Tricky Transition

"When you come to a fork in the road, take it."
– Yogi Berra (1925-2015)

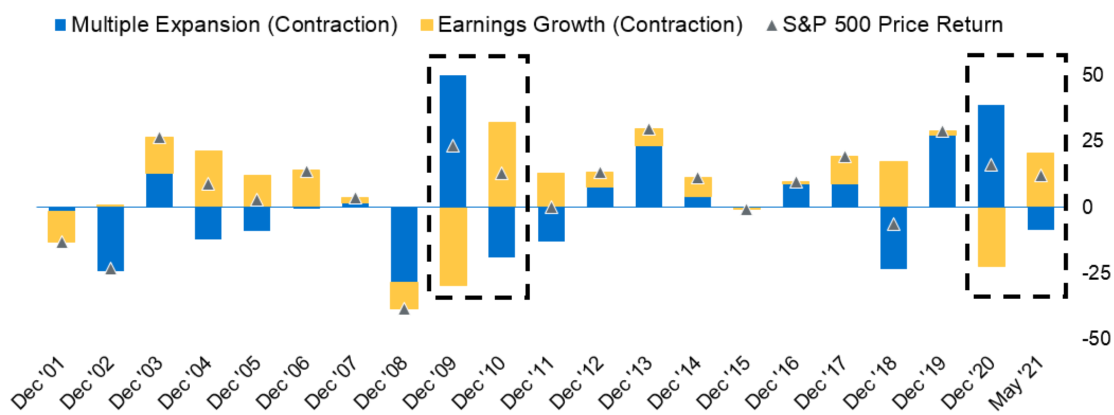
I think it's fair to say that this global pandemic has ushered in some tricky transitions along the way. From school and business closings to vaccine distributions back to re-openings, transitions seem to be an almost everyday occurrence that are not always synchronous.

Such a tricky transition may be underway in the markets as well. The cyclical bull market that began in March of last year is now 14 months old. As we've noted in past writings, year two of a cyclical bull market typically gets more challenging as the return trajectory becomes less steep amid higher volatility. Often times, this coincides with the end of a recession transitioning into recovery and then expansion. <u>As investors transition from belief to reality, the return composition of the market also changes from multiple expansion to earnings growth. Essentially, it becomes a "show me" market.</u>

Perhaps one of the better examples of this transition occurred during the Great Recession in '08-'09 and subsequent recovery in '10. As can be seen in the chart below, the S&P 500's return in '09 was driven by multiple expansion which more than offset earnings contraction as investors priced in the belief of recovery. This was followed up by 2010 – the "show me" period – as earnings growth was needed to offset multiple compression. Notice that this return transition seems very similar to last year and this year. <u>Investors began pricing in the chances of a recovery 14 months ago as multiples expanded (despite falling earnings growth). This year, earnings growth is needed to offset (and compress) expensive multiples</u>.

"Show Me" the Money!

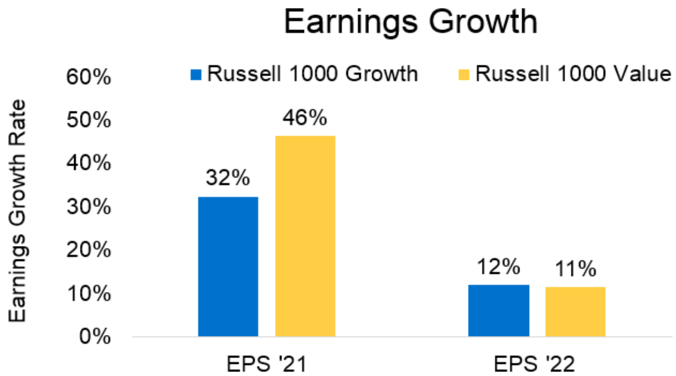
Contribution to S&P 500 Price Return

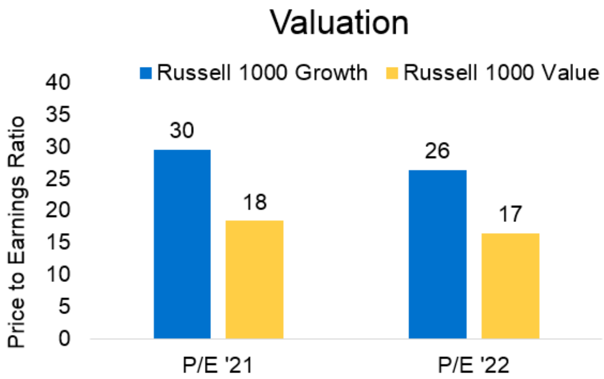


Source: Factset; based on operating earnings.

