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Market Commentary

Weekly perspective on current market sentiment | August 11, 2021

Scott Wren
Senior Global Market Strategist

Last week's S&P 500 Index: -0.9%

A temporary stumble

Key takeaways

- Cyclical sectors and small-cap domestic equities have underperformed in recent months as growth fears have accelerated.
- We see this underperformance as a temporary stumble and continue to recommend leaning into the economic recovery.

Early in an economic cycle, investors are typically attracted to segments of the financial markets that are going to benefit from the growth upswing out of the slowdown or recession that occurred in the recent past. They are also more willing to take on additional risk after hunkering down and hiding out in what they believe to be less risk while the economic environment was more uncertain. And stocks are typically favored over bonds.

Historically, the usual sector beneficiaries of this migration of investor funds are sectors that are going to respond to a better growth path, such as Consumer Discretionary, Industrials, and Financials. In this particular recovery, you could also add Energy and Materials to the mix. The noticeable rise in year-over-year inflation, as illustrated by increased prices for raw materials prices like copper and oil, has also helped boost the prospects for these more commodity-oriented sectors.

From the asset class level, U.S. small-cap stocks are also typically strong relative to larger-cap stocks (think S&P 500-type companies) coming out of any slowdown or recessionary period and usually for the initial years of the new cycle. Once again, as with a number of the sectors just mentioned above, investors are more willing to take on the risk and buy companies that generally have narrower product offerings and weaker balance sheets than their large-cap cousins. They also tend to have revenues that are much more domestically oriented.

While these typical early-cycle market trends have largely played out over the last 12 months or so, in the more recent two or three months they have not. More growth-oriented sectors like Technology have led the way to new record highs while favored sectors such as Energy, Materials, Industrials, and Financials have been the worst performers. In addition, small-cap domestic equities generally have underperformed the S&P 500 by a noticeable amount over that same period.

What's going on here? Probably more than anything else, the market is getting concerned that future growth expectations are not going to pan out. Much of this stems from the COVID delta variant's spread here in the U.S. and abroad. Low bond yields would seem to sync with that view. In addition, with the Federal Reserve indicating it is likely to start tapering late this year or early next with rate hikes coming sooner than previously expected, that might be a further headwind for cyclical plays and push investors more toward growth.

From our view, this cyclical and small-cap underperformance is a temporary stumble. The strong labor market recovery is producing gains in hours worked and wages, which should combine for rising income and spending. We see the delta variant as not leading to the severe level of lockdowns that the initial covid surge produced. And we do not expect the upcoming tapering process to disrupt markets or the economy. Continue to lean into the recovery.

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