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CUSTOM INDEX SMAs

Outlook For Last Three Months of 2021

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A quick recap of my 2021 outlook series would help set the stage for this finale:

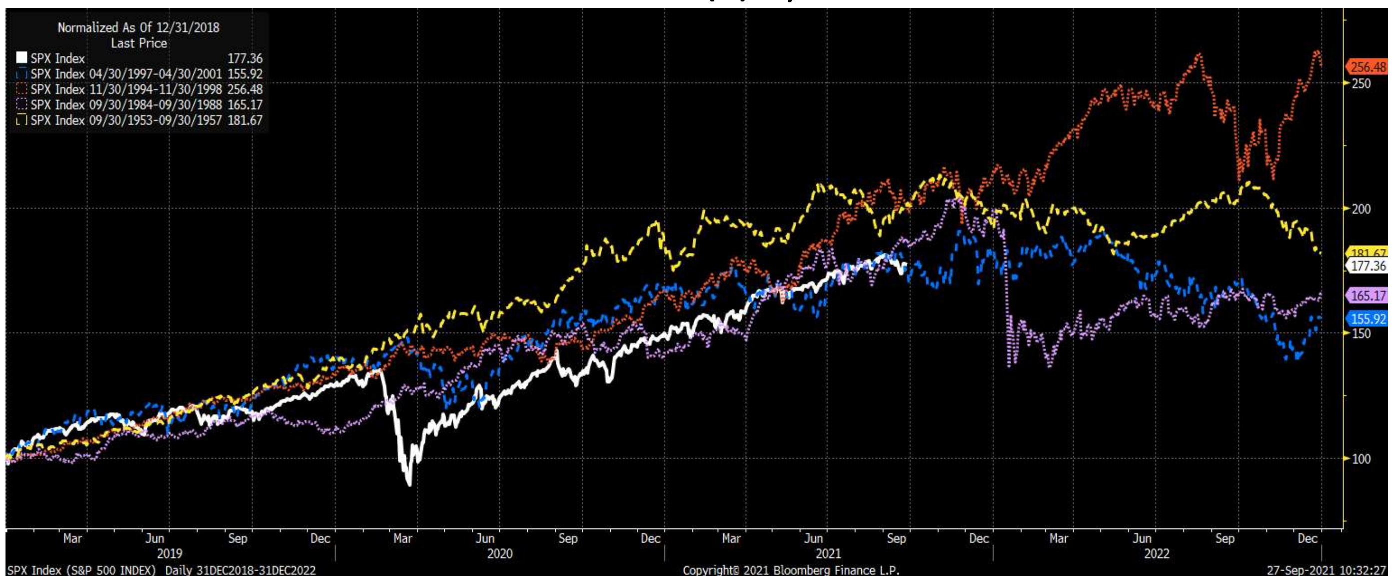
1. Investors with long-term horizons should stay invested with dividend stocks;
2. At today's lofty valuation, tactical moves can protect against a 10+ percent correction;
3. Sectoral choice offers another layer of defense; I prefer dividend paying, value stocks as well as a strategic overweight on commodities;

This article focuses on the tactical view for the remainder of the year.

Are We There Yet?

If viewed as a continuation of the rally that began in early 2019, this bull market would rank as one of the strongest in history. Only the 3-year market run-ups of 1997, 1994, 1984, 1953 are comparable to this record.

Figure 1. The best 3-year market run-ups in history since 1950 (while line is today's S&P 500 rebased to 100 on 1/1/19)



If you ask those climbers who have summited Everest what they did after reaching the peak, the unequivocal answer would be: take photos, savor the moment, and quickly descend before any bad weather sets in. Unfortunately, whether we are at the peak of this cycle is a subjective concept dependent on the starting point and time horizon chosen to frame the measurement. But if history is any guide, we may be 5-10% and three months from the peak. For safety, I would suggest learning from the alpinists and making a plan for the descent after an amazing climb.

Plenty of Intramarket Volatility Within a Rising Market

Except for the brief meltdown in early 2020, most of the climb since January 2019 has been quite smooth. This is especially true of the nice ride since November 9, 2020 when the Pfizer vaccine was first announced. The S&P 500 has experienced down days of 2% or more with an occurrence rate of only 1.3%; i.e. once every 3.5 months. A similar measurement for the past ten years registers an occurrence rate of 3.3%; i.e. once every six weeks.

The next chart (figure 2) shows that the performance of value and growth stocks diverged as a function of interest rates. When rates rose as a signal of a broad-based recovery, the value stocks did better. As soon as the pandemic took another turn for the worse, it was the growth stocks' turn to shine again.

Figure 2. Value (red) outperformed when Rates (green dashed) rose, while Growth (blue) outperformed when Rates fell

Sectoral divergence further magnifies this sensitivity to interest rates and pandemic severity. The energy sector (using XLE as proxy), seen as the poster child for the reopening trade, serves as a market proxy for the economic recovery and higher mobility. The bank stocks (using KBWB as proxy) tracked the direction of the interest rates' rise and fall. The ARK Innovation ETF is a good proxy for long duration, hypergrowth tech sectors.

Figure 3. The energy and bank sectors reflect the economy's reopening and rising rates, while high growth tech sectors prefer a low rates environment

Drawing from the pattern observed above, the relative performance for the next three months would depend on the trajectory of Covid severity, reopening, and interest rates. I remain optimistic that widespread vaccination will continue to beat back variants of the virus, allowing economies to reopen with wider mobility and recover. To express this broad-based bullish view, I continue to hold high concentrations of energy, metals, banks, and travel stocks in my portfolio.

Photo Time but Begin the Descent

For a tactical investor, I think that we are about to approach the cycle peak and it's time to prepare for the journey down. We probably still have another 5% upside in the S&P 500, but the fourth quarter may be the ideal time to take profits and sit back with 10-15% cash reserves. After a relentless climb with this amazing bull, I think it's time to take a break and relish the journey.

For a long-term investor, a tactical move to cash should be about 10-15% of the portfolio. As covered in previous articles, I believe that persistently higher inflation due to climate change policy and years of little to no investment in raw materials extraction have set the market up for a long-term bull in commodities and energy sectors. I recommended a core holding of these sectors in the previous articles. Last but not least, the emphasis on dividend paying stocks as a long-term theme should continue to be the core strategy, because these stocks will be more resilient in any correction in 2022 and continue to reward us with consistently growing dividends.

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