# 3Q 2021 Asset Allocator's Guide

MarketDesk Research

Quarterly Report

July 9, 2021

## Key Portfolio Themes As We Enter 2H 2021

### Markets are Stretched; Favor Risk Mitigation Approach

Equity markets have covered a lot of ground since their pandemic trough and now price in a robust recovery (**Fig 12**). Statistical measures, such as cyclical vs defensive sectors (**Fig 19**), and thematic changes, such as Chinese credit conditions (**Fig 21**), favor a risk-off approach. At this point in the recovery, our goal is to use statistics to (1) limit downside capture by avoiding overbought market segments and (2) increase potential upside by positioning for relative outperformance. Risk-mitigation is a common positioning theme throughout the report including: Large over Small (**Figs 12-14**), Mid-Cap Growth over Mid-Cap Core (**Fig 16**), China within broad EM (**Fig 22**), and DM Asia over Europe (**Fig 31**).

### Expect a Bumpier Ride as Federal Reserve Policy Drives Markets in 2H21

Whether it wants it or not, the Fed has the market's attention. The pandemic's unique recovery (**page 7**) and rising inflationary pressures make it difficult for the Fed to maintain its asset purchases and accommodative policy. The question is how quickly and what steps the Fed takes to normalize policy. We expect the Fed to taper its asset purchases sometime this fall and raise interest rates in late 2022 at the earliest. In addition, it is important to note Biden will nominate the Fed Chair in early 2022. The Fed will be hesitant to make a big policy change ahead of a potential turnover in Fed Chair. Regardless, the market already showed its hand as volatility surged after the June FOMC meeting simply due to the Fed adopting a more hawkish tone. We expect the path to be bumpier in 2H21.

### Notable Positioning Views

► **10Y Yield:** Statistics point to a range bound 10Y yield in 2H21 (**Fig 27**); Performance implications for Large vs Small (**Fig 14**), Growth vs Value (**Fig 15**), and Duration (**Fig 29**)

► **Large vs Small Caps:** Upgrade Large to OW; Downgrade Small to Neutral (**Figs 12-14**)

► **Value vs Growth:** Favor Growth over Value (**Fig 15**) & Mid Growth over Mid Core (**Fig 16**)

► **Dividend & Buyback Factor:** Initiate tactical DIVB position (**Fig 17**)

► **International:** Downgrade Emerging to Neutral and favor China position for risk-mitigation within EM (**Fig 22**); Remain Neutral Developed and favor DM Asia over Europe (**Fig 24-25**)

► **Credit Duration:** Continue to favor long-duration; See **Fig 29** for statistics and implied returns

► **Credit Quality:** Favor HY over IG (**Figs 30-31**), but HY OW is a quarter-by-quarter decision; Tactically OW Fallen Angels (**Fig 32**)

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### Report Overview

Welcome to the MarketDesk Research *Asset Allocator's Guide* . The goal of this report is to simplify the asset allocation process, ask targeted questions to understand key drivers, and build investment conviction. The analysis is designed to break down a complicated market narrative and focus on what matters. A summary of our current asset allocation views is listed on page 2. Up/down arrows indicate a positive (▲) or negative (▼) change in view since the last edition of the *Asset Allocator's Guide* .

Research Portal →

# MDR Asset Allocation Ratings

● Underweight (UW) ● Neutral (N) ● Overweight (OW)

| Asset Class | Allocation View | | | | Rationale |
|---|---|---|---|---|---|
| | Chg. | UW | N | OW | |
| **U.S. Equities** | | | | | |
| Large Caps | ▲ | • | • | ● | Statistically outperforms after the 10Y yield makes a +1std move higher; Offers relative safety with market near record highs |
| Mid Caps | | • | ● | • | Significant regional bank exposure likely impacted by range bound 10Y yield; Favor Mid-Cap Growth over Mid-Cap Core |
| Small Caps | ▼ | • | ● | • | Concerns about pricing power amid rising inflation; Statistically underperforms after the 10Y yield makes a +1std move higher |
| **International Equities** | | | | | |
| ACWI ex U.S. | ▼ | • | ● | • | Tightening China credit conditions point to weaker forward returns; Fed tightening could strengthen USD and weigh on returns |
| Emerging | ▼ | • | ● | • | Latin America near-term overbought after commodities spiked; China now a risk-mitigation opportunity after dismal 1H21 performance |
| Developed | | • | ● | • | Favor tactical DM Asia position to protect against DM Europe selloff after 1H21 outperformance |
| **Fixed Income** | | | | | |
| High Yield | | • | • | ● | Primary catalyst is higher absolute yields rather than spread tightening; OW rating is a quarter-by-quarter decision |
| Investment Grade | | • | ● | • | Expect 10Y yield to trade range bound with an upper boundary of 1.75%; Favor extending duration in the range of 60% mid / 40% long |
| Preferreds | | • | ● | • | Offers attractive yield amid low interest rates; Favor preferreds' yield emphasis over convertible bonds' equity exposure |
| Municipals | | • | ● | • | Biden tax hike proposal increases the attractiveness of municipals' tax benefit; State & local budgets in better shape than feared |
| MBS | | • | ● | • | Offer higher yields than Treasuries, but rising rates slow prepayments and extend duration; Focus on managing duration, such as MBSD |
| TIPS | | • | ● | • | Potential for inflation to run hot in coming months; Expect inflationary pressures to be transitory (Refer to 5/28/21 Strategy Snapshot) |
| Duration | | • | ● | • | More concerned about short-end of yield curve as Fed prepares to raise rates; Favor extending duration to 60% mid / 40% long |
| EM Sovereign | ▼ | ● | • | • | Emerging market central banks entering a tightening cycle; EM Sovereign debt likely to underperform |
| **U.S. Sectors** | | | | | |
| Financials | | • | • | ● | Expect 10Y yield to trade range bound in 2H21, which could weigh on returns; Banks focused on returning capital is a positive |
| Industrials | | • | • | ● | Strong ISM Mfg PMI, but rising raw material costs could hurt margins; Concerned about spending switching from goods to services |
| Materials | | • | • | ● | High degree of operating leverage, which provide hedge against inflationary pressures; Uncertain economic outlook is a potential drag |
| Tech | | • | ● | • | Essential to businesses and leveraged to secular trends; Continued inflationary pressures would weigh on valuations |
| Cons Disc | | • | ● | • | Tied to Growth trade due to AMZN & TSLA weights; Benefits from consumers switching to spending on services |
| Utilities | | • | ● | • | Attractive dividend yield; Prefer Utilities over Cons Staples & Health Care for a defensive play |
| Comm Svcs | | • | ● | • | Mixture of Growth factor & low-beta telecom industry; Social media companies face regulatory risk |
| Energy | | • | ● | • | Expect oil demand to gradually recover but remain volatile; Risk of undersupply if oil production growth lags oil demand growth |
| Health Care | | ● | • | • | Potential Medicaid rate cuts & Biden admin push for price controls = headwinds; Resuming elective surgeries is a potential catalyst |
| Cons Staples | | ● | • | • | Margins expanded in pandemic, but low-beta will underperform in a rally; Less time at home = headwind |
| REITs | | ● | • | • | Different property types are recovering at different speeds; Favor broad diversified approach |
| **U.S. Equity Factors** | | | | | |
| Growth | | • | • | ● | Statistically outperforms after the 10Y yield makes a +1stdv move higher; Exposed to secular trends |
| High Beta | ▼ | • | ● | • | Volatility shifting from Covid linked equities benefitting from reopening to companies experiencing idiosyncratic events |
| Momentum | | • | ● | • | More exposed to cyclical sectors after May 2021 rebalance; Falling yields are a headwind for Financials OW |
| Minimum Volatility | | • | ● | • | Other suitable alternatives, such as Growth & Tech, provide downside protection with superior fundamentals |
| Quality | | • | ● | • | Potential broad market substitute, but offers limited sector differentiation |
| Value | | • | ● | • | Offers more cyclical/reflationary exposure, but statistically underperforms after 10Y yield makes a +1std move higher |
| High Dividend | | • | ● | • | Yield emphasis is attractive in a low interest rate environment, but Financials OW will underperform if rates continue to move lower |

**Note:** The ratings represent our asset allocation view for the next 6-12 months. Arrows indicate a positive (▲) or negative (▼) change in view since the prior report.

