R Thoughts

Morgan Stanley

The Diamond Peak Group
at
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The Stock Markets

As the often quoted Yogi Berra phrase, “It’s like Déjà vu all over again,” seems an apt description of the current state of the U.S. Equity Markets.

Year to date returns at the index level—think the S&P 500 and the Dow Jones Industrial Average—continue to impress as they forge ahead swept up in the waves of liquidity provided by the Federal Reserve Bank of the United States and the unprecedented fiscal policy decisions enacted by Congress over the past 18 months.

With interest rates continuing to remain depressed, there is currently little competition among other asset classes which allow for the potential returns afforded by U.S. equities, in our view.

We recently learned that the National Bureau of Economic Research (NBER) confirms what we had suspected for a while now—that the COVID-19 induced recession was the shortest on record at just two months.[1] This data point is consistent with our view in March and April of last year looking for a V-shaped recovery in the U.S. economy and the term “inflation” gradually seeping it’s way back into the public lexicon.

Back then we held the view in which companies benefiting from the gradually re-opening of the economy might be poised to grow earnings faster than the larger, more popular “stay at home” stocks which were then dominating the U.S. indexes with their significant market capitalizations.

We recently seem to be witnessing a return back to the popularity of the companies which are the largest components of the market indexes “the Big-5”—Apple, Amazon, Google, Facebook, and Microsoft.[2] This trend is somewhat predictable—in our opinion—as these companies are the beneficiaries of the lower interest rate environment which has again dominated the financial markets in the United States over the past few months.

And in this sense it is *like Déjà vu all over again*.

Similar to early 2020, we believe the over-concentration in market weights of the “Big-5” in the popular indexes are disguising a “rolling correction” under the surface in the “average” U.S. stock. With our primary objective of managing risk foremost in our mind and these larger, more popular companies comprising a larger allocation percentages in these indexes, we have felt it prudent to concentrate our equity allocations into more of the “average” U.S. stock. As the “average” stock performance has again experienced underperformance to these well-known and currently more popular investment names, we are acutely aware that these factors may be affecting the relative short term performance in some of our investment models.

To put it another way—the Soldiers’ of the market, the “average” U.S. stock, have retreated from the battlefield leaving only the Generals’—concentrated in the “Big 5”—to fight the current investment battle. In our experience the Generals’ have the ability to continue the fight the good performance fight for a while but will eventually run into trouble without the help of the “average” soldiers’ class of stocks.

The market index which most represents the “average” soldiers’ stock in our view is the Russell 2000, comprised of mostly medium and small companies. The adjustments in these companies’ stock prices—which often occur without much publicity—have been fairly severe despite the recent all-time highs at the benchmark level or Generals’ level. 86% of the members of the soldiers’

class stocks in the Russell 2000 have seen declines of 10% from their 12-month highs, 65% of the soldiers' class stocks have seen drawdowns of 15%, and 44% have seen drawdowns greater than 20% from their 12-month highs.[2]

If this was happening with the "Big-5" of the Generals' class stocks we would bet that the media coverage would be severe and constant as the market is really currently dependent on the performance of these small number of very large stocks, in our view.

In our experience, these higher quality, mega cap stocks—the Generals'—which are particularly concentrated in the technology sector—are often the last holdouts in a rolling correction.[2] They have proven very durable thus far, but ultimately we think that they may be venerable to the combination of demand payback post-COVID and a changing liquidity picture for the worse (due in a large part to an incrementally less accommodative Federal Reserve = higher interest rates) which might start to weigh on performance of these select number of Generals' stock prices.

Speaking of interest rates, Morgan Stanley believes the recent low yield of 1.15% on the 10-year Treasury bond will be the lowest we see in moving forward in 2021 with a target rate of 1.80% by year-end.[3] Increasing interest rates will prove to be a head wind to the beloved "Big-5" Generals' stock prices, in our view.

Given these factors we wouldn't be at all surprised to experience some potential drawdowns at the Index level as we enter the latter half of the summer season. Remember the "average" stock has already experienced its' own rolling correction over the past few months which hasn't been reflected in the performance of the large market indexes like the S&P 500.

If it is possible to remain constructive on U.S. stocks longer term yet somewhat defensive over the short term—this might be the most accurate description of our current outlook regarding the domestic equity market. We expect somewhat increased volatility moving throughout the remainder of the summer months. Our portfolio positioning reflects this opinion—we are constructive yet defensive—and would look to any moderate decline in stock prices to potentially become more fully invested.

In our view, domestic equities continue to be the strongest of the six asset classes we monitor based on the concept of supply/demand and relative strength. Rounding out the remaining five in order of our current outlook, they are International Equities, Commodities, Fixed Income, Cash and Currencies.

In closing, we wish you all the best and hope you enjoy the remainder of the summer season. As always, if you have any questions or concerns please feel free to reach out and contact us.

Be well.

Written July 26th, 2021.
The Diamond Peak Group at Morgan Stanley

Sources and Footnotes

1 Morgan Stanley—U.S. Equity Strategy/North America. Weekly Warm-up. July 26, 2021
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2 Morgan Stanley Equity Research Strategist Call—Friday, July, July 23, 2021
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3 Mike Wilson—Global Investment Committee Tactical Call—Monday, July 26, 2021
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The Diamond Peak Group at Morgan Stanley

Jim Kniffin CPM®
Branch Manager, Senior Vice President,
Portfolio Management Director, Financial Advisor
503.588.5741
NMLS #1262143

Scott Bigham, CFP®
First Vice President, Portfolio Management Director, Financial Advisor
503.588.5726
NMLS #1274637

John Sipple, CFP®
First Vice President,
Portfolio Management Director, Financial Advisor
503.588.5705
NMLS #1261821

William Stabler
Vice President
Portfolio Manager, Financial Advisor
503.588.5744
NMLS#1282844

4582 SE Commercial St., Suite 200
Salem, OR 97302

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R Thoughts—Spring 2021
R Thoughts—Winter 2021
R Thoughts—Fall 2020
R Thoughts—Summer 2020
R Thoughts—Spring 2020
R Thoughts—Winter 2020

R Thoughts—Market Update #3—March 25, 2020
R Thoughts—Market Update #2—March 12, 2020
R Thoughts—Market Update—February 27, 2020

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Technical analysis is the study of past price and volume trends of a security in an attempt to predict the security's future price and volume trends. Its limitations include but are not limited to: the lack of fundamental analysis of a security's financial condition, lack of analysis of macro-economic trend forecasts, the bias of the technician's view and the possibility that past participants were not entirely rational in their past purchases or sales of the security being analyzed. Investors using technical analysis should consider these limitations prior to making an investment decision.

Asset allocation and diversification does not guarantee a profit or protect against loss in a declining financial market.

The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks. The Dow Jones Industrial Average is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. An investment cannot be made directly in a market index.

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