Economic Growth Should Win in Market Tug of War

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The market is experiencing a tug of war between the impressive acceleration of economic growth due to global re-openings and fears of a resurgence of COVID-19 case counts, but we believe economic growth will win out.

While the resurgence of COVID-19 cases is concerning, the optimistic view is that the vaccines are working, and the delta variant is proving not as harmful as anticipated.

As for recent economic activity, it has been more of the same, with both consumption and production activity strong (in some cases above 2019 levels). While we expect that a sequential peak in gross domestic product (GDP) growth likely occurred in the second quarter, the remainder of the year should continue to be quite strong, in our opinion.

Corporate Earnings Growth Impressive

Corporate earnings growth, which has been impressive thus far in 2021, remains underestimated. In fact, projected bottom-up corporate profit growth lags top-down GDP estimates by a wider margin than we saw coming out of the global financial crisis (GFC) of 2008. Thus, we are confident that profit growth will continue to surprise to the upside.

As is the case in almost every economic expansion period, earnings growth has been the key market driver. We are now clearly in expansion mode, with the corporate profit picture and market leadership following the script.

During the second quarter, we saw earnings revisions and momentum lead market performance, while valuation flipped from dominating in the first quarter (typical of recovery periods) to not much of a factor. Quality and growth reasserted themselves positively. All of these characteristics are typical of performance during an economic expansion and, we believe, are likely to continue.

Inflation Abating?

Inflation concerns have been a natural topic of debate all year. We continue to foresee reflation returning to long-term (i.e., manageable) levels. In this unique cycle, we are experiencing price increases driven by the re-opening of supply not keeping up with demand.

While in some cases we are already seeing a few industrial commodity prices reverting, we expect that it will take another three to six months for the supply catch-up to occur across most industries.

Markets Appreciating

The global market is up close to 40% over the last 12 months. While market valuations receive a lot of attention, perhaps unnoticed is that this market appreciation has been driven entirely by earnings growth. The market has actually de-rated a bit during this period.

More economically sensitive sectors of the market (e.g., cyclicals and financials) have re-rated along with a resurgence of their growth. In contrast, companies with stronger structural long-term growth have lagged on a relative basis, and in some cases have seen their stock multiples compress. We view this is a classic period of structural winners “growing into” their multiples.

Consistent with our growth outlook, we believe most of this experience is likely behind us, but may occur off and on during the balance of the year as the market digests the economic and profit picture. Ultimately, as economic growth reverts to the long-term mean and the market begins to discount peak cyclical earnings, we believe the structural growers will again have their day.

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