# MDR Asset Allocation Model

Allocation, Weights, Rationale, & Fund Ideas

This page pulls together all current MarketDesk ratings across equity, credit, and alternatives. It is intended to provide a framework for implementing core and tactical views within a broad portfolio. The Weight column provides target weights across core asset classes and tactical tilts. The weights are provided for illustrative / directional purposes only and will likely vary depending on client-specific needs. The ETF column provides a suggested ETF for each allocation, and the final column includes relevant tactical tilts and report links.

| Portfolio Allocation | Weight | ETF | Tactical Tilt & Full Report Link | |
|---|---|---|---|---|
| **U.S. Equity — Large Cap** | | | | |
| Growth Factor | 12.5% | *VOOG* | Increasing large-cap growth exposure; Refer to Figure 15 | |
| Value Factor | 10.0% | *VOOV* | Slightly UW large cap value vs growth; Refer to Figure 15 | |
| Dividend & Buyback Factor | 2.5% | *DIVB* | Corporate cash near record high; Returning capital will be a significant theme over NTM; Refer to Figure 17 | |
| Industrial Sector | 1.0% | *XLI* | | View Report → |
| Materials Sector | 1.0% | *XLB* | Concerned about aggressive EPS expectations; Refer to Figure 18 | |
| MDR Tactical All Cap Model | 1.0% | | Tactical single name stock ideas from *Strategy Snapshot* and *Tactical Opportunity* reports | View Report → |
| Large Cap Total | 28.0% | | | |
| **U.S. Equity — Mid/Small Cap** | | | | |
| S&P 400 Mid Cap Growth | 4.0% | *VOT* | Less regional banks exposure; Refer to Figure 16 | |
| S&P 600 Small Caps | 2.0% | *VIOO* | Emphasize quality via S&P 600 | View Report → |
| Property & Casualty Insurance | 0.5% | *KIE* | Range bound 10Y yield could weigh on industry; Commercial policy rate increases driving revenue | View Report → |
| Transportation | 0.5% | *XTN* | Broad inventory restocking as economy reopens | View Report → |
| Mid / Small Cap Total | 7.0% | | | |
| **International Equity — Developed** | | | | |
| FTSE Developed | 10.0% | *VEA* | *Broad Exposure* | |
| Developed Asia-Pacific | 3.0% | *VPL* | Risk mitigation opportunity; Refer to Figure 25 for statistics | View Report → |
| U.K. Country ETF | 1.0% | *EWUS* | Buying opportunity post Delta Variant selloff; Trades at valuation discount vs EU | View Report → |
| Developed Total | 14.0% | | | |
| **International Equity — Emerging & Frontier** | | | | |
| FTSE Emerging | 4.0% | *VWO* | *Broad Exposure* | |
| China Country ETF | 1.5% | *MCHI* | Risk mitigation opportunity; Refer to Figure 22 for statistics; Full report coming July 16th | |
| Vietnam Country ETF | 0.5% | *VNM* | Benefits from supply chain diversification outside of China | View Report → |
| Emerging Total | 6.0% | | | |
| **Credit** | | | | |
| Investment Grade | 27.0% | *USIG* | Split between 60% mid / 40% long duration; Refer to page 13 for tickers | |
| High Yield | 9.0% | *USHY* | Tactically OW fallen angels in HY; Refer to Figure 32 | |
| Municipals | 2.0% | *VTEB* | *Broad Exposure* | |
| MBS | 2.0% | *VMBS* | *Broad Exposure* | |
| Credit Total | 40.0% | | | |
| **Alternative Assets** | | | | |
| Real Estate | 3.0% | *VNQ* | *Broad Exposure* | |
| Commodities | 1.0% | *PDBC* | *Broad Exposure* | |
| Cash | 1.0% | | | |
| Alternatives Total | 5.0% | | | |

# Dissecting the Narrative

This page dissects the current Bull and Bear market narratives, including brief discussion of the current narrative.

## Bull Case / Catalysts

**+ Fiscal Spending Surge**: The Biden administration is intently focused on increasing fiscal spending. Spending proposals include infrastructure and domestic priorities (i.e., child and elder care, education, etc.) We expect the White House's spending urgency to pick up during 2H21 as the 2022 midterms approach, especially given the sitting President's party historically loses seats during the first midterms. The Democratic-controlled Congress will play a key role in keeping spending legislation on track. This creates the potential for multiple headline-grabbing fiscal spending announcements during 2H21 and 1H22.

**+ Strong Economy / Pent-Up Services Demand**: Page 7 highlights how the current economic recovery is outpacing the past three post-recession periods. While economic growth likely already peaked for the current cycle, this does not mean the economy has peaked. In fact, we expect the economy to continue grinding higher and expanding. One of the primary areas we are watching is the shift from spending on goods to services. The pandemic pulled forward spending across goods categories, including houses, appliances, vehicles, furniture, and computers required to work from home. In contrast, the pandemic pushed back demand for services, including air travel, vacations, eating out, and elective medical procedures. Pent-up services demand will be an important growth catalyst moving forward.

**+ Corporate Operating Leverage**: Companies cut expenses and implemented technology solutions during the pandemic. The moves resulted in corporate profits holding up much stronger than expected. Some of the changes will stick, which should make companies leaner and more efficient going forward. Corporate margin expansion will be a key catalyst during 2H21-- so long as expenses and inflation remain in check. Refer to Figure 18 on page 10 for commentary regarding recent EPS revision trends.

**+ Corporate Cash Reserves**: Companies rushed to issue debt in 2020 to bridge themselves through the pandemic. With corporate profits holding up stronger than anticipated (refer to 'Corporate Operating Leverage' above), cash reserves sit near a record high. We expect shareholders to push management teams to return capital over the next year. Refer to Figure 17 on page 9 for our tactical position focused on the dividend and buyback factor.

## Bear Case / Headwinds

**— COVID-19 Variants:** The world made significant progress battling the virus during 2Q21 as vaccination programs gained momentum. Even with the progress, a resurgent virus continues to be a significant risk. It is dangerous to draw the conclusion that vaccine success in developed countries signals the pandemic is over. While life is quickly returning to normal in developed countries, virus variants are popping up across the globe. Emerging countries with limited vaccine access, as well as unvaccinated individuals across the world, are particularly vulnerable to variants. While we do not expect public officials to aggressively reimpose restrictions, delays in relaxing restrictions risk stalling the economic recovery.

**— Fed Tightening / Policy Changes:** Monetary policy and the path to normalization will be a big market theme during 2H21. The Fed and its global central bank peers have the unenviable task of removing accommodative support. The big risk is market volatility increases as investors react to Fed communications and try to gauge the central bank's next steps. We already saw how the market reacted and volatility picked up simply by the Fed adopting a more hawkish stance at the June 2021 FOMC meeting. We expect the path to be bumpier in 2H21.

**— Capacity Constraints Stall Recovery:** The extent of the pandemic's impact on global supply chains becomes clearer as the days pass. Freezing global supply chains and then rushing to reopen those same supply chains is proving much easier said than done. Economic data shows companies are struggling to build production capacity back up. U.S. job openings sit at a record high, and a semiconductor shortage is forcing auto manufacturers to temporarily halt production. Freight rates are surging as companies rush to restock their inventories all at once. The longer it takes to unclog supply chains, the greater the risk demand finds an alternative solution and the recovery stalls.

**— Tax Increases Create Fiscal Drag:** The Biden administration is vocal about its desire to increase fiscal spending. A bipartisan infrastructure framework recently emerged, and the White House is already talking about a domestic priorities bill focused on human infrastructure. Funding is still up in the air, but the Biden administration is exploring raising capital gains tax rates and corporate tax rates to pay for the fiscal spending surge. The risk is tax increases drag on economic growth before the fiscal spending works through the economy.

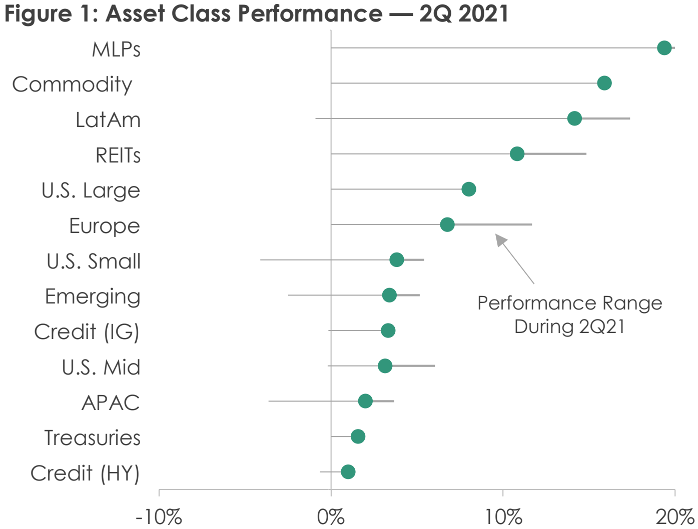
# Asset Class Performance

Recap since last edition of the Asset Allocator's Guide

| Asset Class | Total Return (%) | | | Valuation & Yield | | | Asset Flows[1] | | Price Chart |
|---|---|---|---|---|---|---|---|---|---|
| **Global Equities** | **2Q'21** | **1Yr** | **3Yr** | **NTM P/E** | **P/B** | **Div Yld** | **2Q'21** | **Last 2Yrs** | **YTD** |
| U.S. Large Caps | 8.4 | 40.9 | **66.7** | 21.3x | 4.5x | 1.3% | ↑ 2.8% | | |
| U.S. Mid Caps | 3.4 | 53.0 | 44.0 | 17.6x | 2.8x | 0.9% | ↑ 1.4% | | |
| U.S. Small Caps | 4.0 | **61.9** | 45.9 | 29.5x | 2.7x | 0.8% | ↑ 0.7% | | |
| Europe | 7.9 | 37.3 | 30.6 | 16.7x | 2.1x | 2.5% | ↑ 36.0% | | |
| Asia-Pacific | **2.3** | 38.1 | 38.4 | 15.7x | 2.2x | 1.0% | ↓ 1.1% | | |
| Latin America | **15.5** | 49.3 | 15.4 | 10.2x | 2.1x | 2.1% | ↓ 7.7% | | |
| Developed | 5.4 | 32.6 | 27.6 | 16.3x | 1.9x | 2.3% | ↑ 3.1% | | |
| Emerging | 3.8 | 39.9 | 35.7 | 14.1x | 2.2x | 1.4% | ↑ 2.5% | | |
| **U.S. Sectors** | | | | | | | | | |
| Comm Services | 10.8 | 55.7 | **74.1** | 25.4x | 4.3x | 0.6% | ↑ 3.1% | | |
| Cons Discretionary | 6.4 | 40.8 | **69.1** | 30.1x | 11.4x | 0.6% | ↑ 0.1% | | |
| Cons Staples | 3.1 | 22.5 | 47.6 | 20.3x | 6.2x | 2.5% | ↓ 0.4% | | |
| Energy | 10.9 | 49.7 | **-16.0** | 17.4x | 1.9x | 3.9% | ↑ 6.0% | | |
| Financials | 8.2 | **61.6** | 47.4 | 14.2x | 1.6x | 1.6% | ↑ 3.1% | | |
| Health | 8.3 | 27.8 | 59.6 | 17.0x | 5.1x | 1.4% | ↑ 3.7% | | |
| Industrials | 4.3 | 51.2 | 51.5 | 23.9x | 5.9x | 1.2% | ↓ 2.6% | | |
| Materials | 4.9 | 48.8 | 50.9 | 17.9x | 3.3x | 1.6% | ↑ 30.2% | | |
| Tech | 11.4 | 42.5 | **120.6** | 26.4x | 11.2x | 0.7% | ↑ 1.4% | | |
| Utilities | **-0.5** | **15.7** | 34.4 | 17.8x | 2.1x | 3.1% | ↓ 1.5% | | |
| **Fixed Income** | | | | | | | | | |
| Treasuries | **1.8** | **-3.2** | **14.4** | - | - | 1.0% | ↓ 1.4% | | |
| Invest. Grade | 3.9 | **2.4** | 28.7 | - | - | 2.4% | ↑ 2.9% | | |
| High Yield | **2.0** | **12.9** | 20.3 | - | - | 4.4% | ↓ 2.2% | | |
| **Alternatives** | | | | | | | | | |
| REITs | **11.6** | 34.4 | 40.1 | 20.8x | 3.1x | 3.1% | ↑ 9.5% | | |
| MLPs | **21.8** | **63.8** | **-4.4** | 11.2x | 1.8x | 7.6% | ↓ 0.1% | | |
| Commodities | **15.9** | **56.4** | **12.1** | - | - | - | ↑ 23.1% | | |

