

# Death of the Reflation Trade?

Our Addepar Investor Sentiment Index (ISI) (methodology found [here](#)) uses portfolio-level transaction data to gauge investor sentiment. We analyze the investment data on our platform to gain insight into how ultra-high-net-worth (U/HNW) investors are making adjustments at the portfolio, sector, and stock levels. Additionally, we conduct client interviews to supplement the data and analysis presented in our research notes. To ensure privacy, we never disclose identities.

Investors turned sharply bearish in August while U.S. equity markets continued to rally to new highs. Sector sentiment suggests that since the end of February, investors have been neutral to bearish the reflation trade scenario—that is economic “reflation” of the economy’s nominal growth rate, driven higher by jointly increasing real output growth and accompanying price inflation. This month’s other key highlights include:

- Weekly sentiment grew even more bearish throughout August.
- Investors rotated out of the healthcare and communications sectors.
- Negative sentiment in Pfizer and Zoetis drove the overall sentiment in this sector even as the two firms beat analyst expectations on the previous quarter’s earnings.
- Sentiment toward the reflation scenario has recently diverged twice from the broader market, including at the beginning of August and then again in February and March, while Treasury rates peaked. Reflation sentiment remains neutral at this time.

## Investors bearish as the market hits new all-time high

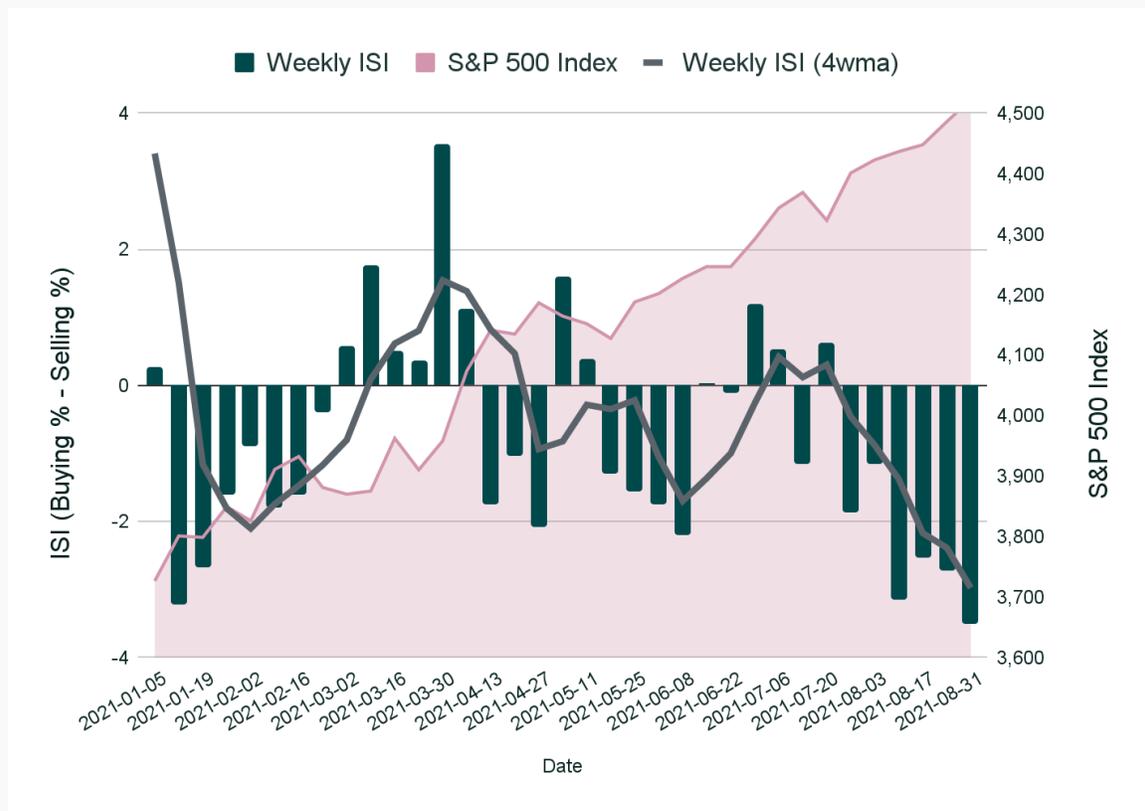
The S&P 500 returned 2.9% in August, the 7th consecutive month of gains. The index rose throughout the month, pausing only mid-month from the 16th to the 18th to momentarily correct. The index finished August at twice its pandemic low on March 24, 2020—an impressive milestone.

