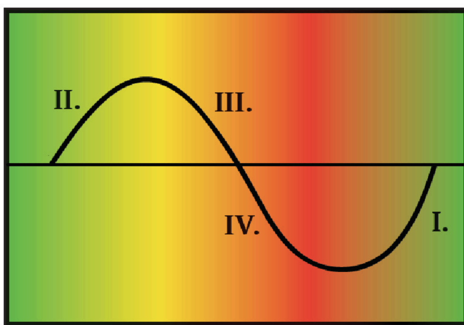
Month in Review

The S&P 500 rose 2.9% in August contrary to conventional wisdom that August is one of the worst- performing months of the year. The S&P 500 has climbed higher for seven straight months--its longest winning streak since January 2018. Inflation worries, supply-chain constraints, labor shortages and the spread of the coronavirus Delta variant could not keep the market down. It's time to check our indicators to see how the rise to new all-time highs 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. If anything, they are even more so since Fed Chair Jerome Powell's spoke at the annual Jackson Hole Economic Symposium. Powell emphasized that the Fed is in no hurry to taper asset purchases, that tapering asset purchases is entirely separate from raising interest rates, and the one should not be taken as indicative of the other. The Fed's dovish pivot opens the door for inflation expectations to turn back up and real rates (interest rates adjusted for inflation) to rise. That in turn could coincide with a shift back to cyclicals. "If dovish Fed policy continues to look past 'transitory' inflation and remains in no hurry to tighten policy, we may very well witness an un-rotation out of technology and back into cyclicals in the back half of 2021," says Bryce Coward, Portfolio Manager at Knowledge Leaders Capital.

II. RISK LEVEL INDICATORS

US STOCKS: Guarded

The Risk Level for **US STOCKS** is **GUARDED**. Softening economic data proved no match for retail inflows. US consumer sentiment dropped to a decade-low, Citi's global economic surprise index turned negative for the first time since June 2020, the PMI Composite Index declined sharply to its lowest level since December 2020, and non-farm payroll growth increased by just 235,000 versus expectations of 720,000. And yet the benchmark S&P 500 Index made 13 record highs—more than any other August in history. Goldman trader Scott Rubner attributes the strength to the unprecedented level of cash flowing into passive index funds from retail investors. "Global equities are annualizing at $1.015 trillion worth of inflows for 2021 versus $727 Billion CUMMULATIVELY over the last 25 years," observes Rubner, "2021 is on pace to record 40% higher than the prior 25 years of equity inflows combined!!" As they say on Wall Street, don't fight the tape! The short-term **SWING INDICATORS** are moving higher suggesting market momentum is positive.

INTERNATIONAL STOCKS: GUARDED

The Risk Level for **INTERNATIONAL STOCKS** is **GUARDED**. China's crackdown on their financial and property markets is beginning to look less like a regulatory clampdown and more like a cultural revolution aimed at cleansing China of some of the worst Western-style imbalances and excesses. Under the slogan "Common Prosperity", Beijing has targeted some of China's most successful corporations, calling for curbs on "excessive" income and for profitable firms "to give back more to society". These reforms are coming at a time when China's growth is already slowing due to tighter credit conditions and China's "zero tolerance" Covid policy, and may add downward pressure to growth. After plunging more than 30% from its high in February, the Chinese stock market may be bottoming here but the Risk Level remains high and we are avoiding Chinese and Emerging Market stocks until it improves.

US FIXED INCOME QUALITY: GUARDED

The Risk Level for **US FIXED INCOME QUALITY** is **GUARDED**. The bond market appears to be at a crossroads with the future direction of interest rates hanging in the balance. Wall Street is divided as to whether yields will be higher or lower by year-end but all agree that the path of the pandemic will largely determine the outcome. An important indicator to watch is the difference between the 2-year and 10-year Treasury yields, known as the yield curve. A steepening curve typically suggests stronger economic activity and rising inflation expectations. After flattening since May, the curve recently turned up. If that continues, it would support the reflation scenario and be a good sign for the economy (though not for tech stocks, see below). Stay tuned!

III. LOOKING AHEAD

BOND MATH AND BIG TECH

Bond math has never mattered more to stock investors. Treasury bond yields are used in mathematical models to discount future earnings into today's dollars. The higher yields go, the smaller the present value of those earnings. That affects all companies but it's especially significant for fast-growing technology companies whose stock prices are more dependent on the large profits they're expected to earn far in the future. The decline in yields since March has been a major factor in the outperformance of the tech-heavy Nasdaq 100 over the S&P 500. But that may be about to change. Citigroup strategists expect the 10-year yield to climb toward 2% and recommend that investors reduce exposure to tech stocks due to the risk of higher interest rates. "A big component of successful investing is getting the narrative right," says Michael Wilson, chief US equity strategist at Morgan Stanley. The bond market will largely determine what that narrative will be.

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