Hibernation or Fossilization?

*"More money has been lost because of four words than at the point of a gun. Those words are **this time is different**."* *– Reinhart & Rogoff (This Time is Different - 2009)*

The *Twilight Zone* was a TV series created by Rod Serling that ran for five seasons from 1959-64. Known for its science fiction tales and unexpected twists, this black and white series was so popular that it was brought back in various capacities over a span of five decades. If you've seen any episodes, the entertainment value is rooted in the unusual world that is often portrayed.

More and more recently, the market environment is feeling a little Twilight Zone-esque as evidenced by these recent observations *(at the time of this writing):*

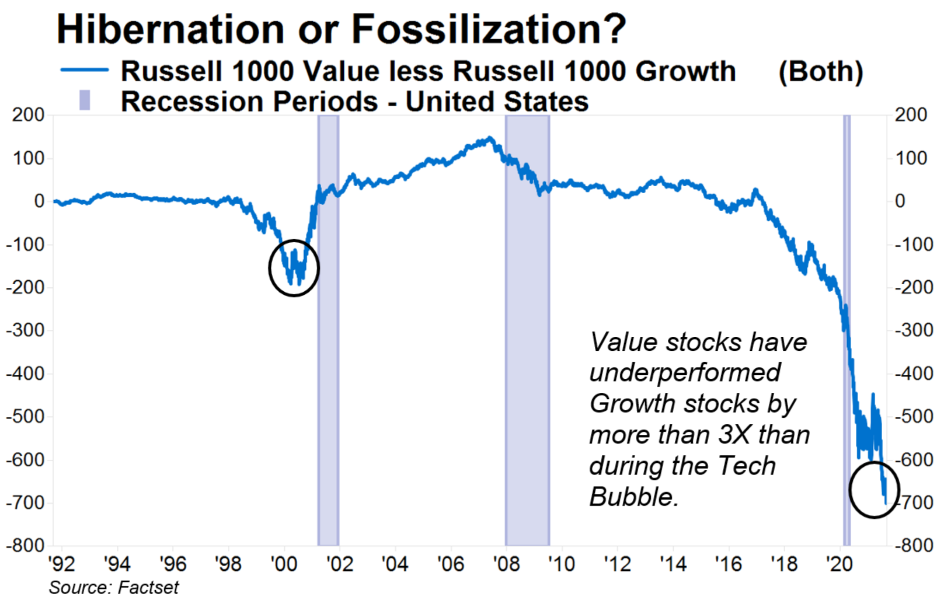
- The top five largest market capitalized companies in the US (which include AAPL, MSFT, GOOGL, AMZN, FB) sum to the equivalent of more than 40% of the ENTIRE US economy (as measured by nominal US GDP).
- Tesla (TSLA), the electric car manufacturer, has a market cap greater than Toyota, Volkswagen, Daimler, GM, Ford, Honda and Hyundai…COMBINED.
- Coinbase (COIN), a cryptocurrency exchange platform, has a market cap that is more than double that of the Nasdaq exchange that its stock trades on.
- In a recent article on CNBC, a 12-year-old made almost $400,000 in two months coding and selling NFT's (non-fungible tokens) paid in Ethereum – another cryptocurrency.
- The number of SPACS (Special Purpose Acquisition Companies), so called blank check entities that raise capital with as much as two years in advance of making ANY investment, have already increased by almost 70% more than ALL of last year – representing $123 billion in funding. One of the most notable registered earlier this year was LMF Acquisition Opportunities – listed under the symbol LMAO.

We can't make this stuff up…strange ruminations indeed.

While these stories may seem random, we would suggest they're more related than not. Investors seem to be distinguishing between old world and new world stocks to an increasing extreme (think Innovator and Disruptor and/or MEME stocks). This isn't to suggest that some of the companies above don't have tremendously successful products and business models. However, we think it's important to recognize that great companies may not always make great stocks if underlying growth assumptions have been pushed to overly optimistic levels. We also think it's not coincidental that the culmination of these events is happening during a period of record setting liquidity and extraordinarily low interest rates.

