

Interest Rate Whiplash

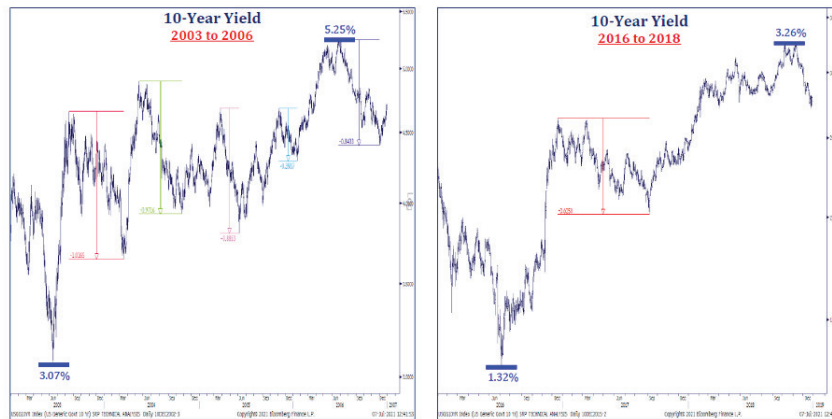
What a difference a quarter makes. In the first quarter of 2021, rising interest rates, expectations of higher economic growth and inflation, and the rally in commodity prices combined to extend the 'rotation' from growth stocks into value that began in October of 2020. In the second quarter all that changed, as declining interest rates and a flattening of the yield curve (See blog **Why Do We Care About the Shape of the Yield Curve?**) led to a reversal of that rotation, and growth stocks, particularly technology stocks, outperformed value. While the market was roiling under the surface, the S&P 500 managed to grind higher, ending the first half up 14.5%.

Falling Bond Yields Contradict the Market's Growth and Inflation Narrative

10-year Treasury Bond yields fell to a low of 1.25% on July 8 from their high of 1.75% on March 31. Some market participants were mystified by this trend, but a host of reasons contributed to the change.

- *Broader acceptance of the Federal Reserve's transitory view of inflation and the likelihood of Fed actions to curb inflation if employment goals are met.*
In their June meeting, the Federal Reserve Board started to talk about tapering their monthly \$120 billion bond purchases (which are meant to support economic growth). Further, some individual Fed Governors showed they expected to raise short term rates in 2022 rather than 2023. The combination of these two views is considered hawkish and led to fears the Fed might act to slow the economy sooner than expected, possibly making a policy mistake. Bond yields have dropped continuously since that meeting.
- *Data indicating possible peaking of growth rates and a slower economic recovery going forward.*
While we are still clearly in expansionary territory, the June economic data showed a drop in both the Services Purchasing Managers Index and the Manufacturing ISM as well as a higher unemployment rate than anticipated. Fed minutes showed 'participants generally saw supply disruptions and labor shortages as constraining the expansion of economic activity this year'. Slowing growth is typically negative for stocks and positive for bonds.
- *Health concerns still impeding global growth.*
The worldwide rise of Delta variant COVID cases and renewed lockdowns are delaying international reopening of economies. Most recently, Japan declared a COVID emergency and banned spectators from the Olympics.
- *Strong buying of Treasuries from multiple sources.*
Foreign buyers, insurance companies matching liabilities, pension funds looking to reduce their equity risk, plus short covering (from players who made bets on rising interest rates) all contributed to Treasury demand. Further, Treasury supply is no longer increasing as fiscal stimulus has paused for the time being.
- *Directional trends don't go in a straight line.*
After the sharp rise in bond yields during the first quarter from .9% to 1.75%, it's not unusual to have a temporary reversal in trend. It is too early to call the recent rally in bonds a sea change. In the last two periods of rising rates, it was a very bumpy ride on the way up. We have seen this movie before.

Last Two Examples of Rates Up Had to Withstand Corrections



Courtesy of Strategas Research Partners

It's not a straight line in this business, and each one of these retreats in yields likely had a scary story to accompany it... but they were distractions to the longer-term trend.

Equities Grind Higher with Resurgence of Technology and Growth Stocks

The second quarter reversed the rebound of value stocks in favor of growth stocks in large part due to the rally in the bond market. Growth companies tend to produce higher cash flows in the future than they do today. So, slower growth, lower interest rate economic environments are ideal for growth stocks. Alternatively, value stocks typically do relatively better in economic recoveries with high growth and rising inflation.

US Growth Stocks Re-take the Lead from Value



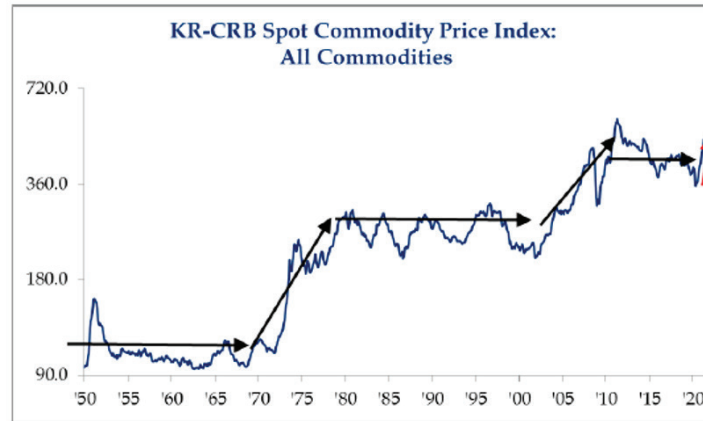
Going Forward

After the sustained 15-month uptrend in the S&P 500 from the March 2020 lows, it's not surprising for the market to go through a period of consolidation. At this point in the recovery, trends are less clear cut, and a lot of churning can happen under the surface. The sector rotation within the equity market mirrors the whiplash in interest rates. In the second quarter, banks, biotech, industrials and materials sectors gave up gains while technology and energy names regained traction. We anticipate more of these kinds of rotations in the second half, providing periodic investment opportunities.

At this point in the cycle, we favor:

- *Commodity companies.* Given the change in market perspective, we see unexpected inflation, either 'transitory for longer' or secular, as a continued risk to portfolios. Commodities are the way to protect your portfolio from inflation, and they tend to move in longer market cycles. (See **1Q 2021 Investor Letter**.)

Commodities Historically Have Moved in Longer Cycles



Courtesy of Strategas Research Partners

- *Companies who can raise prices in the face of rising cost pressures, so that their margins will not suffer.* UPS and Federal Express come to mind.
- *Sustainable growth companies whose growth outpaces any increase in interest rates.* Docusign and Cloudflare are examples.

No rest for the weary. As we send this letter, earnings season begins and the latest CPI showed 5.4% year over year inflation, half a percent above market expectations. Company conference calls will provide clues for the second half.

Let the fun continue.

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