BALDINI
INVESTMENT STRATEGIES

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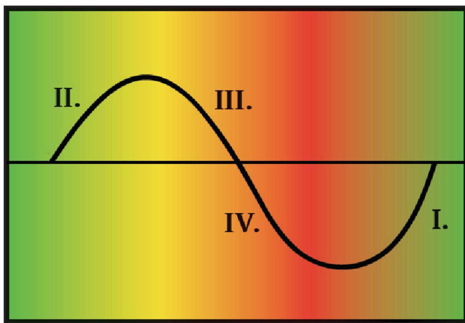
Month in Review

The S&P 500 gained 5.6% in July despite news that the nation's GDP contracted 33% on an annualized basis in the second quarter. The index is now positive for the year, having clawed back from a catastrophic 34% loss in March. Still, there are signs that all is not well. The coronavirus pandemic continues to dampen economic activity and recent data suggests the recovery has slowed since cases began to spike in June. Traditional "safe haven" assets like gold and US Treasury bonds have uncharacteristically climbed in lock-step with equities. It's time to check our indicators to see how this epic rally has affected them. I have also provided a brief summary of my thoughts on the market going forward.

I. CREDIT CYCLE

PHASE I: EARLY EXPANSION



The credit bull market has gone global as governments around the world are spending and printing trillions of dollars, euros, yen, and yuan to offset the economic shock from the Covid-19 crisis. The European Union has agreed on a 750-billion-euro ($885 billion) recovery fund and the European Central Bank (ECB)'s balance sheet has soared by 1.62-trillion-euro ($1.91 billion) since March. Japan has rolled out stimulus programs worth $2.2 trillion and the Bank of Japan (BOJ)'s balance sheet has expanded $600 billion since February. The People's Bank of China (PBOC) continues to flood the Chinese economy with credit, led by a record $2.7 trillion in bank loans over the past 12 months. All that money must go somewhere observes economist Ed Yardeni, "potentially fueling the Mother of All Meltups (MAMU), which potentially could set the stage for the Mother of All Meltdowns (MAMD)."

II. RISK LEVEL INDICATORS

US STOCKS: LOW

The Risk Level for **US STOCKS** has come full circle to **LOW**—the level last achieved in December 2019. Since then, the coronavirus has ravaged the US economy and killed over 160,000 people—and counting. It seems strange that the stock market and the Risk Level should be back to where they began the year, but such is the power of the printing press. With the Fed giving trillions of dollars to Wall Street and Congress sending money directly to consumers and small businesses, it would be strange if the stock market wasn't back to pre-virus levels. The short-term SWING INDICATORS are mixed so the market may be due for a breather but we would view any weakness as a potential buying opportunity.

INTERNATIONAL STOCKS: ELEVATED

The Risk Level for **INTERNATIONAL STOCKS** is mixed. It remains **ELEVATED** for developed markets but has reverted to **LOW** for emerging markets. The Fed's aggressive Quantitative Easing (QE) puts downward pressure on the US dollar which benefits emerging markets. When the dollar is strong, it is difficult and costly for other countries to obtain the dollars they need for international trade and to service dollar-denominated debt. When the supply of dollars increases due to QE, the value of the dollar tends to depreciate. The lower dollar acts like an interest rate cut and stimulates the emerging economies. The stimulus effect of a lower dollar could still be offset by a worsening of the Covid-19 crisis but it is a sign that the international markets are moving in the right direction.

US HIGH QUALITY FIXED INCOME: LOW

The Risk Level for **US FIXED INCOME QUALITY** has also returned to **LOW**. Risk-averse investors continue to favor US Treasury bonds to hedge against a resurgence of the virus and a relapse of the economy. The Federal Open Market Committee (FOMC) is also laser-focused on the threat the virus poses to the recovery, stating that the "path of the economy will depend significantly on the course of the virus". Ironically, Goldman Sachs says the main thing the bond market has to fear is—a vaccine! A vaccine could boost the US economy and spur investors to dump bonds for stocks. They think investors should be open to the possibility of such a shift in the months ahead, especially if the news on the vaccine front continues to be encouraging.

III. LOOKING AHEAD

WHAT'S WRONG WITH THIS PICTURE?

We have previously alluded to the unusual nature of the current market rally. Unlike previous bull markets, valuations for small caps versus large caps are well below average, low-quality stocks have almost never been so undervalued in comparison to high-quality ones, credit spreads remain elevated, Treasury bond yields are scraping all-time lows, and volatility ranks in the top 15% of the last 20 years. What's going on? We believe the answer lies in the 2-tier recovery in the credit markets that is unique to this cycle. Conditions have improved dramatically for large companies that borrow in the capital markets but remain restrictive for small companies that borrow from banks. Banks have tightened lending standards across the board to levels last seen in the financial crisis. In addition, they have hiked loan loss reserves to recessionary levels as they prepare for a wave of defaults. This unequal access to credit is reflected in the narrowness of the stock market advance in which the 5 largest stocks in the S&P 500 have returned 35% year-to-date while the other 495 stocks have declined 5%. "Breadth [the number of advancing versus declining stocks] continues to narrow, and something has to give," warns Morgan Stanley Chief US Equity Strategist Mike Wilson, "either the risks to the recovery—COVID case spike, election concerns, fiscal cliff—need to subside and the market broadens or these risks will ultimately topple the winner, too."

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