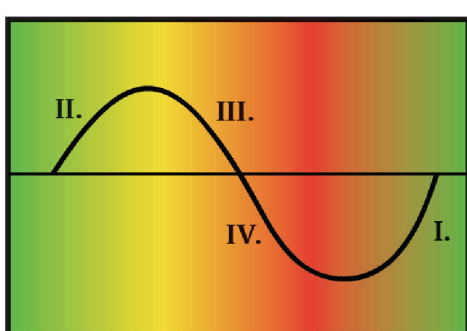


# Month in Review

The S&P 500 rose 5.2% in April--its best monthly gain since November--as expectations for spectacular economic growth became a reality. The US marked the one-year anniversary of the COVID-19 recession low with an earnings growth rate of +45.8% for the S&P 500, according to FactSet--the highest year-over-year earnings growth rate since the first quarter of 2010, when the S&P lapped the March 2009 low of the Great Financial Crisis. Back then, the first quarter marked the peak 12-month rate of change in many key indicators, resulting in a pause over the summer before the bull market resumed in the fall. We may be in for a repeat this year. It's time to check our indicators for signs the bull is beginning to tire. We have also updated your asset allocation and provided a brief summary of our thoughts on the market going forward.

## I. CREDIT CYCLE

### PHASE II: EXPANSION



Financial conditions remain ultra-accommodative despite the fact that the economy is booming and inflation is heating up. For the first time in over a year, Fed Chair Jerome Powell sounded somewhat hawkish in an interview on “60 Minutes” in speaking about the economy. “What we’re seeing now is really an economy that seems to be at an inflection point,” Powell said, “we feel like we’re at a place where the economy’s about to start growing much more quickly and job creation coming in much more quickly.” The markets have soared on a heady mix of strong growth and an easy Fed, but the going may get tougher this summer if (when) markets start pricing in the inevitable phasing out of Quantitative Easing (QE).

## II. RISK LEVEL INDICATORS



### US STOCKS: Guarded

The Risk Level for **US STOCKS** is **GUARDED**. As the US passes the anniversary of the COVID-19 panic low, US equity markets are showing signs of a change in leadership. In the early-cycle stage, the market starts pricing in a surge in economic activity and lower-quality companies with higher economic leverage outperform. The second or “mid-cycle” stage usually involves a rotation back toward stability and profitability with large-cap, high-quality stocks taking the lead. The recent outperformance of the S&P 500 relative to the Russell 2000 small-cap index is an important clue that this process has begun. We expect it will continue as investors again pay up for quality. The short-term SWING INDICATORS are positive suggesting a new up leg may have begun.

### INTERNATIONAL STOCKS: GUARDED

The Risk Level for **INTERNATIONAL STOCKS** is **GUARDED**. China may provide an early indication of what the US and other developed nations can expect as they move further away from the pandemic. China’s lockdown measures began sooner than the rest of the world, so the “base effects” showed up in their economic data first. Chinese GDP soared 18.3% year-over-year in the first quarter while retail sales jumped 34% and industrial production increased by more than 24%. But China’s quarter-to-quarter growth has been slowing and grew by just 0.6% compared with the fourth quarter of 2020. The same fate may await developed countries—including the US--as they return to pre-pandemic trends. “As China is now showing, that likely means slower growth ahead—not an acceleration—another sign this bull market is likely more late-cycle than early-cycle, in our view,” observes the editorial staff of Fisher Investments. Europe, Japan, and the UK each had more severe downturns and troughed later than the US, so they may play catch up in the months ahead. For now, however, they rank below the US in relative performance so we continue to underweight them.

### US FIXED INCOME QUALITY: HIGH

The Risk Level for **US FIXED INCOME QUALITY** is **HIGH**. US Treasury yields peaked in March and have failed to rally despite the highest Purchasing Managers Index (PMI) readings since 1983, the largest Producer Price Index (PPI) increase since 2011, the strongest Q1 GDP growth since 1984, and new highs in the stock market. The bond market tends to sniff out inflection points in economic data and two widely followed indicators of economic momentum—the Chicago Fed Activity Diffusion Index and the Citi Economic Surprise Index—have both rolled over. If the surge in stronger-than-expected economic data has peaked, the sell-off in the bond market might abate or even reverse. For now, however, the BOND INDICATORS are negative and we continue to underweight them.

## III. LOOKING AHEAD

### DURATION ROTATION

Duration is a term borrowed from the fixed income world. It measures the time it takes for cash flows from an asset to fully repay the initial investment. Equities are divided into two sub-groups: 1) long-duration equities which deliver a higher proportion of cash flows in the distant future, and 2) short-duration equities which provide higher cash flows in the near future. Long-duration equities are more sensitive to changes in interest rates and tend to underperform when interest rates are rising. From the trough in August 2020 to the peak in March, Treasury bond yields more than tripled and short-duration, pro-cyclical value stocks outperformed long-duration, secular-growth stocks by a wide margin. Yields have retreated recently, leading some analysts to argue interest rates have peaked and investors will now rotate back to longer-duration stocks. David Kosten, Chief US Market Strategist at Goldman Sachs disagrees. “The ‘defensive’ shift we are seeing today appears to be less about playing defense and more about the duration rotation,” he claims. Kosten believes that while the move into pro-cyclical value stocks may stall from time to time as interest rates fluctuate, they still have more room to run. He may be right but only time—and the bond market—will tell.

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