March Research Summary

MarketDesk Research

Monthly Digest

March 5, 2021

Reflationary Trade Drives Market in February

Cyclical Sectors Outperform; Duration Hurts Bonds

Financial markets are in the midst of a big reflationary trade. Economic forecasts are firming, central banks remain accommodative, and the Biden administration is pushing a massive fiscal stimulus package. Inflation expectations are rising, causing the Treasury yield curve to steepen. The market is convinced 2021 will be a big economic recovery, and we are inclined to agree. The question is how strong and durable the recovery can grow. As with most market narratives, we believe investors are overly optimistic on the actual long-term outcome. As an example, we believe the market is misreading the inflationary environment by projecting sustained inflation. However, that does not mean the market will become rational in the near-term. Our base case is the market narrative remains 'reflationary', but volatile, deep into 2021. Cyclical sectors will likely benefit from a stronger economy, as will factors with underlying cyclical sector exposure. While we are looking for opportunities to increase portfolio cyclicality, the reflationary trade is likely overbought in the near-term after February's rally.

The battle in the credit markets is noteworthy. Central banks are holding down the short end of the yield curve. In contrast, investors are pricing in higher inflation, a global trade rebound, and strong economic activity on the long end. The result is steeper yield curves across the globe. We expect curve steepening to remain a dominant credit theme in 2021 but would caution bonds are at risk of being near-term oversold after February's big move. In our view, the potential for further curve steepening makes duration a bigger risk than credit quality. Spread tightening remains a catalyst in specific credit segments, mainly CMBS and Municipals, but is worn out and less realistic in others, such as corporate bonds. The biggest risk continues to be central banks prematurely remove support as the economy reopens and inflation picks up. However, we view premature central bank action as low probability.

USD and international equity valuations continue to drive our international views. USD trended weaker during 2H20 but started 2021 trading sideways, which we attribute to U.S. yield curve steepening and an improving economic outlook. We expect USD to resume weakening but believe calls for significant USD weakness are premature given the potential for rising U.S. real yields. From a valuation perspective, international equities continue to trade at a valuation discount vs the U.S., with U.S. Tech's stretched valuations raising the risk of U.S. equity underperformance. Due to our expectations for marginal USD weakening and less expensive valuations, we upgraded international to OW and downgraded U.S. equities to neutral. We continue to prefer Emerging but favor tactically lowering China exposure due to mean reversion risk after China's strong 2020 performance. Developed can also outperform U.S. equities in our view, but Europe's underwhelming vaccination efforts could weigh the group down in the near-term. At the country level, we expect 2020's underperforming countries, such as the U.K., to outperform and vice versa.

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Themes Driving the Market

1. Improving COVID-19 Trends
2. Fed & Biden Stimulus Plans
3. Mean Reversion from 2020

Key Opportunities

1. Sector / Country Catch-Up Trade
2. Corp. Operating Leverage
3. Pent-Up Demand

Key Risks

1. Pockets of Irrational Sentiment
2. Uneven Vaccine Distribution
3. Duration in Credit Market

Research Portal →

This Month's Reports

Date	Type	Report	Title	Link
Mar-5	Core	Sector Insights	Reflationary Trade Drives Market; Upgrade Materials to N & Downgrade Real Estate to UW	View Report →
Mar-5	Core	Factor Views	Downgrade Low Volatility from Overweight to Neutral	View Report →
Mar-5	Core	Credit Strategist	Duration Remains a Headwind; No Rating Changes	View Report →
Mar-5	Core	International	Upgrade International to OW, Downgrade U.S. to Neutral, & Maintain EM Preference	View Report →
Feb-26	Tactical	Tradebook	Summary of all open positions with catalysts and performance updates	View Report →
Feb-26	Tactical	Tactical Ideas	Rotating From EU Small Caps to U.K. Small Caps	View Report →
Feb-19	Core	Economic Monitor	Retail Sales & Industrial Production Beat; Nonfarm Payrolls Miss with Prior Revised Lower	View Report →
Feb-19	Core	Strategy Snapshot	Exploring Ways to Lower Duration with Mortgage-Backed Securities	View Report →
Feb-12	Tactical	Tactical Ideas	Managed Care Industry	View 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 weight ranges 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 a rationale and relevant report links.

