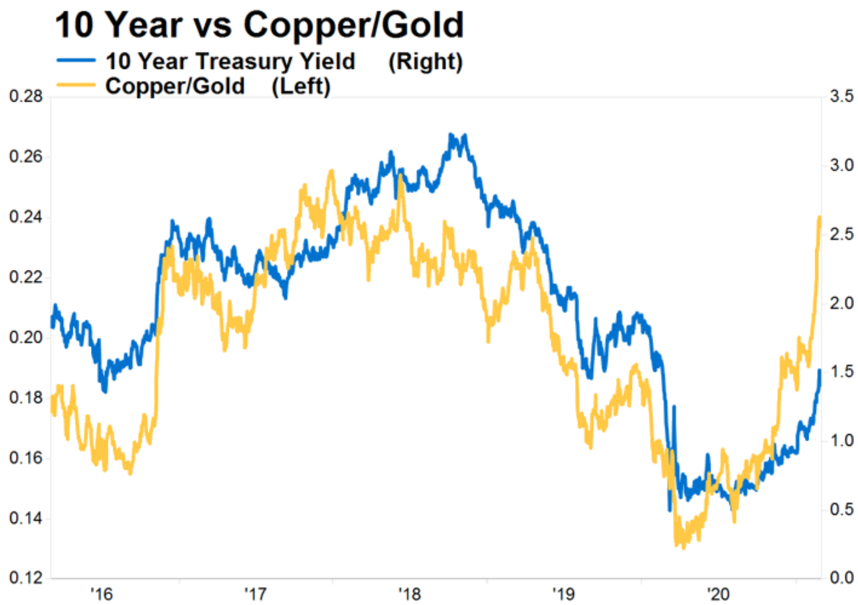
Let’s Get Physical (and Cyclical)

Physical (1981) – Olivia Newton-John

If you’re of a certain age you might recall the 1981 top billboard hit as referred to in the title above. A time that takes us back to the late ‘70’s and early ‘80’s. Big hair, leotards, and leg warmers. Baggy hammer pants and cuffed jeans. And before that, flared lapels, bell-bottom pants, and platform shoes. Velvet suits and tie-dyed shirts. Ahem – classy and timeless looks.

One has to go back to that time period to see some parallels that are now evident in the economic environment today. We’ve written a lot about the change in the money supply – a measure that tracks the change in cash or cash like equivalents in the economy. The growth we’ve experienced over the past year – an effect of the COIVD aid stimulus – has pushed this metric quite literally off the charts. Money growth of over 25% is almost four times the historical average and almost twice the record pace last seen – you guessed it – in the late ‘70’s and early ‘80’s.

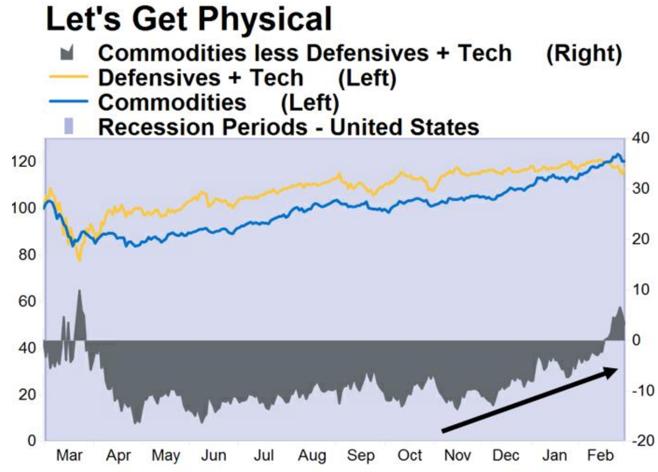
This measure is meaningful because it tends to have a direct relationship to both the economy and the markets with about a 12-to-18-month lag. More money in the system means more money can be spent so it tends to be stimulative and potentially inflationary. And that’s what the markets have been more acutely focused on particularly this past month. As can be seen in the chart at right, the copper to gold ratio has been very correlated to the change in the 10-year Treasury yield over the past five years. Recently, it’s been more of an early moving indicator in its forecast of rising long-term interest rates. ***While the 10-year Treasury yield began to move up in August of last year, that move accelerated in February. We believe this is an indication that the Treasury market is finally starting to come around to a more reflationary view.***



