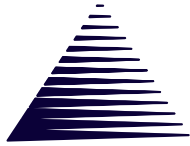


Delta Capital Management

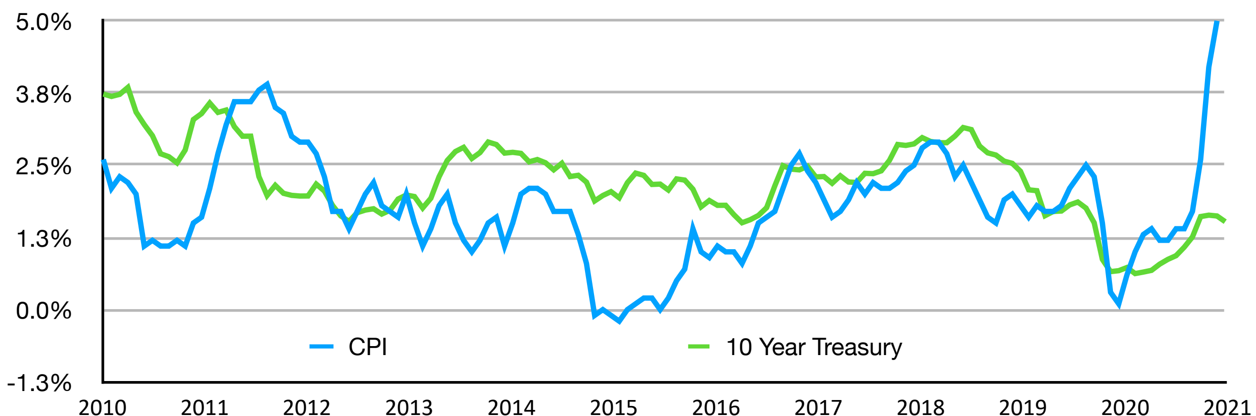
Quarterly Commentary July 2021

U.S. Markets

The first six months of 2021 continued the strong upward trend in the U.S. stock market, with the S&P 500 registering a total return of 15.3%. The strength indicates several factors that are pushing investor funds into stocks and away from other asset classes. The economy across the country and around the world is just beginning to open up its capacity in most areas. However, the recovery has started on a very uneven basis, with some industries returning toward normal much quicker than others. With the equity indexes near all-time highs, we think it is imperative for investors to be cognitive of risk, as we believe the markets are carrying higher levels of risk today than in the recent past. With aggressive government spending in the country's near future, we see the markets moving into a very different phase.

The primary concern for consumers, as well as businesses, is increasing inflation. During the early months of the recovery, the public has seen dramatic increases in the prices of many goods and services. As an example, gasoline prices have risen 50% over the past 12 months, lumber prices have doubled in some products, and with the slowing of new car production, used car prices are up by a similar percentage. The pandemic shuttered many businesses and even if a business was open, the supply chain supporting them typically had challenges to address. Production of new cars has been severely impacted by the lack of computer chips for the cars' electronic components. Ford announced today that they will be operating on a very limited capacity at eight domestic automotive plants. Many components going into vehicles are manufactured overseas. Lack of manufacturing leaves a lot of "pent up" demand among consumers. Demand without supply equals inflation.

We should highlight the fact that interest rates have moved very little over the past 18 months. The 10 year U.S. Treasury note yields just 1.5%. However, inflation in the last three months, has accelerated to above 5% on a year over year basis, the first time it has reached this level in over a decade. If we measure inflation by personal consumption expenditures, inflation has not been above 3% in over 30 years. The graph below illustrates the increase in the Consumer Price Index in comparison to the U.S. Treasury 10-Year note.



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The Federal Reserve has stated that they will not raise short term interest rates, at the earliest, until late 2022. If inflation continues above 2-2.5%, we will see market interest rates rise significantly.

Labor supply was also tempered for many reasons, with companies, especially those in the service industries, continuously desperate for workers. The stated unemployment rate has declined to about 6.5%, but the data does not include workers that have simply stopped looking for employment. The "true" unemployment level is probably closer to 9% across the country. Even with wages rising, much of the populace prefer not working as long as government transfer payments continue.

The second quarter once again saw investors aggressively buying growth stocks. Valuations of these companies are at, what we believe, are untenable levels based on projections into the distant future. The "value" side of the market is trading based on far more current earnings. Firms like Ford, 3M and many others are producing strong earnings and cash flow. Sectors such as Industrials, Finance, and Energy are highly correlated to real GDP growth, more than any of the traditional growth sectors. With growth stocks outperforming their value brethren for close to 10 years, we think the valuation disparity favors the value side of equity markets. Currently, growth stocks trade at a price to earnings ratio of 30, value stocks just 17 times earnings. This difference is about as wide as any time in the past three decades.

With the strong possibility of inflation running above 2% over the next several years, we are positioning our clients' portfolios to prepare for the potential of higher commodity prices. The price of oil has already exceeded $75 per barrel, and corresponding petroleum products have followed with dramatic price increases. Both consumers, as well as businesses have had to adjust their operations in the early stages of the post-Covid era. The strength in both stock prices and corporate earnings has seen the Price to Earnings ratio of the market actually contract to just over 20 times earnings. We believe corporations will hit record earnings in both 2021 and 2022, as long as Washington does not make any dramatic changes in the tax code.