# A Matter of Trust

2nd Quarter 2021

# Quarterly Economic Update

*In this Q2 recap: U.S. economic growth strong as reopening widens. Europe's recovery picks up steam. Stocks reach new record highs, face new interest rate and inflation landscape.*

**Todd Wetsel**

*Senior Vice President*
*Senior Trust Portfolio Manager*

Todd has 19 years of trust and banking experience. He began his banking career while attending West Texas A&M University. After graduating with a BBA in Finance, he went to work in a local trust department where he served as an assistant trust administrator. Todd enlisted in the United States Army in 2005 and served two tours of duty in Iraq. In 2010, he joined Happy State Bank where his principal duties include market research and portfolio management. Todd has attended the Texas Trust School and Texas Graduate Trust School offered by the Texas Bankers Association. He is a member of the Amarillo East Rotary Club and serves on the board of the Wesley Community Center Foundation.

## The Quarter in Brief

The second quarter began by building on the first-quarter's gains, with stretches of sideways trading and incremental increases that led to multiple record highs over the course of the three months. Encouraging economic data, a strong corporate earnings season, and the broadening of the nation's economic reopening was juxtaposed by heightening inflation fears, a short-lived spike in bond yields, simmering anxiety over potential changes in Fed monetary policy, and continued COVID-19 concerns.

Solid corporate earnings, however, did not drive the overall market materially higher, as inflation weighed on investor sentiment. Many investors were troubled for much of the second quarter by an acceleration in the rate of inflation, worried that the Federal Reserve could begin tapering some of its easy-money policies sooner than expected. Some investors were particularly anxious about the prospect of the Fed being wrong about the temporary nature of the pick-up in inflation, which could require the Fed to slam the monetary brakes harder at a future date, potentially sparking a recession and affecting stock valuations.

Stocks stumbled following a Fed announcement that interest rate hikes could begin in 2023—sooner than it had anticipated—and that it had raised its inflation expectation, though it remained steadfast in its position that above-target inflation would be "transitory" (Fed-speak for temporary).

The quarter closed out on a strong note, as investors welcomed the announcement of an apparent agreement on a $1 trillion infrastructure spending bill and news that banks had passed Fed stress tests. The news was enough to send stocks to new all-time highs in the final trading days of June.

## The U.S. Economy

The U.S. economy continued its remarkable recovery in the second quarter, aided by a substantial pick-up in the pace of COVID-19 vaccinations nationwide, an increase in economic re-openings at state and local levels, and by government stimulus spending.

U.S. GDP growth for the second quarter came in at 6.5%, falling well short of most economists' expectations of somewhere in the mid 8% range. Even with this shortfall, the size of the U.S. economy is now above pre-pandemic levels.[1]

Manufacturing activity rose in May, marking the 12th consecutive monthly increase. The central challenge for U.S. manufacturers has been meeting high-consumer demand, as the combination of increased consumer spending and supply chain bottlenecks have created temporary shortages.[2,3]

Consumer confidence is high, with June's reading reaching its highest level since the onset of the pandemic in March 2020, according to the Conference Board's Consumer Confidence Index.[4]

This elevated level of consumer confidence is backed by some $2 trillion in personal savings that Americans may be looking to spend as the summer unfolds and vaccination rates increase further.[5]

The labor market recovery, which has lagged other parts of the economy, such as consumer spending and manufacturing, saw meaningful improvement in the second quarter. The weekly initial jobless claims fell below 400,000 for the first time since the pandemic began, while job openings reached 9.3 million, the highest number ever recorded by the Department of Labor's Job Openings and Labor Turnover Survey (JOLTS).[6,7]

## Global Economic Health

After a decline in output in the first quarter, economic activity in Europe picked up in the second quarter thanks to a widening vaccination distribution and a relaxation of economic restrictions. Despite its slow start to the year, the Euro area economy is projected to grow by 4.3% in 2021, powered by consumer spending, fiscal support, and exports. Unemployment levels are expected to fall to near pre-crisis levels.[8]

