Colorado Capital
MANAGEMENT

QUARTERLY MARKET UPDATE / JULY 2021

Economic Outlook

Overview/GDP

The economy gained considerable momentum this spring as COVID vaccination rates nearly doubled and the number of daily new cases plummeted. These developments allowed for the loosening of restrictions on business operations. Consumer confidence and spending surged, contributing to the economy growing at an estimated annualized rate of 7% to 9%, well above the historical norm of 2% to 3% growth. The stock market followed suit with the S&P 500 delivering an 8.5% return for the quarter, resulting in its price to earnings (valuation) ratio remaining well above historical norms.

The Spring's economic boom was not without growing pains. Shortages cropped up and intensified for a wide array of input materials due to the sudden resurgence in demand amid lean inventories and severely disrupted supply chains. Businesses struggled to find needed workers. Inflation jumped dramatically, the dollar fell and employment improved only modestly. Supply-side constraints notwithstanding, real economic growth for the year is projected to come in at a 6% to 7% pace, the fastest in decades.

CCM Key Economic Indicators

Indicator	6.30.21	3.31.21	6.30.20
US Economy			
Quarterly GDP Growth	Est. 7-9%	6.4%	-31.4%
Unemployment Rate	5.9%	6.0%	11.1%
U.S. CPI (Core)	4.4%	1.65%	1.20%
Interest Rates			
Fed Funds Rate	0.0%	0.0%	0.0%
10-Year Treasury Rate	1.52%	1.61%	0.73%
Currency & Commodities			
Crude Oil (WTI)	$ 73.52	$ 59.19	$ 39.27
Gold Price	$ 1,758	$ 1,685	$ 1,771
Trade Weighted Dollar Index	111.9	113.6	119.9
Confidence			
Consumer Confidence Index	127.3	109.7	98.1
ISM Purchasing Managers Index	60.6	64.7	52.2
Stock Prices			
Dow Jones Industrial Average	34,506	32,982	25,813
S&P 500 Forward P/E ratio	21.5	21.9	21.7

Employment

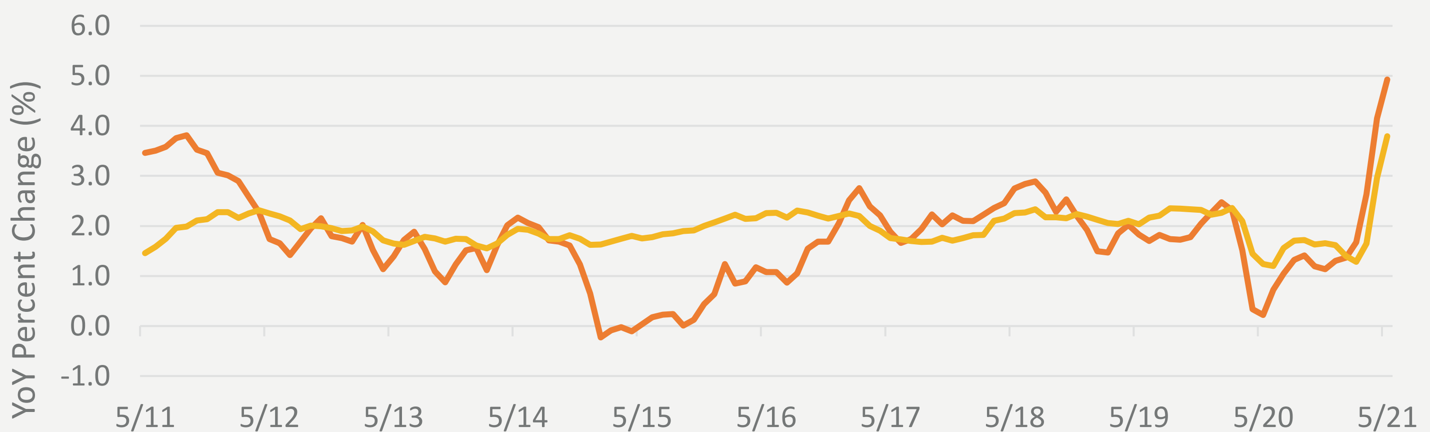
The economy's recovery has continued to be uneven. Hiring gains have lagged GDP growth as millions of workers remained sidelined due to factors such as expanded unemployment benefits, increased child-care responsibilities, and fear of Covid-19. Unemployment improved only modestly during the quarter, dropping from 6% to 5.9%.

