WaterRock Global Asset Management, LLC

MARKET REVIEW & OUTLOOK

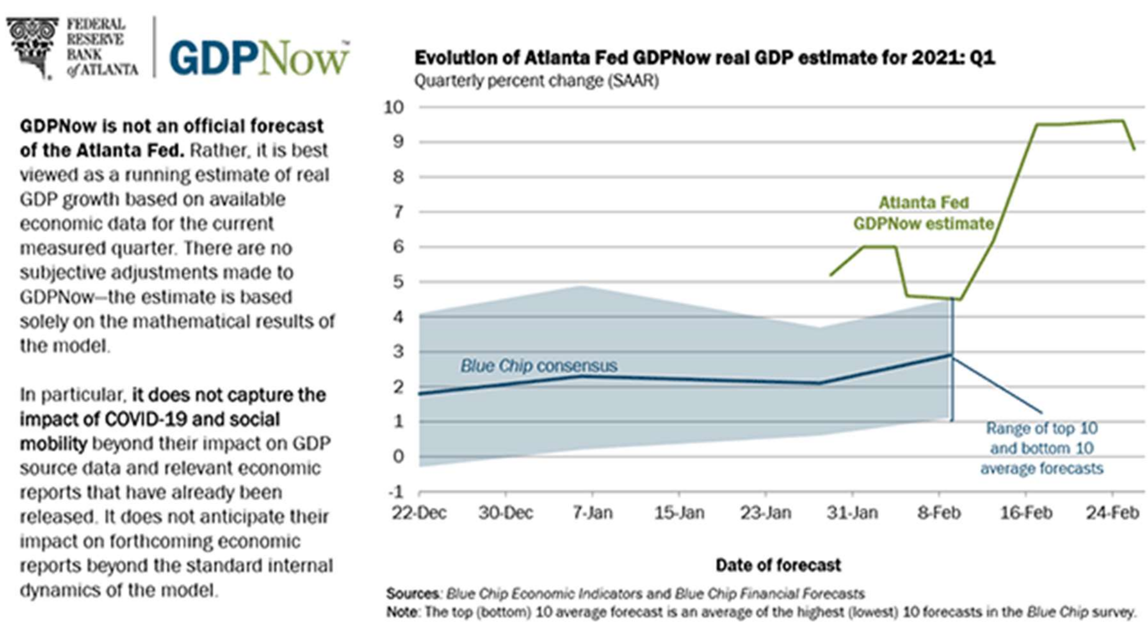
February 2021

KEY TAKEAWAYS

- Global Equities were again flying high to start off the month, with global markets again hitting all-time record highs. However, once again as the month aged markets started acting strange and sold off relatively hard to close out the month.
- The 1st quarter GDP report is setting up to be strong with cases and hospitalizations plummeting, vaccines accelerating and promises of new stimulus any day, all pointing to renewed strength in the economy.
- Interest rates have “skyrocketed” during the month along with commodities. What does it mean? We will discuss later in the piece.

The U.S. Economy

The revised estimate of 4th quarter GDP was reported with little change to the original release of 4.0%, coming in at 4.1%. We still have our doubts as to how robust that number will be by the time final revisions come it, but that is in the rearview mirror at this point. The current outlook seems much improved as the case count of corona virus from 1/8 until now is down about 65% and seems to have fallen out of the headlines. Additionally, the Democrats are using the reconciliation process to push through additional stimulus, though it seems to be slower than the immediately we were promised in January. Nonetheless, the “dark winter” seems to be having an early thaw, which should boost 1st quarter GDP. The Blue Chip forecast is currently lagging the computation of incoming data. As such, the consensus forecast is a mere 3%, whereas the GDPNow forecast is a much more robust 9%, as depicted in the chart below.



Source: https://www.frbatlanta.org/cqer/research/gdpnow

Stocks and Bonds

The fixed income markets had a historically volatile month, with the 10-year Treasury holding above the single digit mark all month with a very strong steady advance in yields. During the month, yields surpassed the March 2020 spike in yields and crossed the 1.50% mark. Quite the rally from the lows of March 2020 at around 0.40%. The persistent rise in yields finally caught up to the equity markets and started causing some wild gyrations in equites as the month came to a close. The rapid rise in base Treasury rates had an impact throughout the fixed income complex, including high quality fixed income. High-quality fixed income, as measured by the iShares US Aggregate Bond ETF, saw deeper negative returns in response to the increase in base Treasury rates, finishing the month with a loss of -1.48%. Fortunately, we have other fixed income vehicles that represent approximately half of the fixed income exposure. One vehicle was essentially flat for the month and the other was down about half of the stated index. The U.S. 10-year treasury bond yield ended the month near the top of the range at 1.46% after hitting a high of 1.61%, up from January's close of 1.09%.

