Investment Commentary: 3/2021

AWM

Against a backdrop of improving economic outlooks, global stocks rebounded strongly in February. Developed markets generally outperformed emerging market stocks, which posted slight gains. US Treasury yields continued to rise along with mouning inflation concerns.

- Continued central bank support, progress on coronavirus vaccine distribution and modest economic gains helped set the stage for a February rally among global stocks. US stocks led the way, with the S&P 500 up 2.8% and the Russell 2000 up 6.2%. Value stocks outperformed growth by close to 6%, and foreign developed markets were up a solid 2.3%.
- US economic data released in February showed month-over-month retail spending surged in January, due partly to the late December federal aid package. The US manufacturing sector moderated slightly but remained in expansionary mode. The services and housing sectors continued to post monthly gains, and the unemployment rate edged lower. In general, US economic data was stronger than other developed economies.
- Amid growing inflation concerns, US Treasury yields rose to their highest levels since early 2020. The broad US bond market declined for the month but modestly outperformed global bonds.

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This month we touch on several 'big-picture' themes: whether we are in a new commodity supercycle or not; whether we are in a current stock market bubble; and lastly we discuss some of the emerging trends from this quarter's earnings reports.

Are We in a New Commodity Supercycle?

Often the largest gains in the financial markets are made from understanding the 'big picture' and being on the right side of large cycle trends. The analyst team at JPMorgan recently published research on the commodity cycle, asking the question of whether or not we are at the start of a new commodity supercycle. Below we highlight some of the findings from their research.

According to JPM, there have been 4 commodity supercycles over the past 100 years, with the last one starting in 1996. Their belief is the last supercycle peaked in 2008 (after 12 years of expansion), bottomed in 2020 (after a 12- year contraction) and that **we have likely entered an upswing phase of a new commodity supercycle**. The chart below illustrates the up and down path of the last cycle. This was driven, on the upside, by the economic rise of China; and to the downside by the 2008 global recession and economic slowdowns in Europe and China. With the final leg of the down cycle driven by trade wars, and the ensuing global manufacturing recession and ultimately the pandemic.

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Figure 1: The last Oil supercycle and its drivers

Source: J.P. Morgan Quantitative and Derivatives Strategy

According to JPM, the upswing of the next cycle has already begun, and is being driven by: expectations of a post-pandemic recovery; ultra-loose monetary and fiscal policies, a weak US dollar, higher inflation, and unintended consequences of environmental policies and their higher costs, leading to physical constraints related to energy consumption and production. Lastly, the "electronification" of commodity investments has made it much easier to invest and increased allocations to the asset class may also contribute to the upswing.

The takeaway from this research is, most investors should have exposure to commodities in their portfolio, as it can improve absolute returns and is also one of the best ways to hedge higher inflation risks in your portfolio. Please note- we are advocates of the transition to green energy and are simply acknowledging the impact the transition will have on commodity pricing and looking for ways to invest and improve portfolio performance.

Are We in a Stock Market Bubble?

Ray Dalio is one of the best investors of this generation and a true historian of financial markets. Dalio and his team have done significant work in the measurement of stock market bubbles, which he simply defines as unsustainably high prices. His measurement of bubbles includes six different factors, the current readings for each factor is highlighted in the table below.

Current Conditions Compared to Previous Bubbles

		Roaring 1920s	Dot-Com Bubble	2007	Today: Total Mkt	Today: Emerging Tech
1	Prices Are High Relative to Traditional Measures	Bubble	Bubble	No Bubble	Somewhat Frothy	Frothy
2	Prices Are Discounting Unsustainable Conditions	Bubble	Bubble	No Bubble	No Bubble	Frothy
3	New Buyers Have Entered the Market	Bubble	Bubble	Frothy	Frothy	Bubble
4	There Is Broad Bullish Sentiment	Bubble	Bubble	Frothy	Frothy	Bubble
5	Purchases Are Being Financed by High Leverage	Bubble	Bubble	Bubble	Somewhat Frothy	Bubble
6	Buyers/ Businesses Have Made Extended Forward Purchases	Frothy	Bubble	Bubble	No Bubble	Somewhat Frothy

The chart on the next page shows the aggregate reading derived by combining the above factors (from the table) into one reading for the stock market going back to 1910. This allows for an easy comparison of how conditions today stack up for US stocks in relation to past times.

