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Today's Investment Challenges

By Mike Skoric

Despite various challenges, U.S. equity markets are having another year of excellent returns. Most of this can be attributed to the largely successful economic reopening following an initial decrease in Covid-19 cases and increased vaccination rates. When considering possible near-term market performance – key drivers will likely be 1) earnings growth, 2) inflation levels, and 3) continued progress against Covid-19.

Corporate earnings were expected to be strong in 2021 given the low base set in a pandemic-challenged 2020, but results have been much better than the already optimistic estimates. In the first quarter, corporate earnings grew 48% sequentially and 280% over the same period last year. In the second quarter, corporate earnings grew 90% as most companies handily beat revenue and estimates. A solid growth rate of 20% is still expected in the second half, but then we will start to see more difficult comparisons and more modest growth rates. Continued earnings growth is critical since that is one way to lower stock valuation levels. Based on forecasts, the forward price-to-earnings (P/E) ratio is around 21x, much better than the current elevated levels. However, that is still meaningfully higher than the long-term average forward P/E ratio of just over 16x.

The second key driver is inflation, and the question of whether it will be more permanent (structural) or temporary (transient). An example of temporary inflation is with lumber, where prices have now fallen over 70% from its all-time high reached back in May. On the other hand, we have rising labor costs which could be an example of more permanent inflation. The shortage of workers is leading many companies (i.e. Walmart, Walgreens, etc.) to increase their minimum hourly wage levels and/or otherwise increase salaries and benefits to attract employees. Modestly above-average inflation is often positive for financial markets but anything over 5% is typically a red flag, and we are very close to this borderline level. Higher inflation generally has not only had a negative impact on bond market returns but also often results in lower equity market valuation levels. The Federal Reserve is looking to head off inflationary pressures by slowing or "tapering" asset purchases early in 2022 and then hiking rates in 2023. It is our hope that this will happen before the current easy-money policies result in a dramatic and longer-term increase in inflation.

Lastly, the Covid-19 virus still remains a concern slowing us from a full economic recovery. Ideally, the Delta variant recedes and the higher level of U.S. vaccinations allow our economy to return to the pre-pandemic levels.

There are still plenty of reasons for optimism as more than half of S&P 500 companies that released quarterly results in the 2nd quarter reported that revenue is already above the same pre-covid period of 2019. Continual progress in fighting the pandemic is a key prerequisite for the domestic and global economy to not only return to its prior size, but towards sustained growth in the future.

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