China's vaccination rollout has only recently gathered steam, with its slow start limiting full recovery from the pandemic shutdown. Nevertheless, China's recovery has been strong, with economic growth this year projected to be 8.5%. Investment has led the recovery, with consumer consumption growth rebounding more slowly. Imports and exports have seen a solid improvement.[9]

The MSCI-EAFE Index, which tracks developed overseas markets, rose 4.37% in Q2, while emerging markets, as measured by the MSCI-EM (Emerging Markets) Index, gained 4.42%.[10]

## Looking Back, Looking Forward

Investors have enjoyed strong gains so far this year as stocks have responded well to rising vaccination rates, economic re-openings, fiscal stimulus, and an accommodative monetary policy.

## INDEX RETURNS

| | U.S. Stock Market | International Developed | Emerging Markets | Global Real Estate | U.S. Bond Market | Global Bond ex U.S. |
|---|---|---|---|---|---|---|
| Q2 | STOCKS | | | | BONDS | |
| | 8.24% | 5.65% | 5.05% | 10.17% | 1.83% | 0.35% |
| 1 YEAR | STOCKS | | | | BONDS | |
| | 44.16% | 33.60% | 40.90% | 34.83% | -0.33% | 0.05% |

If the market is to build on these gains over the next quarter and through the year-end, it may depend on how several important questions are answered over the coming months.

Considering the robust GDP growth in the second quarter, investors can't help but wonder if this represents peak growth. In other words, how much will the economy continue to expand absent further fiscal stimulus and with the prospect of Fed tapering? There is a case for above-trendline economic expansion as consumers spend their accumulated savings and people begin filling open jobs once schools reopen and their comfort level with the safety of returning to work rises. Nevertheless, economic expansion appears set to slow, and that's a potential hurdle for the market.

Then there is the matter of inflation and how "transitory" is defined. The Fed believes that the recent acceleration in inflation is transitory, but transitory is not a technical economic term. It's a rather ambiguous term. Is "transitory" three months? Six months? Or longer? The market may have a different definition of transitory than the Fed, which could lead to future market dislocation.

For the twelve-month period ending June 2021, the annualized rate of inflation accelerated to 5.4%, the fastest pace since 2008. The months ahead should provide a clearer picture of whether inflation proves transitory or becomes a more sustained feature of a post-Covid economy.[11]

There is an additional, more overlooked, concern regarding inflation, i.e., its impact on consumer spending. While inflation may be transitory, price increases generally are sticky. Thus, it remains uncertain if increases in overall consumer prices will dampen consumer discretionary spending, which investors may be expecting to drive future economic growth.

The Fed's easy-money policies have been a contributing factor in the market's sharp recovery from its pandemic lows. Consequently, investors are expected to continue to focus on Fed signals about the timing and degree of its plans to taper its monthly bond purchases. (Its June meeting was silent on this issue.) Tapering is a concern, but given the excess liquidity worries of many investors, any start of Fed tapering later in the year may turn out to be a welcomed development. The Fed is attempting to walk a fine line between providing enough liquidity to support the economy and injecting too much liquidity (along with fiscal stimulus) that it causes significant, uncontrolled inflation.

Another market headwind is stretched investor sentiment. Though markets are hovering around all-time highs, market breadth has not been exceptionally strong, which suggests investor enthusiasm has moderated. A weekly survey by the American Association of Individual Investors reflected a 10% decline in bullish sentiment and an associated rise in bearish sentiment in the month of June. With potentially fewer positive economic surprises ahead and muted buying sentiment, the market may mark time until a new catalyst emerges.[12] We are currently witnessing this concern in action regarding market valuations as we begin the third quarter.

