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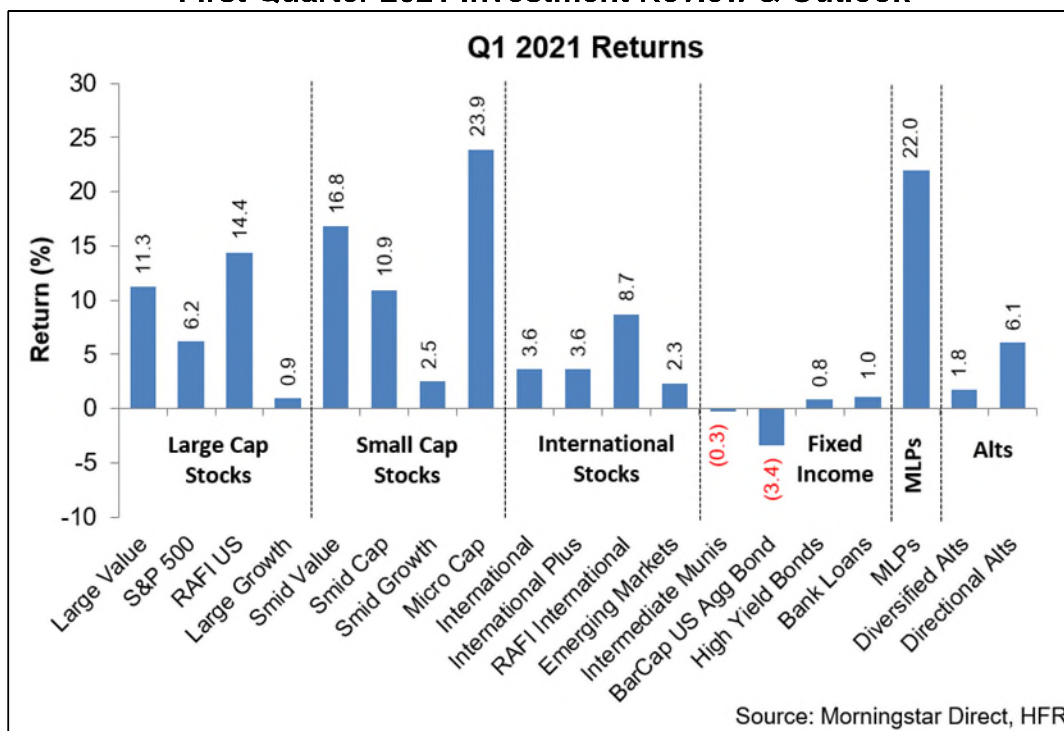
First Quarter 2021 Investment Review & Outlook



EXECUTIVE SUMMARY

Q1 2020 Recap:

- Financial markets largely pushed higher in the first quarter. The S&P 500 ended the quarter up 6.2%, closing out the period at a new all-time high.
- The re-opening trade gained further momentum, as the Covid vaccine rollout accelerated and additional Covid relief was passed by Congress.
- Run-ups in US Treasury yields weighed on fixed income securities, leaving the Bloomberg Barclays Aggregate Bond Index on pace for its worst year ever.