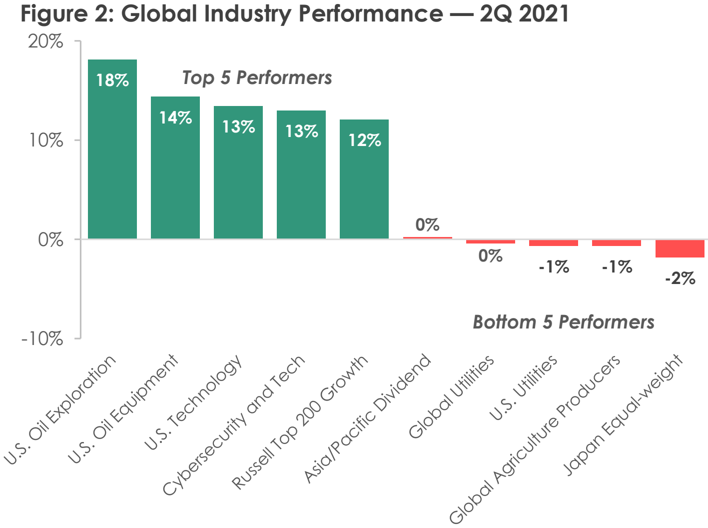
[1] *Asset Flows are calculated using 5 largest ETFs for each category.*

**Figure 1: Asset Class Performance — 2Q 2021**




*Source: MarketDesk Research*

**Figure 2: Global Industry Performance — 2Q 2021**

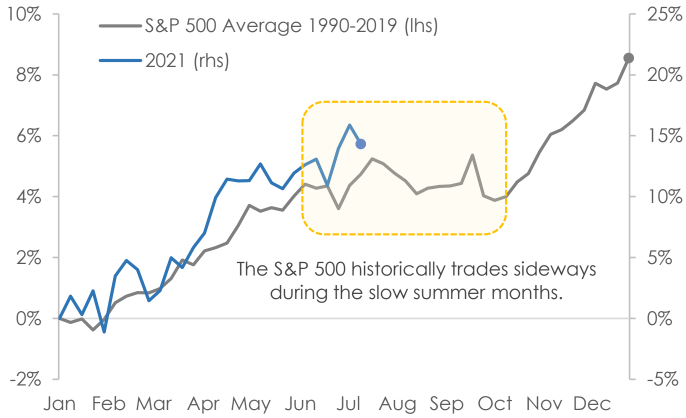



*Source: MarketDesk Research*

# Charts That Will Shape 3Q 2021

Six charts likely to drive the market narrative this quarter

**Figure 3: Average S&P 500 Return Path vs Current Year**

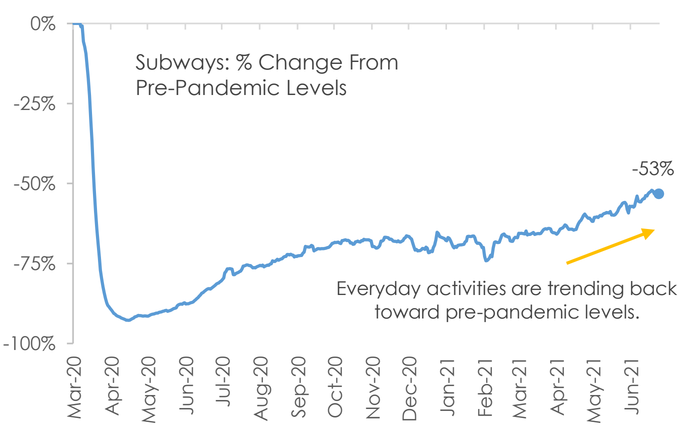



*Source: MarketDesk Research*

**Figure 4: Pandemic Unemployment Benefits Ending**

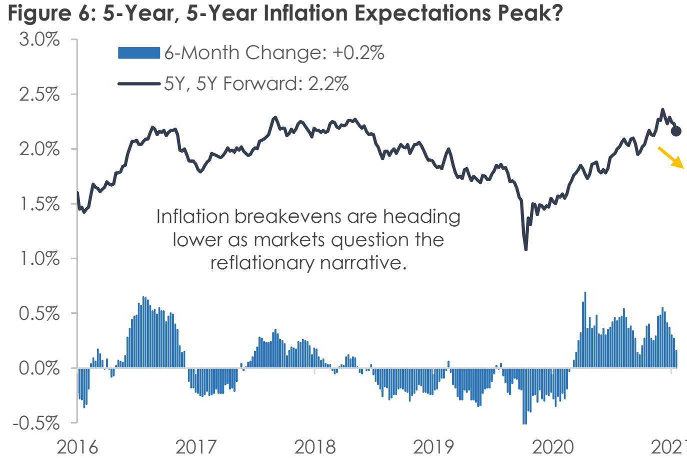

*Source: MarketDesk Research, Various State Governments*

**Figure 5: New York MTA Ridership Hits Post-Pandemic High**



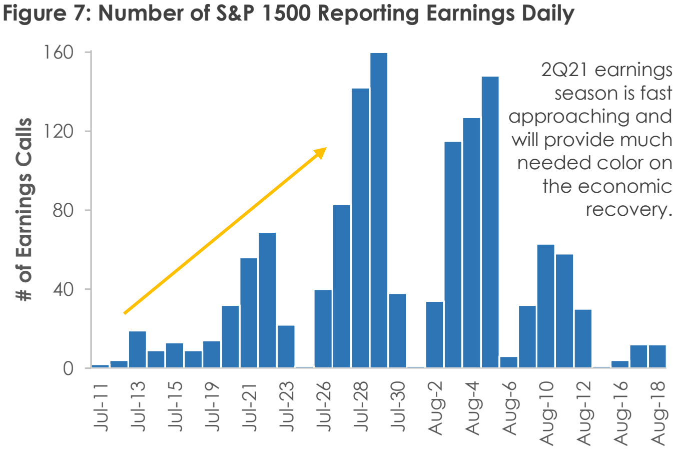

*Source: MarketDesk Research, New York Metropolitan Transit Authority*

**Figure 6: 5-Year, 5-Year Inflation Expectations Peak?**



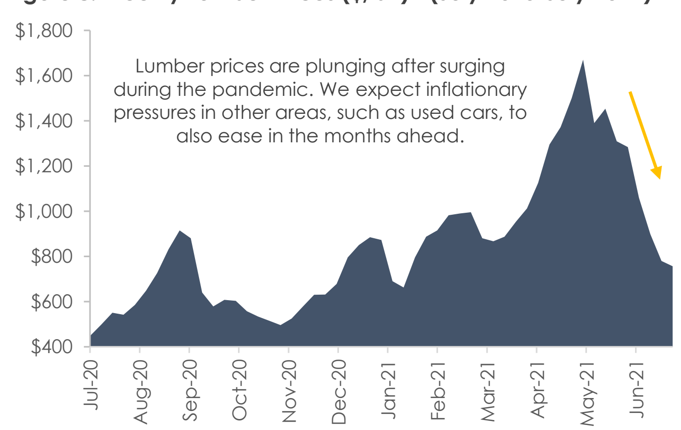

*Source: MarketDesk Research, Federal Reserve*

**Figure 7: Number of S&P 1500 Reporting Earnings Daily**




*Source: MarketDesk Research, Factset*

**Figure 8: Weekly Lumber Prices ($/bft) - (July 2020-July 2021)**

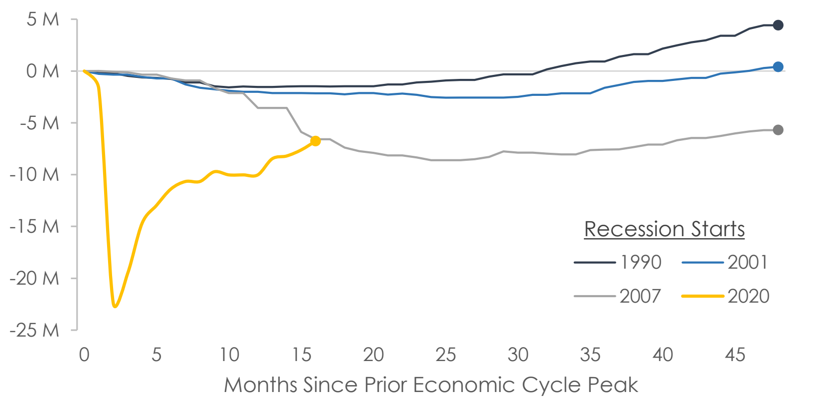



*Source: MarketDesk Research*

► **Framing the Current Recovery and Economic Cycle:** Figures 9-11 compare key datapoints from the current economic cycle against the three most recent cycles (i.e., peak of prior cycle through year four of the next cycle). NBER identifies July 1990, March 2001, December 2007, and February 2020 as the four most recent cycle peaks. The pandemic's unique nature (i.e., sudden shutdown and accelerated reopening) shortened the current cycle's peak to trough.

