agencies. This does not even cover the other Federal Agencies that might add regulations to specific industries like the Federal Deposit Insurance Corporation, Federal Energy Regulatory Commission and Food & Drug Administration.

One could argue then that those that control ESG definitions and promote their use are trying to pressure/influence companies outside of the shareholder/regulator framework, and therefore also outside of the recourse that those venues theoretically offer. The creators of ESG metrics and measurement are neither owners nor are they official regulators, but they are determining what is good and right. Not that that is always bad. Ralph Nader certainly moved automobile safety ahead of where the auto companies and regulators were headed in the 1970's.

But most ESG investors don't even know all of what is under the ESG mantle and the various mandates that companies have to fulfil to be 'approved' or 'blessed'. They just figure it is better than the present. You end up with huge inflows of money responding to the marketing push coming into a system where the ESG scorekeepers are trying to figure out what the ESG definition makers mean, and how to score companies on those measures. This results in unintended consequences.

A number of the investment managers we already work with consider many of the ESG issues when evaluating investment opportunities. They are not doing so to try to score well on the third-party external metrics, and most do not call themselves ESG funds. They consider these factors where they are appropriate for the specific company/industry because it can lead to attractive and sustainable investment opportunities. The investment firms are having specific and personal conversations with companies on these issues and can then ascertain whether companies are following through. Another reason this can be beneficial is if they find a company that would not score well on the third-party measures today but is actively improving their operations. Investing in a company before the ESG world discovers it can lead to more attractive investment returns.

We are happy to talk about this with you, or anything else that is on your mind. Give us a call or send us an email.

Regards,

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