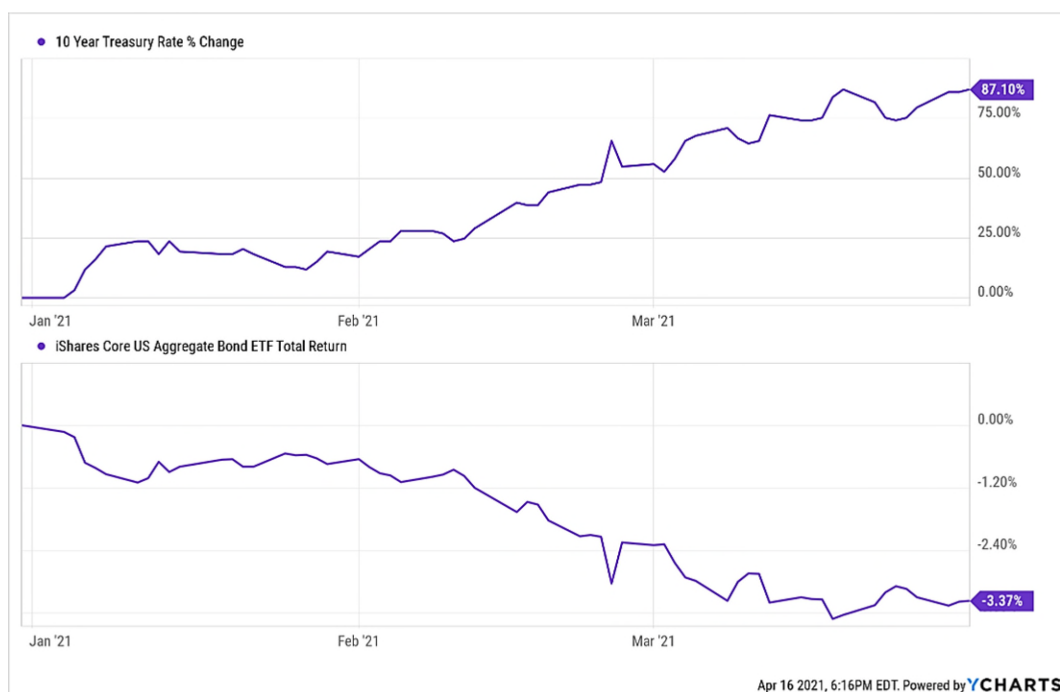
NEXT Outlook:

- As the economy fully re-opens and consumer demand normalizes, inflation numbers should continue to increase, placing additional upward pressure on interest rates.
- The backdrop of an economic re-opening, continued dovishness from the Federal Reserve, and a potential infrastructure package is constructive for equity markets in the near term.
- We expect continued outperformance from early cycle, economically sensitive names during the months ahead. However, the sustainability of that outperformance remains a big question.

To Our Clients and Friends,

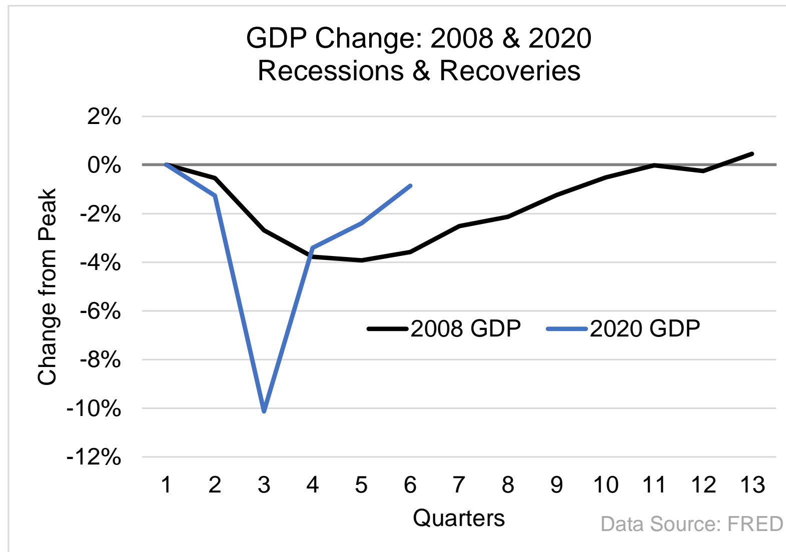
Financial markets were singularly focused on the global economic re-opening during the first quarter of 2021. In a continuation of late 2020 trends, the best performing asset classes and sectors were largely those most closely tied to a normalization in demand/economic activity – namely, small caps and cyclicals. We also observed outperformance in markets demonstrating significant progress in the fight against Covid-19, with the US outperforming Europe and Asia where the pace of vaccination has lagged. Ultimately, the S&P 500 ended the quarter up 6.2%; however, once again an abnormally high level of dispersion occurred across markets and sectors.

Positive macro data benefited many segments in the equity market, but it served as a headwind to the fixed income complex. As business restrictions eased throughout the US and additional fiscal stimulus made its way into consumers' pocket, investors grew increasingly nervous about an overheated economy and the potential for rampant inflation. The 10-year US Treasury yield ended the quarter at 1.74% – nearly double its level of 0.93% at the end of 4Q20 – as bond markets began to price in this threat.



