First Quarter 2021 Market Review & Outlook

April 2021

Executive Summary

- Stock markets continued to advance in the first quarter, led by small company US stocks. Bond markets had negative total returns in most sectors as interest rates popped higher to start the year. (Pages 1 & 2)
- Expectations for economic growth have grown through the first quarter of the year, based on better-than-expected reports on consumer spending and unemployment, a new $1.9 trillion fiscal stimulus law, and the faster than originally expected vaccination campaign. (Page 2)
- Looking back one year, stock markets have generated eye-popping returns, but now leave little margin for error if interest rates or inflation move higher, or if economic growth or corporate earnings growth fails to meet high expectations. (Pages 2 & 3)
- We recommend clients maintain a "neutral" allocation towards stocks relative to their respective target allocations, underweight bonds, and hold additional cash and/or alternatives to offset the underweight towards bonds. (Page 4)

First Quarter 2021 Financial Markets Review

Global stock markets started the year with solid gains, led by the small cap US segment, which roughly doubled the return of the large cap US segment. More cyclically sensitive value-style stocks generated the highest returns across market size and geography stratifications. Trend-following Managed Futures strategies also earned positive returns to start the year. Commodities registered a collective double-digit gain as energy and industrial metal prices rose sharply. Below are selected index total returns for the first quarter of 2021:

- Large company US stocks, as measured by the S&P 500 index, gained 6.2%.
- Mid-sized company US stocks, as measured by the Russell Mid Cap Index, gained 8.1%.
- Small company US stocks, as measured by the Russell 2000 index, gained 12.7%.
- International stocks, as measured by the MSCI All Country World (Excluding US) index, gained 3.5%.
- Commodity prices (oil, gold, metals, grains, etc.) gained 12.0%.
- Managed Futures Strategies, as measured by the Credit Suisse Managed Futures Index, earned 2.3%.

The US investment grade taxable bond market, as measured by the Bloomberg Barclay's US Aggregate Bond Index, had a negative total return in the first quarter, falling by (3.4%). While shorter term interest rates remained anchored near zero, longer term interest rates shot

higher leading to price declines across most areas of the bond market. As a reminder, bond prices generally move in the opposite direction of interest rates. Riskier bonds in the high yield and floating rate bank loan sectors managed to earn positive returns, continuing a run of outperformance that started one year ago. Below are the sector total returns within the bond market for the first quarter of 2021:

- Short Term US Treasury Bonds earned 0.04%.
- Long Term US Treasury Bonds declined by (13.5%).
- US Investment Grade Corporate Bonds declined by (4.5%).
- US High Yield Bonds earned 0.9%.
- US Floating Rate Bank Loans earned 1.8%.
- US Municipal Bonds declined by (0.4%).
- Developed Market Foreign Government Bonds declined by (5.3%).

Market Commentary

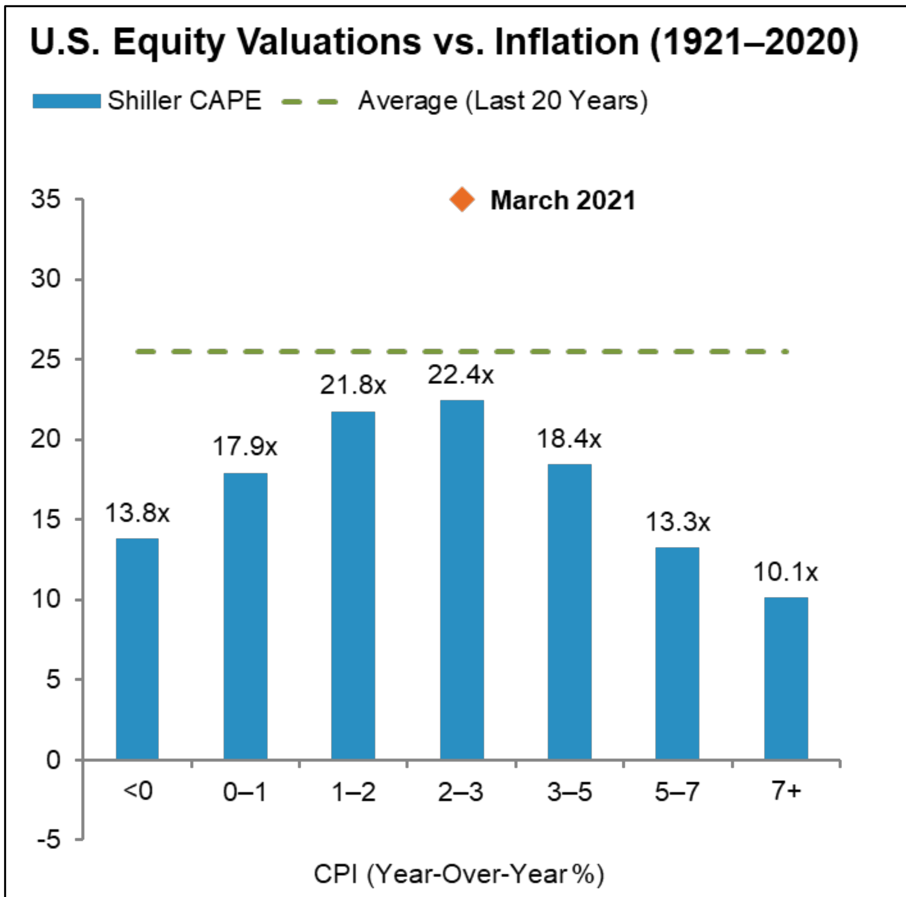
There is little doubt that the US economic recovery accelerated in the first quarter. Real-time economic data reports released since the beginning of the year have almost universally shown year-over-year and quarter-over-quarter improvement. The federal government approved a new $1.9 trillion stimulus package in early March that should provide a further positive jolt to the economy through the end of the year. And while COVID-19 cases remain stubbornly high, the vaccination campaign is proceeding faster than originally expected in November. As a result, estimates for 2021 economic growth rates have been increased by many analysts, and now cluster around 6.0%-7.5%, which if achieved, would be the fastest growth rate since at least 1984.