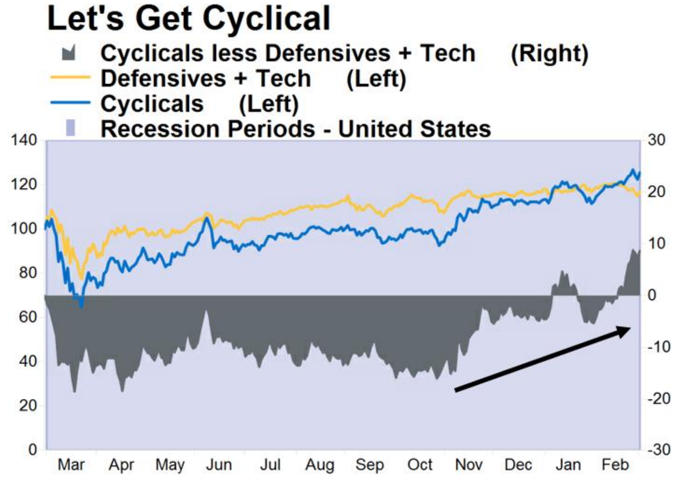
Additionally, as inferred by the title, we believe this environment has been well suited for both the Physical and the Cyclical. Physical or real assets like Commodities have historically been beneficiaries of inflationary conditions. Rising prices have a direct impact on Commodities like oil, copper and gold. Similarly, Cyclical stocks tend to benefit from this environment as well. Energy and Material companies are price takers that also benefit from rising prices. Meanwhile, Industrial and Financial companies benefit from improving economic conditions and rising interest rates. Conversely, the more traditionally Defensive companies like Consumer Staples, Utilities and Health Care have less cyclicality inherent in their business models. Technology – typically a cyclical sector – has been much more defensive throughout this pandemic and essentially never had a crisis to recover from.

As a result, the market has started to rotate based on the above. As can be seen in the charts below, both the Physical (Commodities) and the Cyclicals have quietly become more preferred by investors over the Defensives plus Tech. That change became most noticeable starting in November of last year when the announcement of effective vaccine treatments gave investors a line of sight on a recovery. When one considers the inordinate amount of stimulus on top of a broader economic re-opening, we believed it was only a matter of time before longer dated interest rates needed to catch up. Now investors are coming to grips with the notion that higher interest (discount) rates are a headwind for multiples that need to be offset by higher earnings growth which leaves Defensives and more expensive areas like Tech more vulnerable.

Meanwhile, the jury is still out on if we see an inflationary environment like what we saw in the '70's and '80's. Let's hope for the benefit of our wardrobes that's not in the cards.



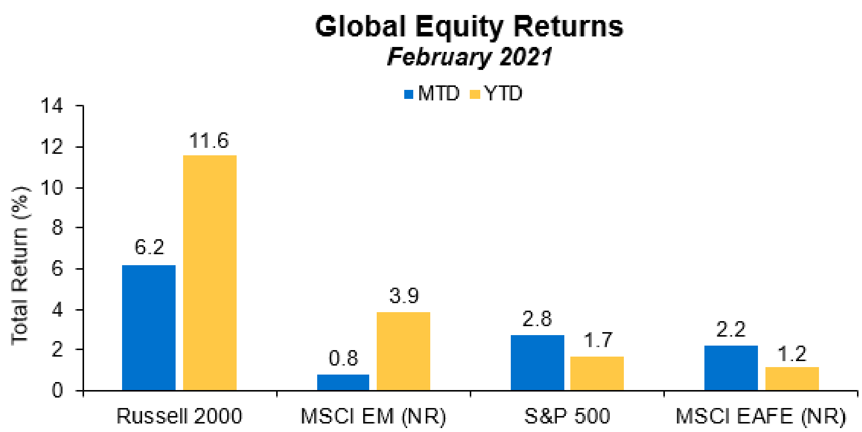
Source: Factset; Defensives + Tech defined as an equal weighted portfolio comprised of Health Care, Consumer Staples, Utilities, Real Estate and Tech sectors. Commodities defined as the Bloomberg Commodities Index.