► **Our Takeaway:** The economic recovery has likely already peaked. While we expect the Y/Y recovery rate to decelerate in 2H21, this does not mean the economy is headed for a recession. However, it does present an uncertain outlook and drives our desire to pull back risk exposure and capture gains within cyclical market segments.

**Figure 9: Labor Market — Nonfarm Payrolls vs Prior Cycle Peak**



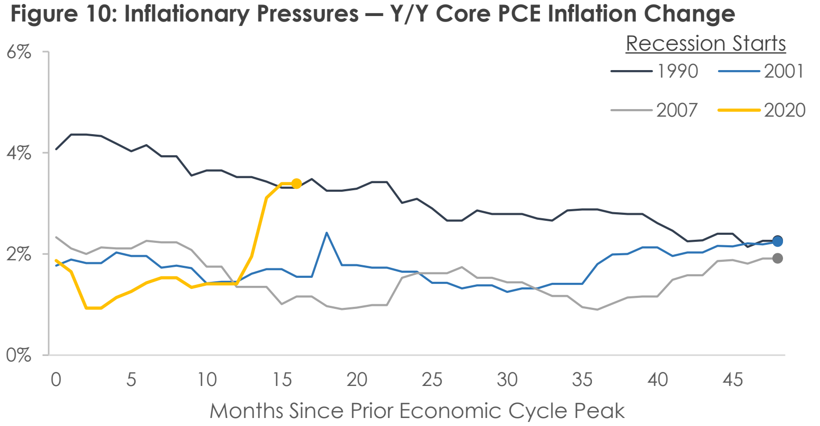

*Source: MarketDesk Research, U.S. Bureau of Labor Statistics, NBER*

## Businesses are Historically Still Cutting Jobs at this Point in the Cycle …

● The number of nonfarm payroll losses sits above prior cycles, but new jobs are being added at a faster pace. We expect payrolls to expand quickly in 2H21 as enhanced unemployment benefits end, virus fears recede, and schools reopen.

● Figure 9 tracks nonfarm payroll changes across the four most recent economic cycles. Nonfarm payrolls troughed during month 3 (i.e., April 2020) of the current cycle. Nonfarm payrolls troughed during months 10 (1990), 25 (2001) and 24 (2007) of the three most recent cycles.

**Figure 10: Inflationary Pressures — Y/Y Core PCE Inflation Change**



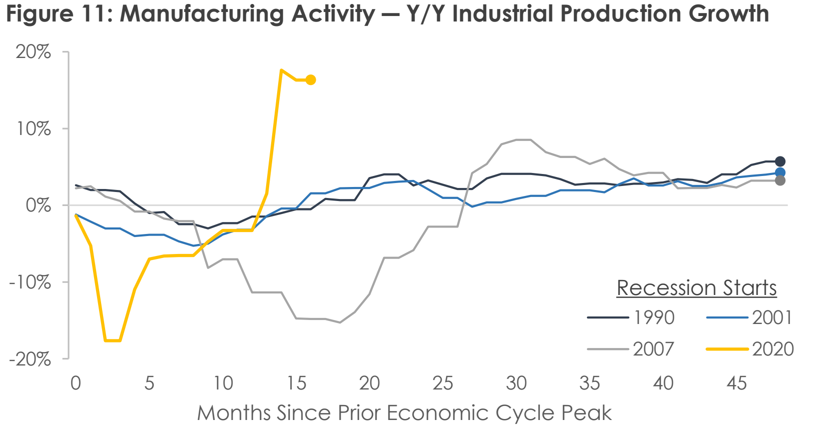

*Source: MarketDesk Research, U.S. Bureau of Economic Analysis, NBER*

## Inflationary Pressures are Historically Still Trending Lower at this Point in the Cycle …

● As another sign of the pandemic's unique nature, pricing pressures are spiking early in the current cycle. We attribute rising prices to consumer demand remaining strong while disrupted supply chains struggle to reopen.

● Figure 10 tracks y/y changes in core PCE inflation across the four most recent cycles. May 2021 core PCE rose 3.4% y/y, the fastest pace in nearly three decades. In contrast, core PCE steadily trended lower during the past three cycles. Supply/demand is historically more balanced during recoveries. In contrast, demand is overwhelming supply today.

**Figure 11: Manufacturing Activity — Y/Y Industrial Production Growth**




*Source: MarketDesk Research, Federal Reserve, NBER.* ***Note*** *: Data is seasonally adjusted.*

## Industrial Production is Historically Still Contracting at this Point in the Cycle …

● The pandemic uniquely impacted manufacturing activity. With services limited by virus restrictions, consumers spent more on goods. Home and vehicle sales both surged. Computer and semiconductor demand spiked as employees worked from home.

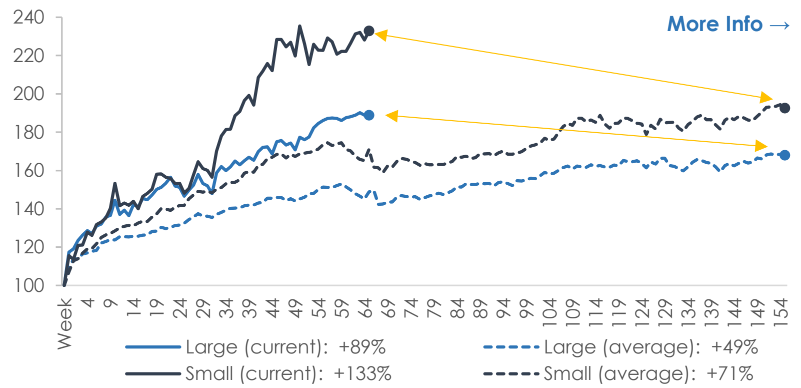
● Figure 11 tracks y/y changes in industrial production across the four most recent cycles. Industrial production is recovering much quicker and rebounding faster in the current cycle. We expect industrial production growth to decelerate in 2H21 as consumers switch to spending on services as the economy reopens.

# Size — Large Caps vs Small Caps

► **Upgrade Large Caps to OW; Downgrade Small Caps to Neutral.** The Russell 2000 outperformed the S&P 500 by 21% over the past 12 months. The current bull market is significantly outperforming prior bull markets, leaving equity markets vulnerable to shifting sentiment. Small caps appear even more vulnerable due to rising inflation, and history shows small caps statistically underperform after the 10Y yield surges higher. With the uncertain outlook, we prefer large caps' relative safety. We are capturing small cap gains from our Dec. 2020 upgrade and rotating back into large caps.

► **Actionable Ideas**: *Large Caps* : IVV, VOO, SPLG. *Small Caps* : Emphasize quality via S&P 600 (ETFs: IJR, VIOO, SLY).

**Figure 12: Current Bull Market Returns vs Average Historical Returns**



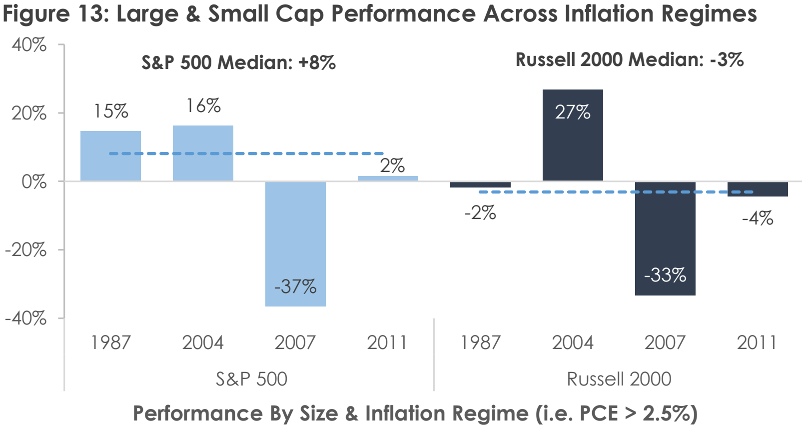

*Source: MarketDesk Research*

## Large and Small Cap Stocks Have Already Priced in a Robust Recovery …

● Equity markets have covered a lot of ground since their pandemic trough. The strong returns leave stocks, especially small caps, vulnerable to a decelerating recovery and fading risk sentiment.

● Figure 12 charts the current bull market return (solid lines) against the average 3-year bull market return (dashed lines). Large and small cap returns are both nearly 2x their average returns at this point in the bull market. Returns also sit above the average full 3-year bull market return -- after only 1.5 years. Click 'More Info' to see large and small cap return paths across historical bull markets.

