AMB

Wealth Management

Market Update June 22, 2021

Strong returns continued in the equity markets to start the second quarter. During the first two months, equity markets, as measured by the S&P 500, were up another 600 bps adding to their first quarter returns. With the equity markets continuing to push toward new highs, we have become more cautious over the short term and raised cash in our equity strategies. We are still constructive on the markets over the long term even though current valuations are giving us angst. When the economy began to reopen last summer, we experienced an ongoing resurgence in the cyclical trade. As mentioned in our last few letters, we expected this, and we positioned ourselves accordingly. However, on June 1, 2021, we began to see a shift in this dominance as long-duration equities (growth stocks) began outperforming once again. Since the start of the month, cyclical and value have sold off on a straight-down trajectory and now are nearing oversold levels that we have not experienced since the March 2020 crash.

The question, “Why is this happening, especially when the economy is continuing to improve at home and abroad?” has frequently been asked by our clients. We see several factors at play. To begin, there are technical factors in the market that needed to clear out. Cyclicals and value have been bought relentlessly for nearly a year causing the trade to become extremely crowded and overbought. With this hindsight, these sectors were due for a correction which is precisely what we have seen in recent days. This violent correction in the financial space has been relentless and has continued for the entire month of June. We expect this to abate as the market imbalances improve going forward. Currently we are seeing inflation and growth numbers come in above expectations which suggests to us that the cyclical and value trade will continue to benefit.

Interest rates have also become a major factor in which types of companies lead the market. Over the last month, we have seen rates trend downward even with inflation and growth numbers beating expectations. Technical factors have been a contributing cause of this recent move. Market participants were more short Treasuries than they have been in recent memory. When rates started moving lower, we experienced a squeeze in the market. This was a major imbalance that needed correcting. An illustration for our current market correction is that of a rubber band that has been stretched to its limits. One can only pull so far before it breaks or the band can be released to revert back to where it began. This “rubber band correction” is a visual for what we are seeing – a move back to a more balanced market.

The FOMC meeting last week caused a rough ride in the market. Rates crumbled, and quality equities were sold in favor of long-duration plays. Below are a few highlights from the meeting:

- Benchmark Rate: 0% to 0.25% (unchanged)
- QE Stimulus Program: $120 billion asset purchase remains in place with only a discussion that tapering may be on the horizon. Chairman Powell committed that any change in policy will be adequately disclosed in a timely manner to market participants.
- Unemployment Rate Projection: 4.5% by end of 2021, 3.8% by 2022, and 3.5% by 2023

- Projected Inflation (Core PCE): May 3.4%, year-end 2021 3.0%, 2.1% year-end 2022
- 2021 GDP Growth Rate: Projection improved from 6.5% to 7%
- 2022 GDP Growth Rate: Projection remains at 3.3%
- Dot Chart: Thirteen members projected rate increases in 2023, 5 see no increases through 2023, 7 of 18 members see a possibility of a rate (possibly two) increase in 2022

The market interpreted the last bullet point to be hawkish. In our view, the market reaction was the opposite of what it should have been. In March, no expectations for rate increases were expected in 2022, and now that seems to have changed with inflation being the main driver. Inflation and GDP expectations were increased which – on the surface – one would expect to be a good thing. The economy's improvement is higher than expected as is demand for goods. Long duration should have been sold while cyclicals should have been bought. Rates should have increased based on the inflation and growth expectations even with the possibility of tapering asset purchases and rate hikes next year.

Currently, we are in a "wait and see" pattern. We believe our strategy is still wisely invested (cyclicals and value). We are going to continue being long in cyclicals and lighten our exposure to long-duration equities. If there is not a major hiccup in the recovery and major virus resurgences remain at bay, we continue to place our optimism in equity markets even though we expect to experience increasing volatility in the interim. We continue to believe that there are pockets of excess especially in non-profitable companies, and we will continue to avoid that segment of the market.

On the fixed income side, we have once again moved into the shorter-duration camp. As rates were hitting 1.7% on the 10-year Treasury, we began to add more exposure further out on the curve. However, with the recent regression to 1.4%, we will once again be focusing on the front end until risk/reward is better aligned. We are currently not seeing value in the fixed income space as credit spreads remain historically tight and overall rates remain at historically low levels. We still believe if growth and inflation numbers come in as we expect, we will see the 10-year around 2% over the next six months.

We will continue to navigate this difficult environment to the best of our ability. As always, we at AMB thank you for your support and for allowing us to partner with you in reaching your financial goals.

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