10-year Treasury yields zigzagged sideways throughout the month, trying to find an appropriate level, and finished up 6 basis points and 1.3%. Meanwhile, oil prices continued to slide from recent record peaks, moving from \$74 to \$62.30 per barrel. Oil has been weighed down by expectations of falling demand due to new restrictions in China and other countries aimed at curbing the Delta variant.

In August, the monthly ISI was solidly bearish at -7.4, the fifth straight month of aggregate bearish reads. The weighty and decreasing indications last month contrast with July's modest reads.

**Figure 1: Weekly Addepar Investor Sentiment Index**

December 30, 2020–August 31, 2021



Source: Addepar, S&P Global

## Rotation out of healthcare and communications

Falling energy prices reflected a -2.0% return in the energy sector while all others showed positive performance. Financial services and communications outperformed. U/HNW investors rotated out of healthcare, communications, and materials while modestly rotating into industrials.

**Figure 2: Sector Sentiment**

August 2021

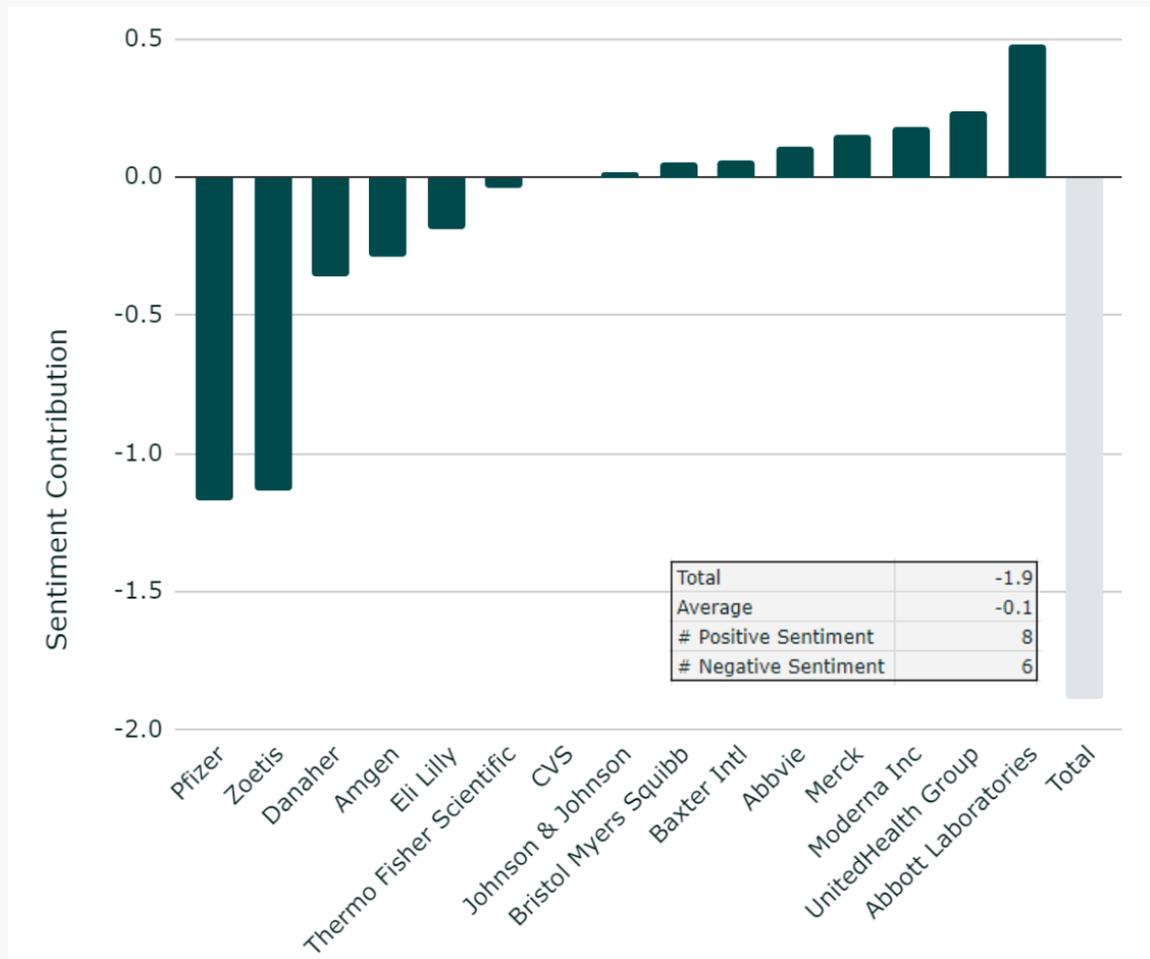
Sector	Sentiment	Z-Score	Performance
Technology	-2.0	-0.3	3.6%
Healthcare	-1.9	-1.0	2.4%
Consumer defensive	-0.6	-0.2	1.4%
Communication services	-0.5	-0.7	5.0%
Materials	-0.5	-0.6	1.9%
Financial services	-0.2	0.0	5.1%
Utilities	0.0	0.0	4.0%
Consumer cyclical	0.1	-0.2	2.1%
Energy	0.3	0.1	-2.0%
Real estate	0.4	0.1	2.8%
Industrials	0.4	0.4	1.1%
Bullish/Bearish			
Relative to own history:			
Strong -			
Moderate -			
Strong +			
Moderate +			

