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SIX SURPRISES SO FAR IN 2021

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2021 has been a very strong year for both stocks and the economy, but that doesn't mean there haven't been some surprises. Below we take a look at some things that have happened so far in 2021 that have surprised the LPL Research team.

SURPRISE 1: YIELDS AREN'T HIGHER

Interest rates have surprised us twice this year. While we expected interest rates to increase this year, the strength of the move higher in the first quarter of 2021 was the first surprise. But reversing course and steadily falling since March may be an even bigger one. Put them together and the 10-year Treasury yield is still about 0.35% above where it was at the start of the year. Incredibly enough, we're still in a rising rate environment. But the more recent decline is what's on investors' minds.

We don't think there's a simple explanation for why rates have fallen since March. A lot of factors have contributed: outsized inflation expectations coming down; short covering from crowded bets on higher rates; foreign buying; the drawdown of the Treasury General Account balance; and rising economic concerns about the impact of the Delta variant have all contributed. Part of the story is just one surprise correcting another. The 10-year yield had likely risen too far too fast in late 2020 and early 2021 and a course correction was natural, even if the pullback has been stronger than expected.

What's the outlook for the rest of the year? Despite four months of falling rates, growth and inflation expectations still point to higher rates. Plus, don't forget that the 10-year yield is still higher this year and we wouldn't be at all surprised to see it resume its climb.

SURPRISE 2: STOCKS HAVE BEEN STRONG AND CALM

Although we came into the year expecting solid stock gains, even we are surprised by just how much strength there has been this year for equities. After gaining 16% last year and 29% in 2019, the S&P 500 Index is up another more than 17% so far this year. Even more surprising though is the lack of volatility we've seen so far.

Historically, year two of a bull market can be choppy and quite frustrating. After the huge gains we saw the last nine months of 2020, we entered 2021 expecting there to be more give and take than we've seen this year. In fact, the S&P 500 hasn't even had as much as a 5% pullback since October 2020, one of the longest streaks ever. That is very surprising indeed.

After more than a 90% rally off the March 2020 bear market bottom (and near double on a total return basis) we do think the odds are much higher of a standard 5-8% pullback during the historically troublesome August/September/October period. This isn't a bad thing though, as some type of break could be necessary before another move higher.

SURPRISE 3: PRESIDENT BIDEN HAS BEEN TOUGH ON CHINA

In the aftermath of President Biden's victory, political pundits immediately began forecasting friendlier relations with China than had been experienced under the Trump administration. The logic was relatively straightforward. Foreign policy is one area where a president can act relatively unilaterally, and under the Obama administration, then-Vice President Biden played a crucial role in America's policy of 'engagement' with China and reportedly had a warm personal relationship with President Xi Jinping.

So what happened? Since then, China has grown bolder in its ambitions to become the dominant global player, continuing unfair trade practices and intellectual property theft to help fuel its rise. President Biden seems determined to follow through on President Trump's more hardline approach, maintaining the Trump tariffs on China, calling out China for human rights abuses, demanding a global investigation into the origins of COVID-19, and perhaps most importantly building a coalition of European allies to confront China on its trade practices and its increasingly aggressive foreign policy. Whereas President Trump took a more 'on our own' stance toward China, President Biden is building a coalition allied against China.

The more hardline approach may be particularly important during this period of significant technological infrastructure buildout, such as 5G internet, which may set the technological rules of the road for decades to come. Frosty relations with China looks to be one feature of the prior US administration that is here to stay.

SURPRISE 4: CRUDE OIL SOARED

A Democratic sweep in the 2020 elections brought with it expectations for swift climate action, and, some thought, likely much lower oil prices. It may seem a bit counterintuitive, therefore, that oil prices and its investors have benefitted greatly since then, with crude oil starting the year at less than \$50 a barrel but currently flirting with \$70 a barrel.

The macroeconomic backdrop has played a large part. Coming out of the 2020 recession, risk assets, including oil, generally rallied strongly. While an unprecedented strong fiscal response was enacted to rescue the economy, investments tied to a reflationary environment, such as crude oil, saw outsized gains. The resulting ballooning deficit paired with a "risk on" market environment has seen the US dollar generally fall since the market bottom in March 2020, buoying commodities broadly.

But, there have also been some specific policy actions that have propped up oil. Political analysts generally expected a swift resumption of the Obama-era Iran nuclear deal, which

would have paved the road for Iranian crude to come back to market. This has still yet to occur, limiting global supply relative to prior expectations.

Meanwhile, at home, President Biden has generally sought to restrict US oil production, lowering supply expectations and boosting prices. Finally, OPEC+ has so far generally cooperated well with one another, cautiously increasing supply and (narrowly) avoiding the breakdowns in negotiations that have led to supply gluts and lower crude prices in the past.

SURPRISE 5: GROWTH ISN'T DEAD

Value stocks outperformed growth by 6 percentage points in the final four months of 2020 and we expected that trend to continue amid the early stages of the economic expansion. That thesis played out in the first few months of the year, as the Russell 1000 Value Index outperformed its Russell Growth counterpart by more than 12 percentage points through early March. However, since then growth stocks have staged a furious comeback, breaking out higher in absolute terms, while value-oriented sectors have largely stagnated amid falling Treasury yields. Through July 23, value and growth are separated by less than 1%, with both indexes returning approximately 17% year to date.

We believe value stocks will see leadership again in 2021 as Treasury yields rebound and the under-the-surface rotation continues. However, the first half of this year has made it clear that rumors of growth's demise are greatly exaggerated. We believe a balance of both styles, with a modest tilt toward value, will be important for diversified investors over the historically volatile next few months.

SURPRISE 6: BLOW OUT EARNINGS

Coming out of lockdowns last summer, we were amazed by the pace of the economic recovery. Just as surprising was how well corporate America managed through the pandemic, putting the powerful earnings rebound near the top of our list of biggest surprises this year.

When 2021 began, the consensus estimate for S&P 500 Index earnings per share (EPS) was about \$167. Today that number is about 14% higher at over \$190 (Source: FactSet). This is impressive on its own. But considering estimates have historically fallen by an average of about 10% during calendar years, it's even more impressive.

Companies have simply blown away expectations, having delivered some of the biggest quarterly upside surprises ever recorded, even under challenging conditions. The pandemic disrupted supply chains, bringing shortages of key materials and labor. Input cost pressures from a variety of sources weighed on profit margins. Yet, despite these challenges, in 2021 S&P 500 companies are on track to exceed the pre-pandemic peak in earnings by more than 20%. Our forecast for S&P 500 EPS in 2021 is \$195, a nearly 40% increase over 2020.

CONCLUSION

WEEKLY MARKET COMMENTARY

There are always going to be surprises when it comes to investing and 2021 is no different than any other year. Still, our big calls this year, included stocks significantly outperforming bonds and the economy likely seeing one of its best years ever, are alive and well so far.

What could the rest of 2021 hold? We'd be willing to bet there will be more surprises for sure, but the good news is the economy continues to improve and the earnings backdrop is spectacular.

For more of our thoughts on the rest of this year, we invite you to read the full [Midyear Outlook 2021: Picking Up Speed](#) for more investment insights, and for the [interactive version, click here](#).

Thanks to Barry Gilbert and Scott Brown for their help this week.

IMPORTANT DISCLOSURES

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The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet.

Please read the full [Midyear Outlook 2021: Picking Up Speed](#) publication for additional description and disclosure.

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