If one thinks further about this dynamic, it seems rational that cyclical value stocks tend to be preferred in this environment. After all, stocks often (initially) look expensive as investors bid up shares based on the belief of better days ahead. <u>And because it's the cyclical stocks that typically grow earnings the fastest, they tend to be advantaged because they can quickly grow into more reasonable valuations through good old-fashioned earnings growth.</u>

As can be seen below, stocks in the Russell 1000 Value index are expected to grow earnings 14 percentage points faster than the Russell 1000 Growth index this year (with comparable growth rates for next year). Even more compelling is that these cyclical value stocks were cheap to begin with, which means that forward valuations indicate about a 40% Price to Earnings discount to their growth stock brethren. <u>In short, these cyclical value stocks are growing significantly faster and trading significantly cheaper than other areas of the market. This comes precisely at a time when more of the market's return is expected to come from earnings growth needed to offset expensive multiples</u>.



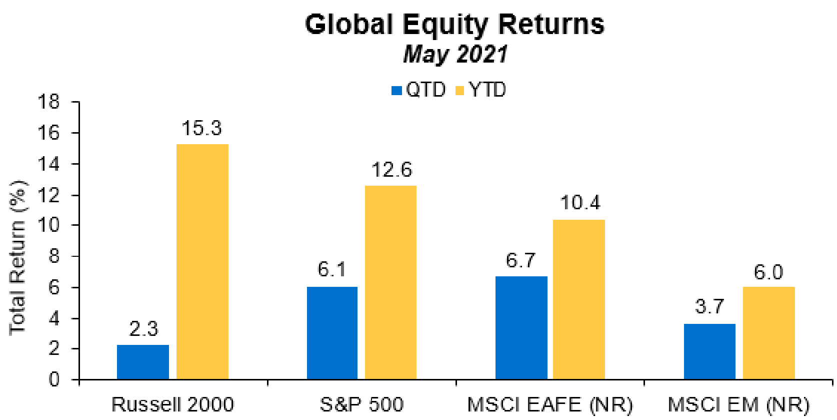


Source: Factset

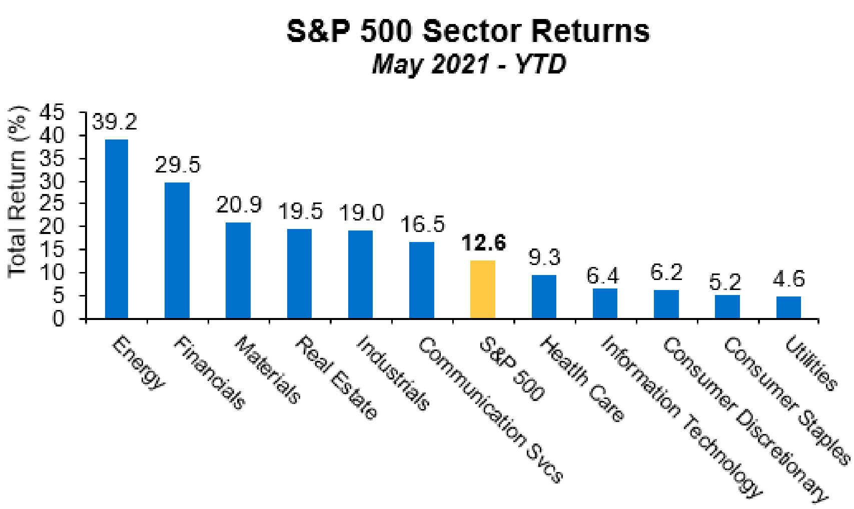
But there's another nuance to this transition – the mid cycle slowdown. At some juncture, a peak in liquidity growth will be followed by a peak in earnings growth. We think the former is happening now which means the latter may happen in the next several quarters. We're not there yet but that scenario is on the horizon. Read more about what that means for portfolios in our outlook section.