Source: Addepar

At the stock level within healthcare, negative sentiment in Pfizer and Zoetis more than offset the eight stocks with positive sentiment. Zoetis and Pfizer beat analyst earnings expectations for the second quarter of 2021.

### Figure 3: Healthcare Sector Sentiment Attribution

August 2021

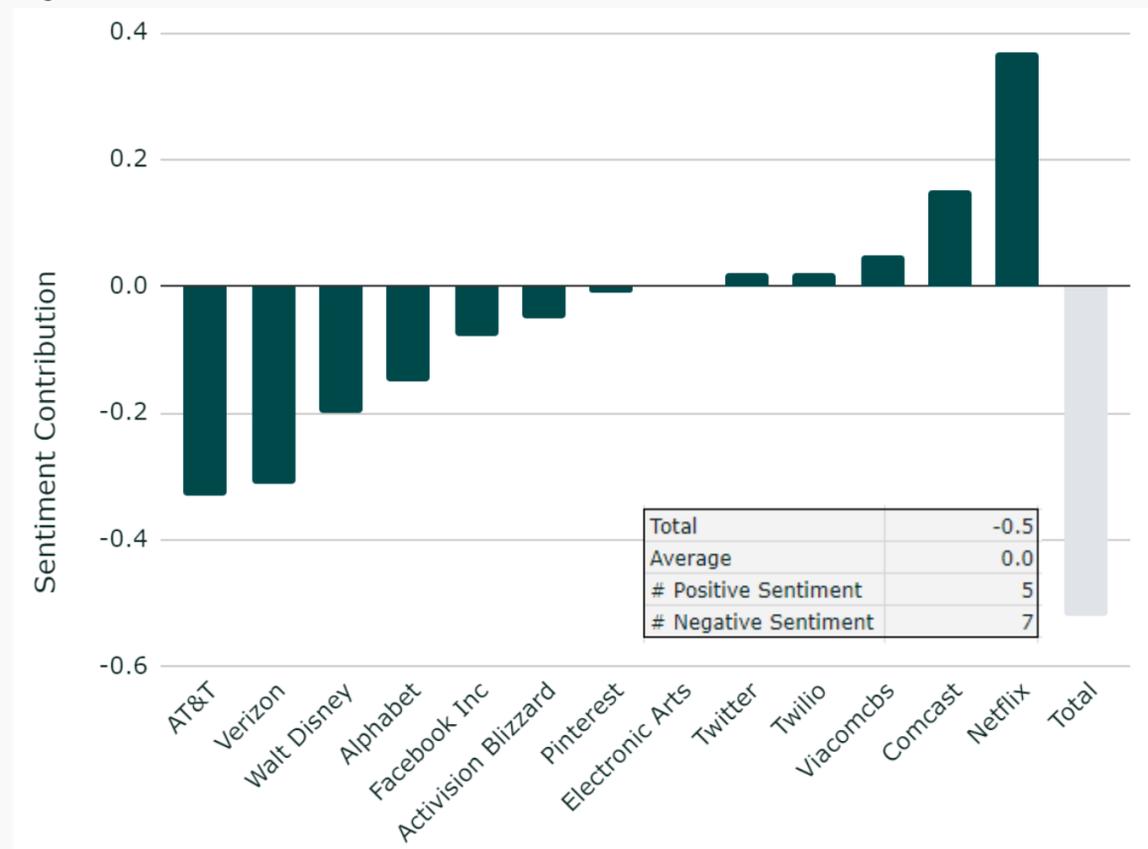


Source: Addepar

Within communications, stocks with bearish sentiment outnumbered stocks with bullish sentiment for a net negative sentiment. Continued bearish sentiment since June on telecommunications leaders such as AT&T and Verizon is of particular note.

**Figure 4: Communications Sector Sentiment Attribution**

August 2021



Source: Addepar

## Sectors to track reflation

As mentioned earlier, the S&P 500 has now had seven consecutive months of positive performance and recently hit a notable milestone. Investors have seen their capital double since the market bottomed out in March of 2020! The near straight-line march of the market to its new highs dulls the memories of all the economic crosscurrents and shifts reverberating through financial markets during this time.

Top of mind is the reflation trade that was so very topical in the press earlier this year and now seems to have ever so quietly exited stage left. It was not that long ago when investors bet that vaccinations would herald a global economic reopening, fueled by excess savings, pent-up demand, and by the historically largest (and fastest) injection of stimulus into the economy. The expectation was that

consumption would rise, supplies would be tight, inflation would increase and employment would grow to meet the abundant demand.

In fact, for a while, the economic environment seemed to be going this way. In March, consumer purchases of goods and services rose month over month by 5.2% and brought consumption above pre-pandemic levels. With concerns over the impact of the Delta variant of the coronavirus, PCE has since sputtered (in July it rose .3%), and with that, our collective images of consumers tearing off their quarantine shackles and rushing out to enjoy their favorite shops, restaurants, and bars have faded.