**Figure 13: Large & Small Cap Performance Across Inflation Regimes**



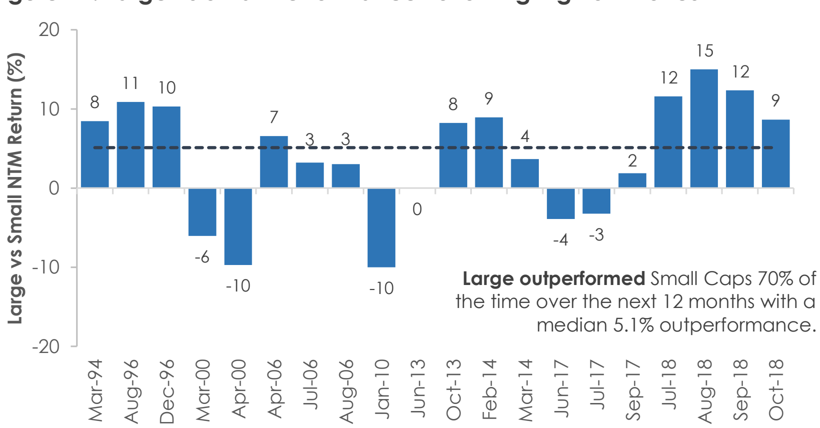

*Source: MarketDesk Research, U.S. Bureau of Economic Analysis.* ***Note*** *: Periods -- May 1987-June 1993, May 2004-Aug. 2006, Sept. 2007-Oct. 2008, and May 2011-Feb. 2012.*

## Small Cap Stocks Have Less Pricing Power than Large Cap Peers …

● Pricing power is a key differentiator as costs rise. Compared to small caps, large caps are more likely to be protected by legal contracts and have the ability to push back against price increases by threatening future business relationships.

● Figure 13 compares large and small cap returns after PCE inflation rises >2.5%. Small caps traded lower 3 out of 4 times but outperformed by 11% in 2004. The tight gap between PPI and PCE in 2004 suggests pricing power was strong in the mid-2000s. We have doubts about companies' pricing power today, especially within goods as demand switches to services. Small cap margins could face pressure.

**Figure 14: Large vs Small Performance Following Big 10Y Moves**




*Source: MarketDesk Research, U.S. Treasury.* ***Note*** *: Analysis compares S&P 500 returns against Russell 2000 returns.*

## Large Caps Historically Outperform After the 10Y Yield Surges Higher …

● The 10Y Treasury yield's surge over the past 12 months represented a +1.2std event (refer to Fig 27). The outsized move pointed to a significant sentiment and positioning shift ahead of the reopening. However, markets tend to overshoot, and prior moves have represented sentiment extremes with important performance implications.

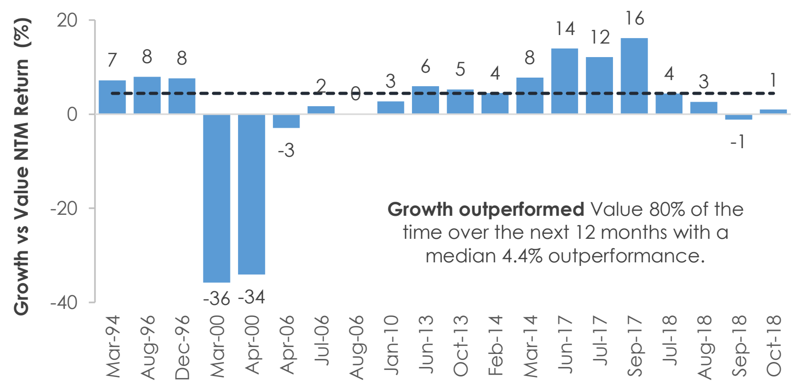
● Small caps surged during the recovery, but history points to large cap outperformance ahead. Figure 14 shows the next 12-month large vs small performance gap after prior +1.2std moves on the 10Y yield. Large caps biggest underperformance occurred around the dot-com bubble and January 2010 (i.e., early in the post-2008 bull market cycle).

# Factor Tilts — Growth & Dividends/Buybacks

► **Upgrade Growth to OW; Downgrade Value to Neutral:** This upgrade should be considered a 'slight OW' rather than a normal OW as recent market noise and a lack of investable signals are clouding the outlook. The key question is whether investors will rotate back to the reflation trade. We are relying on statistics, which favor Growth over the next 12 months.

► **Tactically Emphasize Dividend & Buyback Factor within Large Caps:** Corporate cash balances sit near a record high, and we expect returning capital to shareholders will be a significant theme over the next 12 months. *Dividend & Buyback Factor*: DIVB. (Note: Invesco's PKW only focuses on buybacks and ignores dividends, which results in higher Financials and lower Tech sector exposure.)

**Figure 15: Growth vs Value Performance Following Big 10Y Moves**

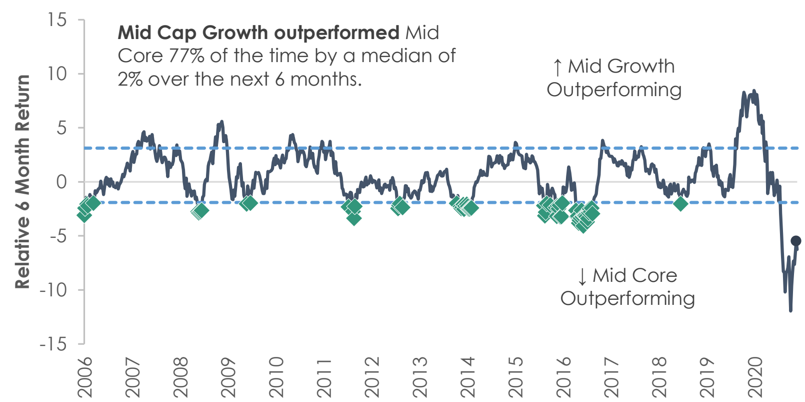



*Source: MarketDesk Research*

## Growth Stocks Historically Outperform After the 10Y Yield Surges Higher …

- Figure 15 is the same analysis as Figure 14 but focuses on Growth vs Value. Growth historically outperforms Value 80% of the time after the 10Y yield experiences a +1.2std move (refer to Fig 27).
- Similar to Large vs Small, we are answering Growth vs Value by using the 10Y yield's surge to highlight extreme sentiment. Value already prices in a robust recovery, and statistics indicate it is time to pull gains off the table. As an additional catalyst, we view a Growth OW as a tactical opportunity to protect against market uncertainty and an overheated market.

**Figure 16: Favor Mid-Cap Growth Over Mid-Cap Core** More Info →

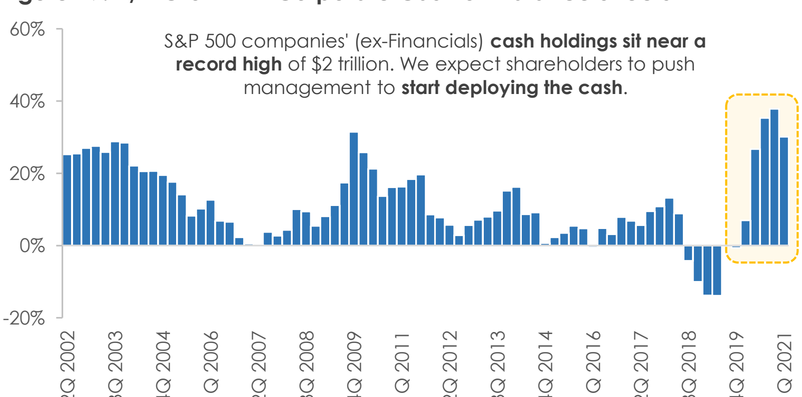



*Source: MarketDesk Research. **Note**: Analysis uses IJK and IJH as proxies.*

## Tactically Emphasize Mid-Cap Growth Over Mid-Cap Core …

- Figure 16 charts the rolling 6m performance gap between mid-cap growth and mid-cap core. Mid-cap growth significantly underperformed over the past 6 months, which we attribute to its technology OW and regional bank UW.
- With expectations for the reflation trade to lose steam, we favor tilting away from mid-cap core toward mid-cap growth. Figure 15 above indicates growth is expected to statistically outperform, and a stalling 10Y yield could weigh on mid-cap core's regional bank exposure. We view mid-cap growth as a tactical risk mitigation measure.

**Figure 17: Y/Y Growth in Corporate Cash on Balance Sheets**




*Source: MarketDesk Research*

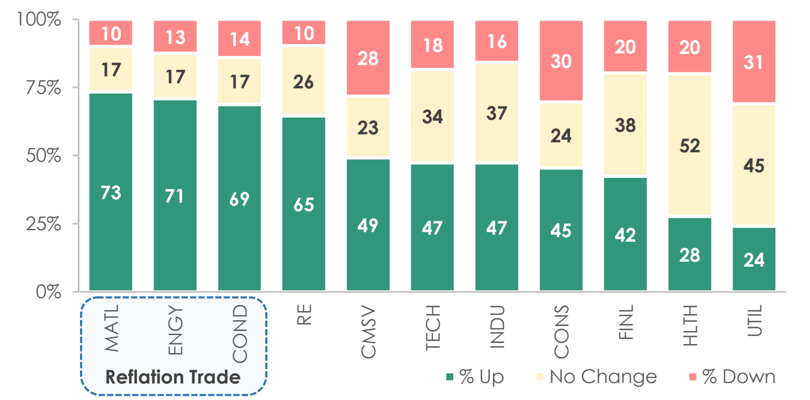
## Focus on Dividends and Buybacks as Companies Prepare to Return Capital …

- Figure 17 shows corporate cash balances grew significantly the last 12 months. We expect shareholders to push companies to return capital over the next 12 months. Refer to Figure 3 in the 6/18/21 *Strategy Snapshot* for further commentary.
- iShares' DIVB invests in companies that return capital through dividends and buybacks. DIVB's top three sector weights are: 24.5% Tech, 19.9% Financials, and 13.2% Health Care. DIVB's sector exposure resembles a hybrid growth/value approach, which helped DIVB outperform both the core and value S&P 500 ETFs YTD. With the hybrid sector exposure and capital return focus, we are initiating a 2.5% DIVB tactical tilt within large caps.

