ICR® 2nd Quarter Newsletter – July 2021

Markets continued to move higher in the second quarter, with the S&P 500 index gaining over 8% as optimism over economic reopening buoyed stock prices. Every sector other than utilities posted positive performance, with real estate leading the way. After lagging to start the year, the tech-heavy NASDAQ composite outperformed with a 9.5% gain in the quarter. Small cap stocks had the opposite story: a strong start to the year followed by underperformance in the second quarter.

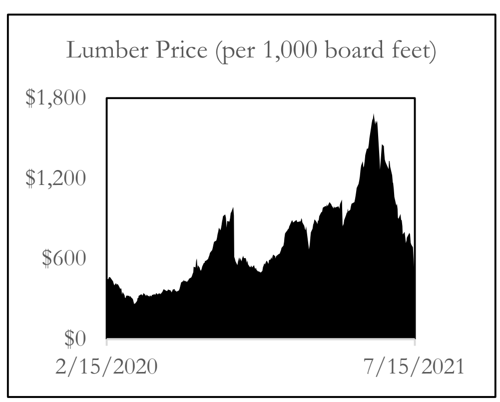
Foreign stocks rose, but lagged the U.S. markets. The MSCI EAFE index for developed foreign markets as well as the MSCI Emerging Markets index rose 4.4% in the second quarter – just a little over half of what the S&P 500 gained. With the vaccination rollout being slower in most other parts of the world, the U.S. is ahead of a lot of other countries in terms of economic reopening, which has been reflected in stock prices so far this year. Assuming other nations are able to get a large share of their populations vaccinated like we have here, we may see those markets follow suit.

Interest rates fell during the second quarter with the 10-year Treasury yield dropping from 1.75% to 1.47%. That decline has continued into the first few weeks of July as well. This move lower in rates has seemingly defied conventional thinking as it relates to other data points in the economy. The Federal Reserve is forecasting 7% GDP growth in 2021 and inflation numbers have hit their highest levels since 2008, both of which would normally indicate rising interest rates rather than declining ones.

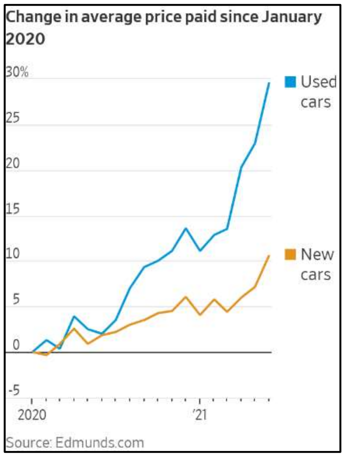
There are a few possible reasons for this seeming contradiction in traditional economic thought. First, and most obvious, is that the Federal Reserve is much more involved in the bond market than it has ever been, accounting for about half of all Treasury bond purchases last year. Second, with an aging population, the demand for safe returns is strong among retirees – even if that return is historically low. Finally, it may be that bond investors are looking past the current state of affairs. After all, part of the reason GDP growth is so strong and inflation is high is because a pandemic and economic shutdowns artificially suppressed both figures last year. So, just because those numbers are high now, it doesn't mean they'll stay that way for long.

Indeed, future inflation is particularly difficult to predict. The recent readings have been high, but the Fed argues that it is largely "transitory" and prices are simply in the process of normalizing after the pandemic-induced shocks of last year. Economists are arguing over whether the Fed is correct or if this will be a more persistent inflationary environment. One thing we know for sure, though, is that the pandemic and economic shutdowns that followed have caused some very odd economic circumstances for everyday people.

Anyone who has purchased just about anything in the past 18 months probably has a story about strange prices or long delays or simply not being able to buy something. In our last newsletter, we talked about the incredible price behavior for lumber, where the price tripled over the course of a year due to supply constraints coupled with high demand. Over the past two months, as sawmills have ramped up production and demand has leveled off, lumber prices have plummeted from a high of $1,686 to just $490.



Despite the return to normal in lumber prices, supply chains haven't been fully ironed out and there may be lasting changes to how companies do business. The global economic system has been constructed on a "just-in-time" inventory system wherein companies only produce products as needed to satisfy incoming orders. This is a very efficient system in that it doesn't require producers to find space for excess inventory. And during "normal" economic times, it works extremely well. But it is also a fragile system where a disruption at any point in the chain can bring production to a standstill for anyone further down the chain.



There is perhaps no better example of this type of supply chain disruption than the automobile industry. Now that most cars are basically computers on wheels, microchips are a vital component to building an automobile. A recent microchip shortage (caused by economic shutdowns in areas that produce them as well as increased demand from more people working from home) has slowed the production of new vehicles. With limited supply of new cars, many shoppers have turned to the used car market, where some used models are actually selling for more than new versions of the exact same car simply because they are available now rather than three months from now.

Surely, this situation won't last forever, but it is changing the way companies operate. Automakers have realized they can't be completely dependent on one manufacturer or even one region of the world, so they have begun diversifying their supply chain, both from a company perspective as well as a geographical perspective. That way, the next time a region is shut down – for whatever reason – they will have other means of procuring microchips for their vehicles. This period should provide a blueprint for companies to reduce their fragility in uncertain times, but for now, there are still many areas of the economy experiencing strange conditions from labor shortages at restaurants to exorbitantly expensive car rentals.

There are always challenges in every investment environment, but this chapter is unprecedented in many ways. GDP is booming, but the government continues to roll out economic stimulus programs. Inflation is spiking, but interest rates remain stubbornly low. Stock valuations are historically high, but just keep going higher. These – and many more – factors make it challenging for investors to navigate the markets and anticipate where things might be headed. We believe that building an all-weather portfolio with the flexibility to take advantage of opportunities that present themselves is the prudent approach to creating and protecting wealth for our clients.

As always, please reach out with any questions or concerns you may have and thank you for your support and partnership in these uncertain times.

Sincerely,

James A. Heine

James L. Cobb

Market Report (as of 6/30/21)

Index	**2021 YTD (%)**	**3-Year Annualized (%)**	**5-Year Annualized (%)**
S&P 500	14.4	9.6	15.4
Dow Jones Industrial Average	12.7	7.3	14.0
U.S. Aggregate Bond Index	-1.6	3.2	3.0
MSCI EAFE (Foreign Index)	7.3	5.6	7.5

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