RICE HALL JAMES
& ASSOCIATES, LLC

*Market Review*
*Second Quarter 2021*

The second quarter marked the grand reopening of the U.S. economy with over half of the adult population vaccinated and low COVID-19 incidence, hospitalizations, and deaths. It also continued the fifth straight quarterly gain for the major domestic indices.

While almost all markets rallied, the big winner in the period was large cap growth. The S&P 500 gained 8.6% versus 4.3% for the Russell 2000. In a sharp reversal from the first three months, the S&P 500 Growth trounced the S&P 500 Value by 7.0%. Although small cap value (+4.6%) technically fared better than small cap growth (+3.9%), all the momentum was on the growth side into quarter end. Coincident with the pivot was an unexpected decline in the 10-year U.S. Treasury bond yield from 1.74% to 1.45%; the conventional wisdom remains that lower bond yields support higher equity valuations.

On one hand, the reversal in favor of large cap and growth wasn't surprising considering the extreme underperformance in the prior period. But it wasn't intuitive why bonds rallied (yields declined), or why investors would temper on the prospects for a broad-based recovery. We believe there were three primary factors that drove the shift.

First, while the signs of inflation were rampant and borne out in the pricing data, the April and May employment reports were shockingly weak. Because of its dual mandate, this provided the Federal Reserve with cover to preserve a (credible) dovish posture longer than investors believed possible. More specifically, April nonfarm payrolls increased by 278,000 jobs, which was wildly below Wall Street forecasts for 1 million additions to the workforce. This made it easier for debt and equity investors to tolerate the subsequent largest monthly increase in the CPI since 1982; after an initial spike in response to the inflation report, bond yields quickly settled lower.

Second, with the momentum at its back, the Federal Reserve was masterful in its communication and navigation. While Chairman Powell was steadfast that it was premature to think about removing accommodation, multiple committee members opined it was time to talk about tapering. This "engineered dissent" pushed the inflation debate further to the back burner while planting the seed that a change in policy course was close at hand. As a result, the central bank was able to deliver a more hawkish communique in June without derailing the bond market rally.

Lastly, inflation concerns were assuaged by a pullback in commodity prices in May and June, which was aided by a crackdown on speculation by Beijing. The trend reinforced the Federal Reserve's mantra that the increase in inflation was temporary. It also catalyzed a new narrative of "peak inflation and peak growth" that attempted to explain the pullback in yields and pivot to growth equities.

The irony, however, is that since the Fed started to discuss the importance of tightening policy, its actions have gone in the opposite direction. In May, M2 swelled by $250 billion, which translates into a $3 trillion annualized rate. The central bank's balance sheet has risen in 17 of the past 21 weeks to $8 trillion currently, and grew at an accelerating pace in June. The contradiction in sentiment and action doesn't sit well for many reasons.

In re-embracing aggressive growth, we think equity investors are taking their cue from the decline in bond yields, which is a manipulated outcome, not a market-driven signal. The inconsistency is also a stark reminder of just how difficult the actual tapering process – phasing Federal Reserve purchases out of the long-end of the bond market – is going to be. The stretch for returns in hard-to-value and unproven areas such as early-stage biotech, cryptocurrencies, blank check listings, and meme stocks provides evidence every day that we remain in a liquidity-driven market.

As bottom-up, valuation-sensitive growth investors, we remain encouraged that the majority of our holdings are still early in their earnings recovery and growth trajectory, regardless of recent concerns about the reopening recovery. While not fixed income experts, it's hard to fathom why market forces wouldn't drive bond yields higher over time. Any sustained bounce in yields in a period in which low interest rates have become the go-to justification for extreme valuations and speculative investments could be quite sobering.

Sources: *FactSet, U.S Bureau of Labor Statistics, Briefing.com, Furey Investment Partners, Wolfe Research*



*The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas. Average price data for select utility, automotive fuel, and food items are also available.*

*S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market, this world-renowned index includes 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. S&P 500 is part of a series of S&P U.S. indices that can be used as building blocks for portfolio construction.*

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Index Definition Sources: *S&P Global, FTSE Russell*