

Summary: Most asset classes performed well in the second quarter led by “more risky” assets such as commodities, real estate, and a resurgence in large cap growth. A decline in interest rates helped the “less risky” assets recoup much of the losses they had sustained during the first quarter. Lower interest rates, and a sense the Federal Reserve is taking the inflation threat more seriously, caused value stocks to pause while pushing growth stocks higher. Stock market valuations rose broadly on increasing earnings expectations. Individual investors remained enthusiastic and further increased their allocations to more risky assets. In the past, this type of behavior has been associated with euphoria and a top in the cycle. Economic demand in the U.S. and around the globe spiked significantly as optimism grew that a more normal world was right around the corner. COVID restrictions have been loosening yet remain stringent in most of the world. A slower re-opening could be a blessing in disguise as it will give supply a chance to catch up with demand. Labor and parts shortages are also slowing the pace of growth while at the same time contributing to inflation pressure. The recent demand spike and inflation fear may be just a foreshadowing of what is to come when restrictions are completely lifted. It is a striking contrast to fears that some new COVID variant will cut short the nascent economic expansion. An economic slowdown would surely explain the drop in 10-year treasury rates and flattening yield curve. However, FED action to reign in liquidity and capacity constraints are more likely to blame. Given high market valuations, the potential for higher interest rates and inflation, clients should consider reducing their exposure to more risky asset classes.

- In the second quarter, more risky asset classes were led by Commodities, up 13.3%, US Large Cap Growth, up 11.9% and Real Estate, up 11.7%. Gold and Silver were notable underperformers, down 7.0% and 1.2% respectively. Less risky asset classes were positive with intermediate taxable bonds, up 1.5% and intermediate municipal bonds, up 1.0%.
- The stock market cycle remained in the “Euphoria” phase, as individual investors followed the market higher and moved their allocation to more risky assets above 71% based on data from the Association of Individual Investors monthly survey. The CAPE ratio, our preferred valuation measure, moved up further to the highest level since prior to the 1999 internet bubble. These indicators are at levels that have been historically associated with major tops in the stock market.
- While the stock market is reflecting an outlook for increased earnings growth and economic expansion, the bond market is suggesting something else. The 10-year treasury rate dropped significantly during the quarter, flattening the yield curve, which is often a sign of a slowing economy. Some have blamed fears that a new COVID variant will bring an end to the expansion before it really gets going. International investors tend to buy the 10-year treasury bond in “flight to safety”, which causes the U.S. dollar to strengthen. A stronger dollar is a headwind for precious metals. The past quarter does not change our view that the longer-term trend that the value of the U.S. dollar is likely to be lower.
- The bond market is more likely responding to the Federal Reserve as it signaled that it is likely to begin tapering its support sooner than expected as inflation has run hotter than expected. The FED have already made big moves in the Repo market draining almost \$800 billion in liquidity from the financial system. In the short run, capacity constraints have put a lid on economic expansion. Labor and parts shortages have left many businesses unable to fill orders. The Bureau of Labor Statistics recently reported that there are 9.5 million unemployed people in this country and a record 9.2 million unfilled job openings. Goldman Sachs has estimated that chip shortages alone are costing the United States as much as 1% in GDP growth.
- As the vaccine rolled out, optimism grew quickly that a more normal world was right around the corner. Economic demand spiked, sending most commodities to historically high levels. Many market watchers, including those at the Federal Reserve, viewed this spike as inflation that would be transitory in nature under the assumption that supply will quickly catch up to demand bringing prices back down. Since much of the world is still under stringent COVID restrictions, it seems more likely to us that the spike in demand is just a foreshadowing of what is to come when restrictions are completely lifted.
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