FIRST NEBRASKA Trust COMPANY

Second Quarter 2021
Quarterly Letter to Clients
By Chad Reeson, CFA
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It's hard to believe that we're halfway through 2021. As the quarter ended, we not only had a chance to celebrate our nation's 245th year of independence with fireworks and gatherings, but we also celebrated what feels like the beginning of a return to "normal." The global pandemic is still underway, but significant progress has been made here at home in the U.S. According to the CDC, roughly 67% of the adult population has received at least one dose of the COVID vaccine. As such, that light at the end of the tunnel to begin 2021 is now brighter than most expected.

Unprecedented stimulus, massive savings, pent-up demand, energetic consumers, and accelerating capital expenditures represent solid underpinnings for the economy, which appears ready for strong growth heading into 2022. Yet, various factors – labor, inflation, fading stimulus, and policy errors have the *potential* to end the party as we move through the remainder of 2021.

Economic Overview

Spending propelled the broader U.S. economy, which grew at a 6.4% seasonally adjusted annual rate in the first quarter. Vaccinations, eased social distancing and mask mandates, and warmer weather contributed to more consumer mobility and demand across the economy. This has, in turn, lifted economic activity in many areas of the market. According to the Atlanta Fed, second-quarter GDP growth is estimated to come in even hotter at 8.6%.

Most investors have identified inflation as the next serious risk. The high monthly inflation readings in April (+4.2%) and May (+5.0%) have validated their concerns. Prices have been buoyed by a combination of rising demand (reopening economy) and constrained supply (disrupted supply chains). Commodities, used cars and trucks, transportation services, food, and shelter costs were the most significant contributors.

Oil prices continue to climb because of supply and demand imbalances. Oil companies are still producing less than their pre-pandemic levels, yet demand is roaring back as the economy reopens. Additionally, talks between OPEC and its oil-producing allies were postponed indefinitely after the group failed to reach an agreement on production for August and beyond. Crude prices rose by 24% in the second quarter alone and 51% for the first half of the year. Oil is currently trading in a range of $70-$75 per barrel, its highest level in nearly six years. This has resulted in a gallon of gasoline costing three dollars or more in many parts of the country, leaving consumers with less disposable income.

Of course, investors' inflation concerns are not just about inflation itself but policymakers' responses to it. How the Federal Reserve reacts to inflation is a key risk as we head into the second half of the year.

One of the most significant issues facing the economy during the recovery has been an undersupply of workers available to fill positions. Economists attribute this to lingering concerns over contracting COVID-19, difficulty finding childcare, and federal unemployment benefits, which may provide a disincentive for some to find work. Regardless of the cause, the labor shortages are placing a cap on GDP growth.

After falling short in April and May, the labor market ended on a high note in June as nonfarm payrolls jumped by 850,000 - the fastest pace in 10 months. Yet, the unemployment rate ticked higher to 5.9% from 5.8%, while the labor participation rate was unchanged at 61.6%. Job gains were driven by the leisure and hospitality industries; as more restaurants reopened, more COVID restrictions were relaxed, and more people emerged from their COVID caves. Overall, the labor market has added 15.6 million jobs since April 2020, but that still leaves some 6.8 million fewer employees than before the pandemic outbreak in February 2020. Job openings remained little changed at 9.2 million on the last day of May.

While still robust, the ISM manufacturing index declined to 60.6 in June from 61.2 in May, suggesting that growth could be peaking. Historically, turns in the index have tended to signal turns in the broader economy. The goods-producing sector is having difficulty meeting customer demand, as the fallout from the pandemic continues to disrupt supply chains globally. Many goods-producing manufacturers continue to find it challenging to fill open positions, limiting manufacturing growth. Notably, ISM prices paid jumped to their highest level since 1979, with a 4.2% increase.

Consumer confidence rose to its highest level since the pandemic broke out more than a year ago. Interestingly, higher prices did not appear to impact consumer spending attitudes as the proportion of consumers planning to make large purchases (e.g., homes, autos, etc.) rose. However, optimism for the labor market was somewhat mixed. Those that say jobs are "plentiful" increased by 6.6%, while those expecting more jobs to be available in the months ahead decreased by 2.0%.

Housing prices accelerated for the 11^{th} consecutive month, with the National Home Price index posting its highest annual growth rate on record. On an annual basis, the index rose by 14.6%. While higher prices are great for those who already own a home, higher prices are creating an affordability issue, which is leaving many first-time buyers out of the market.