Inflation

Consumer prices are surging, fueling concerns that the Federal Reserve will not raise interest rates soon enough to contain inflationary pressures. Core inflation for the last twelve months was 4.4%, more than triple the level a year ago. The broader index, which includes food and energy was up 5.3%. While the pace of inflation has certainly accelerated (see chart below), it is important to recognize that the pandemic pushed inflation numbers to unusually low levels last year.

Demand for goods, and especially services, has increased as a result of higher vaccination rates, fewer restrictions on businesses, massive federal spending on pandemic relief programs and ample consumer savings. At the same time, supply constraints arising from widespread shortages of materials and labor and lengthened delivery times, together with sharply rising energy, transportation, and commodity prices have all contributed to inflationary pressures exceeding expectations.

Inflation (Consumer Price Index)



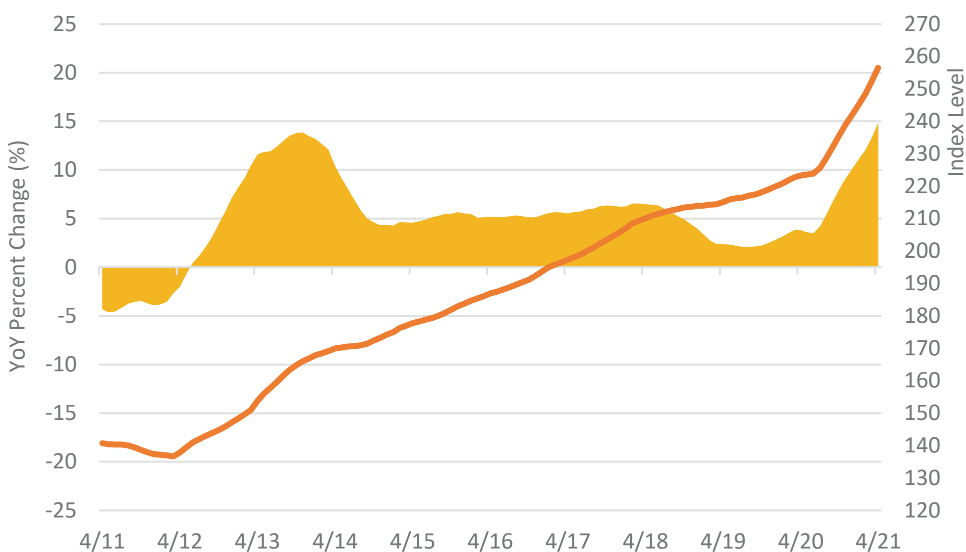
Source: U.S Bureau of Labor Statistics

The core PCE deflator, which is the Fed's preferred measure of inflation, is now anticipated to average 3.0% over the next four quarters. Whether an upswing in prices proves temporary is a key question for financial markets and the U.S. recovery, as the Biden administration, Congress, and the Fed continue to support the economy with fiscal and monetary policy measures.

Fed officials expect the current mismatch between supply and demand to be temporary. They see inflation receding next year after the initial spike in demand abates and as the labor force expands once the pandemic has subsided. But if tight inventories and supply shortages extend into 2022 - putting more pressure on inflation - officials could find themselves under pressure to change their easy-money policies sooner than planned.

Housing

The number of home sales climbed to a 14-year high toward the end of last year but has since eased considerably. The overriding theme has been one of a shortage of inventory. Housing resale inventories currently sit at a little over one million, near record lows and down 20% from last year. This tight supply has resulted in sharp home price appreciation. In most states, however, home price gains have slowed from the red-hot pace at the end of last year. Builders have ramped up the construction of homes, an element that should offer further price respite down the road. However, rising building input costs e.g., soaring costs of copper and lumber, have posed an added challenge.



Together with a likely upward trend in mortgage rates, affordability challenges could become more significant in the quarters ahead. This could tilt some demand back toward the rental market, particularly for lower-income households and those whose jobs require a physical presence in dense urban areas.

The Dollar

The U.S. dollar fell 1.6% during the quarter against a basket of foreign currencies and is down 6.7% over the last 12 months. The dollar rose sharply during the first months of the pandemic, but it has now given up all of those gains and more. Part of the reason for the softness in the dollar has been that interest rates set by the Fed in the United States have remained unchanged over the last year, while foreign central banks across the G10 have already taken, and will likely continue to take, more concrete steps to tighten monetary policy.

A weaker U.S. dollar also reflects the improving growth outlook for foreign economies. Synchronized growth across the major developed countries pushed the dollar lower after the global financial crisis in 2009 and again in 2017. As the post-COVID recovery becomes more engrained, those dynamics will likely repeat themselves and the U.S. dollar may depreciate further against both developed and emerging market currencies. However, if the Fed continues to become more hawkish and accelerates its timetable for raising interest rates, the dollar would likely be much more resilient.