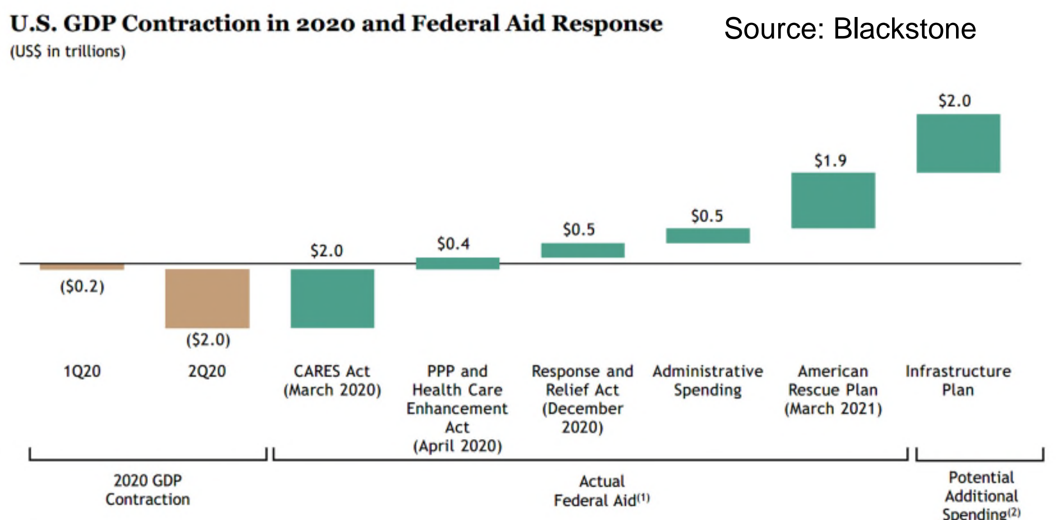
With yields sitting near all-time lows, there was (and continues to be) very little cushion to protect bonds from further increases in rates. The Bloomberg Barclays US Aggregate Index, which we look to as a broad proxy for the bond market, has been in a steady downward trend since early August 2020. Treasury yields remain near all-time lows, suggesting that the risk of more downside is still significant.

For many, the speed with which rates increased in Q1 was a surprise. However, the move was certainly justified given the economic data that materialized over the first three months of the year. Economic forecasts were constantly revised upwards in the first quarter, beating expectations and boosting US Real GDP to a level of 6.4%. Other than Q3 of last year, when our economy initially rebounded from the Covid-19 recession, this was the best rate of growth since 2003.



Accordingly, we saw gains in labor markets and inflation data. The unemployment rate ended the quarter at 6.0%, down from 6.7% at the end of 2020, and consensus forecasts now imply that it may fall to 4.8% by year-end. Meanwhile, consumer prices made notable moves higher, with the consumer price index (CPI) increasing 2.6% in March and 4.2% in April. As we will discuss later in this letter, the near-term increase in prices is due to transitory factors that will likely dissipate. Nevertheless, the data serves as fuel for the inflation narrative that has taken hold over market participants.

To that end, we note that with the signing of the American Rescue Plan Act in February, an additional $1.9T in stimulus brings the total fiscal expenditures since the advent of the pandemic to $5.3T. That represents approximately 25% of our entire pre-pandemic economy – and dwarfs the $2.2T drop in GDP that occurred during the pandemic. The massive influx of transfer payments, coupled with increased vaccinations and easing restrictions throughout the country, should lead to a large boost in demand. Additionally, pandemic-induced disruptions to supply chains have created back-logs for manufacturers and vendors, which places further strain on prices from the supply-side.



Whether inflationary pressures remain transitory or become a more sustained phenomenon will be one of the most critical developments in the quarters and years ahead. A sustained push higher in inflation will

