Between a Rock and a Hard Place

July 2021

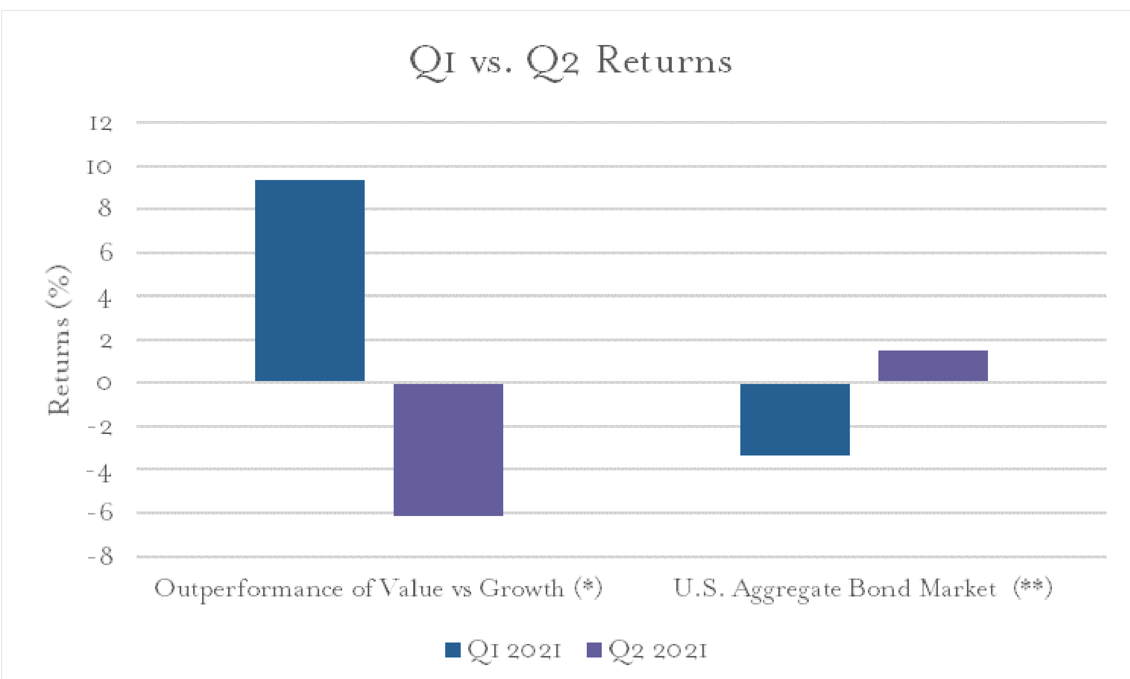
Key Points:

1. Q1 vs. Q2: A tale of two quarters
2. The Fed is in the unenviable position of tackling inflation without disrupting the recovery
3. The Windhaven Strategies ended the quarter as they began: positioned for Market Participation

A Tale of Two Quarters

Vaccine rollouts, global fiscal support, and accommodative monetary conditions have resulted in a recovery of economic growth but have also introduced inflationary pressures due to stronger demand and COVID-19 related supply bottle necks. In the U.S., real Gross Domestic Product (GDP) grew 6.4% in the first quarter, and the U.S. Consumer Price Index (CPI) hit mid-single digits during the second quarter. This kind of economic environment tends to be a boon for sectors tied to the reflation of the economy – generally the more cyclical and value-oriented such as energy, materials, industrials, and financials.

Chart 1: The contrast between Q1 and Q2



Source: *Value vs Growth: total return outperformance of MSCI World Value Index over MSCI World Growth Index over the period; **total return performance of Bloomberg Barclays Aggregate Bond Market Index during the period.

The first quarter of 2021 played out as scripted: cyclical more value-oriented sectors outperformed the more expensive high earning growth sectors – like info tech and consumer discretionary. Interest rates rose quite rapidly to reflect higher expectations around growth and inflation with the yield on a generic 10 year U.S. Treasury bond jumping from sub 1% at the beginning of the year to over 1.7% at the end of the first quarter, resulting in overall bond market losses.

