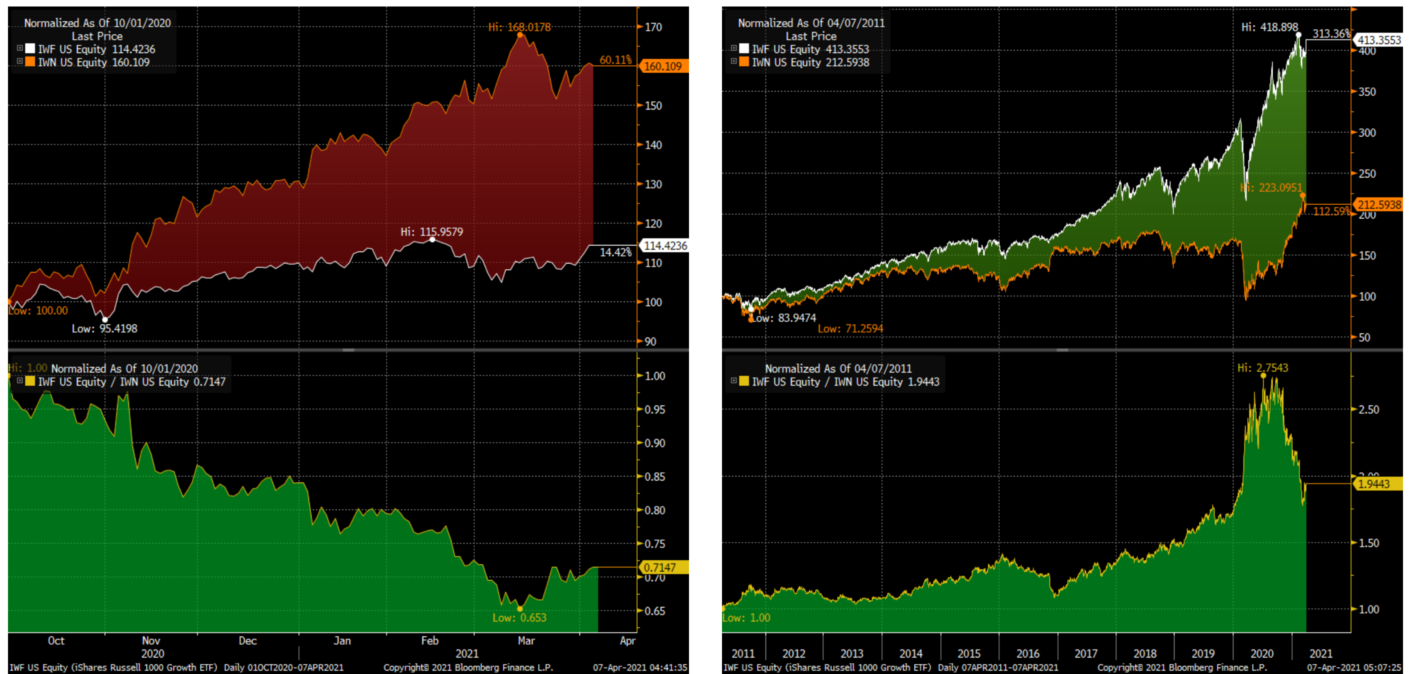
FROM THE DESK OF ERIK OROS

MARCH 2021

How hot is too hot? This is the difficult question investors have had to grapple with over the first quarter of 2021. As the economy reopens, massive stimulus is digested, and supply chains become stretched, the robust growth outlook for the US economy has sparked impassioned worry over inflationary pressures. These concerns have rippled through treasury markets, pushing yields across the curve to levels that have tested the mettle of equity investors accustomed to bond market tranquility. Yet while economists wrestle with the implications of potentially overwhelming aggregate demand, Wall Street has contended with forces of unprecedented supply of new offerings. New SPAC IPOS in the first quarter topped $95 billion, exceeding 2020's full year tally of just over $80 billion, resulting in imbalance that has crimped investor enthusiasm and share prices. Similarly, the pronounced draw down in the ARK Funds over the first quarter, a post pandemic darling, have shaken growth investors who have become very accustomed to gains. These pockets of vulnerability underline the unrelenting speculative demand that has characterized the equity markets may be reaching a tipping point.

The waning reward for excess risk taking were laid to bare in the month of March with two high profile fund failures. The implosion of both Archegos Capital Management and Greensill Capital remind investors that the age-old dangers of excessive leverage remain acute and enduring. These incidents are seemingly isolated and with limited systemic effect; however these implosions are in many ways representative of the magnitude of Wall Street's recement complacency around risk taking.

Small Cap Value/Large Cap Growth



*Past performance does not guarantee future results.

Global indices however have remained resilient to the turbulence felt in growth shares and those sectors most acutely exposed to higher rates as a powerful rotation has continued to take hold. Since our October letter where we

highlighted the “staggering” outperformance of large cap growth shares over their small cap value counterparts, the trend has meaningfully reversed with IWN (Russell 2000 Value ETF) outperforming the mighty IWF (Russell 1000 Growth) by over 45% points. This rotation has entrenched itself beyond just small caps but into cyclical sectors of the market such as financials, energy, materials, and industrials. Investors have embraced cyclical growth’s reemergence after years of paying hefty premiums for sustained secular growth. While the outperformance has been pronounced over the past two quarters, it is likely that these factors will continue to attract investors in an environment where economic growth is likely to exceed expectations.

The extent of the recovery poses a unique challenge to Federal Reserve. Armed with a new mandate allowing for “symmetric” inflation targeting, Chair Powell has made clear his willingness to let inflation run hot before taking away the punch bowl. However, market participants are rightfully looking ahead to 2022 where it is likely the US will reach “full employment” with inflation well in excess of the Fed’s 2% target. There is worry the Fed may be backed into a corner in such a scenario and forced to raise rates well before 2023 the current signal from the FOMC’s dot plot projections. As we lap what should be the fastest GDP growth in decades in 2021 and the pent-up demand for reopening wanes, the Fed may be wise to have some ammo to combat any disruptions. With $120bn of monthly security purchases and a zero-interest rate policy ongoing, the Fed has little left in the chamber. Fears of these premature rate hikes have manifested in the 5-year treasury yield where the implication is the bank will have to move well before 2023. How the central bank navigates and communicates its next steps to normalize policy is ripe for misinterpretation and market disruption.

US 5 Year Treasury Yield

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