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QUARTERLY UPDATE & ECONOMIC COMMENTARY—MARCH 31, 2021

QUARTER IN REVIEW

The first quarter was a solid quarter for stocks. The S&P 500 TR had a strong March, finishing positive by 4.38%, and is currently positive by 6.17% year-to-date. Continuing the momentum established during the fourth quarter, small-cap stocks and mid-cap stocks outperformed the S&P 500 for the quarter. The S&P SmallCap 600 returned 18.24% and the S&P MidCap 400 returned 13.36% for the first quarter. In addition to small-caps outperforming large-caps, value outperformed growth. The S&P 500 Value index outperformed the S&P 500 Growth Index by 865 basis points. This trend was consistent for small and mid-caps as well. The SmallCap Value Index outperformed the SmallCap Growth Index by 1190 basis points. The performance was driven more by affiliation with value sectors as opposed to investors flocking to undervalued companies. The top 5 performing sectors were: Energy (30.85%), Financials (15.99%), Industrials (11.41%), Real Estate (9.02%) and (Materials 9.08%). Collectively these five sectors only make up about 31% of the S&P 500 in comparison to the Technology, Consumer Cyclical, and Communication Services which makes up 46% of the S&P 500. Comparatively, those top five performing sectors comprise approximately 47% of the S&P 500 Value Index and only 16% of the S&P 500 Growth Index.

International stocks had a good quarter, but U.S. investors holding international positions were hurt by the reversal in the U.S. dollar as the dollar strengthened during the quarter. The MSCI EAFE in U.S. dollar terms returned 3.48% for the quarter, but in local currency the index was positive by 7.59%. There was a similar story in Emerging Markets, though not quite as pronounced. The EM index returned 2.29% in U.S. currency but 3.96% in local currency. While currency swings can both help and hurt an investor's return, taken as a whole they should be viewed favorably because currency impacts provide an additional source of diversification. There were some standout performers in the developed international markets; these include Sweden, Netherlands, Austria, Hong Kong, Ireland, and Singapore. Within the emerging markets, the following countries led the performance: United Arab Emirates, Chile, Taiwan, and South Africa.

Fixed income returns were not nearly as good as we saw last year or compared to the performance of equities. In anticipation of strong economic growth and growing concerns around inflation, longer-term interest rates spiked during the quarter. The 10-year Treasury yield started the year yielding 0.92% but moved to 1.77% during the quarter and ended at 1.75%. The increase in rates caused bond prices to fall, impacting returns. The Barclays Aggregate Bond Index (Agg) lost 3.37% for the quarter, its worst quarterly return since 1981. While the yield increases have hurt returns during the quarter, bonds benefited during 2020 from falling yields, as the Agg returned 7.51%. The shorter duration Agg index, comprised of 1–3-year maturities, fared much better, only losing 6 basis points. The high yield index made up of lower quality positions posted a positive quarter returning 0.85%. It is important to remember that from a long-term perspective, rising yields will be good for bond investors.

We have seen a continued move higher within the oil markets. West Texas and Brent Crude had a strong quarter, returning over 20% for the second straight quarter. Metals were a mixed bag with the popular metals Gold and Silver both losing value, Gold by 9.47% and Silver by 7.12%, but Copper had a strong quarter returning 13.23% and Platinum returned 10.41%. A couple of other notable performers in the commodity markets were Lean Hogs up 49.84%, Corn 16.58%, Wheat -3.51%, and Cocoa -9.80%. If inflation does become prevalent you should expect to see many commodities trading higher. Bitcoin, although not a commodity, but worth reporting, had an outstanding quarter, starting the quarter around $29,000 and finishing the quarter at over $59,000.

From an investment and portfolio perspective, the story was around diversification. After last year's performance, especially the first three quarters of the year, being led by large-cap and growth companies, the last two quarters saw markets led by small-cap and traditional value sectors. The theme driving this shift was based on U.S. and global economies re-opening. The roll-out of vaccines in the U.S. started very slow but accelerated during the end of the first quarter. Vaccines are the key to get back to normal and Americans are ready to travel and spend money. As a result, energy stocks performed well; as demand for oil and gas is expected to increase, other cyclical areas of the market, like industrials, have performed well as did travel related stocks like hotels, airlines, and booking companies.

Another big story of the first quarter was the inauguration of President Joe Biden. By the time the new president took office the Georgia elections were finalized and the Democrats had full control of Congress, although by thin margins. This is a big development as it will allow more of the Democratic agenda to be passed. The lack of commanding control will limit what can get put into law. The immediate impact of the control was the additional stimulus plan that was passed totaling $1.9 trillion. This stimulus is in addition to $900 billion former President Trump passed in December and $2.5 trillion passed previously during 2020. This is a staggering amount of money to spend, and Democrats are looking for more. We will touch more on what the Democratic agenda could mean for markets later in the commentary.