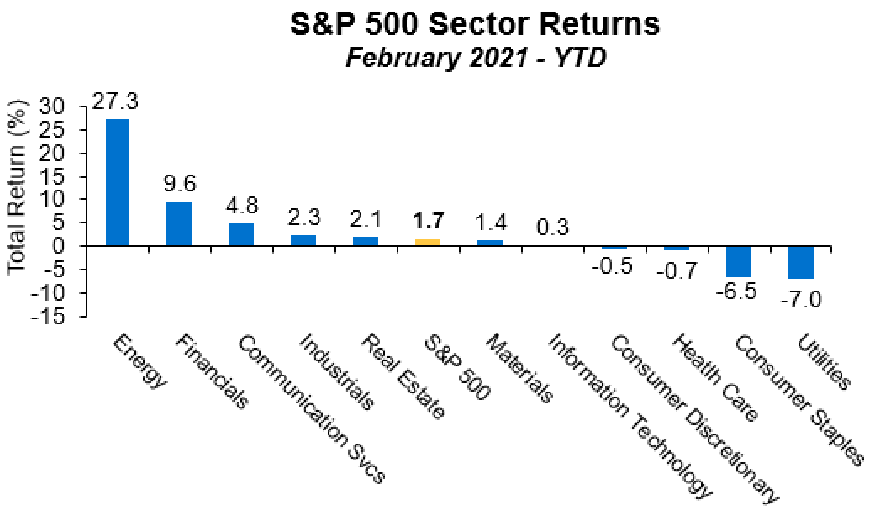
Source: Factset; Defensives + Tech defined as an equal weighted portfolio comprised of Health Care, Consumer Staples, Utilities, Real Estate and Tech sectors. Cyclicals defined as an equal weighted portfolio comprised of Financials, Industrials, Materials and Energy sectors.

The S&P 500 had a much better February than a year ago with year-to-date returns in solidly positive territory. Market dynamics reflect an investor preference for reflationary assets across a range of markets including Commodities, Small Caps, Emerging Markets and Cyclical Value stocks.

Stocks

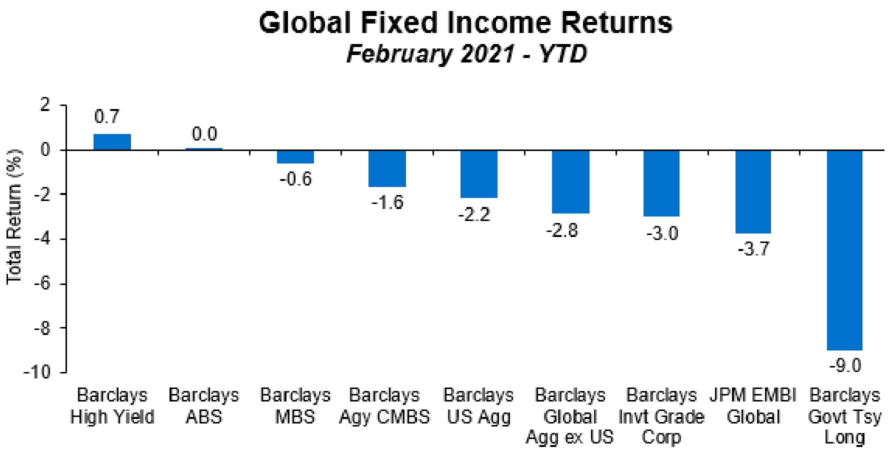


Global equities posted positive returns for February and year-to-date. We think investor preference for both US Small Caps (Russell 2000) and Emerging Markets (MSCI EM) may suggest a desire for more pro-reflation assets in portfolios in an environment where inflation could surprise to the upside. By S&P 500 sector, performance favored cyclical value areas with Energy, Financials, Industrials and Materials all outperforming in February, thus, leading to performance leadership year-to-date. This is a noticeable change from last year as cyclical growth sectors including Tech and Discretionary have been early underperformers as have been the more defensive sectors including, Health Care, Staples and Utilities. We think the anticipated recovery in corporate profits has been very influential.