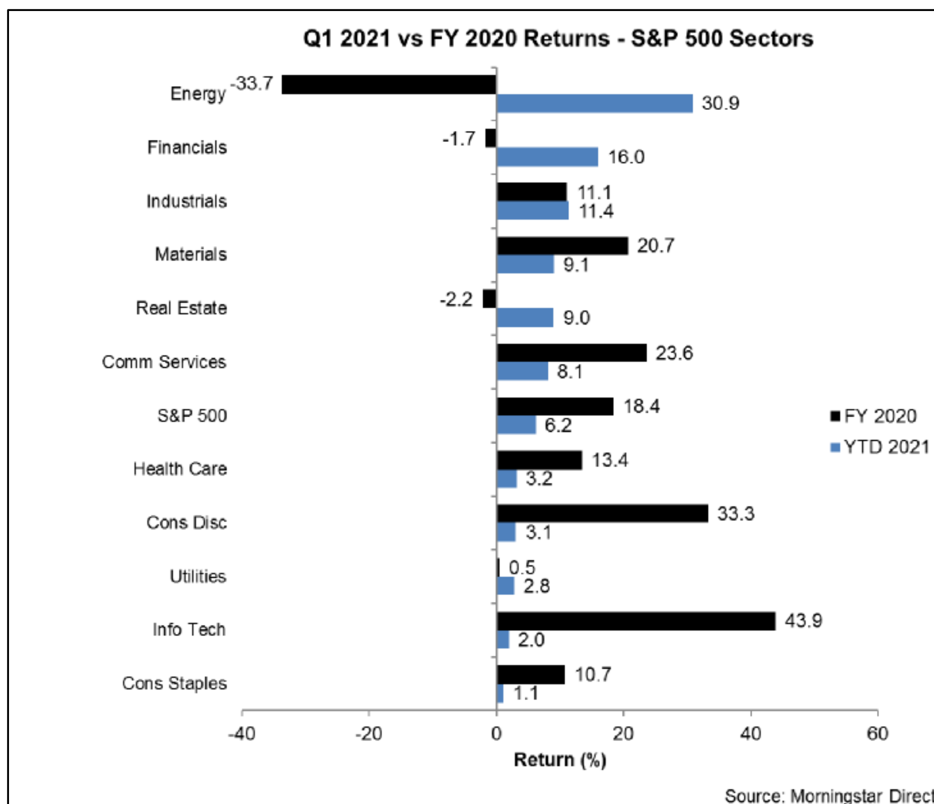
have a number of negative consequences, including less accommodative Federal Reserve policy, higher interest rates, and restrained economic growth. It potentially creates an environment where both bonds and stocks perform poorly – the inverse of the last decade of strong equity and bond market performance – which would cause severe stress for most traditional investors.

Market Recap…

During the first quarter, US equity markets continued the trend that began after positive Phase 3 vaccine trial news in November of last year. US large cap stocks posted notable gains (with the S&P 500 adding 6.2% during the period), but a more robust rally took place in the value and small cap segments of the market. As we have noted in the past, these areas are more representative of the "real economy" than the overall stock market. As such, the rebound in strong economic data propelled these segments into strong double-digit gains for the quarter.

Large cap value stocks outperformed growth stocks with returns of 11.3% and 0.9%, respectively, while small cap stocks returned an impressive 10.9% for the quarter. Most notably, small cap value stocks – a long underperforming area of the market – led market performance with a return of 16.8%.

Sector returns were the big driver behind the dispersion between value and growth indices. Strong performance in the Energy and Financial sectors – traditional value sectors – were emblematic of the "re-opening trade," with industry constituents benefiting from improvements in economic activity (namely, higher oil prices and a steeper yield curve). Alternatively, rising rates put a dent in the frothy valuations exhibited by "long duration" technology and communication services stocks, companies whose valuations are more dependent on earnings projected far out into the future rather than those that are readily visible today. We view this rotation as a healthy rebalancing, as the divergence between growth and value stock valuations had become quite stretched in the latter portion of 2020.



Overseas, non-US equity markets were surprisingly weak on a relative basis, with International stocks up 3.6% and Emerging Markets up 2.3% in the quarter. A declining US dollar had led many to anticipate outperformance in non-US markets. While this was initially the case, issues surrounding the distribution of vaccines and new, more virulent strains of the Covid-19 virus led to renewed lockdowns in several European countries that affected market performance. Emerging Markets have also been coping with poor vaccine rollouts, as the most populous counties (China, India, Brazil, Indonesia, and Russia) have vaccinated less than 10% of their citizens as of the end of the first quarter. Increasing anti-trust tensions in China served as an added headwind to the region.

As noted in our preamble, bond portfolios had a tough start to the year, as markets began to grow increasingly concerned about inflation. The Bloomberg Barclays Aggregate Bond Index – a proxy for high quality, intermediate maturity bonds – ended the quarter down 3.4% amid a backdrop of sharply rising interest rates. This puts the broad bond index on pace for its worst year ever; with rates still extraordinarily low, more pain could be in store for traditional fixed income investors.