In financial markets, the 10-year Treasury bond yields, which price in growth and inflation expectations, peaked at the end of March at 1.7% and since mid-July, are now hovering in the 1.3% range. This indicates that long-term growth and inflation expectations have eased and look like a headwind to those who continue to hold to the reflation trade scenario.

One may ask whether U/HNW investors bet on the reflation trade and what are they doing now? The August edition of the Investor Sentiment Index research note examines how sector rotations can be engineered to construct the reflation trade. Then, this novel sector/reflation lens will be used to compare investor sentiment against market action to answer the question posed.

Since the onset of the pandemic, monetary and fiscal policy has operated in a coordinated fashion to bring about economic reflation. Currently, much of this is expected to occur through a recovery in prices that suffered in the initial stages of the pandemic. In the financial markets, Treasury rates price in long-term nominal growth and are therefore used as a primary gauge for understanding the market's assessment of reflation.

Characterizing sectors in terms of the connection between their performance and Treasury rates is both intuitive and can be rigorously documented through regressions. Energy, industrials, financial services and materials ("cyclicals") do well when inflation and growth are rising, which often coincides with increasing 10-year Treasury rates. Similarly, "defensive" sectors including consumer defensive, real estate and utilities will outperform when inflation and growth are falling. This also may track with falling 10-year Treasury rates. While healthcare is traditionally thought of as a defensive sector, it can also have elements of growth in it and will be excluded from this analysis. We will subsequently write a piece just on this sector.

