Notes from the Trading Desk - July 12, 2021

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by Benjamin “Ben” G. Carew, CFA

MARKET MOVERS & SHAKERS

U.S. equities are off to a steady start in the third quarter, despite a little bit of chop in the middle of last week. The Dow, S&P 500 and Nasdaq are all up more than 1% so far for the month of July. Small cap stocks, as measured by the Russell 2000, have been a little less well received so far. The Russell 2000 was down 1.12% last week and is down 1.32% for the quarter. The most notable trend quarter-to-date has certainly been the rally in the bond market. In fact, the Barclays U.S. Treasury 20+ year index, which measures Treasury bonds that mature in 20+ years, is up 1.62% so far this quarter. That is more than the Nasdaq, the Dow, and the Russell Midcap. Only the S&P 500 is currently outpacing long-dated treasuries. The move in the bond market has been driven by the quick decline in yields. The U.S. 10-year Treasury yield has fallen 20 bps over the last five trading sessions. REITs, Utilities, and Tech have all been clear beneficiaries from the drop in yields. Consumer Discretionary also performed well last week thanks to Amazon, which had traded between $3,000 and $3,500 since last summer. It finally broke out of that range. Elsewhere, gold has rallied for much of the month – up 2.1%.

There is an interesting mix to sentiment that we have not really seen since the start of COVID. In the February 18th, 2020 edition of Notes, we made the following observation:

Money is rushing into growth and defensive names rather indiscriminately. According to the American Association of Individual Investors, cash allocations have only been lower three times, which were all met with 20+% declines – just prior to the top in early 2018, the height *of the Tech Bubble at the turn of the century and just prior to the Russian Ruble Crisis in 1998. Current cash allocations would indicate a euphoric market that is getting ahead of itself. Cash allocations have been this low three other times in the last 30 years and all have been met with ~20+% declines.*

Very similar statements could be made today. Defensive corners like Utilities and REITs are beginning to outperform the market, coinciding with a surge in Tech and other growth names. We saw similar moves going into the February 2020 market peak, as well as prior to the selloff in Q4 of 2018 – even the selloff at the start of 2016 saw similar market leaders to that which we are currently seeing. Meanwhile, cash allocations have fallen precipitously and are now only surpassed by the period prior to the Russian Ruble Crisis, the bursting of the Tech Bubble, Volmageddon in 2018, and the COVID top in 2020. Again, each of those periods were eventually met with a ~20+% decline in the S&P 500. This time could certainly be different, but the similarities are worth noting, nonetheless.

The major banks are kicking off the start of earnings season this week. Over the course of the next four weeks, 423 names in the S&P 500 are expected to report Q2 results. According to FactSet, analysts are currently expecting earnings to grow 64% on a year over year basis – an impressive number to be sure. However, what is perhaps even more remarkable is the acceleration in estimates so far. At the start of the year, analysts had Q2 EPS pinned around $40. It has since risen to closer to $45. Clearly, the economy is continuing to recover at a rate more quickly than the general consensus previously anticipated. However, it is also necessary to put some of this into perspective. The $45 EPS estimate for the S&P 500 in Q2 of 2021 is still below what analysts were originally anticipating before COVID for the quarter. The 64% growth rate is also somewhat misleading because it is comping against Q2 2020 which was the worst quarter for businesses last year as it was the peak of COVID-related shutdowns. A much better gauge would be to compare the past quarter's results to that of 2019. Comparing Q2 2021 estimates to that of Q2 2019 results in a growth rate closer to 10% — which is well below the 2-year average growth for the S&P 500 for the past 15-20 years.

TRANSITION UPDATES & NEWS **

Earnings are not only about to pick up for the broader index, but a number of Tandem names are reporting over the next few weeks as well. The first two weeks of a quarter always feel like the calm before the storm. There is never a ton of news during this period. However, last week did seem to buck this trend a little. First, Dollar General announced their plans to expand its healthcare offering. They are increasing the number of healthcare related products they sell in their stores. News was not so sweet for Microsoft, which saw the U.S. Department of Defense cancel their $10b JEDI contract that was awarded to the company under President Trump. Last, but certainly not least, JM Smucker announced a 10% increase in their quarterly dividend payable September 1st.

***The transition update describes activity taken by Tandem on the transition level, not the composite or firm-wide level. The transition update is applicable to new accounts and new money. New accounts and new money are not automatically invested on the first day. Rather, they are transitioned into our strategy over a longer time period that is dependent upon market conditions. This update describes that transition.*

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