The U.S. stock market was cruising along the first half of the month with a steady climb but hit some turbulence as the 10-year yield crossed 1.25%. The equity markets regained their footing with a 3%+ two-day rally, then gave it back the last two days of the month with the final push higher in 10-year yields over 1.50%. The Dow Jones Industrial Average jumped +3.17%, the S&P 500 rose +2.61%, and the small cap Russell 2000 continued soaring +6.14%. The developed international markets followed a similar, though less robust, path as the U.S. The MSCI EAFE iShares Core International Developed Markets ETF Index gained +2.33% and the MSCI Emerging Markets iShares Core ETF Index climbed +1.16%.

In February, we saw the most divergent sector performance that I can remember, again with nearly equal green and red. As the chart on the next page shows, the spread between the haves and have nots was very wide for many sectors of the S&P.

The best performers were…

- Energy: +18.16%
- Financials: +8.13%
- Industrials: +4.03%

The worst performers were…

- Utilities: -8.04%
- Consumer Discretionary: -5.55%
- Consumer Staples: -4.54%

Source: https://www.sectorspdr.com/sectorspdr/tools/sector-tracker

Oil Report

In February, crude oil was strong the entire month on the back of optimism that the corona virus is fading off into the sunset and that "normalization" i.e. demand will return soon. Further, OPEC+ has been playing nice and holding supply in check. The current NYMEX WTI Crude Oil futures settled at $61.66 and posted a gain of over 18% from the prior month close of $52.20 a barrel. One leg of the rising commodity prices that is surely helping to drive the 10-year yield higher. The price for RBOB gasoline followed a similar path to crude oil, though continues to be stronger than oil. RBOB finished higher by over 25% for the month of February. The oil patch seemingly was looking across the valley, which we thought that may have been premature. However, as discussed earlier, the crash in new cases and hospitalizations in combination with steadily increasing vaccinations is starting conversations about nearing herd immunity in some areas. However, since many people are still working from home, the immediate impact to the consumer of rising gas prices should be minimal.

The Rest of the Data

The news seems to be in a steadily improving cycle, with some forecasts of record full year GDP growth, while that would be great, let's not forget we still have 10 months to go. Hopefully at the end of 2021 we look back and say, "wow that was a great year", but let's not put the horse before the cart. As previously discussed, there are many positive developments that should continue economic growth.

The January ISM Manufacturing Index slipped 1.8 points to 58.7 from December's reading of 60.5, as previously mentioned, the strong commodity prices are a potential sign of inflation as prices paid continue to strengthen. Additionally, the ISM Services Index increased to 58.7 from 57.7 in December.

Any reading above 50 generally indicates improving conditions. Consumer confidence increased to 91.3 in February, which compares to a downwardly revised figure of 88.9 in January. The unemployment rate dropped, coming in at 6.3%, as the economy added a weaker than expectations, 49,000 jobs in January. The Consumer Price Index for All Urban Consumers (CPI-U) was up +0.3% in January on a seasonally adjusted basis. Over the last 12 months, the All-Items Index remained stable at +1.4% on a non-seasonally adjusted basis. Overall, these numbers suggest a stable middling single digit growth rate for the economy. Though the risks seem to be to the upside with the building tailwinds. The remaining potential fly in the ointment is the burgeoning signs of inflation and the spill over into interest rates. So far, the Fed is staunchly stating that the inflation signs are transitory. However, the numbers are likely to look much worse before they may get better. Recall, 12 months ago things were very uncertain and deflationary, that now is our base for the next several months of reporting.

Summary

The potential positive path forward that we foresaw last month seems to be bearing out. The question though, is with the markets over 15%+ above the pre-corona virus highs of February 2020, have we already priced in all this forth coming good news? Further, with those gains come valuations in a lot of segments of the market, that have that bubbly vibe. That doesn't mean we crash tomorrow or go to the moon either. Maybe we just chop around for months on end frustrating all before picking a direction.

Below is a chart to ponder and in half a way a head scratcher. Not surprising that CEO's are exuberate, with all the stimulus and the easy comparisons going forward the next several months, after the damage caused to many sectors from the corona virus hit. However, the headscratcher part is that the Leading Economic Indicators are in a downtrend.

Source: https://twitter.com/MichaelKantro/status/1364207276576432128

To reiterate, this is not meant to cause fear but to draw attention to extended valuations and potential downside risks. We have built our asset allocation models with dynamic features and quarterly rebalancing, both in fixed income and equities. If the markets continue to march higher, we will capture some of those gains and reallocate to less volatile high-quality bonds. If the equity markets enter a period of negative performance, we have dynamic investment vehicles that utilize rules-based defense mechanisms to reduce the risk of the portfolio.   Further, if the market gets too extended on the upside, some of the vehicles will capture partial gains and wait for the extension to correct.

If you have specific questions about your portfolio or financial situation, we are here to help. Long-term financial planning is designed to deal with uncertainty like those we discussed above. Our portfolio management process is to design a prudent allocation across many asset classes. Equities are for long-term growth and several vehicles that we utilize offer defensive mechanisms to mitigate equity market declines.

Kevin Churchill, CFA®, CFP®
Chief Investment Officer
WaterRock Global Asset Management

WATERROCK
GLOBAL ASSET MANAGEMENT LLC