There is, of course, a diverse subset of sectors within the fixed income universe, and some fared better than others. Traditional high quality, long duration bonds performed most poorly – if you were unfortunate enough to own long dated Treasuries in Q1, you lost approximately 14% in the quarter. Conversely, more credit-oriented areas benefiting from an improved economic environment saw modest gains. Bank Loans and High Yield generated returns of 1.0% and 0.8%, respectively. Even in these areas, however, valuations have become stretched, limiting the number of attractive opportunities available to investors.

Non-traditional sectors generated robust performance in the quarter, benefiting from a continued rebound in valuations from last year's pandemic and a strong backdrop for private assets. Private credit funds gained more than 3% in Q1, Core Real Estate gained more than 2%, and while no official industry-level Private Equity Returns are available just yet, anecdotal data suggests those strategies too will be positive. Meanwhile, the hedge fund industry posted another quarter of gains – Diversified Funds rose 1.8% and Directional ones rose 6.1% – despite the stress levied upon the industry in January when a number of so-called short squeezes affected "meme stocks" like Gamestop and AMC.

Outlook…

Market behavior during the first quarter of the year has painted a clear picture of investor priorities over the coming months. Namely, macroeconomic data will remain under severe scrutiny given that the main lynchpin of this market – Fed support – could be tested with hints of stronger-than-expected growth. As we finish this letter in May, the market is providing mixed signals. The bond market seems to be suggesting that the initial fears of inflation were somewhat over-blown, as the 10-year US Treasury yield has retreated to below 1.60%. On the flip side, equity markets are indicating that inflationary risks are gravely important, given the continued volatility exhibited by expensive growth stocks, and the strong outperformance of stocks in cyclical sectors that can readily pass along price increases onto the consumer.

The bond market's current posturing is consistent with the narrative that has been espoused by the Fed for some time now – that inflation may temporarily run hot but that it will likely subside after we work through transitory issues relating to the pandemic. Furthermore, Fed Chair Jerome Powell has continued to put forth a very dovish stance, asserting that the FOMC is not thinking about any tapering or rate hiking in the foreseeable future.

It has been said that "fighting the Fed" is a fool's errand, and that concept has certainly played out in recent years. However, we must also observe that it is not in Mr. Powell's interest to telegraph anything but easy money policy for the foreseeable future. The concern that prudent investors must have at this point is not whether the Fed *wants* to change its accommodative stance, but whether it is *forced* to by both an economy

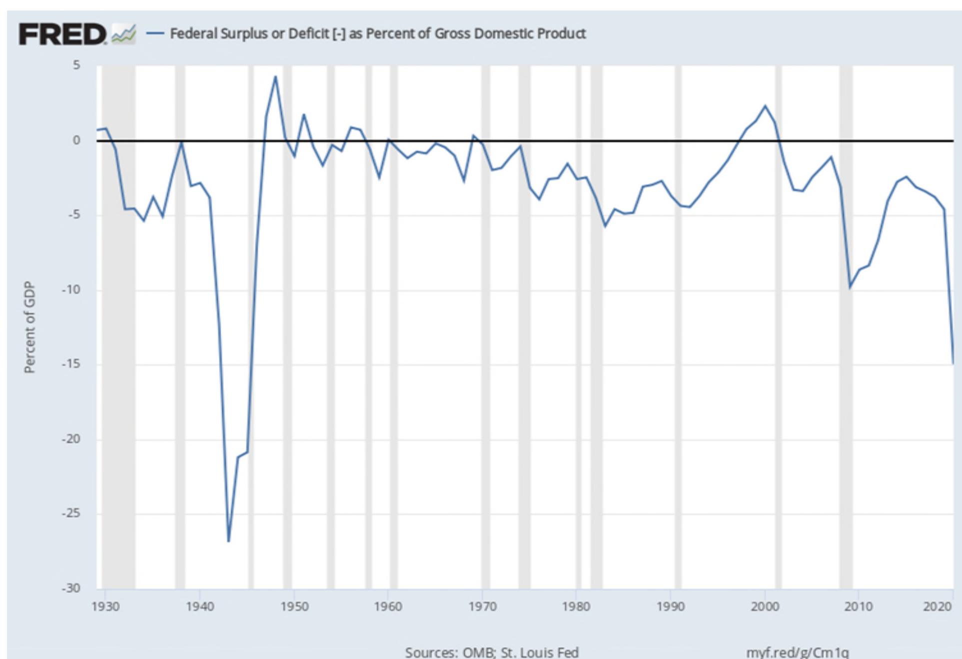
and market that is abundant with fiscal and monetary liquidity. While a similar environment after the Global Financial Crisis did not trigger runaway inflation, we observe that at the time we were undergoing a multi-year deleveraging process that was inherently deflationary. That is not the case today.

