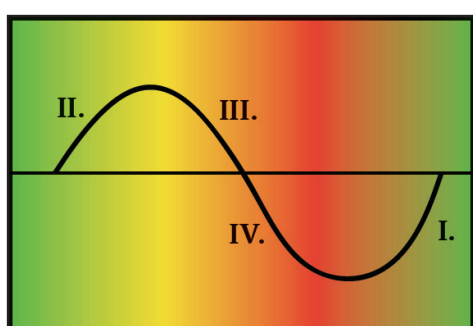


Month in Review

The S&P 500 Index gained 4.5% in May as the lockdown restrictions were lifted and the steep drop in economic activity leveled off. The Fed continues to call the tune and investors were encouraged by Fed Chair Jerome Powell’s assurance on 60 Minutes that there is “no limit” to what the Fed can do to support the economy. It’s time to check our indicators to see how the gradual reopening of the economy and the Fed’s jawboning have affected them. I have also provided a brief summary of my thoughts on the market going forward.

I. CREDIT CYCLE

Phase III: Early contraction



The “shock and awe” campaign released by the Fed in April seems to have achieved its mission of kick-starting a new credit cycle. The Fed’s expanded lending facilities for credit markets and corporate borrowers have reduced the risk of a significant widening in credit spreads and helped companies like Boeing, Southwest, and Hyatt Hotels gain access to financing. In the last cycle, the government was forced to step in and save mortgage lenders Fannie Mae and Freddie Mac when they lost access to the credit markets. “In this cycle, it is not a specific institution that is too big to fail,” observes Scott Miner, CIO of Guggenheim Investments, “It is the investment-grade bond market that is too big to fail. We are all government-sponsored enterprises (GSEs) now.”

II. RISK LEVEL INDICATORS



US STOCKS: ELEVATED

The Risk Level for US Stocks is **ELEVATED** but improving. While the economic data for the last month continued to get worse, the rate of change slowed—i.e. things were getting worse at a slower pace. That’s the first step on the road to recovery and it appears the worst-case scenario is off the table for now. Market internals are also improving with the number of stocks trading above their 200-day moving average beginning to climb. The short-term **Swing Indicators** are positive so the uptrend remains intact.

INTERNATIONAL STOCKS: ELEVATED

The Risk Level for International Stocks is **ELEVATED** but is also improving thanks to the fiscal stimulus plans approved by the EU (750-billion euros) and Japan (\$1.1 trillion). International stocks have underperformed US equities for over a decade, but that may change as new economic cycles tend to bring new market leadership. Looking back at the past 30 years, US stocks led from 1990-2000, then international stocks took the lead in 2001-2007, only to relinquish it to US stocks in 2008-2019. No one knows what the next decade will bring, of course, but the last two recessions did produce dramatic shifts and this one may do so as well.

US HIGH QUALITY FIXED INCOME: GUARDED

The Risk Level for US Fixed Income Quality remains **GUARDED**. The Fed’s unlimited bond-buying plan (open-ended QE) is having the predictable effect of suppressing Treasury yields and driving yield-hungry investors into higher-yielding, riskier assets. Unless the pandemic worsens, it seems likely that Treasuries have peaked and better opportunities lie elsewhere.

III. LOOKING AHEAD

BEAR MARKET RALLY OR NEW BULL MARKET?

The stock market is caught between two conflicting forces; the first is severe economic collapse, the other is money printing on a mind-boggling scale. Investors are left with the Hobson’s choice of investing in companies with dismal earnings based on the premise of “don’t fight the Fed”. This dichotomy has resulted in a fierce but abnormal rebound in which the sectors that usually lead the market coming out of a recession aren’t doing so. Instead, the leadership has come from secular growth stocks like big tech and pharmaceuticals rather than cyclical stocks like financials, industrials, and others that closely track the ups and downs of the economy. For the stock market to make the next leg higher, investors will need to see a stronger signal from these economically sensitive sectors that the recovery is indeed underway.

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