► **Earnings Revisions:** Analysts are revising reflationary sector EPS estimates higher. The increase comes as supply chain logjams disrupt supply, causing inflationary pressures to surge (refer to Figure 10 on page 7). The risk is analysts are too optimistic and 2H21 EPS disappoints. Over the coming weeks, 2Q21 EPS releases will provide much needed insight regarding the economic recovery.

► **Cyclicals vs Defensives:** In typical post-recession fashion, cyclical sectors significantly outperformed defensives over the past year. Statistics indicate now is the time to raise the risk antenna and dial back risk exposure. This is not to say the market cannot continue to trade higher and grow more extreme, because it can. It simply means the market is more vulnerable to unexpected shocks.

**Figure 18: Sector EPS Revisions Over Last Month**

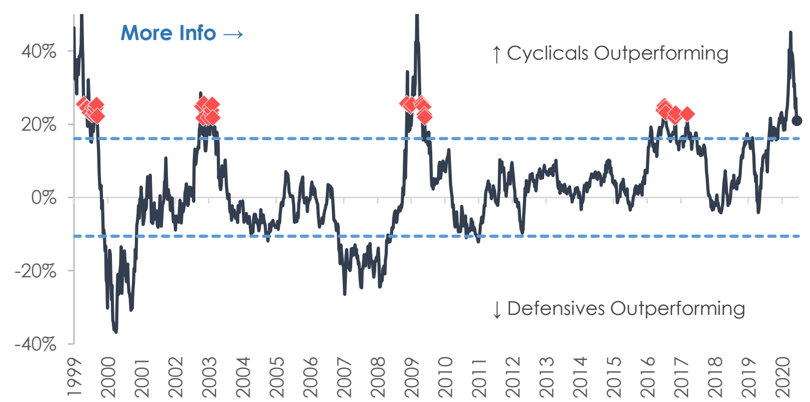



*Source: MarketDesk Research, Factset*

## Can EPS Gains During 2H21 Keep Pace with Strong Upward Revisions ...

- Figure 18 charts the most recent 1-month change in EPS revisions across sectors. Analysts continue to raise EPS estimates for the reflation trade. Materials, Energy, and Cons Disc saw the highest percentage of upward revisions, while Utilities and Health Care saw the fewest upward revisions.
- The risk is actual EPS during 2H21 miss analysts' optimistic estimates. As Figures 7 and 8 in the 4/23/21 *Strategy Snapshot* highlighted, EPS gains are an important performance driver during year 2 bull markets. EPS misses could hurt performance.

**Figure 19: Rolling Y/Y Performance — Cyclicals vs Defensives**

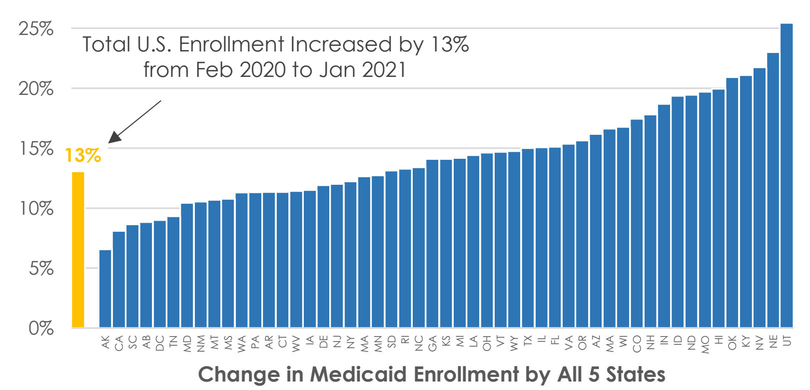



***Note**: Uses MSCI sector breakdown. Defensive: Health Care, Cons Stpls, Energy, Utilities. Cyclical: Tech, Cons Disc, Comm Svcs, Financials, Industrials, Real Estate, Materials.*

## History Indicates Now is the Time to Put Up the Risk Antenna and Be On Guard ...

- The market has covered a lot of ground since the pandemic's depth thanks to the combination of fiscal stimulus and easy monetary policy. However, stocks now price in a robust recovery and are increasingly vulnerable to unexpected shocks.
- Figure 19 charts the rolling y/y performance gap between cyclical and defensive sectors. Cyclicals outperformed defensives by 22% over the past 12 months, which represents a +1.4std event. Looking ahead, cyclicals only outperformed defensives 27% of the time from current levels. Click 'More Info' to see return statistics from prior +1.4std events.

**Figure 20: U.S. Medicaid Population Growth During Pandemic**




*Source: MarketDesk Research, Centers for Medicare and Medicaid Services*

## Closing Managed Care Position As States Re-evaluate Medicaid Eligibility ...

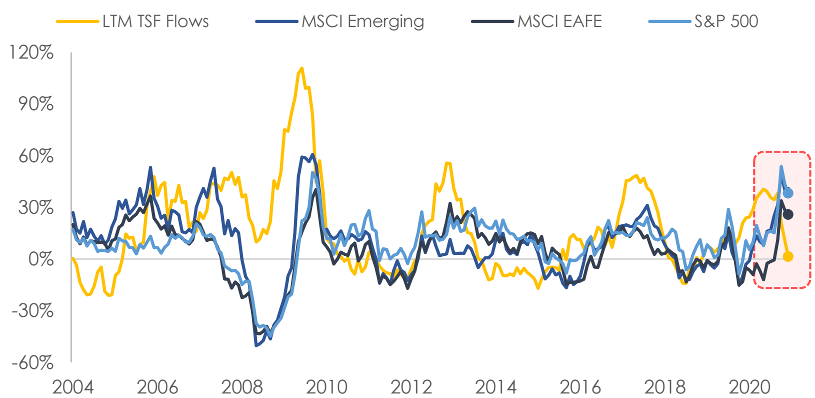
- Figure 20 charts each state's change in Medicaid population from Feb. 2020 through Jan. 2021. A record 1 in 4 Americans are covered by Medicaid after unemployment surged during the pandemic. The surging Medicaid population benefitted the managed care industry. Managed care is up 25.4% vs health care's 9.4% gain since we initiated a tactical position on 2/12/21.
- The next 12 months will be much more difficult for managed care as states redetermine Medicaid eligibility and remove individuals. With redeterminations ahead, we are exiting the managed care tactical position.

# Emerging Markets

► **Downgrade EM & International to Neutral; China is No Longer a Headwind; Downgrade EM Sovereign Debt to UW.** Three big themes are driving our EM positioning. (1) China's credit conditions tightened during 1H21 and now point to weaker forward EM, DM, and international returns. (2) Latin America is near-term overbought after commodities spiked during 2Q21 and is now setup for a mean reversion trade lower. (3) China is no longer a headwind and is now a risk mitigation opportunity after its dismal 1H21 performance. On the credit front, EM central banks are entering a tightening cycle, which we expect to weigh on EM Sovereign debt.

► **Actionable Ideas:** *China Tactical Tilt* : MCHI; Full tactical report coming 7/16; *Exit EM Dividend & Sovgn Debt* : DGS; VWOB

**Figure 21: China Total Social Financing vs FTSE Emerging Performance**



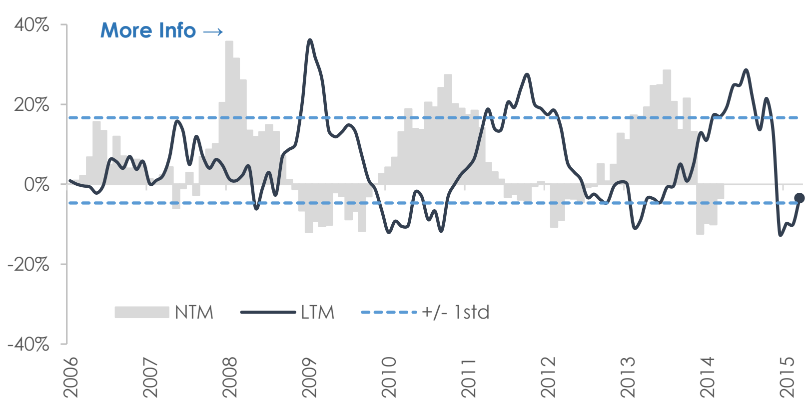

*Source: MarketDesk Research, People's Bank of China.* ***Note*** *: TSF is a proxy for China's liquidity and tracks loans to the private sector, including off-balance sheet financing.*

## China's Credit Cycle Peaked in 4Q20; Downgrade EM & Intl to Neutral …

- Before we launch into international, we want to highlight a noteworthy China chart. Figure 21 charts the y/y change in last 12-month China total social financing (TSF -- see notes for definition) against rolling 12-month S&P 500, EM, and DM returns. China's credit cycle clearly impacts equity returns.

- The U.S. fiscal spending surge and dovish Fed policy drove the reflation narrative. In contrast, China's credit tightening received little attention. We are downgrading both Intl and EM from OW to Neutral. DM is already rated Neutral.

