3 Market Risks to Watch for in the Months Ahead

By the end of August, the S&P 500 index had posted seven straight monthly increases and had touched a new record high over 50 times – the most in seven months since 1964.[1] The U.S. economy has also been in recovery and expansion mode, with corporate earnings and revenues powering higher alongside a rallying market.

As many investors know, however, the post-pandemic boom has been far from perfect. Supply chains remain tangled, many companies are struggling to hire needed workers, and supply/demand imbalances have thrown off the prices of everything from cars, to homes, to lumber and aluminum. The latest surge in Covid-19 cases is also weighing on consumer sentiment and throwing a wrench in office reopening plans.

Even still, the stock market has largely taken these issues in stride, seeming to reflect only the overwhelmingly better-than-expected earnings season. To me, this outcome is to be expected – I have written many times that stock prices are affected most by how earnings and interest rates perform *relative to expectations*. Better-than-expected earnings coupled with lower-than-expected interest rates are great for stocks, in my view, and that's what we got in the first half of 2021.

Looking ahead, investors should weigh how different factors could affect earnings relative to expectations, and also how interest rates may move relative to expectations. With this in mind, I have three risks to monitor for the rest of 2021.

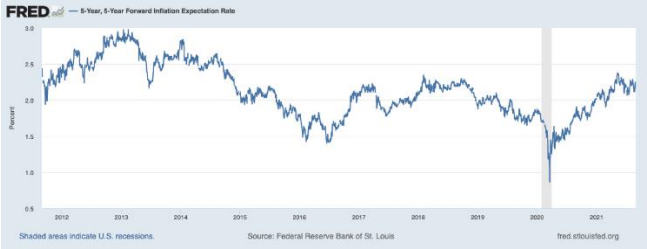
Risk #1: Sticky Inflation Puts Upward Pressure on Rates

Inflation has been running hot this summer, and prices have arguably been moving higher and faster than many expected. Consumer prices (CPI) rose 5.4% in July 2021 from July 2020, which marked the highest 12-month jump since 2008. The May CPI increase of 5.0% also raised plenty of eyebrows.

We know from parsing the inflation data that food, energy, and items like used cars, freight expenses, and 'reopening' items like airline fares are having an outsized effect. But rising

producer prices are also worrying corporations, and much-needed commodity inputs like copper, aluminum, and nickel are feeling sustained price pressures.[2]

All of these price pressures exist, and yet we have the 5-year forward expected inflation rate moving sideways since April:



Source: Federal Reserve Bank of St. Louis[3]

Policymakers continue to insist that inflationary pressures are 'transitory,' and the market appears – *for now* – to be confirming the Fed's stance. But the risk to watch in the second half is if inflation is stickier than some expect, which could put pressure on the Fed to speed up the tightening cycle and ultimately put upward pressure on longer duration U.S. Treasury bond yields. If interest rates go up faster than expected, it could spell volatility for stocks – particularly in high valuation categories.

Risk #2: Rising Costs and Souring Consumers Put Pressure on Margins

This risk is tied to corporate earnings and the factors that may cause earnings to come in lower than expected in Q3 and Q4. We know the Delta variant is causing problems in many parts of the country, and the latest University of Michigan consumer sentiment print shows it may be weighing on consumers:

Source: Federal Reserve Bank of St. Louis[4]

There's a possible scenario where rising costs and souring consumers can put some pressure on profit margins, at a time when the market is largely expecting corporations to continue to post strong recovery-like numbers. A scenario where corporations need to adjust earnings estimates downward – or a scenario where a higher-than-expected number of corporations miss – could weigh on stocks.

Risk #3: The World Ex-US Undergoes Restrictions and Shutdowns

The United States has a relatively high vaccination rate and more than enough vaccines for the entire population. The rest of the world, and in particular emerging markets, has the opposite.

The risk here is that out-of-control cases and hospitalization rates could lead to economic restrictions and more shutdowns in countries critical to global trade. We've already seen issues tied to this risk – a surge of cases in Malaysia has added to semiconductor supply chain woes, and even China is seeing significant slowdowns in factory and services activity tied to economic restrictions. China's gauge of construction and services fell to 47.5 in August, which moves it firmly into contraction territory – the first time it has dropped below 50 since February 2020.[5]

The world is far from having enough vaccines to stem the spread of Covid-19 – perhaps even years away. The question for the global economy and global trade is whether production and economic activity can keep moving, despite a pandemic that's ongoing.

Bottom Line for Investors

The U.S. economy is expanding and will almost certainly continue to do so for the balance of 2021. What hangs in the balance, in my view, is whether corporate earnings can overcome the headwinds discussed in this column – namely,

margin pressures tied to rising input costs and a potentially skittish consumer as the pandemic roils on.

The other side of the coin is interest rates, which most market participants expect to move higher this year. The question is, by how much? To date, rates have largely been defying expectations, which has been good news for stocks. In the second half, continued inflationary pressures and a Fed pivot into scaling back monetary stimulus could alter the landscape. Investors should watch these factors closely and also remember that stocks, over time, can act as an effective inflationary hedge.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] NY Times. August 31, 2021. https://www.nytimes.com/2021/08/31/business/stock-market-record.html?referringSource=articleShare

[2] Wall Street Journal. August 11, 2021. https://www.wsj.com/articles/us-inflation-consumer-price-index-july-2021-11628633099

[3] Fred Economic Data. August 31, 2021. https://fred.stlouisfed.org/series/T5YIFR

[4] Fred Economic Data. August 27, 2021. https://fred.stlouisfed.org/series/UMCSENT

[5] Wall Street Journal. August 31, 2021. https://www.wsj.com/articles/covid-19-delta-variant-pummels-chinas-services-sector-11630386778

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

3 Reasons to Expect Downside Volatility in the Second Half of 2021:

Reason #1: Downside Volatility is Normal, and It's Been a While

Reason #2: Companies May Be Facing Peak Growth and Peak Profit

Reason #3: The Federal Reserve Moves Closer to 'Tapering'

Reason #1: Downside Volatility is Normal, and It's Been a While

The S&P 500 has not pulled back -5% since October 2020, over which time it has continued to rally strongly. Even though downside volatility is very normal in equity investing, it's been a while since the S&P 500 has exhibited much of it.

