Client Note

April 13, 2021

The first quarter was marked by two distinct phases. The first phase was a continuation of markets climb from the late October early November lows which peaked in mid-February. The second phase was characterized by a distinct outperformance in value or cyclical areas of the market. This is the third instance in the past 16 months where we have seen value outperform growth. Generally, this does not persist for more than a month or two.

The S&P 500 gained 5.5% during the first quarter while the aggregate bond index fell 3.7%. Oil gained 26%, aiding the energy sector's gains of 31% and gold fell by 10% Corporate bond prices fell by 5.4%. Junk bond prices were unchanged. This is a slightly odd relationship, but indicative of 'risk-on' alongside a rise in interest rates. The gain in the general stock market and decline in bonds (and gold) left most balanced and multi-asset **portfolios flat or in the low single digits**. With energy up, bonds and gold down, and seemingly only the largest companies are carrying the general stock indices higher.

Most recently, gold appears to have formed a "double bottom" in late March and has made slight gains. Stocks continue to grind up, but with the largest names leading. This contrasts with the period from April 2020 to February where micro- and small-cap stocks dramatically outperformed large stocks. If we do not see a re-rotation into smaller stocks and those outside the major indices may be the prelude to a larger market pause in the coming months.

Bonds too may have realized a bottom in mid-March as prices have been net sideways. A bit more improvement in prices (rates lower) should begin a nice rally, giving a reprieve to the general investor who have gained in stock prices, but lost some on bonds, especially for the more conservative.

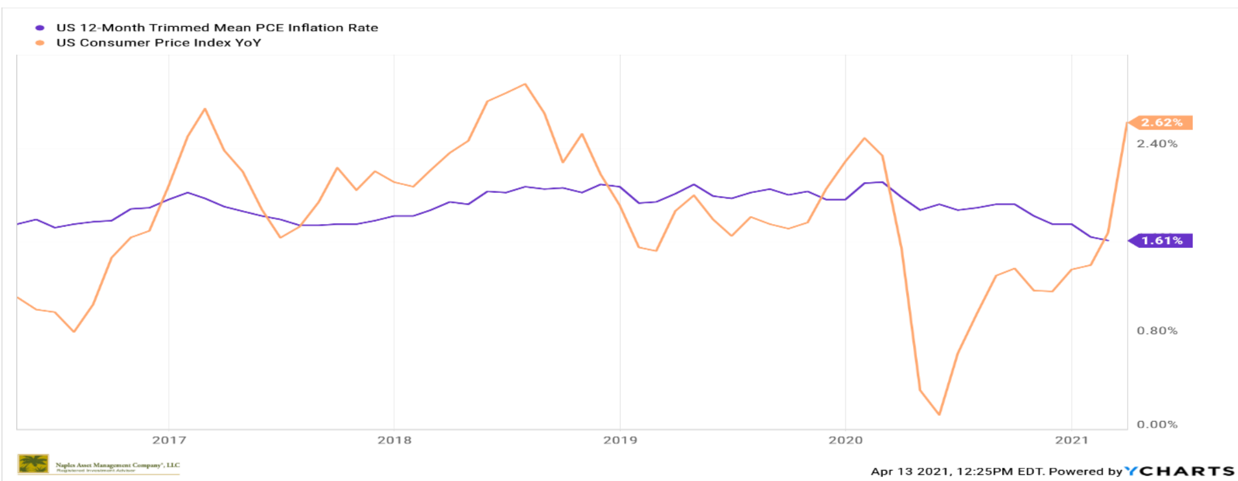
How could or would interest rates actually decline? Again, we see in the media how 'everyone' knows rates are going higher and inflation is at the door due to either 'cash on the sidelines' (doesn't exist), or bank savings, or 'pent up demand'. Once 'everyone' knows something its more likely the near-term trend is over or soon will be. We may already see this in gold and bonds, as interest in these areas is low, while SPACSs and cryptocurrency are all the rage currently.

Inflation concerns are due to the recent and quick rise in rates that have its roots in price increases due **to supply-chain problems** and the Asian/China resurgence **and stimulus. Supply chains issues will be resolved on their own in short order.** High prices attract businesses to produce more/fix problems which lead to lower prices, the essence of a free market. Very recent news tells us that China's credit impulse/stimulus has begun to wane. The past 10 years we have seen two previous large credit cycles in China. China is a massive buyer of raw materials and we have seen prices in commodities rise the past year driven by easy money from China. There is about a 3–6-month lag time until we see the impact of a ***change*** in China's rate of credit creation. **Given that this China credit data is already 4 months old should mean, as recent price action alludes, a decline in interest rates and commodity prices and thusly, inflation expectations.**

While stocks look to have another 5-7% upside momentum, the asset classes that have faired worse recently should see gains alongside stocks. **As mentioned in the past Notes, its post July 4 that concerns me the most when we may see a flattening of economic growth and decline in expectations of rapid growth which can weigh on risk assets.**

The reason I am concerned about the second half of the year comes from a few places. Valuations are exceptionally high right now. Many metrics are above 1999 levels. This is commonly discounted due to the low interest rates. If we are elevated over 1999 levels, how much more elevated should we accept? Another element to today's market is the ever-present Fed liquidity. Yes, the Fed could continue as long as there is dollar-denominated debt to liquify. And finally, there is the current expectations that we are entering a new era of high growth. Its this last item that is most sensitive to changes in short term economic and Covid data.

The high growth thesis stems from stimulus in the pipeline and the observations that inflation is occurring. Stimulus, or government infrastructure spending will take years to filter through the economy. Inflation as measured by the CPI varies greatly, while the PCE is smoother (and what the Fed watches). One can clearly see the past overshoots of the CPI vs. the PCE, and PCE is trending down. Once supply chain issues are resolved/lessened and Chinas credit impulse fade, its likely CPI will catch down to PCE.



If inflation expectations come down, while job growth and spending data come in cool, beginning in the next few months, we could see forward expectations and valuations come down, pulling 'risk assets' with it. Add in any kind of Covid 4th wave or failure at herd immunity via vaccinations, we could see the most powerful driver of asset prices, optimism, take a hit; and along with it create a more volatile period for stocks.

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