Federal Reserve

The June meeting of the Federal Reserve's Open Market Committee (FOMC) attracted a lot of attention even though no significant changes were made to monetary policy. However, the Fed did take some important steps towards laying the groundwork for changes it will make in the future. The "dot plot," which shows policymakers' views on future interest rates showed that seven policymakers (still a minority) are in favor of at least one 25 basis point hike in 2022, up from only four back in March. For 2023, a majority of policymakers – thirteen of eighteen – are forecasting two rate hikes (for a total of 50 basis points) in 2023. Yet, the Fed's statement did not reference any changes in their thinking regarding the size of their balance sheet, which is currently growing by at least $120 billion each month through open market purchases.

The change in outlook comes on the heels of U.S. inflation data accelerating while job creation has been disappointing. The central bank has a difficult choice: keep monetary policy easy until unemployment falls further or tighten policy to keep inflation under control. Given the Federal Reserve's two primary objectives of "price stability" and "maximum employment," it appears policymakers could find themselves in a bind. As such, the risk for a Fed policy error seems to be higher.

Stocks:

Stocks are soaring again this year. The S&P 500 had its second-best first half of a year since 1998. The index ended June up 14.4% year to date, hitting record highs time after time (34 new highs this year). June was the seventh positive month out of the last eight for the S&P 500 despite the risk of rising inflation and slowing earnings growth. The Dow Jones Industrial Average (DJIA) and NASDAQ indices, the other two major equity benchmarks, were also higher by 13.8% and 12.5% year-to-date, respectively. The S&P 500, DJIA, and NASDAQ were up 8.5%, 5.0%, and 9.5% for the second quarter, respectively.

Investors trying to time the markets have had a tough time of it this year. Growth and value stocks traded market leadership positions like a hot potato during the quarter. Once left for dead during the bear market of 2020, value stocks outperformed their growth counterparts during the first half of the year. However, growth stocks regained most of that lost ground during the quarter as interest rates drifted lower. The S&P 500 Value index was higher by 5.0% during the second quarter, while the S&P 500 Growth index was higher by 12.0% during the same period. The tug-of-war between value and growth was closely tied to the direction of the 10-year Treasury rate. We still prefer a bottom-up approach to portfolio construction rather than one that tries to time the market by hopscotching based on top-down factors and timing.

As noted last quarter, the stock market continues to be expensive by most valuation measures, making it vulnerable to economic shocks that could change the future expectations of corporate earnings. According to the Wall Street Journal, the S&P 500 trading at a level of 4,297 carries a forward price/earnings ratio of 22.6x, down slightly from last quarter's 23.1x, but above the long-term historical average.

Much like GDP, the consensus on earnings seems too low. Corporate profits as measured by the S&P 500 index continue to exceed expectations. According to FactSet, first-quarter earnings grew by 52.5% on revenue growth of 10.9%. For the second quarter, analysts are projecting earnings growth of 63.6% on revenue growth of 19.6%. As a result, analysts continue to revise their numbers higher, with full year 2021 earnings now expected to grow by 35.5% from 22.6%% at the start of the year.

Bonds:

Strong economic activity in the U.S. would suggest that intermediate and long-term Treasury yields should be rising. Strong GDP growth, high inflation, rising wages, and fiscal stimulus all support this move. Yet, the U.S. benchmark 10-year Treasury yield continues to confound as growth accelerates and prices surge higher. The benchmark yield declined by nearly 30 basis points to 1.45% to end the quarter, which was well below the March 31, 2021, reading of 1.74%. As a result, the yield curve flattened, reducing the 2-10 spread by 38 basis points from 1.58% to 1.20%.

The Fed most likely remains the key force in repressing market yields. The policy-setting FOMC continues to signal 0% target rates and a growing balance sheet for the foreseeable future. However, the highly accommodative stance by central banks across the world is also suppressing global yields and attracting capital to U.S. Treasuries.

The bond market rallied and posted solid returns for the second quarter. The Bloomberg Barclays U.S. Aggregate Bond Index returned 1.83% during the quarter, after posting its worst quarterly result on record during the first quarter (-3.37%). Longer maturity bonds performed better than shorter ones, thanks to the decline in long-term interest rates; while riskier credits (junk bonds) outperformed higher quality paper (investment grade). Intermediate corporate bonds gained 1.43% for the quarter, while intermediate government bonds gained 0.44%. High-yield bonds gained the most, with a return of 2.24% for the quarter.

Finding solid investments in a period of rising uncertainty and high valuations is becoming increasingly challenging. Yet, we will continue to adhere to our investment philosophy by constructing a portfolio designed to meet your long-term investment objectives. Even though yields are unattractive, fixed-income investments will continue to be an essential part of a diversified portfolio. The fixed income portfolio's primary purpose is to protect and preserve capital, provide a stable source of income, and deliver a source of funds should a cash need arise. We will continue to buy stocks at prices that meet our investment criteria while providing an adequate margin of safety. Similarly, we will trim or sell stocks that exceed our fair value estimate to help preserve capital during a period of market downturn.

Thank you for your business. If you have questions or comments, please don't hesitate to contact us.