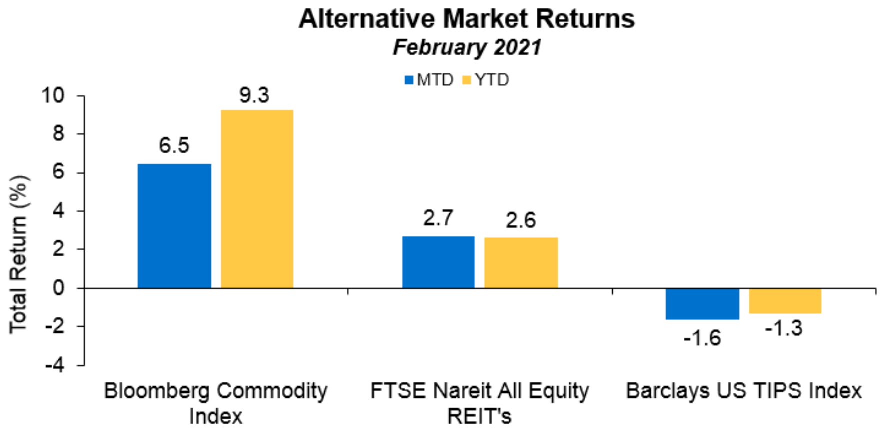
Bonds

Long-term interest rates started to trend higher last August though the pace picked up noticeably this past month. Meanwhile, short-term rates remained anchored by the Fed – resulting in a Yield Curve that has steepened to its highest level since late 2015. This is also consistent with a breakout in inflation expectations to levels we haven't seen in about eight years. As a result, the more interest rate sensitive areas of the bond market have been underperformers to start the year, including long-duration Treasuries (Govt Tsy Long), Emerging Market Debt (EMBI Global) 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 mixed returns. Treasury inflation protected securities (TIPS) were held back by the rise in longer dated interest rates though outperformed nominal Treasuries given increasing inflation expectations. Publicly traded real estate posted solid returns for the month as relative valuations have become increasingly attractive. Commodities posted among the best returns for the month and year led by notable increases in Energy, Industrial Metals and Agriculture prices – consistent with the market's message of budding cost pressures on the rise.



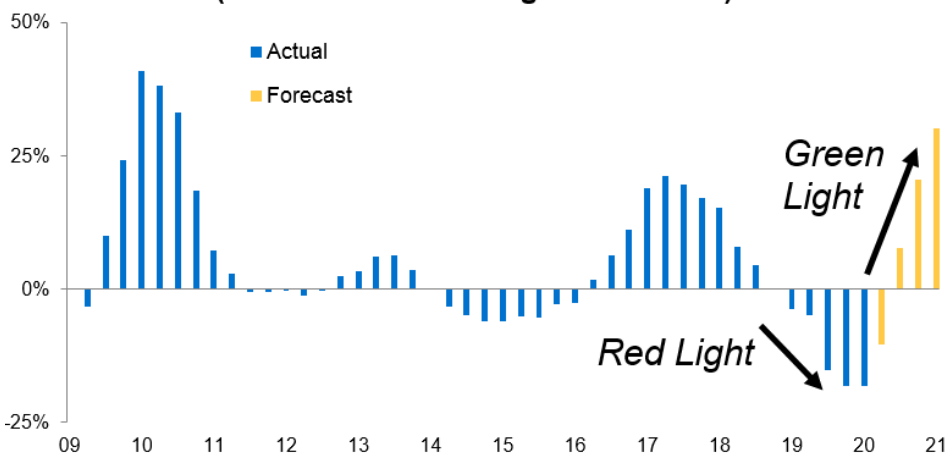
Market Outlook

Our outlook for this year remains unchanged as the economy goes "From Red Lights to Green Lights". Things won't be easy or even normal but we do believe they will be better. Our expectations are for economic growth to shift from negative to positive, labor markets to continue to heal and a strong recovery in corporate profits helped by easy comparisons, a more open economy and a massive liquidity push. While strong growth is expected, we think it could actually surprise to the upside. This remains our base case. There are risks, of course, including the emergence of variant COVID strains being more resistant to the vaccines as well as the potential for rising rates and inflation to set up an overheating environment and the need for more restrictive policy – eventually.