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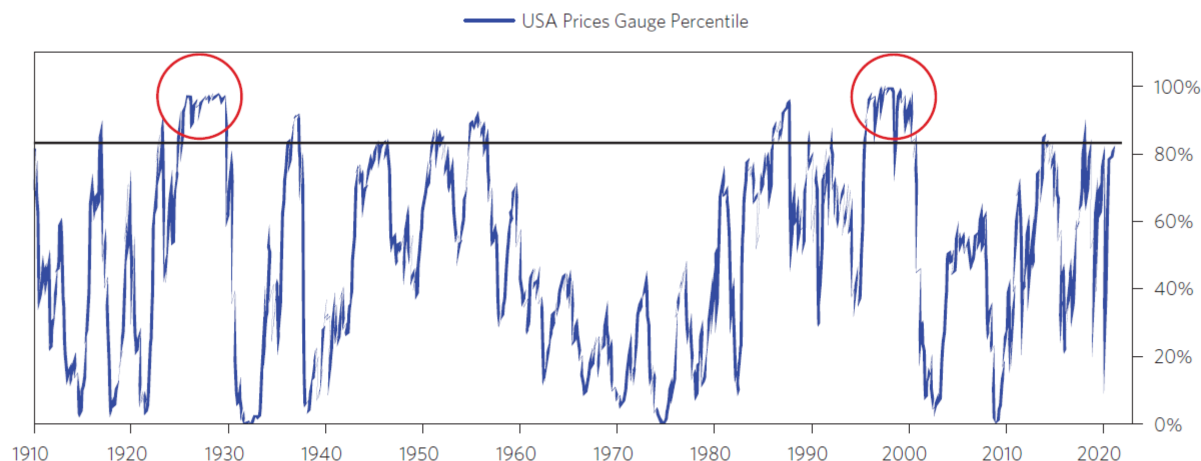

As of February, the aggregate bubble gauge was around the 77th percentile for the US stock market overall. For comparison, the bubbles of 2000 and 1929 rated in the 100th percentile. The takeaway is that there are certainly signs of 'bubble-like' activity in areas such as emerging technology stocks, SPACs, Bitcoin and others. However, on a broad market basis it doesn't look we've reached the bubble stage yet. In general, it is a good time to avoid or dial back risk in the frothiest parts of the market, but not to panic on the market as a whole. As we write, it appears the market is in the process of correcting some of the most speculative technology stocks, reinforcing our recommendation to avoid them.

S&P 500 beige Book

Every quarter the research team at Goldman Sachs publishes a S&P 500 Beige Book report. The report aggregates fundamental and thematic trends from the earnings reports of companies, to determine the key themes being discussed by corporate management teams and reflected in their performance. We find it a valuable tool to understand the key drivers of corporate performance and it often helps us to find quality companies to invest in. In the most recent Beige Book, Goldman identified four dominant themes:

1. **Companies with positive earnings stories highlighted three drivers of realized and potential growth:**
    a. Growth driven by revenue and margin expansion (mix of cyclical and defensive sectors)
    b. Growth mostly attributable to margin expansion (industrials, materials and energy)
    c. Growth primarily due to top-line sales growth (companies with digital or "COVID-save" product lines)
2. **Consumer demand across the market remains largely contingent upon the severity of the COVID -19 pandemic:**
    a. Consumer demand has remained resilient throughout the pandemic, but primarily for products and services that can be safely consumed in quarantine. While demand for services such as catering and outdoor dining depend on the speed and efficacy of the vaccine rollout.
3. **Corporate managements are focused on inflation and rising input costs, including wages, commodities, logistics and healthcare**

4. **Pricing power is a key part of the discussion about anticipated inflation.**
    a. As rising input costs put pressure on margins, firms are considering pricing power as a tool to offset inflation.

Several of the themes reflect the impact of higher commodity prices and inflation discussed earlier. We consider all of these factors when evaluating investments.

Closing Thoughts

Our general outlook has been positive for risk assets and is reflected in our portfolio positioning. In most portfolios, we gradually increased exposure to risk-oriented investments last-year, including small-cap stocks, foreign developed and emerging stocks and commodity related investments, and expect to hold those positions. **Our expectation for absolute returns and risk protection from bonds is muted, and believe supplementing portfolios with alternative investments and real return investments can improve the risk and return outlook for most portfolios.** If you have any questions on this commentary or would like to discuss your investment strategy give us a call.

- AWM Investments (March 2021)