A lot of the previously mentioned stocks fall into the Growth category and are represented by high Price to Earnings valuations making their terminal growth rates very sensitive to interest rate changes. To that point, according to Factset, the S&P 500 Growth index sports a P/E ratio of 29 times forward earnings (52% above the 10-year average) compared to the S&P 500 Value index of 16 (15% above the 10-year average). That gap of 13 multiple points compares to a difference of only 2 a decade ago. With rates at exceptionally low levels, expensive Growth stocks have flourished but should rates rise – as we've previously evidenced by a higher growth and inflation backdrop – caution might be warranted for that group.

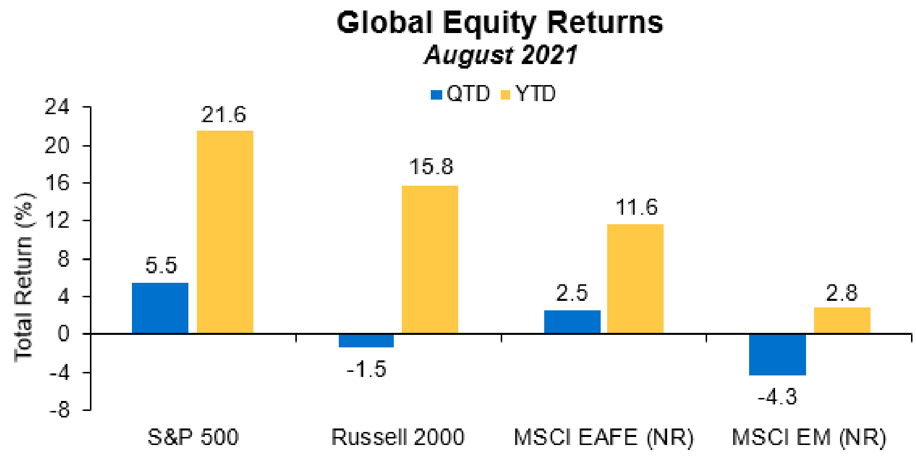
As can be seen in the chart below, the cumulative performance of value stocks relative to growth stocks consolidated late last year into early this year but recently took another leg lower. ***Currently, the performance differential is now more than THREE TIMES greater than that witnessed during the '90's decade – concluding with the 2000 Tech bubble.***



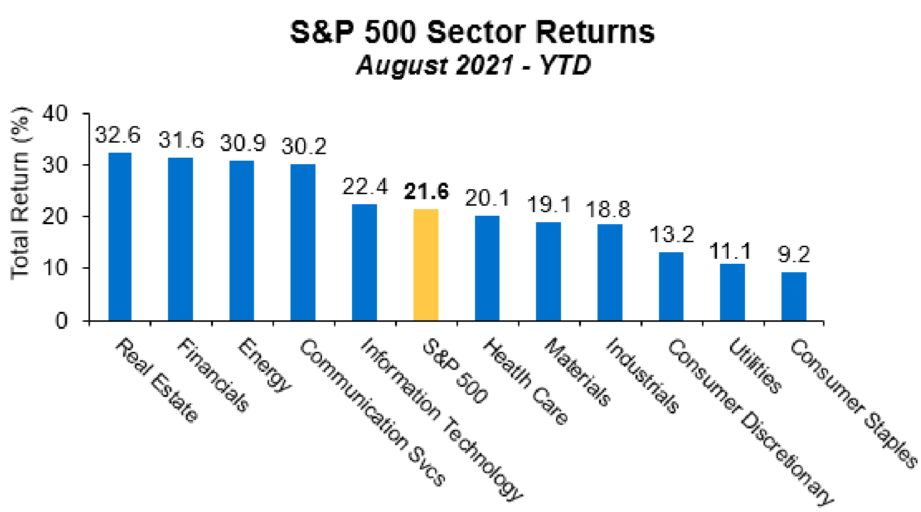
Are value stocks hibernating after a LONG winter lull or have they gone the way of the dinosaur – fossilized in time? In other words – dare we say – "is this time different"? We're not convinced the answer is yes. That doesn't mean that some of these technologies won't be life changing. It simply may suggest that some of the growth stocks leveraged to these themes may have valuations that reflect better-than-best-case scenarios. Hardware and software companies in the '90's introduced computing technologies that absolutely changed our lives. But, with hindsight, we often joke that stock valuations back then not only reflected the assumption that there'd be a PC in every home and office on earth, but also on every planet of the universe as well.