The economy appears to be in much better shape, and most economists expect it to remain strong into 2022. The recovery has come a long way from where we were a year ago, but we are certain to face additional volatility as much of the market is currently priced above it's historical average. As always, investors will continue to be well served by maintaining their long-term focus. Happy Investing. •





**CITATIONS:**

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5. kansascityfed.org, April 29, 2021
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9. oecd-ilibrary.org, July 1, 2021
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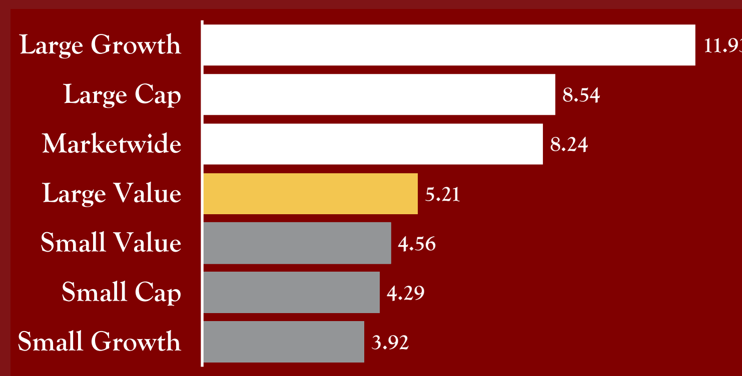
12. aaii.com, July 1, 2021

# Second Quarter Market Summary

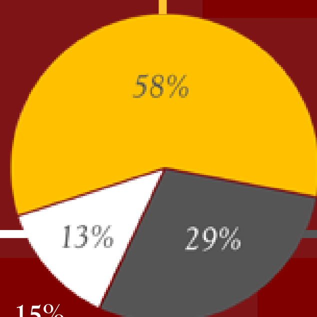
## US Stocks

Equity markets continued to make new highs here in the U.S. during the quarter. International and Emerging Markets also performed well. Value stocks underperformed in the U.S. large cap space and in International Developed markets while outperforming in U.S. small caps and in Emerging Markets. Bonds had a slightly positive performance as yields declined somewhat. For a more detailed quarterly report please see the publications tab at www.HappyTrust.com.

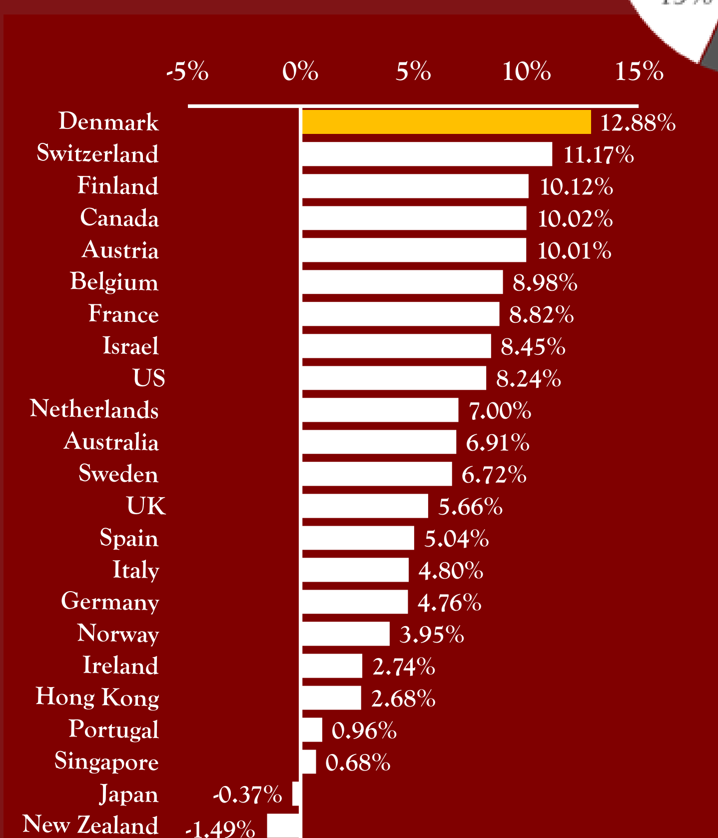
### Ranked Returns for the Quarter (%)



