

## Shake Down, Rate Down

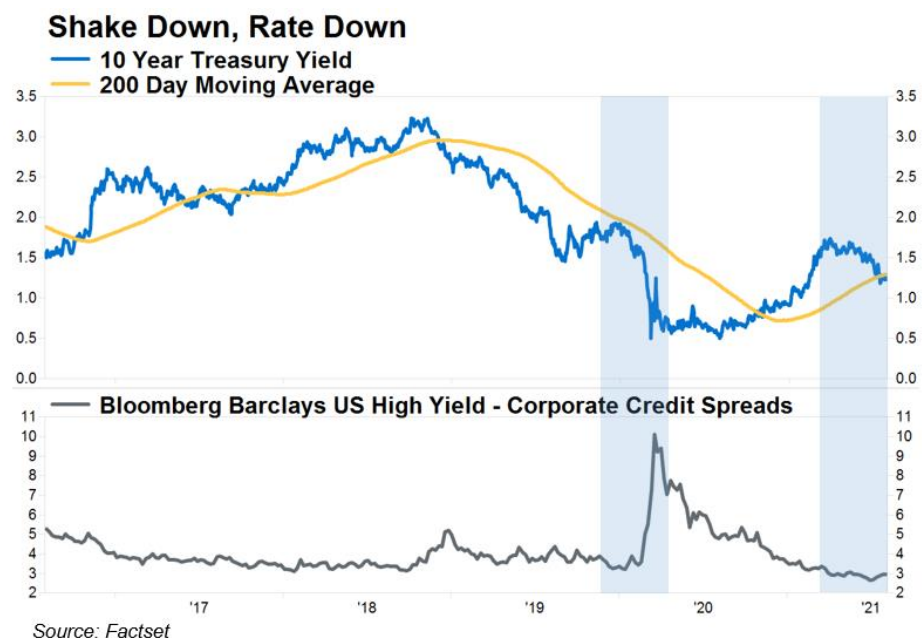
*“Shakedown, breakdown, takedown, everybody wants into the crowded line.”*  
– Shakedown (Bob Seger - 1987)

We couldn't help but recently be reminded of this number one hit from Bob Seger, which debuted back in 1987. Often used in the hero-villain movies to induce an added element of drama, a good old-fashioned “Shakedown” often involves the use of coercion to produce a desired result.

**A parallel can be drawn to the investment backdrop as it's felt like that “Shakedown” mantra has been playing out in the rates market of late.** As is often said, the market has a way of keeping one humble so when the 10 Year Treasury Yield was at its peak of around 1.7% in early April (with everyone thinking it was going to 2.0%), it's not terribly surprising that we saw a move back down to below 1.2% last month. Regardless of direction, moves in this business are never in a straight line and we can't help but wonder if this is the market's way of trying to shake out the weak hands. As we've mentioned in prior writings, disconnects have continued to widen between long standing – 70 year – relationships. At these levels, the Fed forecast for nominal GDP growth is exceeding the 10 Year Treasury Yield by the most on record. Similarly, the gap between consumer inflation and long-term rates is the highest since 1980. **And yet, the 10 Year Treasury Yield has done nothing but yawn at these relationships.**

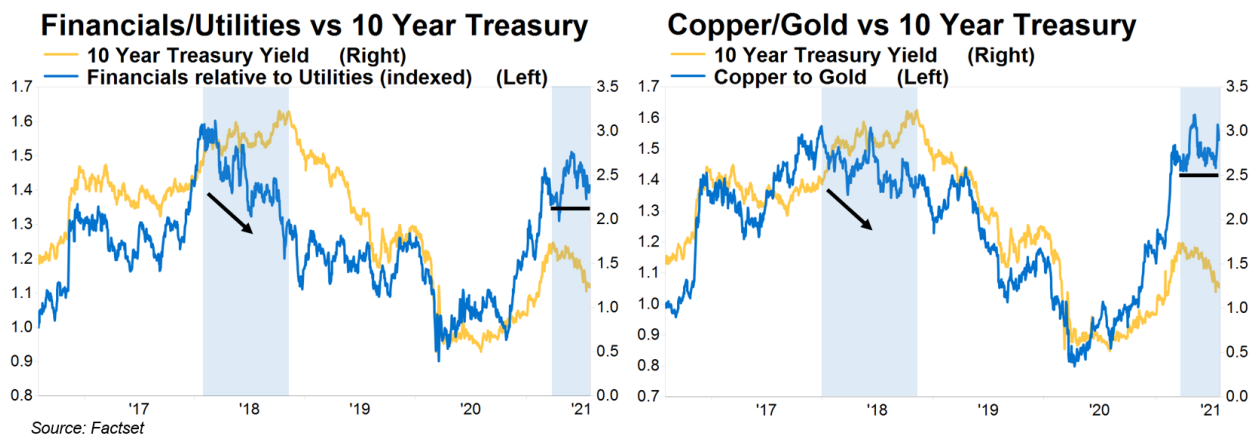
**As can be seen in the chart below, the 10 Year is testing investors' resolve as well as its 200-day moving average.**

