Key Questions

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What Is the Outlook for Equities in the Second Half of 2021?

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We believe the second half of 2021 will play out in two distinct acts.

Many believe that the outlook for equities in the second half of 2021 hinges on the outlook for the delta variant and its impact on the global economy. The bottom line is that, barring a nefarious mutation, if the delta variant remains what it looks like today -– a more highly contagious but less lethal virus, particularly for those already vaccinated -– then we do not see a science-based case for a return to widespread business and school shutdowns in the US.

We recognize the severity of the impact of the virus on those infected; however, annualizing the latest weekly US COVID-19 death total (1,777) implies a current run rate of fewer than 100,000 deaths annually. Per data from the CDC, this is less than the annual US deaths from accidents (173,000), strokes (150,000), and Alzheimer's (121,000). Of course, heart disease (659,000) and cancer (600,000) are much higher. This contrasts sharply with the situation earlier this year. At its peak in early January 2021, COVID-19 was claiming lives at a rate of 24,000 per week, or roughly 1.25 million on an annualized basis.

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There are lingering supply chain issues that could alter the outlook. For example, we have heard that global shipping container rates are not expected to normalize until year-end 2022. However, we believe the global economy will manage through such disruptions as vaccination rates slowly climb and societies adjust to the new reality.

So, if we take COVID-19 off the table as a potential negative, what does the future hold for stocks? We think the second half of the year is likely to have two acts. The first act will consist of more of what we have seen recently, as market participants grapple with the implications of a monetary and economic environment that is in a mid-cycle transition. As we progress through the second half of the year, the Federal Reserve is likely to move away from a crisis level of accommodation as the economy moderates from a blisteringly hot recovery. This monetary and economic transition is manifesting itself in significant sector and industry rotation within the market, all while the market itself climbs to new highs. This has led to a sharp underperformance in cyclicals relative to the S&P 500 in the past two months.

Although the market cap-weighted S&P 500 continues to reach new daily highs, the S&P 500 Equal-Weight Index has been stalled since April and has ceded its strong relative performance since February. This recent underperformance of the equal-weighted index makes perfect sense, with economically sensitive sectors (Financials, Industrials, Materials, and Energy) coming under pressure due to the decline in US Treasury yields. It also reinforces the view that the market had already discounted the sharp economic recovery and is now in the process of discounting the mid-cycle transition.

In our view, this creates an opportunity through the end of the year, and investors should again embrace an offensive stance once three things occur:

1. Stabilization of long-term inflation break-evens, which would suggest that inflation fears have passed. (The break-even inflation rate is a market-based measure of expected inflation. It is the difference between the yield of a nominal bond and an inflation-linked bond of the same maturity).
2. A clear understanding of potential monetary policy tapering and the pace of asset purchases.
3. Clarity over potential stimulus and tax measures.

Investors can observe signs that this bullish scenario is playing out when they see stronger performance by the equal-weighted S&P 500 and dramatic improvement in the relative performance of the four reflationary sectors mentioned earlier.

Both momentum and excess liquidity continue to help the broad market power higher. Still, the sectors and industry groups that would signify that market participants are taking a more economically offensive position continue to underperform.

We believe that it is too late now to rotate away from these areas. In hindsight, the time to do that was back in April as the economic recovery theme was peaking. Looking forward, however, the current poor absolute and relative performance of cyclicals will likely set the stage for a year-end recovery once we finish the current mid-cycle transition. Until then, try to enjoy the rest of the summer!

For more information, please contact your Key Private Bank advisor.

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