**Figure 22: Rolling Y/Y Performance — China vs Emerging Markets**



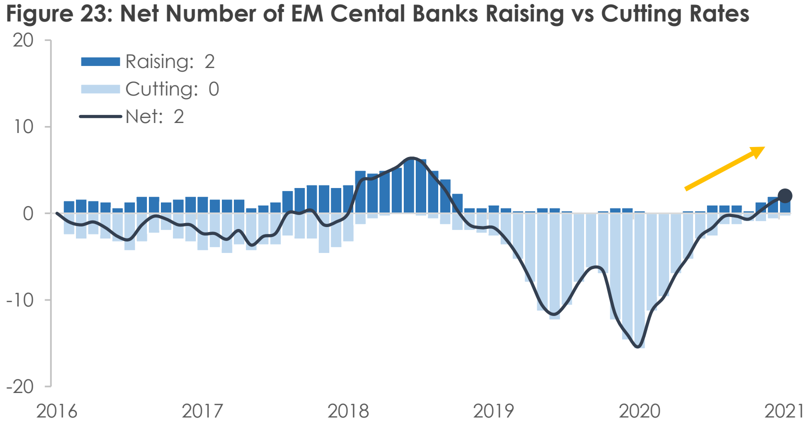

*Source: MarketDesk Research.* ***Note*** *: Analysis uses MCHI and VWO as proxies.*

## Initiate China Risk Mitigation Opportunity; Full Tactical Report Will be Published on 7/16 …

- In the *2Q21 AA Guide* , Figure 23 highlighted China as an EM headwind. We tactically tilted away from China during 2Q21 using the EM dividend factor, which boosted EM performance. DGS (+6.2%) outperformed both VWO (+4.3%) and MCHI (+0.9%) during 2Q21.

- Figure 21 charts the y/y performance gap between China and the broad EM index. The data suggests China is no longer a headwind for EM, and we are now adding a tactical, risk mitigation China tilt during 2H21 to replace DGS. Click 'More Info' to see return statistics from current levels.

**Figure 23: Net Number of EM Cental Banks Raising vs Cutting Rates**




*Source: MarketDesk Research, Various Central Banks.* ***Note*** *: Net represents the rolling 3-month average of net interest rate hikes among EM central banks.*

## Emerging Market Central Banks are Entering a Tightening Cycle …

- The EM easing cycle is coming to an end as more central banks raise rates to battle rising inflation. Higher interest rates point to lower bond prices. With more rate hikes expected, we are downgrading EM Sovereign debt from OW to UW.

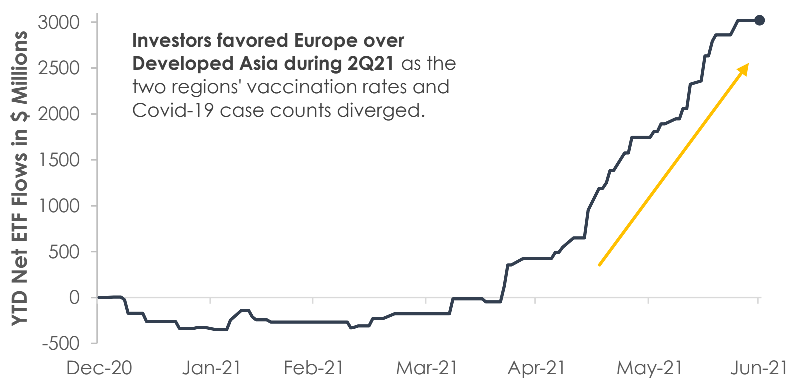
- Figure 22 compares the number of EM central banks raising vs cutting interest rates. A net number of EM central banks is raising rates for the first time since February 2019. The most recent EM tightening cycle occurred during 2018. Local currency (LEMB) and USD (EMB) denominated EM debt both traded more than 10% lower in 2018.

# Developed Markets

► **Maintain DM Neutral Rating; Focus on Regional Differences.** Our primary focus within DM is regional. Europe outpaced developed Asia (primarily Japan) YTD with both higher vaccinations and fewer Covid-19 case spikes. We expect the regional virus divergence to tighten in 2H21, which should benefit DM Asia performance over DM Europe. In addition, we continue to favor a tactical U.K. tilt despite the recent Covid-19 case surge. Removal of the Brexit overhang should strengthen the British Pound and benefit the U.K. economy as trading relationships are finalized.

► **Actionable Ideas:** *Maintain Tactical DM Asia Tilt* : VPL. *Maintain Tactical U.K. Equity Tilt* : EWU or EWUS.

**Figure 24: YTD Net ETF Flows — DM Europe vs DM Asia**



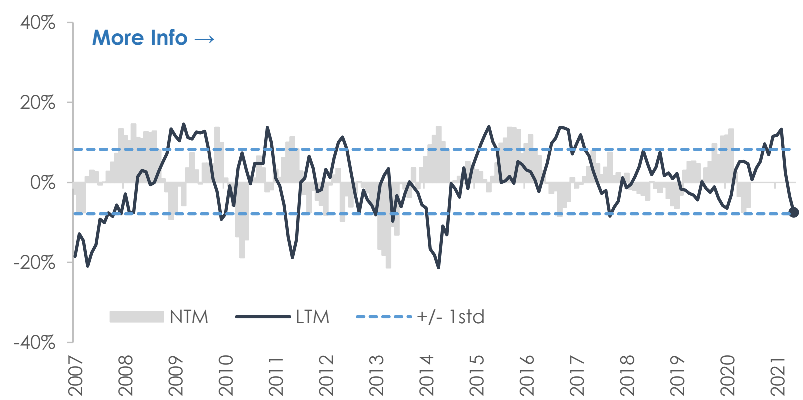

*Source: MarketDesk Research.* ***Note*** *: Analysis uses VPL and VGK as proxies.*

## Developed Market ETF Flows Favored Europe Over Asia During 2Q21 …

- Regional Covid-19 divergences drove DM ETF flows during 2Q21. Figure 24 charts the YTD net difference in ETF flows between DM Europe and DM Asia. DM Europe's YTD flows are a net $3 billion higher than DM Asia.

- Europe's vaccine program gained momentum during 2Q21, while Japan's vaccine program lagged and Covid-19 cases spiked. Performance followed, with DM Europe returning 6.8% during 2Q21 vs DM Asia's 0.8% return. Refer to Figure 25 below for our tactical position taking advantage of the regional divergence.

**Figure 25: Rolling Y/Y Performance — DM Asia vs DM Europe**



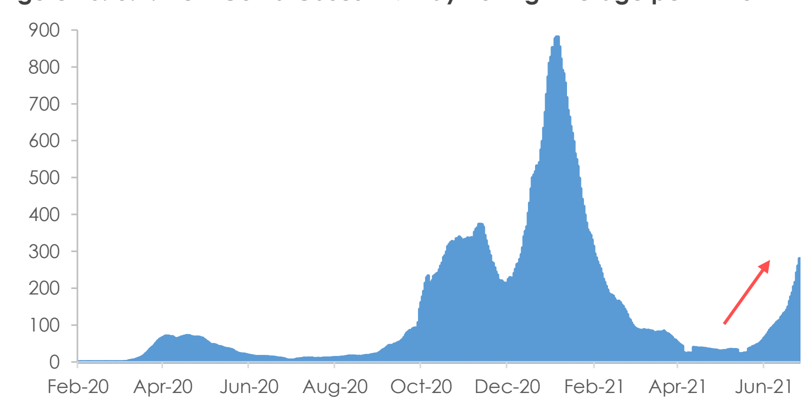

*Source: MarketDesk Research.* ***Note*** *: Analysis uses VPL and VGK as proxies.*

## Remain Tactically Tilted Toward Asia in Developed Markets …

- We continue to favor a tactical DM Asia position as Japan's vaccination program closes the gap vs Europe. Refer to the 6/11/21 tactical opportunity report for the full position writeup.

- Figure 26 charts the rolling y/y performance gap between DM Asia and DM Europe. The two regions are historically highly correlated but traded in opposite directions over the past 12 months. DM Asia historically outperforms DM Europe nearly 80% of the time from current levels. We view DM Asia as a risk mitigation opportunity within DM. Click 'More Info' to see return statistics from current levels.

**Figure 26: U.K. New Covid Cases — 7 Day Rolling Average per Million**




*Source: MarketDesk Research, Our World in Data.* ***Note*** *: Represents the 7-day rolling average of new confirmed cases.*

## U.K. Stocks Selloff After Delta Variant Emerges; Maintain Tactical U.K. Position …

- Figure 25 charts the 7-day rolling average of new confirmed U.K. Covid cases per million individuals. After falling in early 2021, U.K. cases spiked in June 2021 as the Delta variant emerged. British PM Johnson responded by pushing back the reopening from June 21 to July 19.

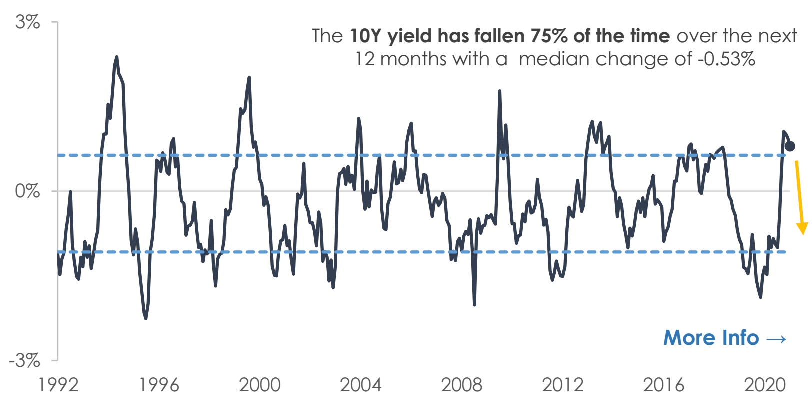
- U.K. equities sold off and the British pound weakened against USD as cases spiked. We view the recent selloff as a buying opportunity and continue to prefer U.K. small caps (EWUS). Refer to the 2/26/21 tactical opportunity report for the full position writeup.