So, is this a “Shakedown” or something much more sinister? We can't be sure, but we'd highlight three relationships to suggest its more the former than the latter. First, we think it's notable that the trend for long-term rates has changed. From late 2018 through much of 2020, the 10



Year stayed below a falling 200 day moving average. But late last year, that reversed – the 10 Year has mostly stayed above a rising 200 day moving average. Additionally, when one looks at High Yield corporate bond credit spreads back in the early days of the pandemic (first shaded region in the chart on the previous page), signs of stress were clear with low quality corporate bonds reflecting rapidly deteriorating fundamentals in the form of widening (or higher) credit spreads. The picture today (second shaded region) looks decidedly different with no material fundamental deterioration in high yield spreads despite the 10 Year retracing about 40% of the move from its highs.

**Other relationships are also not reflective of a trend change in long-term rates.** Remember, back in late 2018, the 10 Year fell below its (declining) 200 day moving average. As can be seen in the two charts below, two associated relationships also began deteriorating in early 2018 (first shaded region). Financial stocks began materially underperforming Utility stocks and Copper began materially underperforming Gold. Interestingly, both of these relationships look in better standing today (second shaded region). While we've seen some consolidation activity in both, neither have broken down directionally with the 10 Year.



**To be clear, we're not dismissing the drop in long-term rates.** Concerns are brewing with regards to the COVID delta variant and peak liquidity suggests that peak growth is likely around the corner. Fiscal policy remains murky with additional spending plans that could likely be financed with higher tax rates on corporations and wealthy individuals. But credit markets, equity markets and real asset markets don't exactly jive with the suggestion of a rapidly deteriorating fundamental backdrop that warrants declining rates last seen during the throes of the pandemic. Remember – in March of 2020 – COVID was not widely understood, we were nowhere near herd immunity and, most importantly, we were without any effective vaccines to combat it. That feels very different than where we are currently.

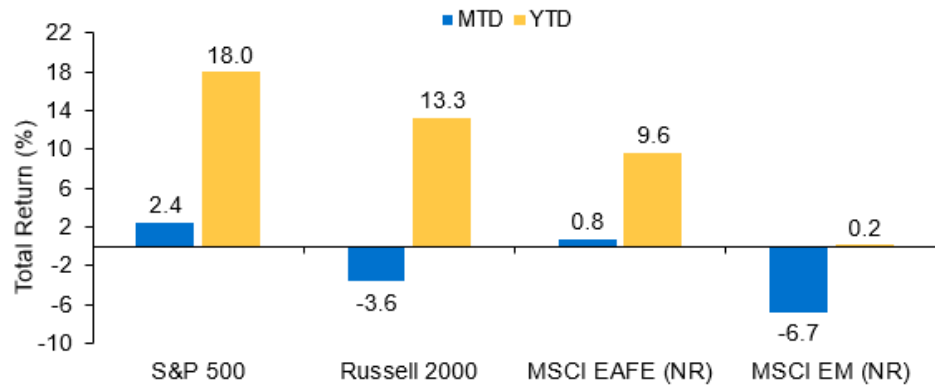
While some market trends reversed over the past couple months, the first seven months of the year generally still indicated a reflationary bias. Real Assets outperformed Stocks and Stocks outperformed Bonds. Commodities, Real Estate, and Cyclical sectors did the best while interest rate sensitive Bonds suffered the most.

