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# Second Quarter 2021 Commentary

An Oxford Harriman & Company Market Commentary


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## Economic Rebound Continues as Economy Reopens

Throughout the second quarter, the economic reopening pace continued to progress. With rising vaccination rates nationwide, states eased their restrictions, allowing for capacity raises for both indoor dining and large events, not to mention an increase in air travel and public transit usage. Recovered economic data confirms the nationwide economic rise as the labor force once again grew while unemployment claims began to fall. The economic outlook in general continues to improve as life returns to normal.

## Federal Reserve Surprises Market at June Meeting

The Federal Reserve's June meeting led to increased volatility in equity prices. In line with investors' expectations, the Fed said it would keep interest rates near zero and continue to buy $120 billion of U.S. Treasury bonds each month. [1] However, the Fed's press conference after the meeting and changes to its economic projections caused surprise in the market. The Fed increased its 2021 inflation expectations and pulled forward its expected timeline for increasing interest rates. More members of the Fed's policy-making committee now see the potential for at least one interest rate hike by the end of 2023, with some members predicting multiple interest rate hikes. [1]

The Fed's tone marked a significant change from prior meetings and represented the first step toward tightening monetary policy. Moving forward, the Fed has the difficult job of phasing out support for the recovery without alarming the market and stalling the economic recovery. The job will be made more difficult by an economic recovery that is both uneven and progressing at a faster pace than the historical standard. It's clear to see that investors will be intently watching and listening to the Fed over the coming months for clues about its next steps.

## Inflation Fears Persist as the Economy Reopens

Rising inflationary pressures also grabbed the market's attention during the second quarter; Manufacturing costs rose due to supply chain issues, higher raw material costs, global shipping challenges, and Labor costs rose as companies struggled to fill open jobs. There is now a record number of job openings, which is causing companies to increase wages as they compete for workers. The labor supply crunch is expected to ease later this year as enhanced unemployment benefits end, virus fears recede, and schooling returns to in-person.

These inflationary pressures are starting to show up in consumer prices. The headline consumer price index rose 4.9% year-over-year in May 2021, which was the fastest pace since September 2008.[2] The key question is whether current inflation pressures are transitory (i.e., temporary) or longer lasting. [2] The Fed views inflationary pressures as transitory and points to big price drops early in the pandemic artificially making today's inflation figures look higher. As further evidence, data indicates most of the price pressures are occurring in categories where demand is soaring as the economy reopens, such as used cars, air travel, and hotel rooms. [2]

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The Fed previously said it would let inflation run slightly above its target to make up for years of weak inflation. This new inflation policy suggests it will wait longer to raise interest rates, which is why the market was caught off guard by the sudden change in tone at the June meeting. We believe the risk is that inflation runs too high and forces the Fed to raise interest rates sooner rather than later.

## Reflation Trade Loses Steam During Second Quarter

The second quarter came with shifts to both the market environment and investor sentiment. While the first quarter focused on the reopening trade and strengthening economy, the Fed's changing outlook and rising inflationary pressures during the second quarter caused investors to question if the market was too optimistic. Investors' appetite for riskier asset classes, such as small cap stocks and cyclical sectors, declined at the thought of higher interest rates and rising consumer prices.

The change in demand for riskier assets may point to the start of the unwinding of the reflation trade, which focused on the rebounding economy and rising prices. The timing of this coincided with the Fed's June meeting. While the Fed's policy was not actually altered, the change in tone was enough to cool the reflation trade.

## Bond Market Repositions Due to Fed & Inflation

The bond market also felt the effects of the Fed's changing outlook and rising inflationary pressures. After long-term interest rates rose during the first quarter in anticipation of a stronger economy, investors reversed course and rates lowered during the second quarter. The downward move was especially pronounced in long-term rates. Declining interest rates support higher bond prices, which caused longer maturity bonds to outperform during the second quarter. While long-term rates fell during the second quarter, shorter-term rates rose.  We believe the timing of the move higher in short-term rates coincided with the Fed's June meeting, suggesting that investors are already positioning for the Fed to start hiking short-term rates. The move higher in short-term rates, combined with the move lower in long-term rates, may mean investors are more concerned about the risk of the economic recovery slowing.

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## Second Half 2021 Outlook – No Clear View

***We believe investors are struggling to interpret the Fed's recent change in tone and the potential impact from inflationary pressures.***

Market volatility increased as the second quarter came to an end. We believe investors are struggling to interpret the Fed's recent change in tone and the potential impact from inflationary pressures. The big question is whether investors will return to the reflation trade later this year, and asset class returns are producing mixed signals. Interest rates rise one week and fall the next as the market attempts to find clarity amid the economic reopening and new levels of inflation. During all this, cyclical sectors similarly outperform one week only to underperform the next week. There is a battle occurring beneath the market surface as it struggles for direction.

The unanswered questions may continue to weigh on the stock market in the coming months. However, this does not mean the market will necessarily trade lower; It simply means the ride could be bumpier in the months ahead. The pandemic's unique nature and corresponding quick economic reopening are unlike recent recessions.

***The next quarter should provide more clarity regarding the ongoing recovery. As Fed Chairman Jay Powell has repeatedly stated, there is not a template or model for the current recovery.***

The equity markets have reached new highs since the pandemic low point in early 2020. As we have been discussing for the last year, we believe the market has already priced in a strong recovery. It is possible the second quarter performance reversal suggests the market may have gotten ahead of itself. The next quarter should provide more clarity regarding the ongoing recovery. As Fed Chairman Jay Powell has repeatedly stated, there is not a template or model for the current recovery.

We will continue to watch virus data and in particular data on the newer Delta strain, as significant case climbs and associated hospitalizations may lead to parts of the economy having to take defensive measures. We also have geopolitical issues, the hurricane season and the new threat of cyber-attacks to keep us on alert as we navigate the second half of 2021.

We hope you have a safe and enjoyable summer, and please reach out to us with any questions.

Sincerely,

**Oxford Harriman & Company**
**Dennis P. Barba, Jr.**
**President & Managing Partner**

**Sources:**

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2. https://www.cnbc.com/2021/06/09/hot-inflation-became-scorching-in-may-and-is-expected-to-hit-a-28-year-high.html