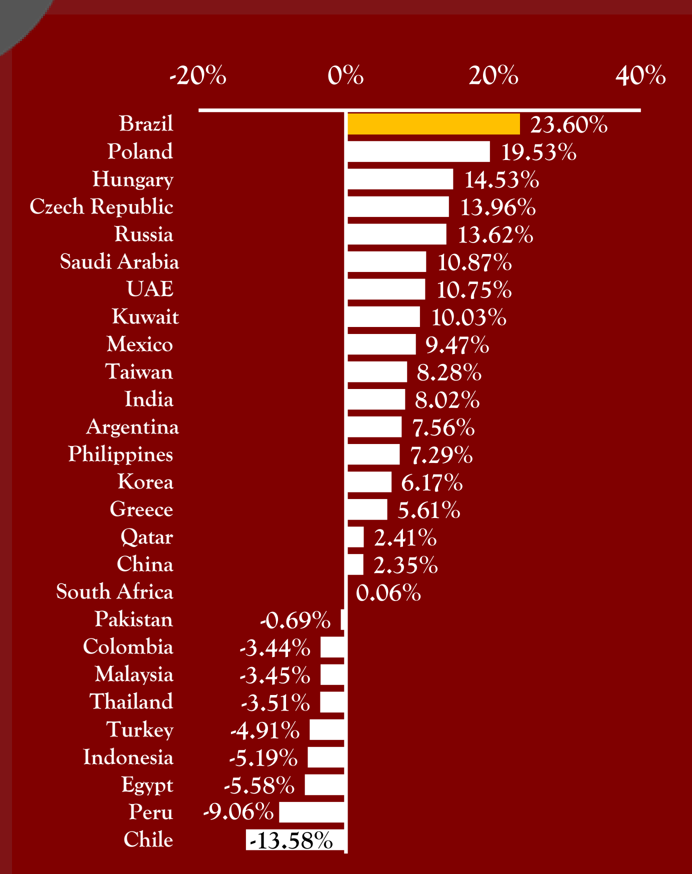

### World Market Capitalization




## Emerging Markets




## International Developed



# Meet the Team

## Sue Turnage

Senior Vice President
Senior Trust Officer

Fort Worth Office

Sue Turnage has over 35 years of experience managing wealth management relationships for individuals, families and nonprofit organizations. She was involved in starting two trust/wealth management groups in the North Texas region, managing one organization for over 20 years and overseeing the growth of its boutique style wealth department. Given responsibility for developing Happy Trust in Fort Worth, Sue joined Happy in 2020 as the market leader and senior trust officer.

She earned a BBA from the University of North Texas where she concentrated in banking and finance and was named its outstanding student. Sue is also an honors graduate of the National Graduate Trust School. A past officer of the Texas Bankers Association Trust Division, she was an ethics instructor in its trust schools for over 25 years. Sue is currently a member of the Fort Worth Business and Estate Planning Council and the Tarrant County Probate Bar.

Active in the community, Sue currently serves as an advisory director of Kids Who Care and volunteers for several organizations. She is particularly interested in programs that help children and teens develop financial life skills.

## Tori Bennett

Trust Operations Specialist

Amarillo Office

Tori was raised in Spearman, Texas and graduated from Perryton High School in 2017. After graduation, she moved to the Amarillo region where she earned her associates in Education at Amarillo College, as well as received her Dental Assistant License. While attending school, Tori began her banking career as a Teller. After graduation she started working in the dental field, where she realized her true passion was in banking.

Tori left the dental field behind and began working for Happy State Bank in December of 2019, where she was a teller at the Buchanan branch. During her time there, she became a Senior Teller and Customer Service Representative.

Tori shifted to the trust department within Happy State Bank in November of 2020, serving as a Trust Operations Specialist. Even though she was working from home due to the COVID-19 pandemic, she continued to learn with the help of her supportive team in the trust department.