While some market trends reversed over the past several months, full year returns have 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

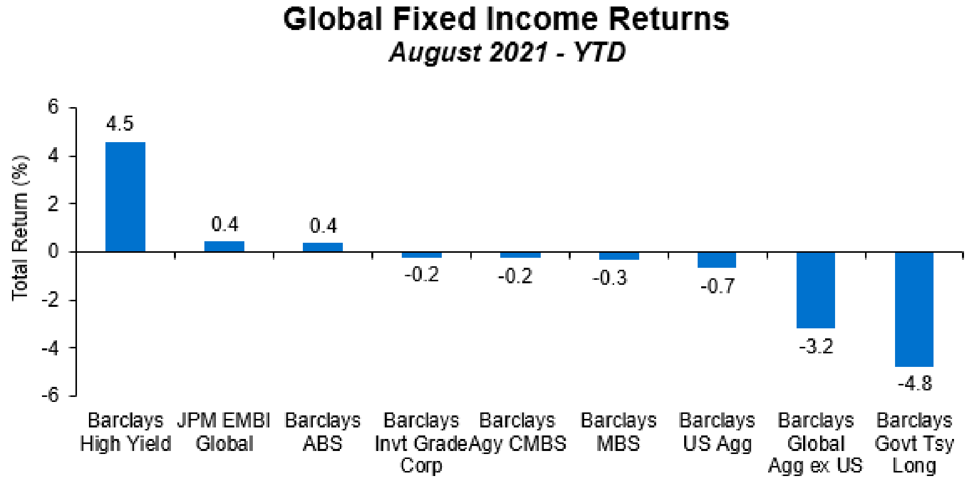


Global equities posted mixed returns so far in the third quarter amid still mostly strong year-to-date totals. Of late, a more defensive market posture has been evident with profit taking in the more cyclical areas like Small Caps (Russell 2000) and Emerging Markets (MSCI EM). A combination of COVID resurgence along with inflationary pressures dampened consumer sentiment. Policywise, Fed tapering remains on the horizon while fiscal spend continues to advance in Congress. At the same time, corporate profit growth (albeit likely peaking) has remained exceptionally robust. For the year, S&P 500 sectors have 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) were positive but lagged – though this started to reverse quarter-to-date as yields backed down and these sectors outperformed.



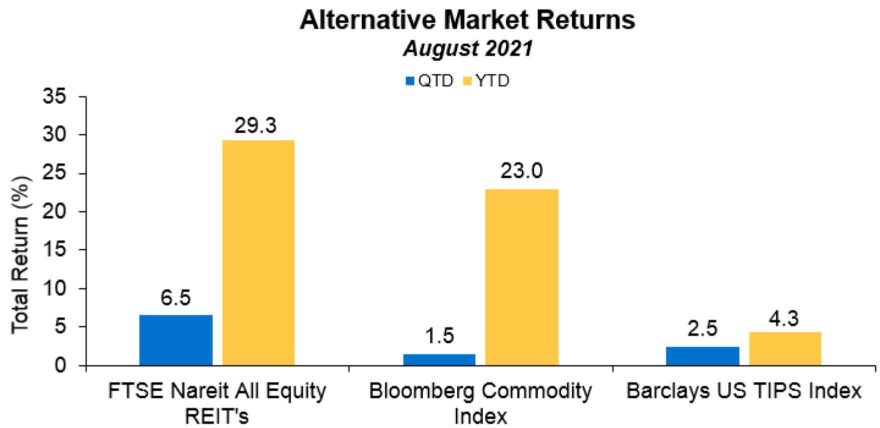
Bonds

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) – though that reversed quarter-to-date. 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 along with Emerging Market Debt (EMBI).



