QUARTERLY REPORT

INVESTMENT PERSPECTIVE

30 June 2021

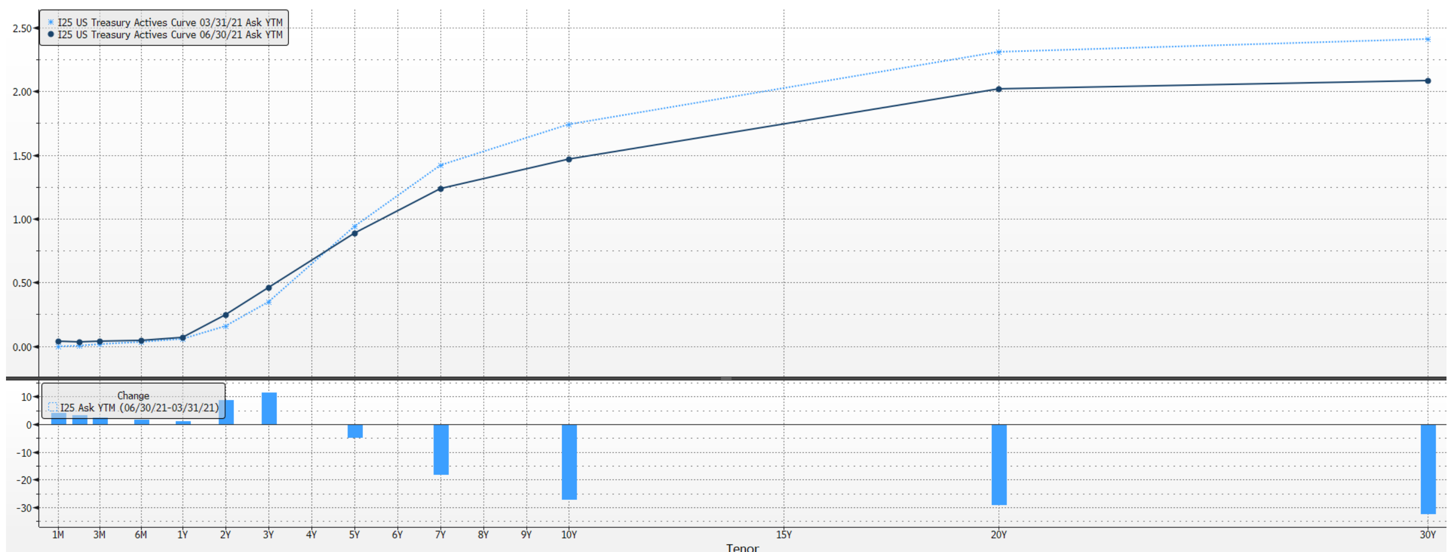
Reversing the trend of the prior two quarters, larger capitalization equities led the market higher in Q2 2021 with the S&P 500 and Russell 2000 Value rising 8.5% and 4.6%, respectively. Growth stocks also resumed their leadership over value during the quarter. The leadership shift to larger cap equities with growth characteristics is consistent with the modest decline in Treasury yields and flattening yield curve experienced during the quarter (Chart 1). The key question for markets is does the shift in equity market leadership and the flattening yield curve signal a regime change in economic growth and inflation expectations?

As we mentioned in our prior quarterly communications, our longest leading indicators were starting to signal a potential slowdown in economic growth. During the most recent quarter, the long and short-term leading indicators have confirmed a growth rate downturn. This downturn in the industrial cycle is underway globally, with China and the U.S. leading the slowdown in industrial activity. Our current expectation is for economic growth to decline from the current unsustainably high levels and begin to moderate into the second half of the year. As industrial activity slows, the services side of the economy should remain healthy as the economy fully reopens, employment growth accelerates, and consumers continue to reduce their excess savings rate. Should the economic slowdown become too pronounced, the growth in the services economy may also slow, but this is a risk equity markets would not likely begin to discount until late 2021 to early 2022.

Despite the industrial growth slowdown, self-reinforcing inflationary pressures continue to build globally led by labor costs, housing prices, and energy prices. Inflationary pressures may prove transitory over the medium term, but the stickiness of these short-term pressures may limit the Federal Reserve’s ability to respond should the economic slowdown prove excessive, or equity markets come under downside pressure. Recent downside volatility in the most speculative assets is consistent with peaking liquidity conditions. Given the Federal Reserve’s excessive quantitative easing in the last decade, market prices are reliant on continued increases in quantitative easing, and if inflationary pressures prevent the Federal Reserve from expanding quantitative easing as needed, further equity market volatility should be expected.

The Bloomberg Barclays Aggregate Index returned 1.8% during the second quarter. After selling off in the first quarter “recovery trade”, the bond market rallied modestly after digesting higher growth and inflation readings. Treasury yields at the long end declined by approximately 30 basis points after increasing 80 basis points in the first quarter (Chart 1).

Chart 1 - U.S. Treasury Curve



Over for conclusion.

Credit spreads continued to benefit from ultra-accommodative fiscal and monetary stimulus tightening another 10 basis points to +77 basis points over Treasuries. While we remain overweight the Corporate bond sector, we have reduced our position by allocating more to Treasuries, especially at the short end of the curve where credit spreads are historically tight. Due to the steep yield curve, we are still finding attractive opportunities in Corporates in the 5 to 10-year area, but we continue to maintain a shorter average duration relative to the benchmark in preparation for higher Federal Funds rates.

The ICE BofA AAA-A Municipal Index returned 0.56% in the quarter. The Biden infrastructure plan is a positive for municipal bonds as it will likely boost GDP growth and lead to tighter spreads. Further, the proposed corporate tax hike to 28% should increase the demand for municipal bonds from corporate buyers.

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