**Stocks**

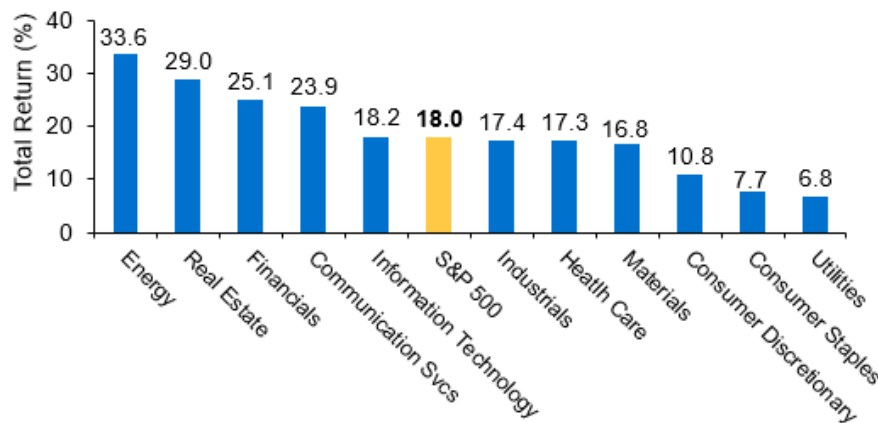
Global equities posted mixed returns in July amid still mostly strong year-to-date totals. A more defensive market posture was evident in July with profit taking in the more cyclical areas like Small Caps (Russell

2000) and Emerging Markets (MSCI EM) giving some back. Concerns have increased around COVID variants especially in areas with lower vaccination rates. Peak liquidity leading to peak growth has also been a worry. Meanwhile, for the year, S&P 500 sectors reflected an investor preference for Cyclical exposure with outperformance in Energy and Financials (Cyclical Value) as well as Communication Services and Tech (Cyclical Growth). Conversely, more traditional Defensives (Health Care, Utilities, Staples) were still positive but lagged – though this started to more notably reverse in July as yields backed down and these sectors outperformed.

**Global Equity Returns**  
July 2021



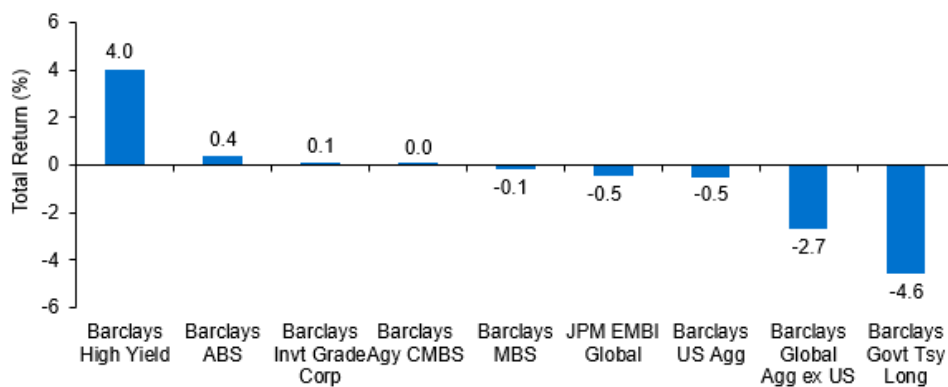
**S&P 500 Sector Returns**  
July 2021 - YTD



**Bonds**

Bond returns were mostly negative year-to-date. Long-term interest rates started to trend higher last August with the pace picking up in the first quarter only to consolidate over the past several months. Meanwhile, short-term rates remained mostly anchored by the Fed – resulting in a Yield Curve that steepened in the first quarter to its highest level in over 5 years – only to retrace about 40% of that move since then. Year-to-date, the more interest rate sensitive areas of the bond market saw their returns pressured the most – including long-duration Treasuries (Govt Tsy Long) and EM Debt (EMBI Global). A stronger dollar also pressured International Fixed Income (Global Agg ex US). Meanwhile, securities with shorter durations and more sensitivity to equities outperformed, including Securitized Assets (ABS, MBS, CMBS) as well as Investment Grade and High Yield corporate bonds.

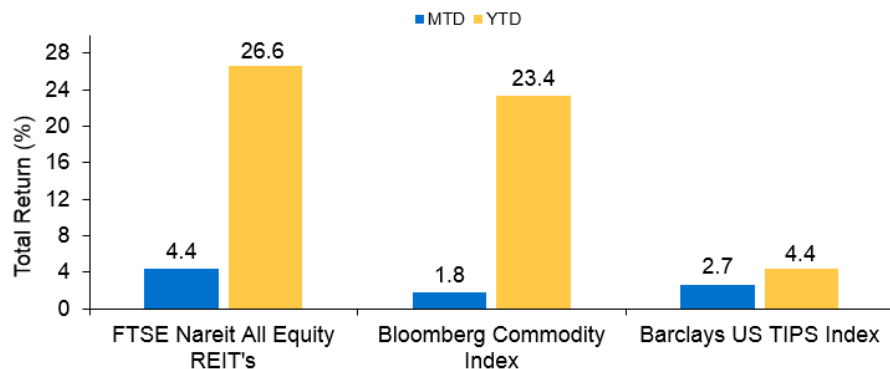
**Global Fixed Income Returns**  
July 2021 - YTD