Government Spending

President Biden has outlined his policy agenda to "Build Back Better" by spending roughly four trillion dollars over ten years on a host of infrastructure, research and development, education, and childcare measures. The administration has estimated that this ambitious spending agenda will be paid for over 15 years through increases in taxes on corporations and high-income taxpayers. The plans are unlikely to pass "as is," even under the reconciliation process, but a large element will likely be incorporated in the months ahead. Unlike the recently enacted American Rescue Plan, which was intended to stimulate the economy in the short-term to counteract the damage from the pandemic, the policies in Biden's latest plan would be an attempt to increase the productive capacity of the U.S. economy over the long term through investments in human and physical capital.

Depending on the timing, these plans could modestly boost GDP growth starting in 2022. However, without much detail at this point and with changes likely, any estimates at this stage would be highly uncertain. A very rough range would be that they could add around 0.3 to 0.5 percentage points to GDP growth in 2022, increasing slightly through 2023-24. Thereafter, there would be some fiscal drag as the peak spending years of infrastructure spending wind down.

Over the medium term, the American Family Plan (AFP) could help lift women's labor force participation rate through a combination of paid parental leave and direct funding for childcare.

Eurozone

The Eurozone economy is recovering but at a slow pace. In part, this has reflected a slower start by many Eurozone governments in vaccinating their populations against COVID. Unlike in the U.S., the level of Eurozone Q1 GDP was still 5.1% below its pre-pandemic peak from Q4 2019. Going forward, the euro should perform moderately well versus the U.S. dollar, although the euro could strengthen over the long term as the economic recovery in the Eurozone gains further momentum.

Outlook

The U.S. economy has outperformed most expectations in the first half of the year. Thanks to two rounds of fiscal stimulus and quick ramp-up in vaccinations, real GDP sprinted out of the starting blocks in the first quarter at 6.4% (annualized) and likely grew even faster in the second quarter. The consumer has been the biggest part of that story as household spending surged by 11% in the first quarter. Businesses are also spending, with investment in equipment and intellectual property growing 15%.

Turbo-charged government spending, substantial household savings, rising wages and reduced COVID risk should continue to underpin a freedom-induced spurt in consumer demand. Households have built up over $2 trillion in excess savings and are well placed to keep spending as the economy reopens. However, spending is likely to increasingly shift from goods to services as restrictions for social engagement ease and supply constraints continue. Shortages of everything from semiconductors to sweatpants have deepened, adding to pressure on inflation and testing the Federal Reserve’s resolve to keep juicing the economy. While these constraints will limit economic expansion, we still expect to see 6% to 7% real economic growth for the year, which would be the strongest since 1984.

