July 30, 2021

"The curve is more powerful than the sword."

– Mae West

Dear Client,

The recovery and reflation trade persisted for most of the second quarter. Commodities were up 15.2% from April to June. Equity markets were also strong. The S&P 500 was up 8.4% and the MSCI All-Country World Index was up 7.1%. In an unusual twist, "risk-off" asset classes similarly performed well. Gold was up 3.5% and long-dated US Treasury bonds were up 7.0%.[1]

Grey Owl's All-Weather strategy increased 1.7% for the quarter bringing the total return for the first half of year to 8.7%. In comparison, a 60/40 benchmark was up 6.7% from January through June.[2] Returning 5.0% in the second quarter, the global 60/40 benchmark played catchup to our strategy beginning in mid-May when bonds began a multi-month rally (we are underweight bonds) and especially in June when small capitalization value stocks meaningfully underperformed larger capitalization and growth-oriented equities (we had been overweight small value).

End of the Recovery and Reflation Trade?

While the full quarter was positive for financial assets of just about every sort, the riskiest of assets began to underperform in early June: The S&P 500 was up 2.3% for the month and the Russell 2000 Value index was down 2.6%.[3] This separation has persisted through July with the

[1] We refer to US equities, long-dated US Treasury bonds, gold, and commodities as "primary" asset classes borrowing the language of HCWE & Company. The idea is that these four assets best capture two variables that explain a significant amount of asset price movement: global growth (explained by investor risk sentiment) and inflation. This framework is the basis for a permanent portfolio, an "all-weather" portfolio, risk-parity, etc. US equities and commodities are "risk" assets, while US Treasury bonds and gold are "haven" assets. The market (or asset class) returns are measured on a total return basis using index exchange traded funds (ETFs): SPY for the S&P 500, ACWI for the MSCI All-Country World Index, GSG for the S&P GSCI Commodity Index, TLT for 20+ Year Treasury Bond index (i.e. "long-dated" US Treasury bonds), and GLD for gold.

[2] The Grey Owl All-Weather strategy performance is taken from an individual representative account. The 60/40 benchmark is 60% ACWI and 40% AGG for the iShares Core U.S. Aggregate Bond ETF.

[3] S&P 500 measured by SPY ETF and Russell 2000 Value measured by IWN ETF.

S&P 500 up 2.6% for the month through July 27th, while the Russell 2000 Value index is down 4.7%.

Observers point to several factors including the rise of the Covid-19 “Delta variant” in the United Kingdom starting in early June.

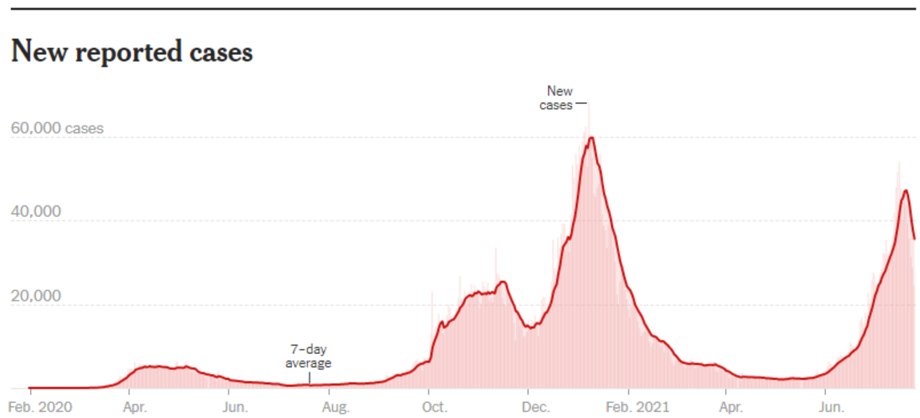

Figure 1 - United Kingdom Covid-19 Cases; [NY Times]

Notice that cases appear to have peaked in mid-to-late July. Importantly, the ratio of hospitalizations and deaths to cases is much lower than in the past – a hopeful sign that vaccines and improved treatment protocols are protecting the population from the worst outcomes. None-the-less, the United States Covid-19 case count began to climb again in mid-June, apparently following the United Kingdom on a slight lag.