		Red Lights	***Green Lights***
Indicator	**2019**	**2020**	**2021 e**
GDP (yoy)	2.3%	-2.4%	4.2%
Unemployment Rate	3.6%	6.7%	5.0%
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 December 2020. COVID case count from www.coronavirus.jhu.edu as of 12/28/20.

The MSCI ACWI Profits Cycle (Year-on-Year % Change in TTM EPS)



Source: Factset based on iShares MSCI ACWI ETF data.

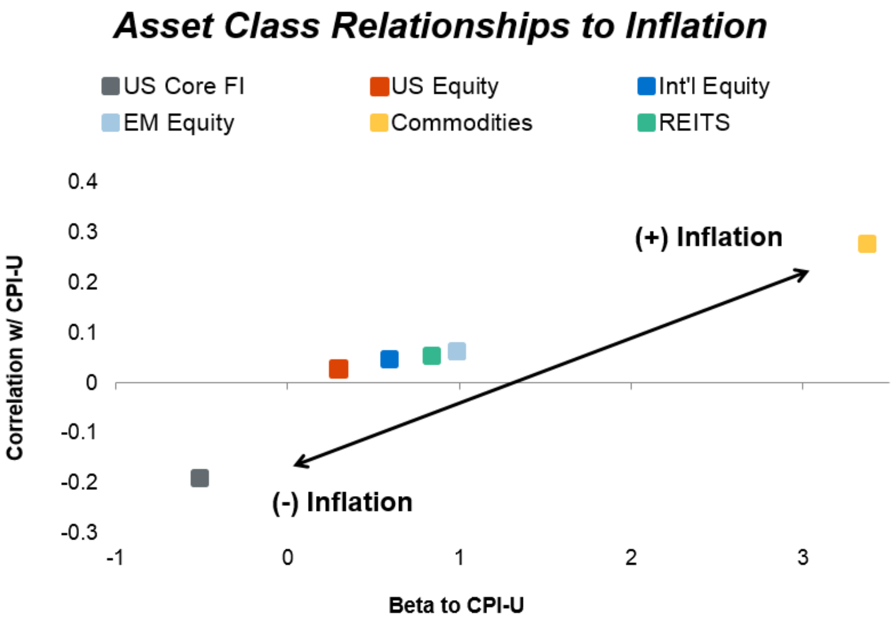
From an investment perspective, we remain focused on our "Reflation Reset" theme – an environment where growth improves because either real growth gets better, inflation rises or some combination of the two occurs. We think a key storyline for the market will be the idea that "everything changes if everything changes" – meaning new leadership may be ushered in as a <u>rotation within the market</u> favors areas that have not been preferred in quite some time. As can be seen above, the recovery in corporate profits remains a key signpost.

Reflation Reset

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

Source: FFWM Research

In an environment where reflation may be the dominant characteristic, our view remains influenced by the table above and the chart below. Areas that tend to be more sensitive and highly correlated to inflation include Commodities, Real Estate and International Equities. Conversely, longer duration assets are more negatively effected as they're adversely impacted by higher interest rates. We also believe that opportunities are evident within US Equity sectors as well. As growth becomes more prevalent in 2021, investors may uncover the opportunity to pick up stocks with substantially faster earnings growth rates trading at substantially cheaper valuations. That tends to favor cyclical value sectors over the defensive and expensive sectors (like Tech) as discussed previously.



Source: Factset, Data November 2001 - February 2021

As such, cyclicality and reflationary assets remain preferred in our positioning consistent with the thesis above. Market rotation has started to reflect this positioning over the past several months, however, <u>it's important to remember that markets never move up in a straight line and controlling overall portfolio risk becomes critical</u>. As a result, we recently trimmed our OW to risk assets (trimming Equities and adding to Bonds, Real Estate and Commodities) as Equities may have to deal with some indigestion that comes along with an increase in rates and inflation – though our overall cyclical bias remains unchanged.

Within equities, our OW's continue to favor a pro-reflation bias. Previously, we've increased our exposure to an EW in International Developed Markets to complement our OW to 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 especially within our US Large Cap exposure.

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 in International Fixed Income which has benefited from a weaker dollar trend.

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