Market Commentary

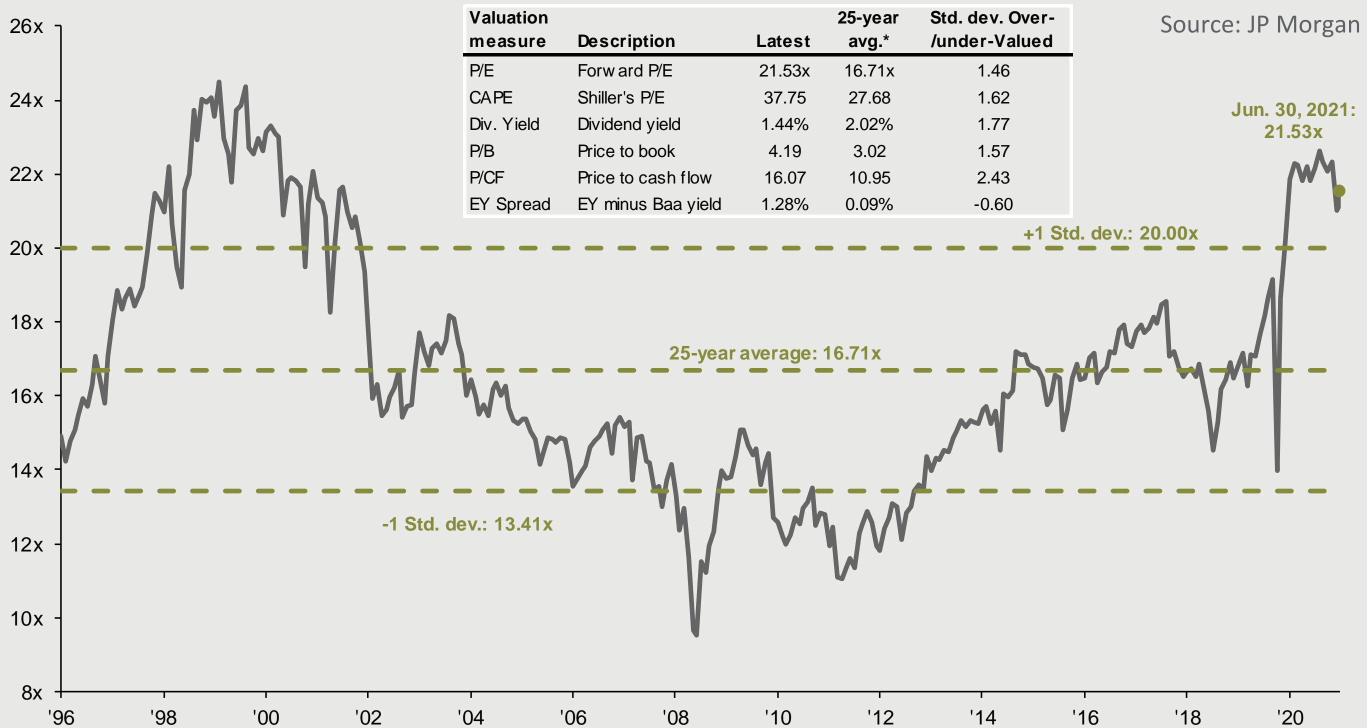
Recap

Equity markets rose during the second quarter amid the ongoing rollout of COVID-19 vaccines and strong reported first quarter corporate earnings. For the quarter, the S&P 500 gained 8.6%. Overseas, the MSCI EAFE Index earned 5.2%, and the MSCI Emerging Markets Index increased 5.1%. Fixed income markets produced broadly positive returns. The Barclays U.S. Aggregate Bond Index gained 1.83% but is down for the year.

Domestic Equities

The S&P 500 closed Q2 at an all-time high. The appreciation was supported by strong earnings growth as 86% of S&P 500 companies reported first quarter results that exceeded analyst expectations. The S&P 500 ended the quarter priced at 21.5x projected earnings, about 30% higher (1.5 standard deviations) than the average multiple the market has traded at over the last 25 years. And as shown in the chart below, most other valuation measures suggest the market is even more overvalued.

S&P 500 Index: Forward P/E Ratio



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	21.53x	16.71x	1.46
CAPE	Shiller's P/E	37.75	27.68	1.62
Div. Yield	Dividend yield	1.44%	2.02%	1.77
P/B	Price to book	4.19	3.02	1.57
P/CF	Price to cash flow	16.07	10.95	2.43
EY Spread	EY minus Baa yield	1.28%	0.09%	-0.60

Reversing a trend established last October, growth stocks outperformed value names. During Q2, the Russell 3000 Growth index gained 11.4% while its value counterpart rose a more modest 5.2%. Year-to-date, value remains ahead of growth by about five percentage points. For the quarter, the energy, technology, communication services, and real estate sectors led the way, each generating double-digit gains. Small cap stocks posted a 4.3% gain in Q2. With a year-to-date gain of 17.5%, small caps have outperformed large and mid-cap names during the first half of the year.

International Equities

Overseas, equity markets also produced positive gains but underperformed their U.S. counterparts. In Europe, share prices rose as the pace of the vaccine rollout accelerated. First quarter corporate earnings in Europe were generally very robust. In Japan, stocks produced a negative result for the quarter as a persistent increase in COVID cases led the government to delay lifting its declared state of emergency. Emerging markets generated solid equity returns during the second quarter. Among the BRICs, Brazil led the way with returns boosted by currency strength. Russian stocks also delivered double-digit gains as oil prices rose, while Indian stocks increased nearly 7% despite the country's surge in COVID-19 cases. Chinese equities lagged the broader emerging markets index for the quarter.

