



ECONOMIC & INVESTMENT PERSPECTIVES

MID-YEAR REVIEW: INTER-CONNECTED MARKETS

Figure 1: 6/30/2021 Returns (source: Bloomberg)
 Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	QTR	YTD	1YR	Current vs. 52-wk High	Current vs. 52-wk Low
US Aggregate Fixed Income	AGG	0.8%	1.8%	-1.7%	-0.5%	-3.7%	1.9%
Investment Grade Corp Bonds	LQD	2.2%	3.9%	-1.8%	2.4%	-3.6%	5.0%
U.S. Treasury Bonds	GOVT	0.9%	1.8%	-2.0%	-3.2%	-6.1%	2.0%
20+ Year Treasury Bonds	TLT	4.4%	7.0%	-7.9%	-10.7%	-16.2%	8.4%
Muni Bonds	MUB	0.3%	1.5%	0.8%	3.6%	-0.6%	2.0%
High Yield	HYG	1.3%	2.0%	2.6%	13.0%	0.0%	8.1%
Non-US Corp Bonds	IBND	-2.1%	1.4%	-4.1%	8.4%	-5.6%	8.2%
Emerging Markets Bond LC	EMLC	-1.1%	3.6%	-3.8%	7.2%	-6.4%	3.4%
Global Equity							
ACWI Global Equity	ACWI	1.3%	7.1%	12.3%	39.3%	-0.5%	36.9%
United States	VTI	2.5%	8.1%	15.2%	44.4%	-0.3%	42.3%
International Developed	EFA	-1.1%	5.4%	9.6%	32.6%	-3.9%	29.8%
Emerging Markets	EEM	1.0%	3.8%	7.2%	39.9%	-5.4%	37.3%
Global Equity by Region							
United States	VTI	2.5%	8.1%	15.2%	44.4%	-0.3%	42.3%
Europe	IEUR	-1.5%	7.7%	13.4%	37.3%	-4.4%	36.3%
Asia ex-Japan	AAXJ	0.5%	2.3%	5.8%	38.1%	-7.8%	35.9%
China	MCHI	1.0%	1.1%	2.0%	27.2%	-15.5%	25.3%
Japan	BBJP	-1.0%	-0.8%	0.9%	24.6%	-5.7%	25.5%
Latin America	ILF	4.1%	15.5%	8.7%	49.3%	-3.1%	52.8%
US Equity							
US S&P 500	IVV	2.3%	8.4%	15.2%	40.9%	-0.2%	38.6%
NASDAQ 100 QQQ	QQQ	6.3%	11.2%	13.2%	43.8%	-0.2%	43.4%
US Large Growth	IWF	6.1%	11.8%	12.9%	42.3%	-0.3%	41.4%
US Large Value	IWD	-1.2%	5.0%	16.9%	43.4%	-2.9%	43.8%
US Eqwt S&P 500	RSP	0.0%	6.7%	19.1%	49.8%	-1.4%	51.6%
US Mid Cap	IJH	-1.1%	3.5%	17.6%	53.1%	-3.2%	56.0%
US Small Cap	VTWO	1.8%	4.0%	17.4%	62.2%	-2.2%	67.2%

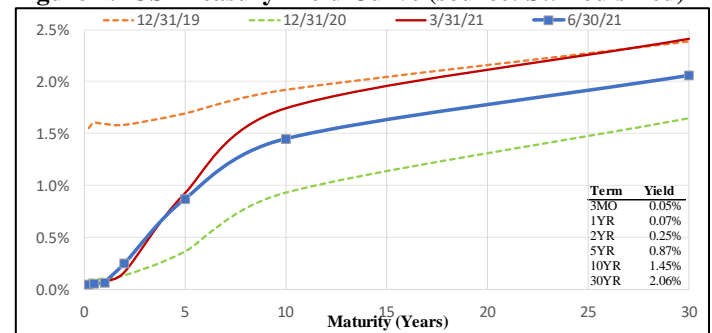
Interest rates edged lower in June as investors shrugged off inflation worries for the time being and bid up growth assets. The S&P 500 closed the month at an all-time high, but returns varied across size, style and regional cohorts. Performance highlights for the month and second quarter (Q2) are summarized below.