Tori volunteers her time with Kids' Bank, as well as volunteering for bank events. During her free time, she enjoys photography, hiking with her fur baby Bear, and spending time with friends and family. Tori looks forward to growing within Happy Trust Company, as well as learning as much as she can from her colleagues.

*We have had several questions from clients and others about investment topics. If you have a question that you would like answered in the next "Matter of Trust" newsletter please submit those to* **trustinvestments@happybank.com**.

**Scott Richardson**
*Vice President*
*Trust Portfolio Manager*

Scott has been in the financial services industry for over 16 years of which the last 14 years has been spent as a financial planner helping clients meet their financial goals. He has a Bachelor of Business Administration from Texas Tech University. His role with Happy Trust Company includes research and security selection, and portfolio management. Scott is the Vice President of Endowments for the Golden Spread Council of the Boys Scouts of America. He also serves as a Vice President of the Amarillo downtown Kiwanis.

# Inflation & the Real Rate of Return

## *Is your money gaining or losing purchasing power?*

The real rate of return is an important personal finance concept to understand. As investors, we don't only look at the return that we receive from our investment but we have to compare that rate to the inflation rate to get a real return.

The real rate of return indicates whether you are gaining or losing purchasing power with your money. Why does this matter for you or your investments? Before we answer that question, we should define inflation. Inflation is the increase in prices of goods and service and the decline in purchasing power of money. In short, your ability to purchase a dollar worth of goods has fallen by the rate of inflation. If you have filled up with gasoline or gone to the grocery store lately you have seen the effects of inflation.

So with inflation checking in at a 5% annual rate, does that mean any investment with less than a 5% rate of return is losing purchasing power?[1]

That's where it gets a little complicated.

In theory, any investment with less than a 5% rate of return may lose purchasing power. Assets that have little growth potential will be the most affected by inflation. If you are holding cash in a money market or savings account your real rate of return is very likely negative right now.

For fixed income, a rise in the inflation rate can be damaging. As inflation rises, yields on bond generally rise to compensate investors for the loss of purchasing power. As yields rise, the price of bonds will fall with longer term bonds having a larger loss.

The Federal government has come up with a way to combat this by issuing Treasury inflation-protected securities (TIPS). As inflation rises the principal amount of the TIPS rises to match.

Equities are also affected by inflation. Higher inflation is usually looked on as a negative for stocks because it increases borrowing costs, increases input costs (materials, labor), and reduces standards of living. But probably most importantly in this market, it reduces expectations of earnings growth, putting downward pressure on stock prices.[2]

It's not all bad news though. By building a balanced portfolio you can offset some of these risks. Not all assets move at the same rate or at the same time. There is significant benefit to diversifying your portfolio not only with different investments but investments that may mature in different years.

The financial markets are giving mixed signals about how long they expect inflation will stay at its current level. Fed Chair Jerome Powell has indicated that the inflation numbers we are seeing won't be long lasting and can be attributed to improving economic conditions.[3] Should inflation be more permanent than expected the Fed will take action usually by targeting a higher Fed Funds rate or selling bonds in the open market.

In the end, the real rate of return is only one factor to consider when building a portfolio. Your time horizon, risk tolerance, and goals are the primary drivers. •



**CITATIONS:**

1. CNBC.com, June 10, 2021
2. CNBC.com, May 13, 2021
3. CNBC.com, May 3, 2021

# Transitory Inflation, What does It Mean?

The Fed uses Monetary Policy to manage its dual mandate for maintaining: 1) full employment, and 2) a long-term target inflation rate of 2.5%. Note that historically, inflation is always a "monetary" phenomenon that's defined as too much money, chasing too few goods. It's also important to point out that Monetary Policy acts with a lagged economic effect… whereas Fiscal Policy (government taxing and spending) typically has an immediate impact. When used together properly, monetary and fiscal policies can act like economic shock absorbers when the U.S. falls into recession, or conversely when it starts heating up too much.