Through the first five months of the year, market returns have indicated a reflationary bias. Real Assets have outperformed Stocks and Stocks have outperformed Bonds. Commodities, Real Estate, Small Cap companies and Cyclical Value sectors have done best while interest rate sensitive Bonds have suffered the most.

Stocks

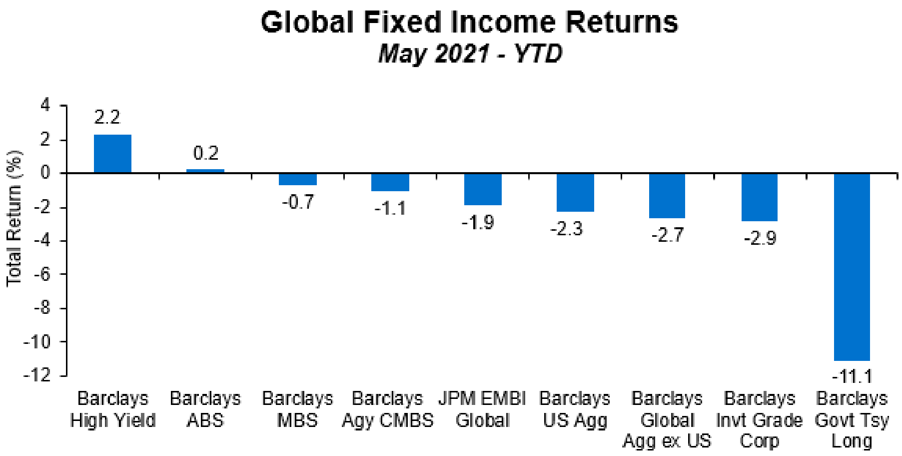


Global equities posted positive returns so far in the second quarter to tack on to their strong year-to-date totals. US markets and Small Caps (Russell 2000), in particular, have taken the prize thus far. International markets (MSCI EAFE and EM) have lagged for the year as vaccinnation rollouts (and COVID case improvements) have been slower than that witnessed in the US. However, as the dollar has started to weaken and as vaccines have become more widely available, international markets have more recently started to outpeform in May. Meanwhile, S&P 500 sectors continue to reflect an investor preference for Cyclical Value exposure with Energy, Financials, Industrials and Materials all outperforming for the year thus far. Conversely, more traditional Defensives (Health Care, Utilities, Staples) and pandemic beneficiaries (big cap Tech and Discretionary) have lagged as progress towards an economic recovery continues to benefit the former more than the latter.



