Perhaps the Latest Rally Was a Bit Excessive

The three-week rally in cyclical stocks came to a sudden stop last week. The S&P 500® index had climbed 12 percent between May 15 and June 5. Leading the way were industrials, financials and energy, each with gains in excess of 25 percent, in what was a dramatic shift in leadership for sectors that had been largely laggards throughout much of the recovery. Whether driven by in part by speculative fever, monetary and fiscal largess, reawakening economies, a weaker dollar, or something else entirely, it all came to screeching halt last week. These same three sectors led stocks on the way down last week, bringing an end to the S&P 500’s three-week winning streak. Small stocks, which had outperformed large with a gain of 20 percent over the previous three weeks, also underperformed with a decline of 8 percent. Bond yields fell, credit spreads widened, and volatility rose, as the VIX index climbed back up to 36 after three straight weeks of decline had taken it from 32 to 25. And after rising by more than $10 a barrel in three weeks, WTI crude oil fell by more than $3 last week.

Last week’s reversal was variously attributed to reports of rising coronavirus infections in more than twenty states, a dour economic outlook from the Fed, and perhaps the realization that a 43 percent rise from the March low in the S&P 500 was a touch excessive. But in fairness to the Fed, it is difficult to describe the current state of the economy in terms that are anything other than dour. Yes, activity is beginning to improve, but from extraordinarily low levels. And while it offered little insight into its next move, that was not expected to come until September anyway. And it did reaffirm the size of its QE program for the near-term and indicated its expectation of no interest rate increases for three years.

What Could a Second Wave Mean for Markets?

As for the virus, it should not be a surprise that the early opening of certain state economies, combined with the relaxation of social distancing discipline, should result in a rise in infections. The healthcare community had been warning of such an outcome for some time. If the economy’s recovery is going to be slow, with a great deal of uncertainty, then it becomes a tougher case to make that cyclical stocks should be the leaders.

Maybe the previous three weeks were a leap of faith that a V-shaped recovery was a real possibility. If so, the agnostics reasserted themselves last week. But if they did, they also failed to reassert their faith in the previous leadership of growth stocks, as all eleven sectors of the index declined. It is worth noting that the S&P 500 did seem to find support at its 200-day moving average at 3013. After closing slightly below it at 3002 on Thursday, the index managed to fight back and end the week at 3041.
Stocks in the Eurozone followed a similar path, only last week’s selloff was more severe following a sharper rise over the previous three weeks. The EuroStoxx 50 index fell 6.8 percent last week in euro terms, after having risen 22 percent over the previous three. And last week the euro edged lower versus the dollar after having surged higher by more than 4 percent over the previous three.

Investors Look for Yield Curve Control in the Bond Market; Economic Data this Week Will Be Telling

Part of the, so far, short-lived cyclical story was a rise in bond yields and a steepening of the yield curve. Also, part of it was some expectation that the Fed would say something about possibly initiating some form of yield curve control, such as employed by the Bank of Japan. The ten-year Treasury note yield had climbed from 0.64 percent to 0.90 percent during cyclical’s three-week outperformance, and the slope of the 2-10 year curve widened from 49 to 68 basis points. But last week the air came out of that balloon. The yield on the ten-year fell back to 0.70 percent last week, and the 2-10-year curve flattened back to 49 basis points, and the Fed downplayed any talk of yield curve controls. Over that same three-week interim, high yield spreads had narrowed by 228 basis points, but reversed course and rose 78 last week.

This week’s economic calendar will provide a little more insight into how quickly the economy is rebounding, and whether the cyclical story has any basis in actual results. Retail sales for May are expected to rise 8 percent after having declined by 16 percent in April. Industrial production is forecast to rise by 3 percent following an 11 percent decline in April. Building permits, housing starts, and home builder sentiment are all expected to rise sharply as well. The index of leading indicators is expected to show its first increase in four months. And both weekly and continuing jobless claims are expected to show some ongoing moderation. And Fed Chairman Powell testifies before both houses of Congress in his semi-annual monetary policy report.

On Monday, China reported its May readings for retail sales, industrial production, and fixed-investment, all of which showed modest sequential improvement but ongoing weakness on a year-over-year basis. And EU members will meet on Friday to discuss the Commissions proposed recovery fund.

Important Disclosures:

Sources: Factset, Bloomberg,

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The Standard & Poor's 500 Index (S&P 500 Index), an unmanaged index of common stocks, is frequently used as a general measure of market performance. The index reflects reinvestment of all distributions and changes in market prices but excludes brokerage commissions or other fees.

The S&P 500 Energy Select Sector Index measures the performance of energy stocks, as classified by the Global Industry Classification Standard (GICS). Every Select Sector stock is also a constituent of the S&P 500 Index. It is float-adjusted market capitalization weighted.

The S&P 500 Financial Select Sector Index measures the performance of financial stocks, as classified by the Global Industry Classification Standard (GICS). Every Select Sector stock is also a constituent of the S&P 500 Index. It is float-adjusted market capitalization weighted.
The **S&P 500 Industrials Select Sector Index** measures the performance of industrial stocks, as classified by the Global Industry Classification Standard (GICS). Every Select Sector stock is also a constituent of the S&P 500 Index. It is float-adjusted market capitalization weighted.

The Chicago Board Options Exchange (CBOE) **Volatility Index (VIX)** is a widely used measure of market risk. It shows the market's expectation of 30-day volatility. The VIX is constructed using the implied volatilities of a wide range of S&P 500 index options.

**West Texas Intermediate (WTI)** is a grade of crude oil commonly used as a benchmark for oil prices. WTI is a light grade with low density and sulfur content.

The **EURO STOXX 50 Index**, Europe's leading Blue-chip index for the Eurozone, provides a Blue-chip representation of super-sector leaders in the Eurozone. The index covers 50 stocks from 11 Eurozone countries: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

A **10-year Treasury note** is a debt obligation issued by the United States government that matures in 10 years. The 10-year yield is typically used as a proxy for mortgage rates, and other measures.

A 2-year Treasury note is a debt obligation issued by the United States government that matures in 2 years.

An index is a statistical composite that is not managed. It is not possible to invest directly in an index

**Past performance is not a guarantee of future results.**

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