Portfolio Allocation	Weight	ETF	Rationale & Full Report Link	
U.S. Equity — Large Cap				
S&P 500	15-19%	VOO	*Broad Exposure*	
High Beta Factor *	2-3%	SPHB	Reflationary exposure (e.g., Financials, Energy); High Beta factor = COVID impacted companies	View Report →
Growth Factor	2-3%	IWF	Quality companies with strong fundamentals; Added benefit of 'safe haven' Tech	
Managed Care	1-2%	IHF	Biden administration support via regulatory actions after Trump administration sought to dismantle	View Report →
Industrial Sector	1-2%	XLI	Manufacturing rebound & potential for sector operating leverage; Value tilt & mean reversion trade	View Report →
Large Cap Total	**25.0%**			
U.S. Equity — Mid/Small Cap				
S&P 400 Mid Caps	4-5%	IVOO	*Broad Exposure*	
S&P 600 Small Caps	4.0%	IJR	Mean reversion vs Large Cap tech; More cyclical sector exposure; Emphasize quality via S&P 600	View Report →
Property & Casualty Insurance	0.5-1%	KIE	Commercial policy premium rate increases; Yield curve steepening	View Report →
Transportation *	0.5-1%	XTN	Stressed logistics networks support higher freight costs; Broad inventory restocking as economy reopens	View Report →
Mid / Small Cap Total	**10.0%**			
International Equity — Developed				
MSCI EAFE	8-10%	EFA	*Broad Exposure*	
U.K. Country ETF	2-3%	EWUS	Top 3 vaccination program in world; British Pound strengthening; Trades at valuation discount vs EU	View Report →
Hong Kong ETF	1-2%	EWH	Trade normalization after Trump administration trade war with China weakened economy	View Report →
Developed Total	**13.0%**			
International Equity — Emerging & Frontier				
MSCI Emerging Markets	2-4.5%	EEM	*Broad Exposure*	View Report →
Dividend Factor	2-4%	DGS	Income emphasis with lower China exposure (e.g., China's strong 2020 returns = mean reversion risk)	View Report →
Vietnam Country ETF	0.5-1%	VNM	Benefits from supply chain diversification outside of China	View Report →
Emerging Total	**7.0%**			
Credit				
Investment Grade	19.5-20.5%	USIG	Tactically favor shorter duration corporate IG debt as interest rates rise	
High Yield	10.5%	USHY	*Broad Exposure*	
EM Sovereign	2.5%	EMLC	Tactically favor local currency over USD denominated due to USD weakening catalyst	
Municipals	3.0%	VTEB	*Broad Exposure*	
MBS	2-3%	MBB	Short duration alt. to replace portion of high duration IG; Fed asset purchases support MBS demand	View Report →
TIPS	1.5%	TIP	*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%**			

* - These tactical positions were published in 2H20 and are at risk of being near-term overbought after February's reflationary rally.

Current MDR Core Ratings

Long-term View & Rationale

▲ Upgrades This Month

- Materials to Neutral – See page 23 in Sector Insights
- International to OW – See page 1 in International Markets

▼ Downgrades This Month

- Real Estate to UW – See page 27 in Sector Insights
- Momentum to Neutral – See page 10 in Factor Views