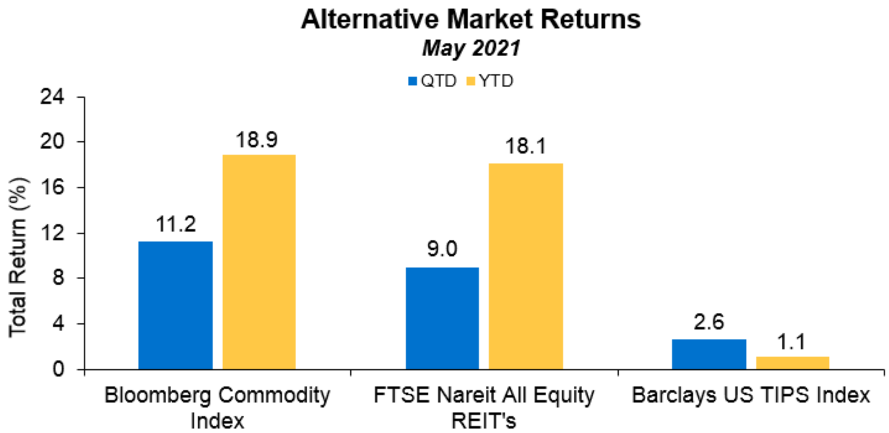
Bonds

Bonds have produced mostly negative returns year-to-date. Long-term interest rates started to trend higher last August though the pace picked up noticeably since the start of this year despite some modest give back quarter to date. Meanwhile, short-term rates remained anchored by the Fed – resulting in a Yield Curve that has steepened to its highest level since mid 2015 (albeit off the highs in March). This is also consistent with a breakout in inflation expectations to levels we haven't seen in over a decade. As a result, the more interest rate sensitive areas of the bond market have been underperformers so far this year, including long-duration Treasuries (Govt Tsy Long) and Investment Grade Corporates (Invt Grade Corp). Securities with shorter durations and more sensitivity to equities have outperformed, including Securitized Assets (ABS, MBS, CMBS) and High Yield.



Alternatives

Alternatives posted mostly strong returns so far for the second quarter and year. Treasury inflation protected securities (TIPS) were held back by the rise in long-term interest rates though outperformed nominal Treasuries given increasing inflation expectations. Both publicly traded real estate (REIT's) and Commodities have generated among the best results for the year. The former has been viewed as an attractive reopening opportunity. The latter has benefited from rising Energy, Industrial Metal and Agriculture prices (with Precious Metals picking up in May) – consistent with the market's message of budding cost pressures on the rise.



Market Outlook

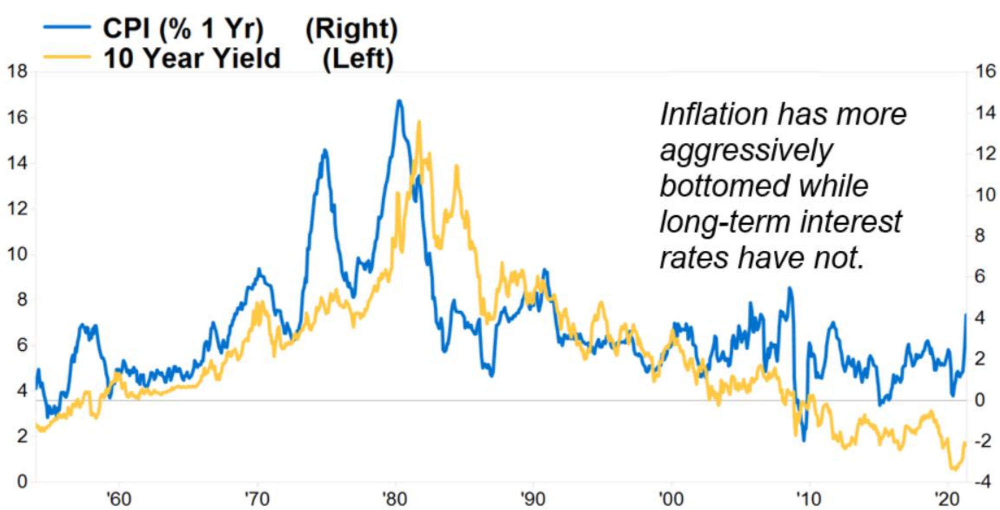
Coming into this year, our business cycle outlook has continued to be best defined by the phrase "From Red Lights to Green Lights". Having a medical solution to the medical problem is ushering in an economic reopening. This, combined with record levels of stimulus, is expected to generate sizeable GDP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

		Red Lights	Green Lights
Indicator	**2019**	**2020**	**2021 e**
GDP (yoy)	2.3%	-2.4%	6.5%
Unemployment Rate	3.6%	6.7%	4.5%
S&P 500 EPS (yoy)	3%	-19%	38%
COVID Cases	N/A	19.1m	?

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 March 2021. COVID case count from www.coronavirus.jhu.edu as of 12/28/20.