Many sophisticated investors are postulating that the current rise in inflation is simply due to our current historically stimulative fiscal and monetary policies, combined with an increased consumer demand (as the country comes out of the pandemic's hibernation-mode); however, that's an incomplete understanding. The best students of financial history can explain that the rapidly rising inflation is being caused by growth in the M2 money supply (that's growing almost three standard deviations greater than trend). This current exogenous M2 money supply is growing so rapidly because our monetary policy is being directly piped into consumers' bank accounts via our fiscal policies. Historically, each and every time M2 money supply has grown this quickly, money has subsequently lost 20% to 50% of its value within a just few years. For example, it happened after WWI, WWII, in the early 1970's… and it's happening again now. Mark Twain is attributed with saying "history never repeats itself, but it often rhymes"… because the current generation repeats the mistakes of their predecessors. To wit, many think that it's going to be different this time; however, that may be an over-optimistic assumption. Therefore, it seems like we ought to give some consideration to creating disincentives for some economic behaviors because we may potentially create a few unintended consequences that become problematic due to the over-use and abuse of these policies.

However, just as it takes at least two different opinions to make a market… there is, at a minimum, two very different opinions surrounding the current outlook for inflation and what the Fed should be doing to properly manage it. This quarter, we're taking a quick optimistic view with regard to how the Fed's Monetary Policy could affect inflation. Next quarter, we will look at a more pessimistic scenario.

In 2020, the pandemic created a huge economic roller coaster ride with GDP-growth quickly falling into a depression-like bust (with many firms cutting everything supply-side related to the bone just to survive). Then within a matter of months, primarily due to Project Warp Speed coupled with the historically loose Monetary and Fiscal Policies, we found ourselves in a demand-side boom. From a practical standpoint, there is just no way for global supply chains to react fast enough subsequent to a consumer whipsawing of this magnitude. Fed Chair, Jerome Powell, says this appears to be a temporary supply shock… where given time, supply chains will catch-up with consumer demand. This is the "transitory nature" of what the Fed is referring to; however, the Fed's outlook for inflation will remain data dependent.

So, Powell sees inflation potentially moderating, but probably not until next year. In the meantime, inflation will stay a little elevated, but so will the economy and GDP-growth. For 2021, if inflation stays high enough, for long enough… we could see a market correction at any time. But there is a remarkable economic revival happening that nobody is denying. Balance Sheets have improved, EPS are great and improving, and we're having a fundamental explosion. Therefore, if we close out 2021 with the S&P 500 at 4200, where its EPS are close to $220, then we could go into 2022 next year with a slightly undervalued market (relative to its long-term P/E valuation average going back to 1990). Again, we may be seeing EPS catching up to provide a good valuation for this bull market to continue. •

**Brooks R. Smith, CFA**
*Senior Vice President*
*Trust Portfolio Manager*

Brooks has over thirty years of fiduciary experience in portfolio management developing client relationships and managing customized discretionary total return investment portfolios. During his career he has managed portfolios for high net worth clients, endowments, and foundations subsequent to assessing risk tolerance, investment goals and objectives. Brooks has helped his clients successfully navigate both "The Tech Bubble" and "The Financial Crisis". In 2018, Brooks joined Happy State Bank and Trust Company as a Senior Vice President and Trust Portfolio Manager. Brooks has earned the right to use the Chartered Financial Analyst (CFA) designation, and graduated from Oklahoma State University with a B.S. in Finance. He and his wife, Joanna, live in Dallas, care for aging parents, and enjoy golf and tennis.


# HAPPY TRUST COMPANY

Wealth Management & Trust Services

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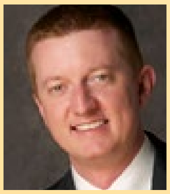
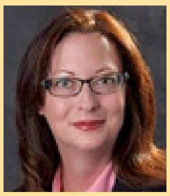
## AMARILLO

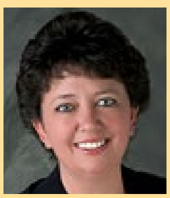
**Joby Mills, J.D.**
*Senior Vice President*
*Director of Trust Services*
(806) 349-9893
jmills@happybank.com