- **Bonds:** The US Aggregate index (AGG) rose 0.8% this month (+1.8% Q2) as interest rates declined. High yield (HYG) gained 1.3% (+2.0% Q2), while non-US bonds (IBND) fell 2.1% (+1.4% Q2) as the dollar strengthened during the month.
- **Global equity (ACWI):** +1.3% this month (+7.1% for Q2).
- **US Equity:** The broad market (VTI) rose 2.5% in June (+8.1% Q2), while the S&P 500 (IVV) was +2.3% (+8.4% Q2). Small caps (VTWO) were +1.8% this month (+4.0% Q2), under-performing large stocks but still lead year-to-date (YTD). Growth stocks (high earnings growth and valuations) dramatically outperformed value stocks (lower growth and valuations, higher dividends) for the month amid diminishing inflation concerns; the growth ETF (IWF) rose 6.1% (+11.8% Q2) while its value counterpart (IWD) fell 1.2% for the month (+5.0% Q2). Value still leads growth YTD and over the last 12 months.
- **Non-US Equity:** Developed market (EFA) lost 1.1% in June (+5.4% in Q2), led lower by European (IEUR) and Japanese (BBJP) stocks. Emerging markets (EEM) were +1.0% (+3.8% Q2), led by Latin America (ILF +4.1% in June, +15.5% Q2); Chinese stocks (MCHI) rose modestly for the month and Q2.

Interest Rates and the Economy

Interest rates declined again this month as inflation fears dissipated. Figure 2 graphs the US yield curve, which plots yields (Y-axis) for various maturities (X-axis) of US Treasuries. Short-term yields remain near zero while long-term rates have moved lower, flattening the yield curve. The US 10-year bond yield fell from 1.74% to 1.45% in Q2 as the Federal Reserve (Fed) reiterated its accommodative policy stance and the belief that elevated inflation readings are “transitory”, forecasting core inflation of 3.4% for 2021, moderating to 2.1% in 2022 and 2.0% longer term.

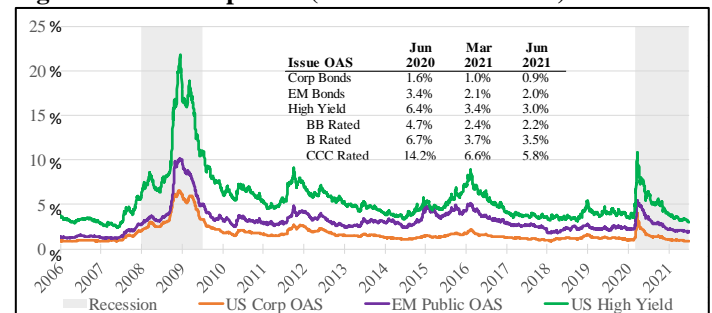
Figure 2: US Treasury Yield Curve (source: St. Louis Fed)



For bonds other than US Treasuries, we track the option-adjusted spread (OAS) between yields and Treasuries of comparable maturities. Low or narrowing spreads signal optimism while high or rising spreads signal fear. Spreads spiked in early 2020 but have tightened steadily since as pandemic fears have eased and investors chase yield in a low interest rate environment.

- Investment grade corporate bond spreads were stable last month at 0.9% versus 1.0% in March and 1.6% a year ago.
- High yield (non-investment grade) spreads narrowed to +3.0% and are significantly below year-ago spreads of +6.4%. The riskiest bonds (rated CCC & below) yield just +5.8% over Treasuries, down from 6.6% in March and 14.2% a year ago.
- Emerging market bond spreads narrowed further to +2.0% this month versus +2.1% in March and +3.4% one year ago.

Figure 3: Credit Spreads (source: St. Louis Fed)



Mid-Year Review: Inter-Connected Markets

Now that we are halfway through 2021, it is instructive to pause and review the year-to-date (YTD) market action. Equities have logged strongly positive returns in aggregate after performing well in the first and second quarters of the year (Q1 and Q2); bonds are down YTD even after a strong Q2. Contrasting the quarterly returns reminds us that markets are inter-related.

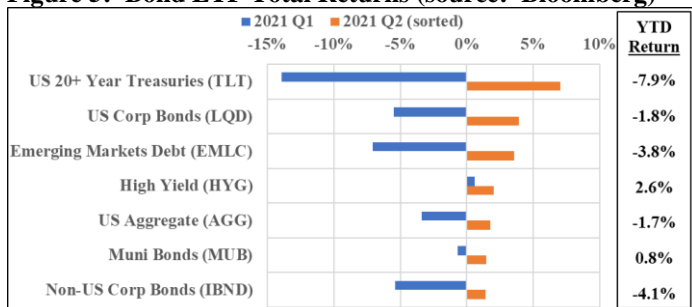
The first and second quarters were marked by distinct interest rate regimes. In Q1, interest rates rose significantly off of pandemic lows as the economy strengthened and inflation fears crept into the conversation. In Q2, rates moderated as the Fed repeatedly calmed investors, stressing their belief that the recent inflation spike is transitory and that monetary policy would remain accommodative (low interest rates) for several more years. Figure 4 graphs the path of long-term interest rates (US 10-year Treasury yield – blue line) versus shorter-term yields (US 2-year Treasury yield – orange line) since the beginning of 2020. The shaded green area is the spread or difference between these two yields.