**Alternatives**

Alternatives posted mostly strong returns in July and for the year. Treasury inflation protected securities (TIPS) were held back by the rise in long-term interest rates though outperformed nominal



**Alternative Market Returns**  
July 2021



Treasuries given increased inflation expectations. Both publicly traded real estate (REIT's) and Commodities generated among the best results for the year. The former has been viewed as an attractive reopening opportunity though with some defensive yield characteristics. The latter has benefited from rising Energy, Industrial Metals and Agriculture prices (prices ex Ag were solid in the recent month).

**Market Outlook**

Coming into this year, our business cycle outlook has continued to be best defined by the phrase “From Red Lights to Green Lights”. Having a medical solution to the medical problem is ushering in an economic reopening. This, combined with record levels of stimulus, is expected to generate sizeable GDP and earnings growth in 2021 (see table at right).

		<b>Red Lights</b> 	<b>Green Lights</b> 
<b>Indicator</b>	<b>2019</b>	<b>2020</b>	<b>2021 e</b>
GDP (yoy)	2.1%	-2.3%	7.0%
Unemployment Rate	3.6%	6.7%	4.5%
S&P 500 EPS (yoy)	3%	-19%	38%
COVID Cases	N/A	19.1m	?

**From an investment perspective, we’ve been believers in the “Reflation**

*Source: Factset; 2020 readings and 2021 S&P 500 EPS growth estimate are as of 1/1/21. 2021 GDP and Unemployment Rate estimates are projections produced by the Federal Reserve as of June 2021. COVID case count from www.coronavirus.jhu.edu as of 12/28/20.*

**Reset” theme, whereby nominal growth improves from a combination of rising real growth and inflation.** A federal budget deficit today that only rivals that of World War II, along with de-globalization trends, and the Fed’s FAIT (Flexible Average Inflation Target) policy are all structural reasons to support this theme. At the same time, a cyclical recovery in economic growth and corporate profits is taking shape. To that point, 1H nominal GDP growth is running at a robust annualized pace of around 12%, comprised of about 6% real growth and 6% inflation. Both nominal and real GDP are now at levels above where they were pre-pandemic. Similarly, 2Q EPS growth is tracking to be up a whopping 85% yoy with trailing twelve month S&P 500 earnings also now estimated to be about 8% above pre-pandemic levels. **As can be seen in the table below, these indicators suggest that we’re moving from recovery to expansion.** Meanwhile, labor markets still have some catch up work to do as we’ve still only regained about 70% of the total jobs lost in March and April last year – representing more than a 6 million job gap. Consequently, productivity growth has doubled as companies are doing more with less. The jury is still out in regards to how sustainable these productivity gains will be as more hiring will likely continue in order to achieve full labor market recovery.

<b>Date</b>	<b>Nominal GDP</b>	<b>Real GDP</b>	<b>S&amp;P 500 EPS (TTM)</b>	<b>Job Payrolls (mil)</b>	<b>Productivity Growth (yoy)</b>
Current	\$22,723	\$19,358	\$170	145,759	4%
Pre-Pandemic	\$21,747	\$19,202	\$157	151,919	2%

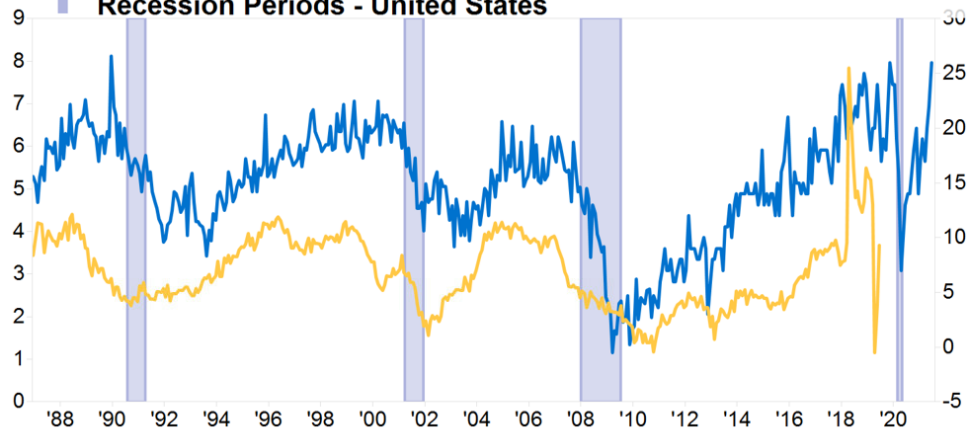
*Source: Factset; S&P 500 Index Trailing Twelve Month Operating EPS. Current as of 6/30/21 except productivity growth dated as of 3/31/21. Pre-pandemic as of 12/31/19.*