A portfolio that's engineered by taking equally risk-weighted cyclical sectors while shorting defensive sectors generates returns that track the path of interest rates, which we will call the "reflation portfolio" for the remainder of this article.

To show that the reflation portfolio tracks interest rates, figure 5 shows the trailing 1-month return of the reflation portfolio relative to 1-month changes in Treasury yields. Correlations are very high at .66. Regression analysis (not shown here) going back to the start of 2020 yields similar results.

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### Figure 5: Reflation Portfolio vs 1-Month Change in 10-Year Treasury Yield

December 31, 2020–August 31, 2021



Source: Addepar, S&P Global

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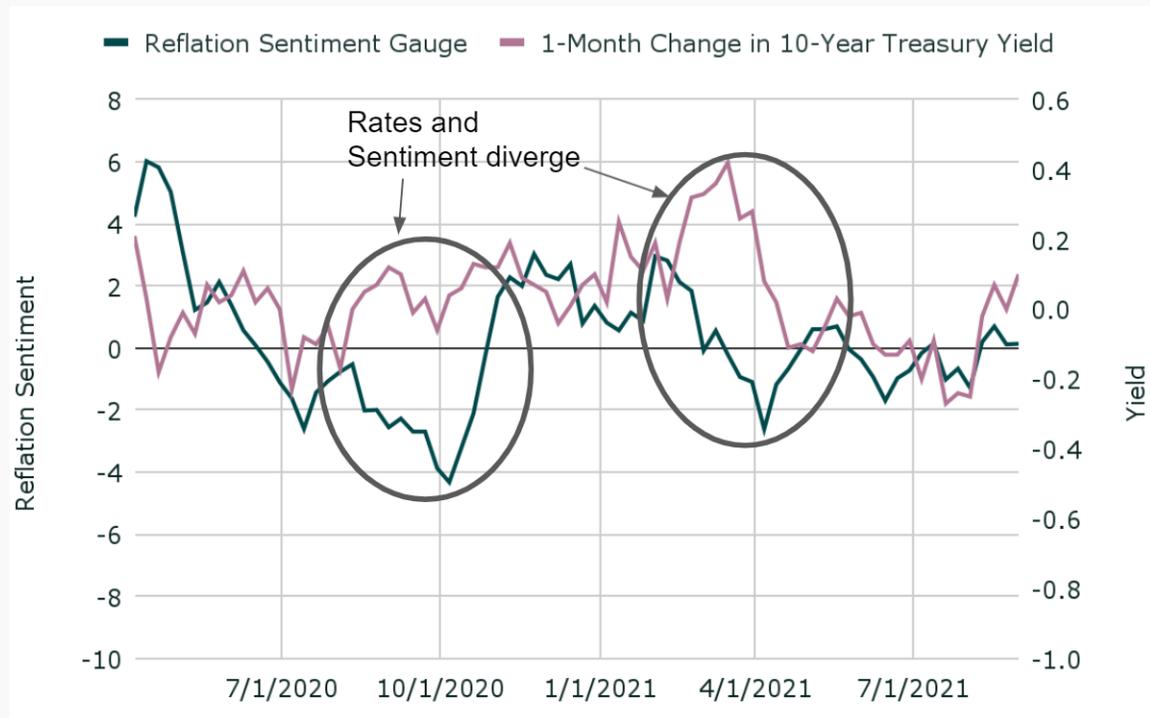
A weekly sentiment gauge constructed similarly to the reflation portfolio is compared against 1-month changes in Treasury yields sampled on a weekly basis to coincide with the sentiment gauge depicted in figure 6. More specifically, equally weighted defensive sector sentiment is subtracted from equally weighted cyclical sector sentiment to construct the Reflation Sentiment Gauge.