Figure 4: US 10YR vs. 2YR Yields (source: St. Louis Fed)



Prior to the pandemic, interest rates were higher than today; the US10YR yielded 1.92% while the US2YR yield was 1.58%. The spread between these two was only 0.34%; this is what we mean by a flat yield curve – little difference between short- and long-term rates. (Note: You can also see how flat the yield curve was in Figure 2 on the prior page.) As the crisis unfolded, the Fed cut interest rates and injected massive liquidity into the bond market, bringing interest rates down across the board. Long-term yields stabilized and began to move higher in late 2020 through March, 2021, but short-term rates remained near zero, resulting in a steepening yield curve (measured by the growing spread between long- and short-term yields). The curve began to flatten in Q2 as long-term rates fell and short-term yields began to rise. As one might expect, the distinct interest rate regimes resulted in dramatically different bond returns in Q1 (negative as yields rose) and Q2 (positive as long-term yields fell), as illustrated in Figure 5.

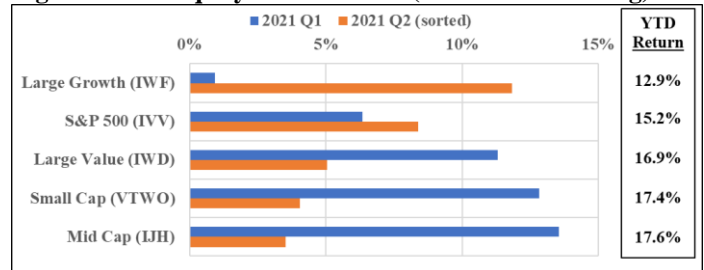
Figure 5: Bond ETF Total Returns (source: Bloomberg)



That bond market returns differed in the two regimes is not surprising, but an analysis of equity returns across the two periods

underscores how important interest rate changes are to the equity markets (stocks). Figure 6 illustrates the complete reversal of leadership within the US equity markets in Q2 versus Q1.

Figure 6: US Equity ETF Returns (source: Bloomberg)



While long-term yields were rising and the yield curve was steepening in Q1, growth stocks (NASDAQ QQQ) under-performed, as rising interest rates and inflation concerns negatively impacted the perceived value of the future earnings of high earnings growth stocks and sectors (like technology). Economically-sensitive (mid and small caps) and value stocks thrived as the economy recovered; financial stocks (especially banks) performed extremely well because a steeper yield curve directly affects their earnings (net interest margin: banks earn long-term interest rates on money they lend and pay short-term rates on deposits). As the yield curve flattened in Q2, growth stocks resumed the leadership role as lower interest rates and diminishing inflation fears restored investors' faith in the value of high future earnings growth.

Global equity returns varied across regions and time as well (Figure 7). US stocks have led this year, up 15.2% with strong gains in Q1 and Q2. European stocks have been similarly strong (+13.4%) as their pandemic and economic recovery mirrors that of the US. Japan is the laggard among developed markets (weakening yen, Olympics uncertainty, etc.). Emerging market equity returns have been mixed, with Latin America (specifically Brazil) rising sharply in Q2 amid signs of progress against the pandemic, which devastated the region well into Q1 of this year. Chinese equities have been relatively flat this year amid government crackdown on the monopolistic tendencies of the various huge Chinese technology and consumer-related companies.

Figure 7: Global Equity ETF Returns (source: Bloomberg)

Global Equity by Region	ETF	Q1	Q2	YTD
United States	VTI	6.5%	8.1%	15.2%
Europe	IEUR	5.2%	7.7%	13.4%
Asia ex-Japan	AAXJ	3.4%	2.3%	5.8%
China	MCHI	0.9%	1.1%	2.0%
Japan	BBJP	1.7%	-0.8%	0.9%
Latin America	ILF	-5.9%	15.5%	8.7%

Bottom Line

The global recovery has progressed faster than most would have suspected, resulting in stunningly strong equity returns. Markets are transitioning from the “easy money” phase of the recovery, powered by unprecedented monetary and fiscal support and successful vaccines, toward the “show me the money” phase, where economies must stand on their own as the Fed and global central banks contemplate the withdrawal of support. Volatility is likely to remain, and returns will likely be choppy going forward, as economic activity, employment, inflation and interest rates struggle to find equilibrium. The inter-connected nature of US and global markets and the rapidly shifting leadership within those markets underscores the value of a diversified portfolio.



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