Stock and Bond markets reacted very differently to the improving economic picture in the first quarter. Stock markets continued their advance that started about one year ago, and finished the twelve months ended March 31 with truly eye-popping returns. On the other hand, bond markets expressed some concern, if not outright caution, that the combination of high economic growth, additional stimulus, and ultra-accommodative monetary policy would lead to a period of higher inflation. To protect against that risk, investors started demanding higher interest rates on intermediate to longer term bonds, which led to price declines in most high-quality sectors of the bond market, and an unusually large quarterly loss for the bond market index. In some ways these opposite reactions make sense in the short run, as potentially higher inflation and higher interest rates directly impact bond prices, but are only one of a handful of factors influencing stock prices. But history has shown that bond markets often act as a "canary in a coal mine", providing an early warning signal that stock investors are wise to consider.

The incredible rebound in stock markets over the past 12 months has largely been driven by investors being willing to "look through" the severe, but temporary impact of the pandemic, in anticipation that corporate profits would quickly rebound to previous levels and then advance further from there. As we mentioned last quarter, the valuation of the US stock market was, at that time, near the top of the historical range using just about any metric aside from valuing stocks relative to bonds – and this dynamic has stretched further in the first four months of the year. As a result, the consensus among the market strategists and asset managers we follow is that the US stock market is in many ways becoming "priced for perfection". What we

mean is that as long as expectations for high economic growth, fully-recovered corporate earnings, continued low interest rates, and only a transitory increase in inflation this summer are all met, then the US stock market appears reasonably valued. But if reality falls short of any of these expectations, stocks could be vulnerable to a correction. **Said another way, at current price levels, there is very little margin for error if the advance is to continue.**

In their recent Quarterly Market Update[1], Fidelity included a graph, reprinted below, that helped illustrate this point as it relates to inflation. We would highlight two main takeaways from this data. First, stock valuations have tended to be highest when inflation rates have been low, but positive – anywhere between 1% and 3% annually. But if inflation sustainably rises above 3%, then market valuations tend to take a hit. A similar outcome occurs if inflation sustainably falls below 1%, but that does not seem to be a concern today for the United States. The second main takeaway is that although we are currently in the inflation range that supports the highest average market valuation, the actual stock market valuation measure as of March is meaningfully higher than is typical when inflation has been between 1% and 3% annually, supporting the idea that the US stock market seems "priced for perfection" at current levels.



A similar analysis performed recently by Blackstone[2] examined the effect of changes in the 10-Year US Treasury Yield on the "fair value" of the S&P 500 stock market index. They found that changes in interest rates, given very low starting levels, have outsized impacts on the stock market. As an example, a quarter-point (0.25%) change in the yield of the 10-Year US Treasury bond up or down from a starting yield of 1.75% impacts the "fair value" of the S&P 500 index by 500-700 points – a potential 12%-17% change in the value of the index from its current level. These are very large potential swings for relatively small changes in interest rates, with the potential to overwhelm even very strong corporate earnings growth. **None of this is to say the market can't continue to move higher from here, but rather, if it is to continue to do so, inflation and interest rates will likely need to stay low, and corporate**

[1] https://institutional.fidelity.com/app/literature/item/9883196.html

[2] https://www.blackstone.com/insights/article/blackstone-quarterly-webcast-uneven-recovery-ahead/

earnings and economic growth will need to stay high. Alternatively, we would not be surprised to see some level of correction in the US stock market if any of these measures falter, after which the market would likely be in a much healthier fundamental position.

Portfolio Positioning

With that in mind, we feel the most appropriate recommendation is to carry forward our positioning ideas from the start of the year: maintain stock allocations near the midpoint of each client's long-term range; continue holding bond allocations near the bottom end of the range; and continue to recommend filling the gap from our bond underweight with a combination of alternatives and cash. To the extent that recent gains in the stock market have pushed a client's stock allocation above "neutral", we will look to rebalance their portfolio by selling a portion of the stock holdings and using the proceeds to increase other areas of the portfolio where appropriate. For more conservative clients and/or those clients relying upon their portfolios to fund their monthly living expenses, we recommend using currently high market levels to replenish cash reserves as necessary to ensure enough cash is available to meet 6-12 months of portfolio distributions. Within the stock portion of client portfolios, small company US stocks and international stocks of all sizes continue to trade at lower valuations compared to large company US stocks, and more pertinently, their own historical averages, and as a result, we recommend slightly overweighting these areas.

Although bond yields increased meaningfully in the first quarter, they did so from a historically low starting level. So, while the income bond investments can be expected to provide is improved from three months ago, it is still quite low in absolute terms. We continue to recommend publicly traded infrastructure, as well as public and private real estate, as "income alternative hybrid investments" that sit somewhere between stocks and bonds on the risk and return spectrum. We also continue to evaluate other sources of income, from private credit to income-based annuities, and expect to have recommendations to share soon.

We appreciate the trust you have placed in us to help you meet your financial goals, and work diligently every day to continue to earn your confidence. Please do not hesitate to contact us if you have any questions, or if you would like to schedule a meeting to review your portfolio in detail.

Best Regards,

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