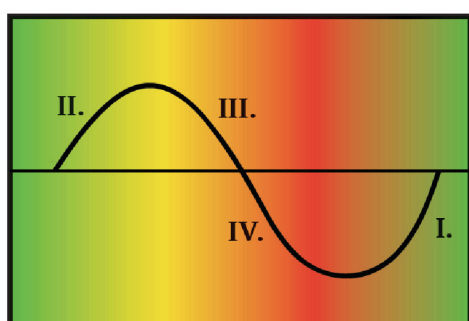


Month in Review

The S&P 500 rose 2.61% in February despite a steep drop towards the end of the month that cut the advance in half. Treasury yields soared, sending 30-year real (inflation-adjusted) rates positive for the first time since April 2020 amid fears of overheating. Higher growth expectations lifted oil prices and steepened yield curves and value sectors such as energy and financial services outperformed. It's time to check our indicators and see how the market's pro-growth shift 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 tightened slightly in February as real yields jumped sharply. The steep drop in real (inflation-adjusted) interest rates over the last year has fanned a broad-based rally in gold, high-growth stocks, corporate bonds and emerging market assets. A sustained rise in real yields threatens to derail the so-called “everything rally”. “[T]he issue to the exclusion of all else is to find out what central banks will do to back up their words on keeping yields low,” writes John Authers, Bloomberg senior editor for markets, “The test is ongoing, but central banks can win it if they really want to.” Volatility will likely remain elevated until the test is finally resolved.

II. RISK LEVEL INDICATORS



US STOCKS: Guarded

The Risk Level for **US STOCKS** is **GUARDED**. Good news for the economy was bad news for stocks as strong data on weekly jobless claims, personal incomes, and core capital goods orders led to a steep rise in long-term Treasury yields. Stocks were down across the board but expensive growth stocks, which are highly sensitive to changes in interest rates, suffered the biggest declines. Sectors that benefit from stronger growth and rising rates such as financials, industrials, materials, and energy fared better, but even they will falter if the economy overheats and the Fed is forced to let rates rise to cool things off. With stocks priced to perfection, it's up to the Fed to keep rates low or risk a more serious market correction that does it for them. The **SWING INDICATORS** are mixed so the market may be choppy in the near-term.

INTERNATIONAL STOCKS: GUARDED

The Risk Level for **INTERNATIONAL STOCKS** is **GUARDED**. Selective lockdowns in the Eurozone are still holding back the recovery. Manufacturing strengthened in February but services remained weak and consumer confidence is only marginally improved. On the bright side, economic data continues to surprise to the upside, and European equities posted a gain with value sectors such as banks outperforming. In China, tighter liquidity conditions pressured the shares of highflying companies in the semiconductor, electric vehicle, and auto production sectors. Investors are beginning to worry that the “credit impulse” in China may have peaked, which has tended to lead nominal GDP growth by four quarters, notes SocGen Cross Asset Research. Those concerns, however, may be premature—a similar crest occurred in Q1 2017 and global stock markets didn't peak until a year later.

US FIXED INCOME QUALITY: HIGH

The Risk Level for **US FIXED INCOME QUALITY** is **HIGH**. The bond market sell-off over the past two months makes 2021 the third worst year for bonds since 1988, according to Bespoke Investments. The bond market seems to be saying that growth is back, reflation is here, and longer-term yields are going higher. Guggenheim's Scott Miner thinks the bond market is overreacting, just like the previous two times in 2000 and 2008, and he is calling for negative 10-year yields in 2022. “No doubt prices will rebound from post-pandemic lows but given the surplus capacity throughout most of the economy and high levels of unemployment, any increase in the rate of inflation is likely transient,” he says. While he may be right in the long run, the **BOND INDICATORS** are negative and we continue to underweight them.

III. LOOKING AHEAD

THE REAL DEAL

By definition, the real yield is the nominal, or stated, rate of interest minus the rate of inflation. Negative real yields occur when the nominal rate of interest is lower than the inflation rate. That's good for borrowers because it drives down the cost of capital, and good for investors because it makes all other assets more attractive by comparison. The decline in real yields to record low levels last year fueled an “everything rally” that some fear could unwind if rates rise. “Should Treasury yields continue to rise too fast, it will bring everything else down with it,” posited strategists at ING as reported in the Financial Times, “From here, slow and steady extends the party in [the] risk asset space...while fast and furious ends it.” Few investors see the Federal Reserve allowing a sharp rise in real yields but the Fed has remained mum regarding their intentions. Investors will be looking for guidance at the next FOMC meeting on March 16-17 which will likely determine the market's direction near-term.

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