Alternatives

Alternatives posted mostly strong returns quarter-to-date and for the year. Treasury inflation protected securities (TIPS) were held back by the rise in long-term interest rates though outperformed nominal 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 (Industrial Metal and Energy prices remained solid quarter-to-date).



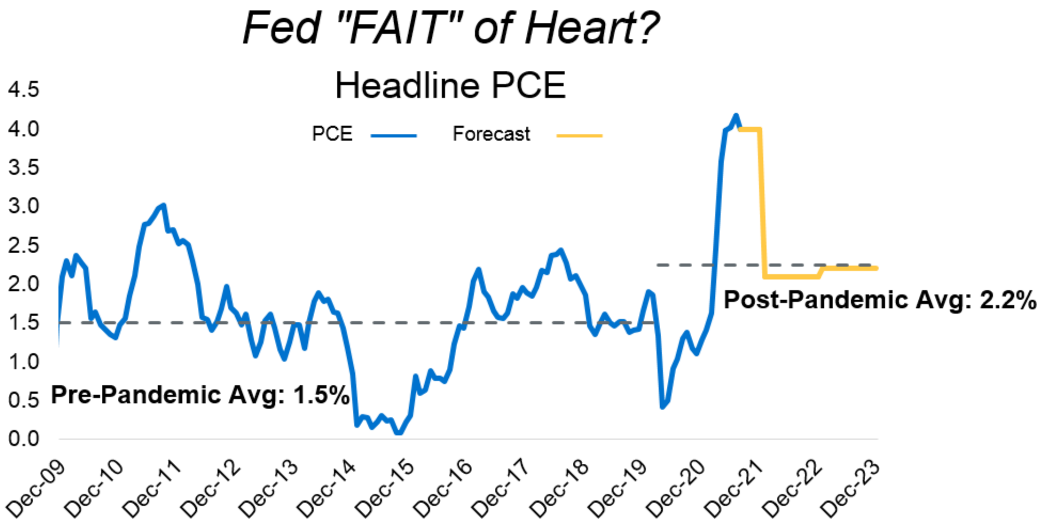
Market Outlook

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).

Indicator	2019	2020 (Red Lights)	2021 e (Green Lights)
GDP (yoy)	2.6%	-2.3%	7.0%
Unemployment Rate	3.6%	6.7%	4.5%
S&P 500 EPS (yoy)	3%	-19%	37%
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 June 2021. COVID case count from www.coronavirus.jhu.edu as of 12/28/20.

