CAPITAL INVESTMENT SERVICES, LLC

Stocks Hit New Highs as the Pandemic Recedes and Inflation Soars: Market Commentary – Q3 2021

Market Highlights

The S&P 500 had a strong start to the second quarter thanks to numerous positive developments in April.

- The pace of vaccinations in the U.S. accelerated. The increased pace of vaccinations combined with a decline in COVID-19 cases helped numerous states fully reopen their economies. That served as a positive signal to investors that a return to pre-pandemic normal may be on the horizon.
- The Federal Reserve reiterated its support for the economy and promised not to remove any accommodation in the near term. That continued "safety net" gave investors confidence in the future economic outlook and the sustainability of the economic recovery.
- First-quarter corporate earnings were very strong, as the vast majority of U.S. companies beat earnings estimates.

In May, concerns developed on structural issues within our capitalistic economy thanks to uncertainty regarding inflation, the labor market and when the Federal Reserve would begin to reduce, or taper, its quantitative easing (QE) program.

- A disappointing jobs number in early May implied the labor market might not be recovering as quickly as expected.
- With inflation data hitting multi-decade highs, some institutional investors became concerned that the economic recovery might not be as strong as forecasted.
- It became apparent that the lackluster job growth was more a function of a labor supply issue rather than there not being enough jobs available.

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Federal Reserve officials reiterated their long-held position that any increase in inflation would be temporary and due to pandemic-related supply chain disruptions and not the return of 1970's style inflation problems.

Stocks resumed the rally in early June, as measures of economic activity remained strong. The June Fed meeting provided a small surprise to markets, as it revealed that Federal Reserve officials began discussions about when to reduce the current quantitative easing program, while Federal Reserve forecasts showed interest rates could start to rise late in 2022, sooner than previously expected. Those two surprises caused some mild market volatility late in June, although ultimately investors remained confident that the Federal Reserve will not remove economic support too quickly and the S&P 500 hit another record high during the last few days of the quarter.

In summary, the strong gains of the second quarter and the first half of 2021 reflected continued government support for the economy combined with a material improvement in the pandemic in the United States. As we start the second half of 2021, we are happy to say the world looks a lot more like it did pre-pandemic than it did for most of 2020, and that sentiment is supportive of risk assets going forward.

2nd Quarter Performance Review

US Equity Indexes	Q2 Return	YTD
S&P 500	8.95%	15.25%
DJ Industrial Average	4.81%	13.79%
NASDAQ 100	13.07%	13.34%
S&P MidCap 400	3.57%	17.38%
Russell 2000	5.47%	17.54%

- The Nasdaq outperformed both the S&P 500 and Dow Jones Industrial Average thanks to a June rally in technology shares, as investors began to consider that the intensity of the economic recovery had possibly peaked now that virtually all state economies had fully reopened.

- The Federal Reserve signaling that it has begun discussions to reduce its QE program made some investors nervous that economic growth could slow in the future, contributing to that rotation back towards technology stocks, which tend to be less sensitive to changes in economic growth compared to other market sectors.

- Large-cap stocks outperformed small-cap stocks, which was a reversal from the previous two quarters.

- Growth handily outperformed value as investors positioned for the possibility that the intensity of the economic recovery may wane in the coming months.

- Commodities posted strong gains for the third quarter in a row and once again outperformed the S&P 500 over the past three months.

- Gold, meanwhile, posted a small gain as investors rotated back to gold following a spike in inflation metrics, combined with an increase in volatility in Bitcoin, which sent money back into more traditional non-correlated, safe-haven assets.

- Despite inflation indicators surging to multi-year highs in recent months, investors viewed those increases as temporary phenomena related to the global economic reopening and short-term supply chain issues.

3rd Quarter Market Outlook

Strong performance in the first half of 2021 should not be taken as a signal that risks no longer remain. In fact, the next three months will bring important clarity on several unknowns including inflation, labor shortage, future Federal Reserve policy, and the pandemic.

Regarding inflation, some metrics in June implied that the spike in inflation during the second quarter is starting to reverse, but that debate is far from settled. To that point, no one knows what the trillions in pandemic stimulus combined with 0% interest rates and the Fed's ongoing QE program will do to inflation over the longer term. If this sudden surge in inflation is indeed just temporary, we should see more conclusive evidence of that during the third quarter. However, if inflation is not temporary and becomes "sticky" inflation then higher prices will act as a significant headwind to economic growth.

The Federal Reserve, meanwhile, has started the process of communicating how it will begin to reduce support for the economy via "tapering" or reducing, its quantitative easing program. The last time the Fed had to deliver that message, they triggered the "Taper Tantrum" of 2013, which saw stock and bond market volatility rise significantly.

Finally, despite significant progress against COVID-19 here in the U.S., the pandemic is not over. There remains a possibility that a new COVID-19 variant appears and renders the vaccines less effective. If that happens, markets will become concerned that progress towards a return to economic "normal" will be reversed and that will cause volatility.

While there has been progress made in the United States against the pandemic, and life as we know it has returned mostly to normal, now is not a time to become complacent as numerous economic and pandemic-related risks remain. We should remain prepared for bouts of market volatility. Yet while risks remain to the markets and the economy, as they always do, it is important to remember that a well-executed and diversified investment strategy can overcome bouts of volatility.

At Capital Investment Services, we understand the risks facing both the markets and the economy. We are committed to helping you effectively navigate this still-challenging investment environment. Successful investing is a marathon, not a sprint. Therefore, it's critical for you to stay invested, remain patient, and stick to the strategy. We remain focused on risks to portfolios and the economy, and we thank you for your ongoing confidence and trust.

Our team remains dedicated to helping you successfully navigate this market environment. Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio review.

Sincerely,

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