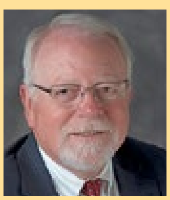
**Todd Wetsel**
*Senior Vice President*
*Senior Trust Portfolio Manager*
(806) 349-9901
twetsel@happybank.com



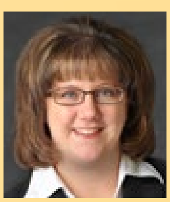
**Alisa Scott, J.D.**
*Senior Vice President*
*Senior Trust Officer*
(806) 349-9880
ascott@happybank.com



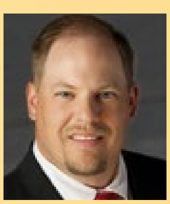
**Terri Wright**
*Vice President*
*Trust Officer*
(806) 379-5409
terri.wright@happybank.com



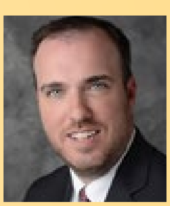
**Terry Wright**
*Senior Trust Officer*
*Oil and Gas*
(806) 379-5410
terry.wright@happybank.com



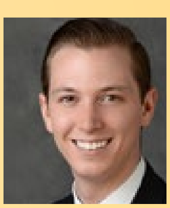
**Buffy Haden**
*Vice President*
*Trust Operations Officer*
(806) 349-9890
bhaden@happybank.com



**Kevin Rider**
*Vice President*
*Trust Officer - Farm and Ranch*
(806) 349-9940
krider@happybank.com



**Scott Richardson**
*Vice President*
*Trust Portfolio Manager*
(806)342-2457
srichardson@happybank.com

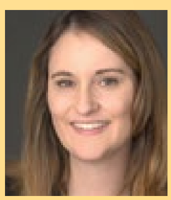


**Hunter Vagrosky**
*Assistant Vice President*
*Trust Officer*
(806) 349-9891
hvagrosky@happybank.com

## DALLAS

**Chris Klemme, J.D.**
*Senior Vice President*
*Senior Trust Officer*
(972) 407-4959
klemme@happybank.com

**Brooks Smith**
*Senior Vice President*
*Trust Portfolio Manager*
(972) 407-4966
bsmith@happybank.com

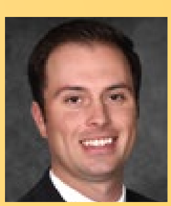


**Shannon Van Campen**
*Assistant Vice President*
*Trust Officer*
(972) 407-4947
svancampen@happybank.com

**Thelma Williams**
*Vice President*
*Trust Officer*
(972) 407-4948
twilliams@happybank.com

## FORT WORTH

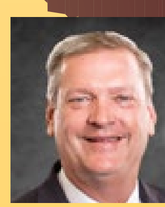
**Sue Turnage**
*Senior Vice President*
*Senior Trust Officer*
(817) 989-3955
sturnage@happybank.com



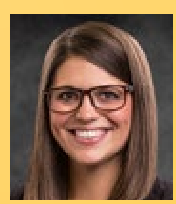
**Jason Carter, J.D.**
*Vice President*
*Trust Officer*
(817) 989-3960
jcarter@happybank.com

## KERRVILLE

**Penny Van Shoubrouek**
*Senior Vice President*
*Senior Trust Officer*
(830) 353-6775
pvanshoubrouek@happybank.com

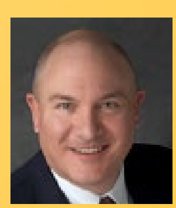


**Mike Klein, ChFC, CLU**
*Senior Vice President*
*Trust Officer*
(830) 353-6766
mklein@happybank.com



**Kendra Miller**
*Trust Officer*
(830) 353-6769
kmiller@happybank.com

## LUBBOCK



**Bryan Limmer**
*Senior Vice President*
*Senior Trust Officer*
(806) 798-4827
blimmer@happybank.com