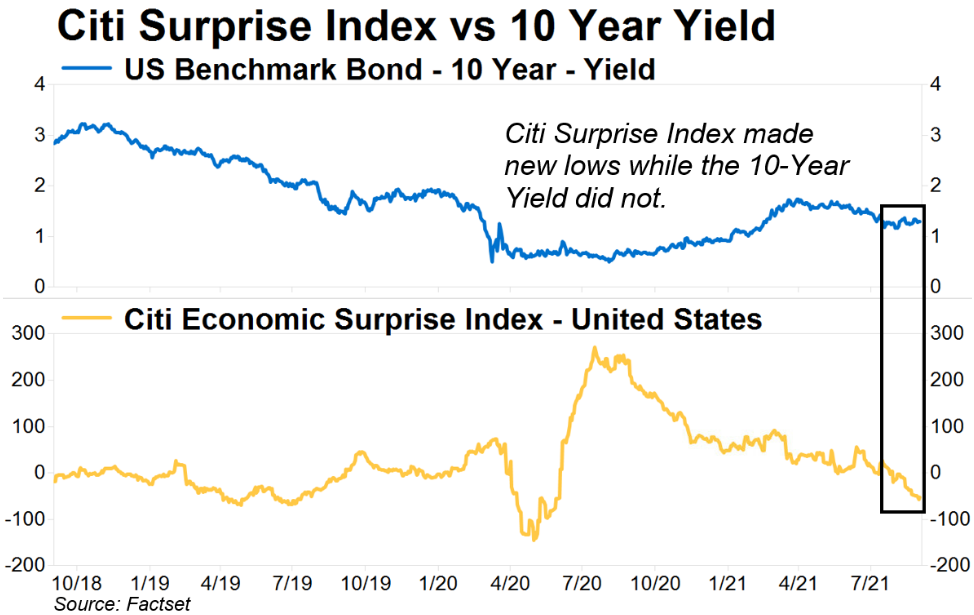
From an investment perspective, we've been believers in the "Reflation Reset" theme, whereby nominal growth improves from a combination of rising real growth and inflation. A federal budget deficit today that only rivals that of World War II, along with de-globalization trends, and the Fed's FAIT (Flexible Average Inflation Target) policy are all structural reasons to support this theme. Similarly, the widening disconnects between the 10 Year Treasury Yield and the Consumer Inflation index (widest since 1990) as well as nominal GDP growth (widest on record since the early '50's) suggest these gaps are not sustainable. ***We continue to believe that the transitory portion of inflation moderates from here, but still normalizes back to structurally higher levels than what we've seen in the recent past.*** The chart below is a good illustration of how the inflation dynamic could play out as described above. The PCE index is the Fed's preferred inflationary gauge which incorporates the Fed's inflationary forecasts out through 2023.



Source: Factset; PCE forecasts are produced by the Federal Reserve as of June 2021.

In short, pre-pandemic inflationary levels might be noticeably lower than post-pandemic inflationary levels. ***Furthermore, should wage inflation remain elevated – and even accelerate from here – structural inflation tendencies might become more embedded especially if investors are surprised by a tighter labor market than previously thought.***

Up to now, longer-term rates have been more sensitive to factors other than inflation, including a stronger dollar, COVID case resurgence, moderating economic data and a Fed that now owns about a quarter of the ENTIRE Treasury market. Might longer-term rates start incorporating a changing view if some of the above factors change? While COVID case counts due to the delta variant remain troublesome, the data is starting to suggest that positivity rates are peaking in US hot spots (South). Meanwhile, the FDA granting full approval for the Pfizer vaccine could spur further vaccination uptakes. More recent Fed commentary has made it clear that policymakers are likely to begin tapering (reducing Treasury and Mortgage bond purchases) late this year or early next year – lessening some of the artificial influence as noted above. Finally, the Citigroup Economic Surprise index, an indicator that measures the degree to which economic data is beating or missing expectations, is now at a low historical level (moving from the 10th decile last year to the 2nd decile currently – relative to history dating back to 2003). As can be seen in the chart above, this index has recently made a new low while the 10 Year Treasury Yield has not. In other words, the rates market might be suggesting that economic expectations have now been sufficiently reset enough for the economic data to begin surprising to the upside.



The confluence of these events may be enough to price in a higher rate dynamic, which would benefit relationary pockets of the market – cyclicality within equities, shorter duration within bonds and real assets within alternatives. All of these areas have been tactical points of emphasis in client portfolio positioning.

At the same time, we want to be cogznizant of risk and recognize that investors may not want to be as aggressive in positioning as they were to begin the year – for the following reasons:

- Year Two of a cyclical bull market has historically ushered in more volatility (albeit positive returns). Through the first five months of Year Two, we've seen comparable historical FULL year returns without much of the volatility.
- As we get closer to the end of the year, corporate profit growth is likely to slow. While this is not a major negative for market returns, in aggregate, it does tend to signal a rotation under the surface – having implications for sectors and risk factors.
- Stock valuations are elevated in an absolute sense and may becoming more so in a relative sense. The equity risk premium may look less favorable if rates rise.
- Policy conditions are likely to be less favorable over the next 12 months than over the past 12 months (less liquidity and more potential headwinds for corporate earnings).

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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