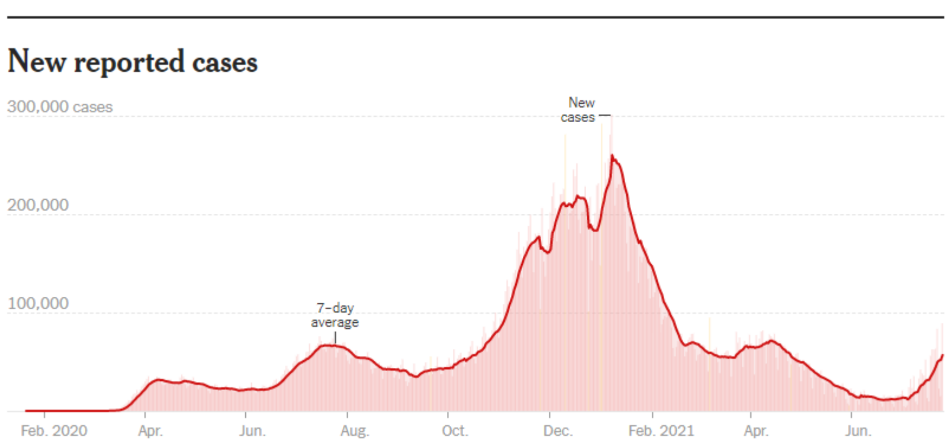

Figure 2 - Unites States Covid-19 Cases; [NY Times]

Stocks tied to economic reopening have fared particularly poorly since the beginning of June. For example, the JETS ETF, a composite of global airlines and travel companies, fell from a June 2nd high of 27.26 to a July 19th low of 21.57 – a drop of 21% in approximately a month and a half.

Figure 3 - JETS ETF Daily Price; [TradingView]

While the "Covid-narrative" is an easy story to follow, there seems to be more going on under the surface. For example, the yield curve began flattening in early April and has continued to flatten at a steady pace since. The start of this trend preceded the Covid case increases by several months.

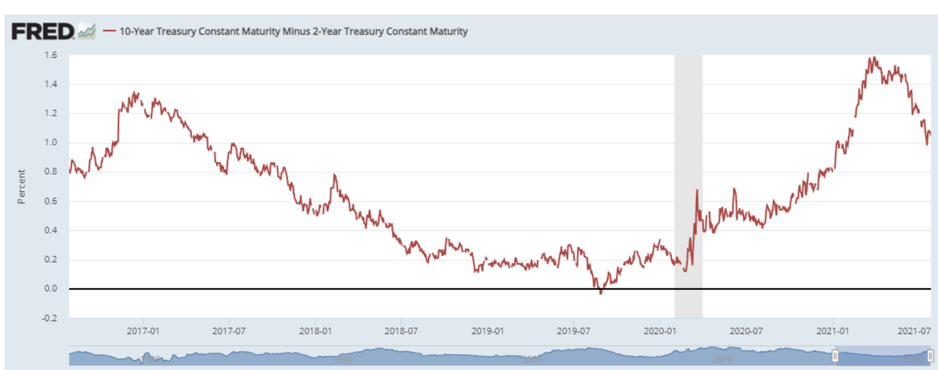

Figure 4 - 10s/2s Treasury Yield Curve; [St. Louis Fed FRED]

As the yield curve has a solid historical track record of predicting economic slowdowns and recessions, many algorithmic investment strategies take this into account. These strategies then sell value to buy growth, sell small capitalization to buy large capitalization, and sell cyclicals to buy defensive equity sectors. Some of the underperformance from the travel and other "reopening" industries equities may relate as much to the yield curve as to the Covid case count.

Further, market internals have weakened across multiple measures. This too predates the Covid case increases. Why are market internals important? Before turning negative, markets typically display increasing selectivity, so these indicators are helpful signals that investors broadly are reconsidering risks. The percentage of stocks above longer term moving averages is one example of a market internal indicator. The decreasing percent of New York Stock Exchange issues above their 200-day moving average shows a market growing more selective.

Figure 5 - Percent of NYSE Stocks Above 200dma; TradingView

Finally, we can look at the spread between the highest quality bonds and those at the bottom of investment grade. Those spreads have increased, but very modestly, since May of this year.