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

Asset Class	Allocation View				Rationale
	Chg.	UW	N	OW	
U.S. Equities					
U.S. Large Caps		•	●	•	Stronger fundamentals than Smalls, but Big Tech OW is a risk; Potential to underperform in reopening trade
U.S. Mid Caps		•	●	•	Cheapest on NTM P/E basis; Nice mix of small-caps' higher growth & large-caps' business model stability
U.S. Small Caps		•	•	●	More cyclically exposed = Benefits from COVID-19 vaccine & fiscal stimulus; Emphasize quality via S&P 600
International Equities					
Broad International	▲	•	•	●	Expectations for continued USD weakening benefits international equities; Potential for Tech to weigh on U.S. equities
Emerging		•	•	●	Benefits from global stimulus, strong mfg. rebound, & USD weakening; China is a potential headwind
Developed		•	●	•	Central banks responded more aggressively with stimulus; EU's vaccine troubles = Potential index headwind
Fixed Income					
High Yield		•	•	●	OW conviction shrinking with junk bond yields at record lows & spread tightening fading; Downgrade Watch
Emerging Sovereign		•	•	●	Attractive spread vs 10Y Trsy; Strong global central bank stimulus measures; USD weakness = Potential catalyst
Quality (IG vs HY)		•	●	•	Favor HY over IG due to HY's shorter duration; Credit risk elevated but Fed supporting credit market
U.S. Treasuries		•	●	•	Favor shortening duration due to interest rates sitting near historic low & potential upward pressure on rates
Investment Grade		•	●	•	Increasing duration remains key risk in IG bonds; Limited potential for addtl spread tightening
Municipals		•	●	•	Stressed state & local budgets raise default risk; Democratic control of Congress positive for state & local stimulus
MBS		•	●	•	Fed's purchases support MBS demand; Low duration alternative to U.S. Trsy & IG; Negative convexity creates risk
TIPs		●	•	•	Biden fiscal stimulus = rising expectations; Potential for demand to overwhelm supply & create inflationary pressure
Duration		●	•	•	Expect more of credit's return to come from yield than duration; Interest rates not likely to move in 2021
U.S. Sectors					
Communication Services		•	•	●	Lower conviction OW due to: (1) increasing antitrust risk for social media companies and (2) a lack of depth
Technology		•	•	●	Expensive valuations are a headwind, but Tech is essential to businesses and leveraged to secular trends
Industrials		•	•	●	Low interest rates & less confrontational Biden trade agenda could spur fixed capital investment & mfg. rebound
Consumer Discretionary		•	●	•	Benefits from vaccine rollout; Higher savings rate & more fiscal stimulus positive, but unemployment negative
Health Care		•	●	•	Potential Medicaid rate cuts & Biden admin push for price controls = headwinds; Defensive industry
Utilities		•	●	•	Attractive dividend yield; Prefer Utilities over Cons Staples if looking for a defensive play
Financials		•	●	•	Vaccine distro, resilient earnings, yield curve steepening, & more stimulus could lead to 2021 reserve releases
Materials	▲	•	●	•	Ability to raise prices if production costs increase; Stimulus could lead to inflation & sector provides hedge
Energy		●	•	•	Expect oil demand to gradually recover but remain volatile; Asset write-downs are still a material risk
Cons Staples		●	•	•	Margins expanded in pandemic, but low beta likely to underperform in rally; Less time at home = headwind
U.S. Equity Factors					
Growth		•	•	●	We continue to OW Growth despite stretched valuations due to its superior operating metrics
High Beta		•	•	●	Reflationary exposure to Energy & Financials; Current holdings = COVID impacted equities; Refer to 12/11/20 Friday Strategist
Momentum	▼	•	●	•	Remains leveraged to Large Cap Tech and secular trends; Watch for trend change in reopening
Low Volatility		•	●	•	Other suitable alternatives, such as Growth & Tech, provide downside protection with superior fundamentals
Quality		•	●	•	Similar exposure to S&P 500 means not making an active sector bet; Use in place of broad market exposure
Value		•	●	•	Low valuations provide a buffer late cycle, but Value ETFs do not provide good "Value" exposure
Alternatives					
REITs	▼	●	•	•	Faces post-pandemic demand & rent uncertainty; Risk of properties hitting market if owners default
Commodities		•	●	•	USD weakening, rising inflation expectations and rebounding global growth all positives

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.

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