From an investment perspective, we've been believers in the "Reflation 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 a Fed that is willing to allow more inflation than they have in the past are all structural reasons to support this theme. At the same time, a cyclical recovery in economic growth and corporate profits is taking shape. Furthermore, this past month, consumer and wholesale inflation metrics recorded significant year over year acceleration with readings that surprised to the upside. <u>This leaves little doubt that inflation is here. The question now shifts to how long is it staying.</u>

10 Year Treasury Yield vs Consumer Price Index



Source: Factset

The Fed has intimated that inflation will be "transitory". The acceleration in trend, they say, should be viewed as a temporary spike caused by easy comparisons and supply chain bottlenecks that are considered a short term problem. But with record amounts of money having been pumped into the economy, does this create a structural, longer lasting phenomenon?

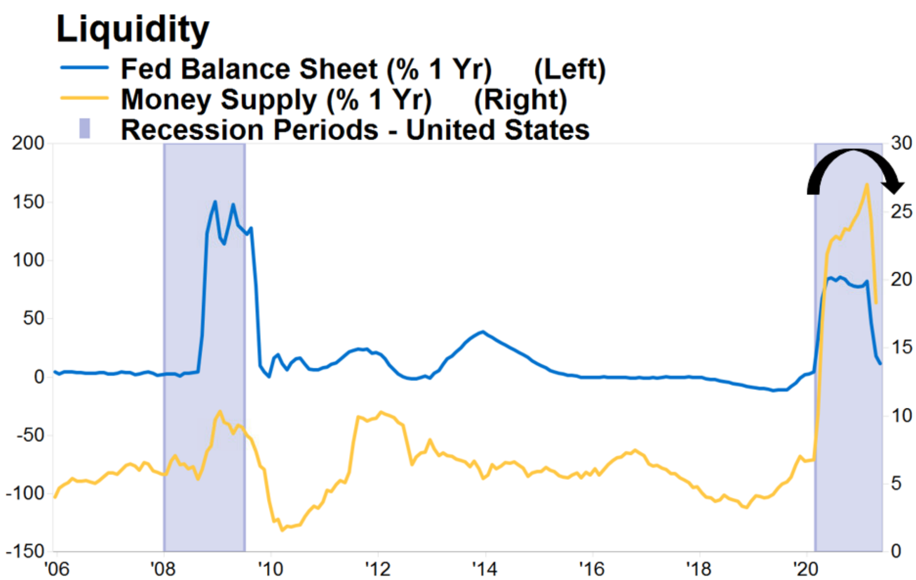
As can be seen in the chart on the prior page, headline inflation as measured by the Consumer Price Index (CPI) has generally been correlated with long-dated interest rates as measured by the 10 Year Treasury Yield. Today that relationship looks to be diverging as inflation has more aggressively bottomed while long-term interest rates (within the context of their longer term) have not. In our view, that divergence continues to set up an opportunity for reflationary assets which have been an emphasis in client portfolios (see table at right).

Reflation Reset

Advantaged	Disadvantaged
International Markets	Domestic Markets
Commodities / Real Estate	Fixed Assets
Economically Sensitive Sectors	Defensively Oriented Sectors
High Operating Leverage	Low Operating Leverage

Source: FFWM Research

Earlier, we referenced a Tricky Transition setting up the idea that a mid cycle slowdown may be coming into view. Such a transition can happen when the economy shifts from recovery to expansion as peak growth occurs. Typically a peak in liquidy growth often precedes a peak in earnings growth. There are several signs that liquidity growth is peaking today. As can be seen in the chart at right, growth in the Fed's balance sheet and money supply (as measured by M2) have peaked in late February/early March. The yield curve has been consolidating as well. We think this suggests that earnings growth may peak in subsequent quarters. ***This transition period is tricky because while we still think it makes sense to emphasize a reflationary tilt, this midcycle slowdown could create some market volatility.***



Source: Factset

In summary, we think it's important to acknowledge market transitions on several fronts:

- The cyclical bull market shifts from year one to year two.
- The return composition shifts from multiple expansion to earnings growth.
- Reflation trends continue, but a midcycle slowdown may be approaching.

As such, we remain deliberate in emphasizing a reflationary bias in client portfolios while also controlling overall portfolio risk. Accordingly, we continue to trim 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 both International Developed and Emerging 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 recently 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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