The last time the S&P 500 went this long without a -5% pullback was during June 2016 to February 2018 stretch. Even when we look at an even longer stretch of history, we find that the S&P 500 has gone a full year without a -5% pullback only three times in the last 50 years – twice in the 1990s and again in 2017.[1] Will 2021 be the third year with such a long stretch?

Every investor wants to see the stock market trend nicely higher with no downside volatility. But it's just not a realistic outcome. Data shows that since 1980, the S&P 500 has experienced an average intra-year correction of -14.3%[2], underscoring how common and oftentimes steep market pullbacks typically are. The longer the S&P 500 goes without exhibiting more downside volatility, in our view, the more likely it becomes.

Long stretches of rallies often cause investors to forget that pullbacks are normal and natural, which increases the risk of making knee-jerk decisions when the stock market does eventually turn volatile. Complacent investors may see downside volatility as more worrisome than it is, which could lead to decision-making that runs counter to an investor's long-term goals *and* adversely impacts returns. We would encourage investors to remain patient and stick to your long-term plan.

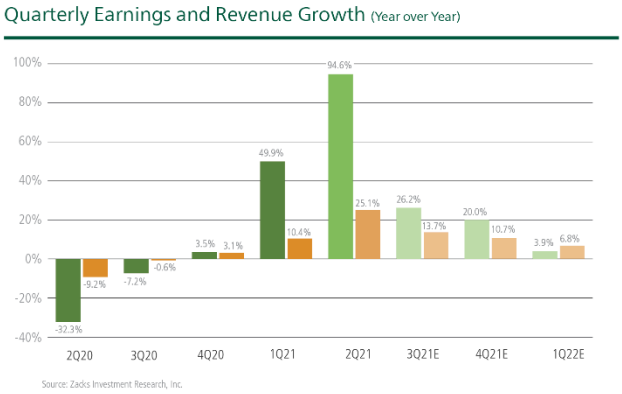
Reason #2: Companies May Be Facing Peak Growth and Peak Profit

Total Q3 2021 earnings for the S&P 500 index are expected to be up +26.2% from the same period last year on +13.7% higher revenues. These are assuredly strong numbers – except when you look at them in comparison to Q2, which posted +94.6% earnings growth on +25.1% higher revenues in Q2.[3] The narrative that economic growth and corporate earnings are decelerating from peaks could cause some choppiness in the markets.

The 'law of large numbers and the end of pandemic comparisons means earnings and revenue growth were bound to decelerate. The question is by how much, and whether investors get skittish if estimates end up being revised downward.

As you can see from the chart below, Q2 2021 stands out, particularly since it is being compared to Q2 2020 – when many economies were shut down. Earnings growth is set to

decelerate in coming quarters, but investors will want to see consistent growth alongside optimistic revisions.

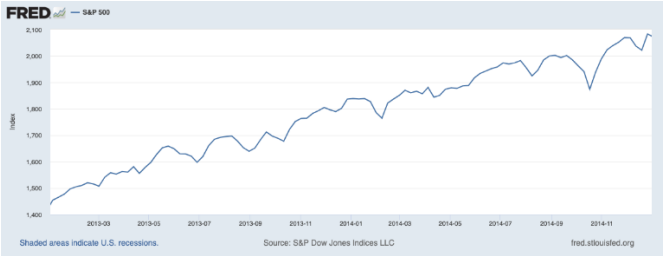


Zacks Investment Research[4]

Reason #3: The Federal Reserve Moves Closer to 'Tapering'

Investors have long parsed every statement made by the Federal Reserve for clues about monetary policy. In the second half of the year, participants will be watching very closely for signs the Fed could start trimming its monthly bond purchases, a process known as 'tapering.'

In 2013 and 2014, Fed tapering became synonymous with downside stock market volatility, and the coined phrase "taper tantrum" is still thrown around quite a bit in financial media. The chart below shows the S&P 500 index performance during the time Ben Bernanke announced tapering (summer 2013) to the actual end of the QE program (fall 2014).



Source: Federal Reserve Bank of St. Louis[5]

As you can see, there's plenty of volatility, *but* it's also true the stock market continued trending nicely higher throughout the tapering period. It's a reminder to investors that volatility is not necessarily synonymous with significant losses. In other words, the market can be volatile and still trend higher alongside economic and earnings growth.

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[1] Wall Street Journal. July 27, 2021. https://www.wsj.com/articles/stocks-keep-climbing-avoiding-routine-pullbacks-11627378201?mod=markets_lead_pos3

[2] J.P. Morgan. Guide to the Markets, Slide 17. https://am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/guide-to-the-markets/?c3apidt=p40886527407&gclid=Cj0KCQjw7MGJBhD-ARIsAMZ0eetAtDTTTXf-7nxGmiDzRfjFi0846AdeQqnqYl_70pIFeGHSE2Hv4TsaAhkvEALw_wcB&gclsrc=aw.ds

[3] Zacks.com. September 1, 2021. https://www.zacks.com/commentary/1790010/can-earnings-continue-to-improve

[4] Zacks.com. September 1, 2021. https://www.zacks.com/commentary/1790010/can-earnings-continue-to-improve

[5] Fred Economic Data. September 4, 2021. https://fred.stlouisfed.org/series/SP500#0

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