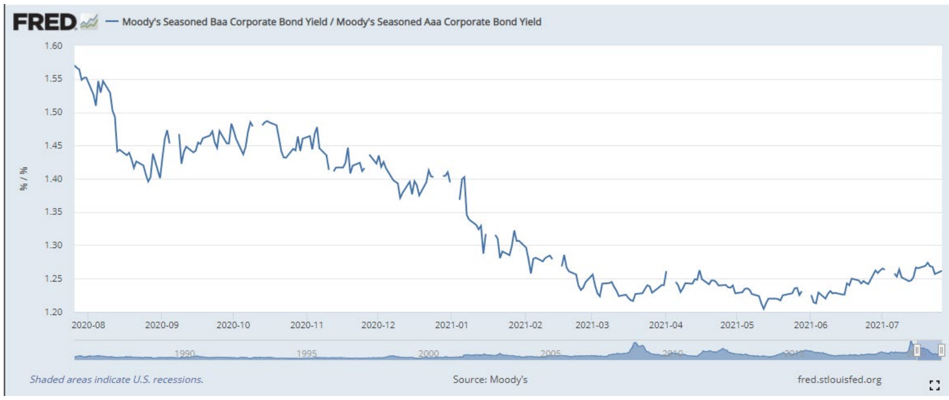

Figure 6 - Corporate AAA - BAA Yields; St. Louis Fed FRED

Overall, these (and other complimentary signals) seem to be flashing yellow lights. Perhaps more importantly, real economic growth likely peaked in the second quarter while inflation could continue to accelerate through at least the fourth quarter of 2021. The Conference Board provides one example forecast of where these economic conditions might trend.

THE CONFERENCE BOARD US ECONOMIC OUTLOOK, 2020-2021-2022-2023
Percentage Change, Seasonally Adjusted Annual Rates

	2020				2021				2020	2021	2022	2023
	I Q*	II Q*	III Q*	IV Q*	I Q*	II Q	III Q	IV Q	ANNUAL	ANNUAL	ANNUAL	ANNUAL
Real GDP	-5.0	-31.4	33.4	4.3	6.4	9.0	7.8	4.2	-3.5	6.6	3.8	2.5
Real Disposable Income	2.6	48.5	-17.4	-7.6	62.0	-25.0	3.0	1.5	6.0	5.9		
Real Consumer Spending	-6.9	-33.2	41.0	2.3	11.4	9.9	7.7	5.1	-3.9	8.2		
Residential Investment	19.0	-35.5	63.0	36.6	13.0	-4.0	5.0	7.0	6.1	13.1		
Nonresidential investment	-6.7	-27.2	22.9	13.1	11.7	7.8	7.4	6.2	-4.0	8.7		
Inventory Change (bln chn '12$)	-80.9	-287.0	-3.7	62.1	-87.0	-52.0	50.0	40.0	-77.4	-12.3		
Total Gov't Spending	1.3	2.5	-4.8	-0.8	5.7	3.1	0.3	1.0	1.1	1.5		
Exports	-9.5	-64.4	59.6	22.3	-2.1	9.1	3.0	4.1	-12.9	4.6		
Imports	-15.0	-54.1	93.0	29.9	9.5	7.1	8.1	5.1	-9.3	13.6		
Unemployment Rate (%)	3.8	13.1	8.8	6.8	6.2	5.9	5.5	4.9	8.1	5.6	4.2	
PCE Inflation (%Y/Y)	1.7	0.6	1.2	1.2	1.8	3.8	3.8	4.1	1.2	3.3	2.5	1.9
Core PCE Inflation (%Y/Y)	1.8	1.0	1.4	1.4	1.6	3.3	3.4	3.6	1.4	3.0	2.3	1.7

*Actual data

Figure 7 - Conference Board US Economic Outlook; Conference Board

If real growth does in fact slow and inflation continues to accelerate, the asset class and sector mix of outperformers and underperformers will most likely change.

Repositioning for Moderating Growth

Given the above factors, we have methodically begun decreasing portfolio exposure to our "reopening basket," though not eliminating it entirely. Should the US follow the UK pattern and Covid case increases begin to decrease several weeks from now, some of the reopening names should still have strong fundamental momentum and we do not want to eliminate that exposure entirely. We took advantage of a fuller price following strong earnings and a strategic investment from a large Asian bank to trim our position in Jefferies (JEF). Financial firms typically struggle in a flat yield curve environment. Much of that exposure has been replaced with larger capitalization ideas, more defensive indices, and a modest increase in commodity exposure.

On the "risk-off" side of the portfolio, we have begun to add back our gold exposure. The idea here is that with a compressed yield curve and persistently high inflation, gold is a competitive asset to bonds. We have not yet added back long-dated Treasuries. Other portfolio ballasts from the past quarter remain: iShares TIPS Bond ETF (TIP) and Quadratic Interest Rate Volatility and Inflation Hedge ETF (IVOL). Likewise, the Hussman Strategic Growth Fund (HSGFX) continues to provide a "hedged" exposure to equity markets and should outperform during periods of "risk-off."

The yield curve is a powerful indicator. More powerful than many others as Mae West reminds us. As the greatest reopening momentum now appears behind us, today, our All-Weather portfolio looks more all-weather than it did earlier in the year.

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As always, if you have any thoughts regarding the above ideas or your specific portfolio that you would like to discuss, please feel free to call us at 1-888-GREY-OWL.

Sincerely,

Grey Owl Capital Management

Grey Owl Capital Management, LLC