# Credit Duration — Long vs Short

► **Extend Duration.** As we highlighted in the *2Q21 AA Guide* and the 6/15/21 *QuickTake*, we favor extending duration. We do not believe risk appetite will increase significantly enough to push the 10Y yield materially higher. The economy is already strong, and we expect economic activity to decelerate in the months ahead (refer to page 7). In addition, stock markets already trade near record highs and price in a strong recovery (refer to Fig 12). Our base case is the 10Y yield remains range bound during 2H21 with an upper boundary around 1.75%. Our target duration mixture is 60% mid / 40% long, up slightly from 75% mid / 25% long in the *2Q21 AA Guide*.

► **Actionable Ideas:** *Mid-Duration Corp*: IGIB, SPIB, VCIT. *Long-Duration Corp*: IGLB, SPLB, VCLT

**Figure 27: Rolling Y/Y Change in the 10Y Treasury Yield**



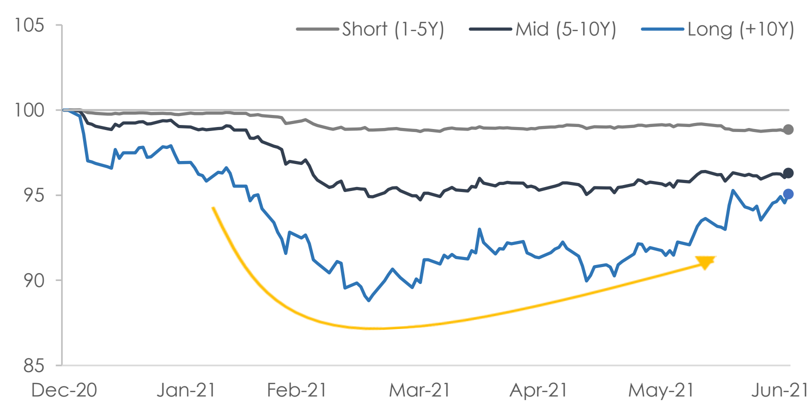

*Source: MarketDesk Research, Federal Reserve*

## History Indicates the 10Y Treasury Yield Will Struggle to Move Higher …

● The 10Y Treasury yield has been on a roller coaster ride since the pandemic started. Figure 27 tracks the y/y rolling change in the 10Y yield. The 10Y yield initially plunged early in the pandemic as the Fed cut interest rates and investors rushed toward bonds. More recently, the 10Y yield spiked during 1Q21 in anticipation of a stronger economy.

● The 10Y yield's y/y change was a +1.2std event. History indicates the 10Y yield has a high probability of trading range bound and could move lower. Click 'More Info' to see statistics regarding the 10Y yield's next 12-month move from current levels.

**Figure 28: YTD Credit Market Performance by Duration**



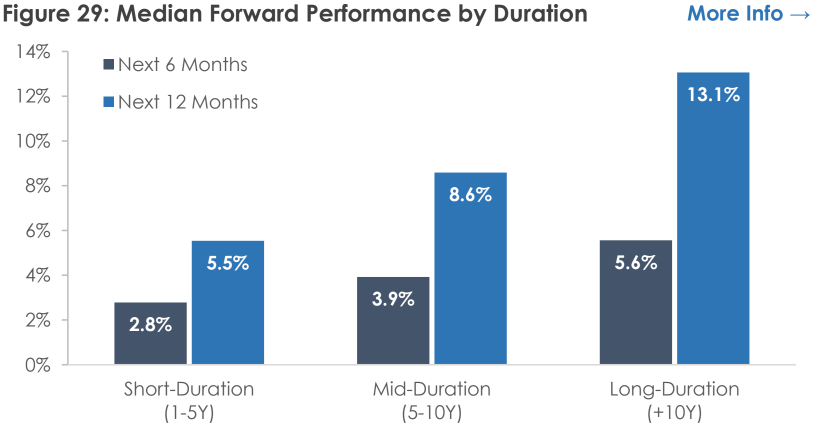

*Source: MarketDesk Research*

## Long-Duration Bonds Rallied During 2Q21 as the Yield Curve Flattened …

● The statistics from Figure 27 are already playing out. The 10Y yield defied market consensus and moved lower during 2Q21. Refer to the 6/15/21 *QuickTake* for a case study on how we used statistics in the *2Q21 AA Guide* to call the 10Y yield's reversal.

● Figure 28 tracks YTD credit performance by duration. Long-duration bonds underperformed during 1Q21 as the yield curve steepened but outperformed during 2Q21 as the yield curve flattened. The 10Y yield's 2Q21 decline transformed duration from a headwind into a tailwind.

**Figure 29: Median Forward Performance by Duration** More Info →




*Source: MarketDesk Research*

## Continue to Tactically Tilt Toward Long-Duration Bonds in 3Q21 …

● History indicates long-duration bonds are set to continue outperforming. Figure 29 shows the median next 6-month and 12-month total returns by duration after the 10Y yield experiences a +1.2std event. Click 'More Info' to see return statistics.

● The primary risk to long-duration's continued outperformance is the Fed hiking rates and the entire yield curve shifting higher. We currently view this as a low probability event in 2H21, because the Fed is in sync with the Biden administration and focused on labor growth. In addition, the Fed is now more willing to overshoot its inflation target.

# Credit Quality

► **Maintain High Yield OW but Expect Limited Outperformance.** Corp HY bonds benefited from their lower relative duration and HY-IG spread compression during the recovery. Despite spreads sitting at record lows, HY's higher yield and favorable credit conditions can support HY's continued outperformance vs IG during 2H21. However, history indicates the outperformance will be limited, and HY vs IG weighting will transition to a quarter-by-quarter decision moving forward. For those not already OW HY, we do not favor initiating a HY OW. Our preferred tactical tilt within HY continues to be fallen angels.

► **Actionable Ideas:** *Fallen Angels* : FALN, ANGL. *Broad HY* : USHY, SPHY, HYLB.

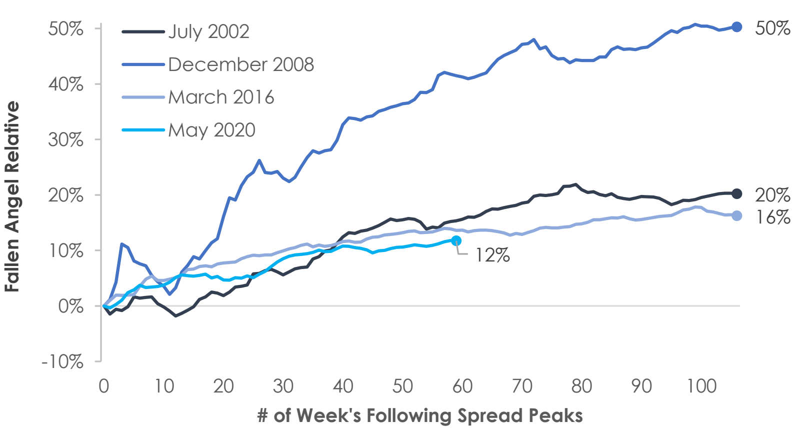
**Figure 30: Credit Quality — YTW Spread of HY vs IG** More Info →


*Source: MarketDesk Research*

**Figure 31: HY vs IG — Rolling Y/Y Performance** More Info →


*Source: MarketDesk Research*

**Figure 32: Fallen Angels Outperformance Over BB Corp Bonds**




*Source: MarketDesk Research*

## History Points to a 95% Probability the HY-IG Spread Widens Over the Next Year …

● Investors are aggressively pricing credit risk. With the HY-IG spread sitting near a record low, history indicates the only obvious way forward is widening spreads.

● Figure 30 tracks the yield to worst (YTW) spread between corp HY and corp IG bonds. The HY-IG YTW spread currently sits at 1.8%, which is traditionally reflective of late credit cycle dynamics. Click 'More Info' to see historical HY-IG spread movement over the next 6-month and 12-month periods from current levels.

## … but a 100% Probability HY Continues to Outperform IG

● History indicates HY can continue to outperform IG even though there is a high statistical probability the HY-IG spread widens over the next 12-months. HY's higher yield, in this case 1.8%, helps offset capital losses as the HY-IG spread widens.

● Figure 31 charts the rolling y/y performance gap between corp HY and corp IG bonds. HY's outperformance over the last 12 months was a +1.3std event. Click 'More Info' to see forward return statistics from current levels. HY outperformed over the next 12 months 100% of the prior 6 times. A word of caution is warranted though, as relative outperformance is limited.

## Remain Tactically Overweight Fallen Angels within HY to Capture Upgrades …

● The pandemic's 'fallen angels' are ready to become the recovery's 'rising stars'. Upgrading fallen angels from HY back to IG offers additional return potential as the bonds reprice higher. The current recovery is lagging prior cycles, but history suggests fallen angels can continue to outperform.

● Figure 32 charts the cumulative total return gap between fallen angels and the broad BB index after the spread between the two peaked in the 2002, 2008, 2016, and 2020 credit cycles. Fallen angels historically outperform the broad BB index on a total return basis over the following two years.

# MarketDesk Research

### MDR Website

www.MarketDeskResearch.com

### Sales Team

+1 (646) 787-0394

Sales@MarketDeskResearch.com

### Client Support

+1 (646) 787-0394

Support@MarketDeskResearch.com

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