Embedded within that productivity debate is whether additional workers will need to be compensated at higher levels than previously. So called wage inflation is viewed to be structural in nature because once a company institutes a pay increase its loathe to claw it back. As can be seen in the chart at right, small business owners' compensation plans are suggesting we'll likely see more pay increases going forward which would imply a give back in productivity and more structural inflationary trends.

### NFIB Compensation vs Wage Inflation

— NFIB Small Business Comp Plans In The Next 3 Months (Right)  
— Average Hourly Earnings (lagged 2 yrs) (Left)  
■ Recession Periods - United States



Source: Factset

At the same time, we're also aware of factors that could lead to a

**choppy market environment for risk assets in the second half of the year.** Year Two of a cyclical bull market has historically ushered in more volatility (albeit positive returns). As can be seen in the table below, bull markets last about 5 years, on average, though total cumulative returns suggest that we might already be a little more than halfway through. As noted previously, COVID variants remain a risk especially in areas where vaccinations have been sub-par. And peak liquidity likely points to peak growth around the corner with fiscal spending plans that might come with higher taxes and more muted earnings growth in 2022.

### Greatest Bull Markets Ever

S&P 500 Index Bull Markets Since World War II

Bear Market Bottom	Bull Market Peak	Months	S&P 500 Return
6/13/1949	8/2/1956	86	267%
10/22/1957	12/12/1961	50	86%
6/26/1962	2/9/1966	44	80%
10/7/1966	11/29/1968	26	48%
5/26/1970	1/11/1973	32	74%
10/3/1974	11/28/1980	74	126%
8/12/1982	8/25/1987	60	229%
12/4/1987	7/16/1990	31	65%
10/11/1990	3/24/2000	113	417%
10/9/2002	10/9/2007	60	101%
3/9/2009	2/19/2020	131	401%
3/23/2020	7/31/2021	16	96%
Average		64	165%

Where Are We In Terms of the Current Cycle?

Months % of Avg

25%

Return % of Avg

58%

Source: FactSet, FFWM Research (1949-Current). Calculations based on S&P 500 daily price returns. Data as of 7/31/2021; Average doesn't include the Current Cycle.

In summary, economic and corporate profit growth continue to point to a reflationary backdrop with structural conditions that could lead to more entrenched inflationary pressures should productivity gains retrace and wages increase (as labor markets more fully recover). At the same time, historical analysis of cyclical bull markets combined with the peak liquidity/growth narrative, lingering COVID concerns and fiscal tax pressures all suggest the potential for near term choppiness.

***In short, we advocate maintaining a reflationary tilt in one's portfolio while managing the degree of that tilt.***

**Consistent with the above, we remain deliberate in emphasizing a reflationary bias in client portfolios while also controlling overall portfolio risk.** Accordingly, several times this year we've trimmed some of our OW to risk assets (via Equities) while bolstering our inflationary hedges (Real Assets including Real Estate and Commodities) and maintaining diversification with lower volatility assets (via US Core Fixed Income and Diversified Alternatives).

**Within equities**, our OW's continue to favor a pro-reflation bias. Previously, we've increased our exposure to a modest OW in International Markets. We've also previously increased our US Small Cap exposure to an OW and have shifted toward more of a cyclical value sector tilt within our (UW) US Large Cap exposure (though recently have shifted some of that value tilt toward higher quality companies).

**Within fixed income**, to mitigate some portfolio risk, we remain UW the most cyclical parts of the bond market (High Yield and Emerging Market Debt) but our US Core managers are OW investment grade credit and UW (defensive) treasuries. We also continue to carry a shorter duration bias (less interest rate sensitivity). Our US Core Fixed Income exposure remains an OW supplemented by our UW position in International Fixed Income which remains a beneficiary of a weaker dollar environment.

**Within alternatives**, we previously have added to real assets as a way to bolster inflationary hedges. As such, we are OW to Real Estate and Commodities. Rounding out our exposure, we're also OW to Diversified Alternatives which provide some hedge against market volatility.

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