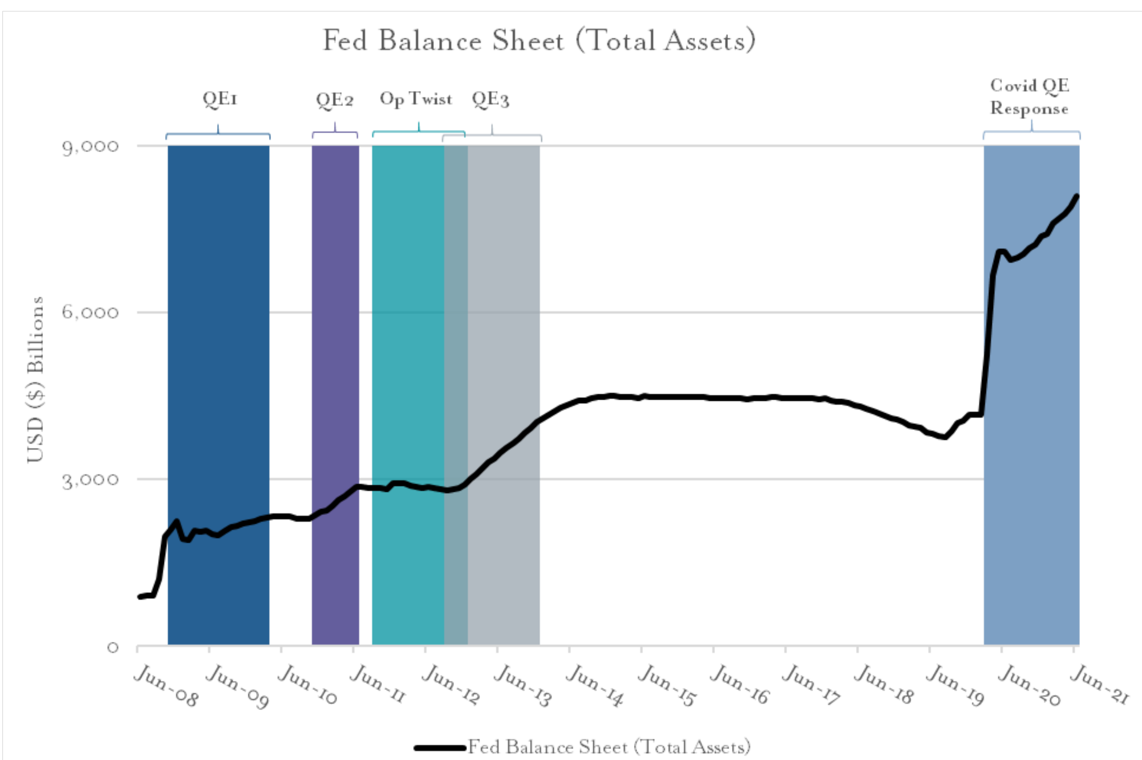
The second quarter, however, saw the reflation trade losing some steam. Global value equity indices ended up underperforming their growth-oriented counterparts. After the sharp spike of the first quarter, the 10-year Treasury yield actually fell, ending the quarter around 1.4% resulting in bond market gains.

Looking Ahead: The Fed Punch

The contrast between the first and second quarter of this year might reflect the fact that markets have already discounted the growth and inflation boost resulting from the reopening of the economy. The next phase of normalization of the economy will rely on the continuation of the current positive trend of the COVID pandemic, and the nature of the policy response from the Fed and other central banks around the globe. The end of the past quarter gave investors a taste of the Fed-induced rollercoaster that might offer a preview of things to come. As the Fed plans for the exit from Quantitative Easing and zero rates, the Fed and investors are facing a new wrinkle that was not a feature of the post-2008 Great Financial Crisis: inflation.

In the aftermath of the 2008 crisis, inflation was a theoretical concern as the Fed aggressively expanded their balance sheet to support the economy with low interest rates and plenty of liquidity via Quantitative Easing. By the time the Fed ended their Quantitative Easing program in 2014, the

Chart 2: Fed balance sheet expansion over time



Source: Federal Reserve via Bloomberg; QE programs: New York Fed https://www.newyorkfed.org/markets/programs-archive/large-scale-asset-purchases and https://www.newyorkfed.org/markets/domestic-market-operations/monetary-policy-implementation/treasury-securities/treasury-securities-operational size of the Fed's balance sheet had more-than quadrupled but the only place where inflation was to be found was in asset prices with the value of U.S. equities (MSCI US) nearly doubling over that time. However, throughout the post-2008 recovery, Consumer Price inflation never materialized due to the lackluster nature of the growth recovery.

The Fed response to the COVID crisis was as aggressive as it was in 2008, with Fed fund rates quickly pushed to zero and an ongoing Quantitative Easing program which has already lead to a doubling of the size of the Fed balance sheet since its inception in early 2020.

This time the concern about inflation does not emanate from Fed money printing, but rather from the strength of the recovery and supply bottle necks. There is not much that the Fed can do to solve supply shortages, but persistent inflationary pressures will likely, in turn, put pressure on the Fed. Removing the "punch bowl" by tightening policy too soon could lead to lackluster economic growth and volatility in the markets; conversely, leaving policy accommodation for too long could result in sustained inflation. Between a rock and a hard place, indeed.

Positioning

The Windhaven Strategies entered the second quarter tilted toward Market Participation, with tactical holdings in pro-cyclical, growth-oriented assets such as equities, REITs, and commodities, and an underweight to bonds. As the quarter drew to a close, that positioning remained intact, albeit with some slight modifications. With valuations elevated in many sectors, investments in some of the more defensive sectors continue to be attractive, including healthcare, energy, and higher-dividend stocks; others in this category that were trimmed or sold were replaced by ETFs invested in technology and communications services stocks. While the overall allocation to equities across all three strategies remained unchanged, US equities were slightly trimmed in favor of developed international stocks, which offer attractive valuations but a more uncertain post-pandemic growth outlook in many regions. Low or falling U.S. interest rates are often a catalyst for investor interest in emerging market stocks, and while rates fell in the second quarter, we remain underweight. Commodities are the best performing asset class so far in 2021, and they remain a tactical holding as our research indicates that commodities may continue to perform even as the inflation spike seen earlier this year moderates. Within the fixed income portion of the strategies, we remain focused on higher-quality investment grade bonds, having trimmed and sold ETFs invested in mortgage backed bonds and U.S. high yield bonds, respectively.

–The Windhaven Strategies Portfolio Management Team

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