GM ADVISORY GROUP
WEALTH MANAGEMENT

Monthly Market Review

June 2021

What happened in June?

The MSCI All Country World Index gained **+1.3%** in June, while the Barclays US Aggregate Bond Index rebounded **+0.7%**. Broad commodities appreciated **+4.3%**, and gold fell **-7.2%**, erasing its entire gain from May.

We favor rotating some exposure from cyclical stocks toward growth stocks as economic and market data are signaling that the reflation trade may be approaching its end.

The most recent CPI report revealed that consumer prices increased +5.0% from May 2020 through May 2021, reflecting the highest inflation growth the US has experienced since August 2008. This recent inflation acceleration has caused considerable speculation as to whether this may be the beginning of a structural transition to a higher inflation regime. However, this is not our base-case forecast. In fact, we believe it is likely that inflation will peak in either June or July, if it has not already done so. Our rationale is based on data that includes the following:

1. **Base effects will steepen in the back half of the year.** Inflation is accelerating sharply in 2Q21, but this is largely because prices are comparing against depressed price levels from 2Q20. Steepening base effects in the back half of this year and into the first half of 2022 should serve as a significant headwind to inflation over the next 12 months.
2. **The Fed is now "thinking about, thinking about" tapering.** At the June Federal Open Market Committee (FOMC) meeting, the Fed indicated that it may begin to hike interest rates as early as 2023. This reflects a slightly hawkish pivot from their previous stance, which should, at least marginally, reduce inflation expectations.
3. **Wage inflation is decelerating:** Although CPI grew at +5.0% in May, wages only inflated by +2.4%, which is an even slower rate than was experienced prior to the onset of the pandemic. Historically, the US has not endured prolonged periods of high inflation without rising wage inflation. Moreover, we believe the probability that wage inflation accelerates materially in the next 12 to 18 months is relatively low, because (1) there is considerable slack in the economy, as roughly 7 million workers remain sidelined relative to pre-pandemic levels, and (2) labor force participation will likely increase in the coming months as many US states have decided to end extended unemployment benefit programs early to alleviate the current labor shortage.

In addition to the fundamental reasons why inflation will likely decelerate, market data has also started to confirm this potential phase transition. Such market signals include:

1. **Bonds are rallying.** US long-term treasuries have returned **+8.2%** since mid-March. Recall that bond prices are inversely related to inflation expectations and that long-term treasury prices are particularly sensitive to this relationship. If inflation were a material concern, we would expect these bonds to continue to perform very poorly, like they did from August through March.

2. **Inflation break-evens are falling.** Inflation break-evens, which some market participants believe [reflect the market's expectation of future inflation], have started to weaken. The 10-year inflation breakeven is down **-0.22%** from its high in mid-May and is currently priced at +2.3%. This is only slightly higher than the Fed's long-term inflation target of +2.0%.
3. **Cyclical stocks are starting to underperform growth stocks.** The price ratio of cyclical stocks vs. growth stocks has been rising since September. However, last month this ratio failed to make a new high, and two weeks ago it put in a "lower low" (see Chart of the Month). This could signal the beginning of a trend reversal that favors growth stocks relative to cyclical stocks.
4. **Price trends are weakening in some commodities.** Lumber and copper prices are **-58%** and **-10%** lower than their respective highs reached in early May. Moreover, the price of gold dropped sharply following the June 16 FOMC meeting and it remains **-15%** below its high reached last August. That said, oil, which represents a large portion of most commodity indexes, remains in a firm bullish trend for now, as the price of WTI Crude just reached $75 for the first time since 4Q18.

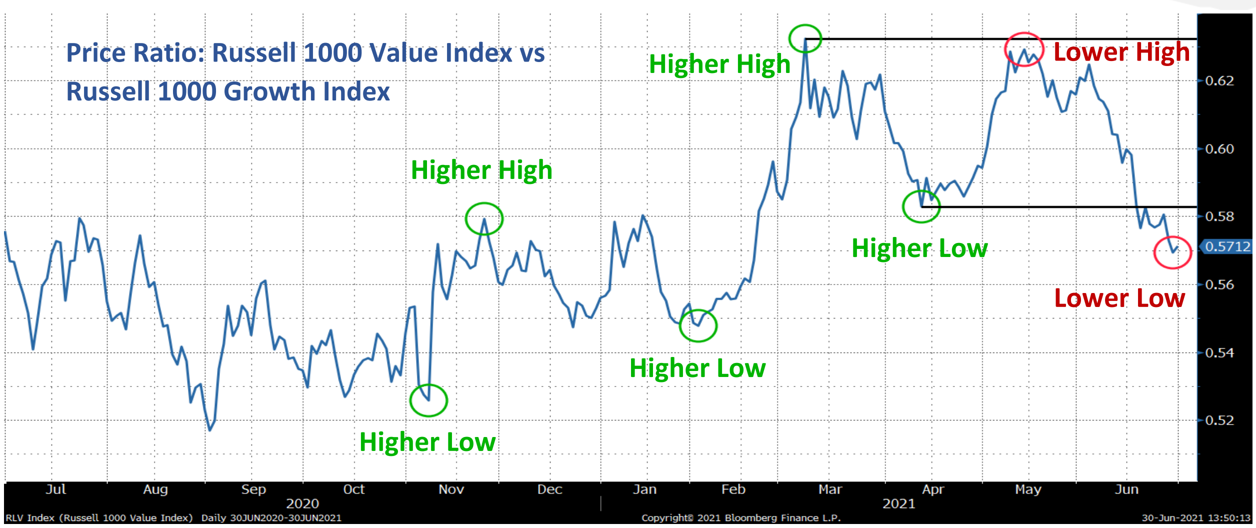
Positioning Highlights

Although there are reasons to exercise caution, our economic outlook remains constructive, and we favor remaining overweight risk assets as a result.

- **Maintain overweight exposure to equities:** We favor increasing exposure to equities as the economic recovery progresses.
- **Increase exposure to growth stocks within equities:** We favor increasing exposure to growth stocks given our expectation for high economic growth while inflation remains under control. We have started to favor reducing exposure to cyclical stocks given evidence that the reflation/recovery trade may be nearing its end.
- **Maintain underweight exposure to defensive assets:** We favor maintaining an underweight posture in defensive asset classes, like fixed income, because we expect defensive assets to underperform while economic growth remains elevated.
- **Maintain overweight exposure to commodities:** We favor maintaining an overweight posture in commodities to hedge against rising inflation. However, we will generally recommend reducing this exposure if it becomes more evident that inflation has peaked.

Chart of the Month

The price ratio of cyclical vs. growth stocks recently made a lower high followed by a lower low, potentially signaling a trend reversal that favors growth stocks relative to cyclicals going forward.



Source: Bloomberg, GMAG Research

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