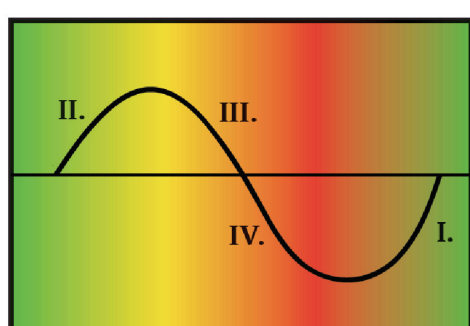


Month in Review

The S&P 500 rose 2.3% in July despite increased concerns over the Delta variant and its implications for a full economic reopening. US equity and bond markets painted conflicting pictures as the S&P 500 hit new all-time highs while US Treasury yields slumped to the lows last seen in February. The reflation trade continued to unwind with growth stocks returning 2.9% while value stocks returned just 0.7%. It's time to check our indicators to see how the rapid spread of the Delta variant has affected them. I have also provided a brief summary of my thoughts on the market going forward.

I. CREDIT CYCLE

PHASE II: EXPANSION



Financial conditions continue to be very favorable. The Federal Reserve made no changes to policy at the July FOMC meeting as it weighed the twin risks of slower growth from increased coronavirus infections and higher prices from global supply chain bottlenecks. The Fed now “has risks in two directions,” said Yale School of Management professor William English. For his part, Fed Chair Jerome Powell noted that with “successive waves of COVID over the past year and some months now, there has tended to be less in the way of economic implications with each wave” signaling that a reduction in asset purchases is moving closer despite the virus, with either late this year or early next the most likely timing for tapering to begin.

II. RISK LEVEL INDICATORS



US STOCKS: Guarded

The Risk Level for **US STOCKS** is **GUARDED**. Mid-cycle transition or temporary growth scare—which is it? In the mid-cycle camp is Mike Wilson, Chief Investment Officer for Morgan Stanley, who cites four predictable changes that occur at this stage of the cycle: 1) the rate of change on economic and earnings growth peaks; 2) equity market breadth begins to narrow; 3) leadership moves away from cyclical and small cap stocks; and 4) interest rates rise as the Fed begins to tighten monetary policy. Wilson claims the first three conditions have been met and the fourth is only a matter of time. JPMorgan disagrees; they maintain the recovery is still in the early-cycle stage gradually transitioning to mid-cycle. Reopening is a process not an event, they say. The current growth scare is just a normal pause in an ongoing bull market. They point to a boom in buyback announcements and the coming “mother of all inventory re-stockings” as two major catalysts that will reenergize the market. Their advice: “Sell Treasuries and trust the expansion.” The short-term **SWING INDICATORS** have reversed up suggesting market momentum is positive.

INTERNATIONAL STOCKS: GUARDED

The Risk Level for **INTERNATIONAL STOCKS** is **GUARDED**. Emerging market equities fell sharply in July, dragged down by weak performance from China. After months of aggressive credit tightening and more recent regulatory clampdown, China’s stock market crashed into a bear market. In the wake of the collapse, Chinese monetary policy has abruptly switched from tightening to easing, cutting the reserve requirement ratio (RRR) for banks back to 2007 levels. With a slower China there is less reason to worry about inflation. Slower growth means less demand for raw materials, lower commodity prices, a weaker currency making Chinese imports elsewhere cheaper, driving down prices in the rest of the world. China helped pull the global economy out of recession in 2020, it remains to be seen if the global economy can continue to expand without China in 2021.

US FIXED INCOME QUALITY: GUARDED

The Risk Level for **US FIXED INCOME QUALITY** is **GUARDED**. Bonds are benefiting at the expense of stocks as the Delta variant casts a pall over the economic recovery. In addition, developments in China are potentially deflationary and the meltdown in Chinese stocks helps explain the melt-up in US Treasury bonds. Normally, such a sharp decline in Treasury yields would imply a significant downgrade to growth expectations, but technical factors unrelated to the economy have had an unusually large influence on bond prices and yields. JP Morgan believes Treasury yields are too low considering the strength of the recovery and will move higher over the remainder of the year. Bonds are technically overbought so we would be a buyer on any dips but would not add to our position at this time.

III. LOOKING AHEAD

BACK TO THE FUTURE

The last two months have been characterized by a rotation back into the Covid-era defensive stocks--especially the Big 5 tech titans Microsoft (MSFT), Amazon (AMZN), Apple (AAPL), Google (GOOGL) and Facebook (FB)--in a reversal of the first-quarter “duration rotation” when long-term yields were rising and cyclical stocks dominated the S&P 500. Since then, long-term yields have plunged and the bond market seems to be saying that either COVID-19 or the Fed (or both) will choke off longer-term growth. This is the scenario the market has started to price in over the past few weeks, says Louis Gave, CEO of Gavekal Research. He believes a more likely scenario is that COVID-19 cases peak, the world fully reopens, demand surges and inflation remains elevated. Money rotates from bonds to stocks causing interest rates to rise and driving another rotation back into value. In other words, don’t sell your first- half winners just yet--the second half may look more like the first.

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