Fixed Income

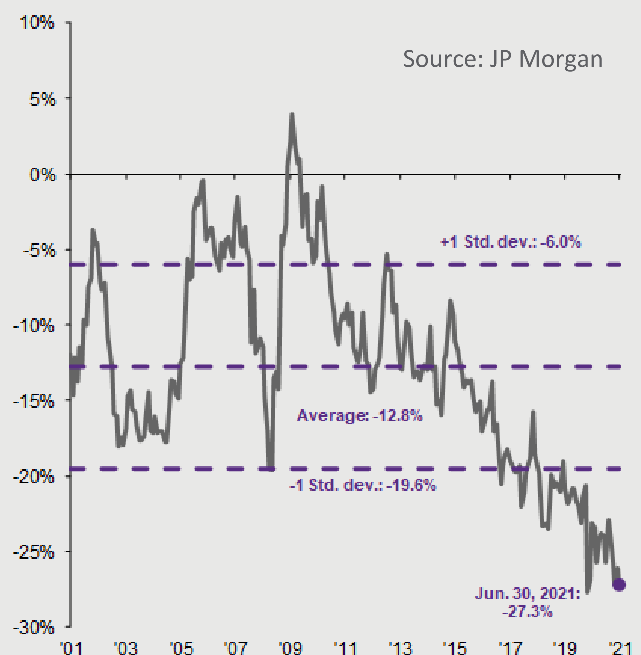
The aggregate US Bond market rose 1.8% during the second quarter as yields fell, but it remains down 1.6% year-to-date. The Fed (FOMC) raised its inflation expectations for this year (now 3.4%) and brought forward the time frame for when it will raise interest rates (now as soon as 2023). Discussions about when to pull back the Fed's $120 billion in monthly bond purchases also commenced. In the U.S., corporate bonds, TIPS, and high yield outperformed with returns in the 3% range for the quarter. European bond results lagged the U.S. while Emerging market bonds were particularly strong.

Outlook

Since bottoming in March of last year, equity markets have generated dramatic returns. Over the last few quarters, pent up consumer demand has provided a tailwind for cyclical stocks in the hardest hit areas of the market. Cyclical names should continue to show strength in the intermediate term.

While economic and earnings growth are expected to remain strong through the rest of the year, there are several risks worth monitoring. As noted previously, U.S. equities appear expensive compared to historical norms. As a result, continuing to meet corporate earnings expectations will be important. Inflation is also a significant risk. If it persists, higher inflation could trigger a more hawkish tone from the Fed and volatility in the markets. Tax policy is also an area of risk to investors as lawmakers debate various proposals

International: Price-to-earnings discount vs. U.S.



Finally, pandemic related concerns remain, particularly in the form of COVID-19 variants.

Broadly speaking, valuations overseas are attractive, with average price-to-earnings ratios two full standard deviations below that of the S&P 500 (see chart). In addition to more attractive valuations, these markets also have relatively more cyclical stocks than the U.S., which as noted above, are expected to outperform.

In Europe, the vaccine rollout is gaining momentum, and a more sustained reopening of economies is on track for the second half of the year. The fiscal boost from the European Union's recovery fund should also help maintain the region's economic rebound. In Japan, the recovery has been constrained by localized outbreaks of COVID-19, which have led to renewed lockdowns of metro areas. However, a solid economic recovery is expected through the back half of the year, boosted by strong global capital expenditures and a rebound in the service sector. In the U.K., strengthening is expected in both GDP and corporate profits as the market recovers from the dual headwinds of Brexit and the pandemic.

Many emerging markets continue to struggle with the pandemic. Unlike the developed economies, the U.S. and U.K. in particular, vaccine rollout remains low. Vaccine hesitancy, vaccine supply and logistical difficulties are all challenges in these markets.
Consequently, the COVID-19 virus continues to mutate, and caseloads and hospitalizations remain high. On a positive note, first quarter economic output exceeded expectations in most developing nations. Emerging market equities have been laggards since the announced development of a vaccine, having been held back by the relatively high weighting of technology stocks, China related issues and COVID-19 challenges. These trends should start to reverse later in the year. U.S. dollar weakness is also supportive of emerging markets.

For fixed income investors, current bond yields do not appear to be consistent with the likelihood of continued strong economic growth and the risk of higher inflation. Thus, rising bond yields in the second half of the year would not be surprising. Anchored by Fed policy, short term rates should remain close to zero, but the 10-year Treasury yield may rise to the 2.0% to 2.5% range. Given this environment, investors may want to keep the average duration in their portfolio relatively short. Expansive fiscal policy and improving economic growth support the credit quality of corporate bonds. Municipal bond fundamentals have seen significantly improved fundamentals, boosted by more than $1 trillion of stimulus. Tax exemptions offered by this asset class will be especially attractive if higher tax proposals are enacted. High quality core bonds should continue to serve as a ballast in equity heavy portfolios.

Sources: Capital Market Consultants, Department of Labor, Department of Commerce, European Central Bank, Morningstar, Bloomberg, Johns Hopkins University

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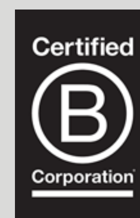

Colorado Capital
MANAGEMENT
Enriching Lives

4430 Arapahoe Ave.
Suite 120
Boulder, CO 80303

Phone: 303.444.9300
Fax: 303.444.2027
info@coloradocap.com
www.coloradocap.com

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