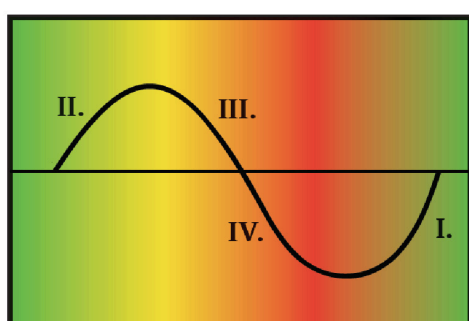


# Month in Review

The S&P 500 rose 2.2% in June as not even the “hawkish” turn by the Federal Reserve could halt the historic advance. It did, however, upend the reflation trade that has dominated markets this year. The Dow Jones Industrial Average (DJIA)—a proxy for so-called value shares--posted its worst weekly loss since October mid-month as investors rotated out of reopening plays and back into secular growth stocks in healthcare and Big Tech. It’s time to check our indicators to see how this “reverse rotation” 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 remain extraordinarily loose but Fed tightening expectations have moved sharply higher. “We’re on the other side of the mountain with respect to monetary accommodation for this cycle,” claims Mike Wilson, CIO for Morgan Stanley. Market action following the FOMC meeting recalled the pre-COVID, slow-growth, low-inflation era, as the markets most sensitive to economic growth such as commodities, emerging markets, and small cap stocks sold off, while deflation beneficiaries such as bonds, the dollar, and Big Tech rose. With the economy booming this year, it was natural for the Fed to tilt a little “hawkish” but Peter Boockvar, CIO at Bleakley Advisory Group, thinks fears the Fed will tighten too much too soon are overblown. “The Fed has been doing 200 miles per hour in a 50 mph speed zone,” he says, “I saw Powell slow down to 175.”

## II. RISK LEVEL INDICATORS



### US STOCKS: Guarded

The Risk Level for **US STOCKS** is **GUARDED**. Cyclical stocks and banks have been the clear winners this year on the back of the economic reopening and V-shaped recovery in earnings. This cycle has run hotter and faster than most due to massive government stimulus and may have already peaked. While growth is expected to stay positive, the 2nd derivative—the change in the rate of growth—has turned down. The prospect of a tighter Fed and slower growth led to a rout of economically-sensitive stocks in the energy, financials, and materials sectors. This is classic mid-cycle behavior, and we believe it represents a pause rather than the end of the move into pro-cyclical value stocks. More likely it means the end of outperformance by lower-quality, speculative stocks and we continue to avoid them. The short-term SWING INDICATORS are mixed suggesting market momentum has stalled.

### INTERNATIONAL STOCKS: GUARDED

The Risk Level for **INTERNATIONAL STOCKS** is **GUARDED**. European stocks outperformed in the 2nd quarter as vaccinations and the reopening gained ground, whereas China is clearly slowing down. Chinese authorities have been aggressively tightening credit for months and the so-called “Credit Impulse” turned negative in April. The slowdown in China has reverberated globally as first copper and industrial metals prices dropped, followed by inflation expectations and Treasury yields. If the economy slows too much, the government will likely take their foot off the brake but until then China and other emerging markets are liable to underperform.

### US FIXED INCOME QUALITY: HIGH

The Risk Level for **US FIXED INCOME QUALITY** has improved a notch to **GUARDED**. As noted above, the tightening of credit conditions in China has had a deflationary impact on the rest of the world. Commodity prices have dropped and with them inflation expectations; growth expectations have also moderated and Treasury yields peaked even before the Fed started talking about raising rates and/or ending QE sooner than expected. Tapering and tightening are bond-positive and stock-negative as the recent outperformance of bonds over stocks attests. These are early days, but the BOND INDICATORS have flipped positive and we bought Treasury bonds for the first time since last year.

## III. LOOKING AHEAD

### HOT POTATO MARKET

The market narrative is changing. What had been a one-way reflation trade is now being buffeted by strong crosscurrents. Just as investors bought the Fed’s argument that inflation was transitory and that the hottest GDP growth in nearly 50 years would not force its hand, the Fed pulled the rug out from under them. The Fed’s flip-flop caused a drastic flattening of the so-called Treasury yield curve as the 2- year yield rose, showing expectations of the Fed raising rates, while the benchmark 10-year yield declined, reflecting less optimism toward economic growth. Slower growth and higher rates are a much more difficult environment for stocks in general and cyclical stocks in particular. Since the FOMC meeting, growth and value have treated market leadership like a hot potato. What happens to interest rates in the 2nd half will likely determine the eventual winner and the fate of the market as well.

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