Sentiment and interest rates diverge in August 2020 and then again in February 2021. As one may recall, positive news on vaccine trials accelerated optimism of the recovery within the broader market, although not with U/HNW investors. Subsequently, reflation sentiment increased largely due to a bullish view on energy, although again, this turned bearish once energy prices rose to clear the mismatch between limited supply and demand. Interest rates, on the other hand, continue to increase through the end of March.

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**Figure 6: Reflation Sentiment vs 1-Month Change in 10-Year Treasury Yield**

April 1, 2020–August 31, 2021



Source: Addepar

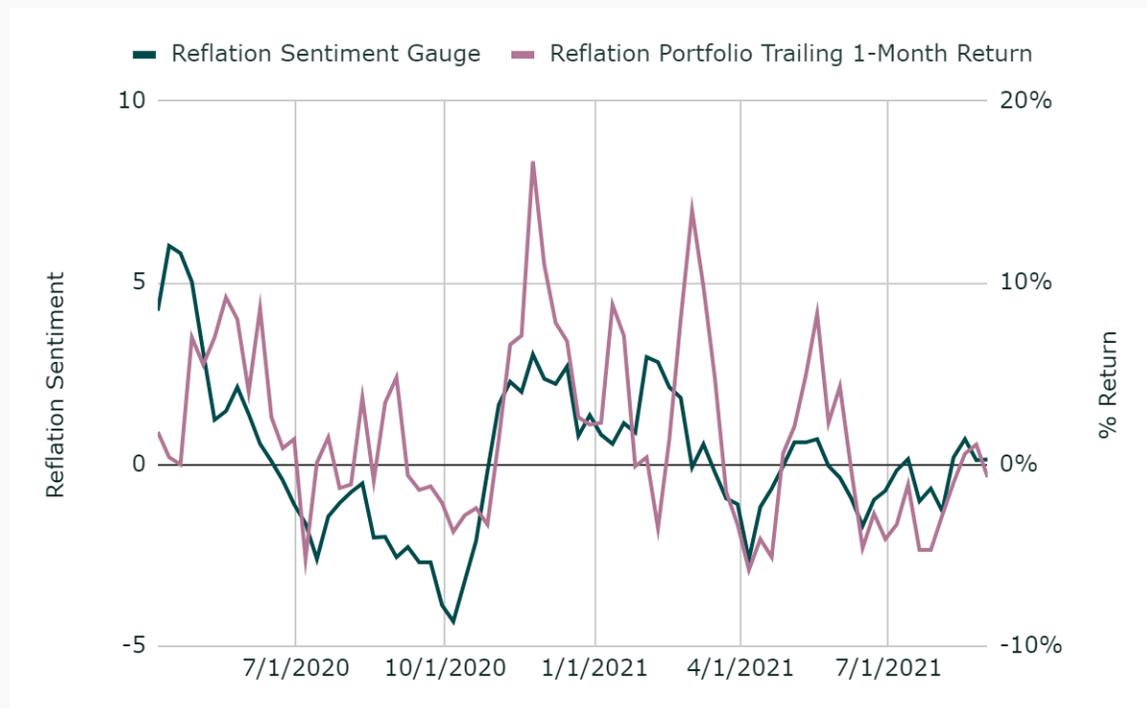
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Finally, the Reflation Sentiment Gauge is charted against the trailing 1-month returns of the reflation portfolio on a weekly basis. Without being overly precise, it appears that portfolio returns effectively oscillate around the sentiment gauge. The apparent higher volatility in the reflation portfolio can be interpreted as less cohesion in the broader market relative to the U/HNW investors represented in the sentiment gauge. Despite this, correlations remain high at .36. In future analyses, we will broaden this study to longer-term time frames and other sectors.

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## Figure 7: Reflation Sentiment Gauge vs Reflation Portfolio

April 1, 2020–August 31, 2021



Source: Addepar

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## Stay tuned

We will continue to develop analytics that provides additional value to our clients through the aggregated and anonymized investment data on our platform. We'll also keep posting the monthly ISI index, our key observations and periodic research notes on our [website](#).

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