Adding to these concerns, of course, is the $2.3T infrastructure package currently making its way through Congress. That amount would represent another 10% of pre-pandemic GDP, bringing the total stimulus bill over the past 12 months to over 35% of our economy. This far exceeds the 5.7% American Recovery and Reinvestment Act of 2009 and rivals the 40% of GDP spent on the New Deal following the Great Depression[1]. While the ultimate bill will likely be somewhat smaller in scale, there does seem to be political will on both sides of the aisle to get something done on this front. Students of economics will tell you the combination of a massive money supply increase and exceptional economic growth provides the necessary ingredients for inflation.

The path forward, of course, is unknown and thus demands strong vigilance in the quarters and years ahead. There are enough counter cyclical forces at play – continued (albeit reduced) globalization, aging demographics around the world, and disinflationary effects of technology – that runaway inflation is not a slam dunk. Still, increasing allocations to diversifying strategies – real assets, hedge funds, and floating rate debt – are all intelligent portfolio construction decisions to prepare for this potential regime where traditional stocks and bonds could underperform.

Watching Washington…

Unfortunately, the other byproduct of elevated fiscal spending is an inevitable increase in taxes. Our fiscal deficit has plunged to depths not seen since World War II. Using more debt to finance the current Administration's proposed infrastructure bill would push our deficit to unsustainable levels. Thus, a combination of personal and corporate income tax increases has been floated as a means to pay for the infrastructure bill and other initiatives.



[1] The Recovery Act of 2009 vs. FDR's New Deal: Which Was Bigger? St. Louis Fed, 2017, https://www.stlouisfed.org/publications/regional-economist/first_quarter_2017/the-recovery-act-of-2009-vs-fdrs-new-deal-which-was-bigger

Those proposals include:

- Returning the highest personal income tax rate to 39.6% from 37.0%
- Increasing the top capital gains rate from 20.0% (23.8% including ACA surtax) to ordinary income rates for those making more than $1 million annually (39.6%, or 43.4% if ACA surtax is included)
- Eliminating the step up in basis at death for gains above $1 million
- Increasing the corporate tax rate from 21.0% to 28.0%
- Increasing the global intangible low-taxed income (GILTI) rate – a minimum tax on international sales – to 15% on international revenues generated by multi-nationals with income exceeding $2B.

As expected, there is stiff resistance to these increases from Republicans. With an evenly split Senate, and moderate Democrats like Joe Manchin playing a key role in the negotiations, we are skeptical the proposals will make it through as currently structured. The capital gains tax increase appears particularly extreme to us. However, it is early in the process and therefore difficult for us to speculate on potential outcomes. We will note that while the GILTI tax may appear to be more obscure to some, those hikes could have a disproportionate impact on mega-cap tech stocks, who pay relatively low global corporate income tax and generate a significant amount of sales from overseas.

Final Thoughts…

Despite our concerns regarding these specific issues, we will note that the immediate years after a recession are typically strong ones for risk assets. Defaults are low, interest rates are stimulative, and risk appetites have been revived as the economy recovers. Many of the potential issues and distortions that may be caused by today's unprecedented policymaking will take time to manifest. Additionally, until the Federal Reserve signals that it is materially stepping back from a posture of market support, there is likely to be a strong technical bid for this market from investors.

What is unusual in today's market, however, is that market valuations are not as cheap as they typically are at this point in the cycle. Both equities and credit are trading at elevated prices, reducing the enthusiasm that we might otherwise have in an early economic recovery. Thus, while we are encouraged about the broader backdrop for markets, we believe proceeding in a cautiously optimistic way is warranted. We continue to have conviction that bolstering traditional portfolios with non-traditional assets like alternatives, real estate, and private investments will be increasingly important as we navigate uncharted waters in the years ahead.

As always, if anything has changed in your financial life, or you feel that your tolerance for risk has changed, please call or email us at your earliest convenience.

Sincerely,

Your Investment Team

5/25/2021

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