The market experienced three trading events during the first quarter that could have been problematic. We touched on these in our monthly Investor Insights so we will not get into detail in this piece. The first event involved options trading in smaller, less liquid companies, like GameStop. The GameStop trading triggered a large retail focused trading platform, Robinhood, to receive a $1 billion lifeline to meet regulatory requirements. Linked to this event, the hedge fund Melvin Capital was betting GameStop shares would fall in price, known as being short the stock. The hedge fund was short more shares then were actively available for trading, thus the hedge had excessive leverage. Melvin Capital received a $2 billion investment from another hedge fund. The third event occurred at the end of the quarter and involved leverage and another hedge fund, Archegos Capital. The firm was overleveraged to the stocks like ViacomCBS and Discovery. The fund got hit with a massive $20 billion forced liquidation of the positions. This hedge fund blow-up hit some large banks, including wiping out $9 billion in market value of Nomura and Credit Suisse. Fortunately, these events were contained, but it shines the light on some of the vulnerabilities in the markets and the concerns with cheap, easy to obtain credit.

The Federal Reserve met in March and laid out the framework for their Flexible Average Inflation Targeting (FAIT) plan announced in August. The framework seeks to achieve inflation that averages 2% over time, which means when following periods of inflation below 2% (the last decade), they will let inflation run above 2%. Based on the Fed's guidance, interest rates are expected to be low for some time, both supporting the economy and promoting inflation. In other news, the Fed declined to extend a rule enacted during the pandemic that reduced the amount of capital banks had to maintain against Treasuries and other holdings. One last announcement impacting the banks: the Fed will allow the big banks to resume normal levels of dividend payouts and share repurchases as of June 30 as long as they pass this year's stress test.

As of this writing, we received March jobs numbers which showed that 916,000 jobs were created in March. January and February numbers were revised upward by 156,000. There were 780,000 jobs created in the private sector, with the leisure and hospitality sector leading the way with 280,000. The unemployment rate moved lower to 6%. This is a positive report and consistent with the market returns and positive forecasts reported during the quarter. The manufacturing sector is showing signs of robust growth. The ISM survey registered a 64.7% reading which translates into a 3.9% increase from February, the highest levels since December 1983. Respondents to the survey did caution about inflationary pressures and disruptions in the supply chain which may impact manufacturing in the future. The last time the ISM manufacturing reading was that high was the year before economic growth reached 7.2% and inflation was 3.8%.

The housing market continues to show strong demand, but lack of supply, rising interest rates, rising costs and supply chain issues could cause home purchases to slow down in the coming months. While interest rates are still at historic lows, combining potential additional price increases from low supply plus building costs, some buyers could be priced out of the market. Consumer spending in February slowed, but the slowdown is being blamed on colder weather in Texas and throughout other parts of the south and from the passage of time since the beginning of January stimulus checks. This slowdown is expected to be temporary, and as the weather improves and consumers receive their additiona l round of stimulus checks spending will accelerate again.

Much of the pandemic, the U.S. was lagging many other nations with how the pandemic was handled. Over the last several months this has changed. The United States has accelerated vaccine distribution while many other countries have fallen behind. Europe has been behind, including powerhouse countries like Germany. Brazil Is a major emerging market country that has lagged in pandemic response consistently over the past year. International markets continue to look attractive from a valuation perspective and could benefit if the dollar weakens on the heels of higher inflation and more robust stimulus.

A Look at the Numbers

Name	1st Quarter Return (%)	YTD Return* (%)
DJ Industrial Average TR USD	8.29	8.29
S&P 500 TR USD	6.17	6.17
S&P MidCap 400 TR	13.47	13.47
S&P SmallCap 600 TR USD	18.24	18.24
NASDAQ Composite TR USD	2.95	2.95
MSCI EAFE NR USD	3.48	3.48
BBgBarc US Agg Bond TR USD	-3.37	-3.37
Wilshire US REIT TR USD	8.81	8.81
IA SBBI US 30 Day TBill TR USD	0.01	0.01
**As of March 31,2021*		

A LOOK AHEAD

As of the end of the first quarter, over 150M Americans have received at least one vaccine shot. Of those vaccinated, more than 73% of the over 65 year-old population received at least one shot and more than 37% of the over 18 year-old population received one shot. There is still work to be done, but this has been a positive trend. In addition to the increased supply and improved distribution, more and more Americans are becoming comfortable with the notion of getting vaccinated. Recent surveys indicate that around 70% of the population intends to get vaccinated, up from about 60% in November

Getting people across the world vaccinated is the most important step to getting back to normal. A reversal in this positive trend is a major risk to stalling the recovery. Another major risk to the recovery would be if the virus mutates to a strand that the vaccines cannot protect against. One way to reduce the mutations is to stop the spread, which comes back to getting people vaccinated, both here in the U.S. and also globally. The positive side to fighting mutations is that technology is better and vaccine cocktails can be adjusted quickly to combat a different strand, potentially without having to go through a full trial. We are not experts in this field, but it is our understanding that there is a slim possibility of the virus getting worse; it is not our base case and we would expect any potential setbacks could be treated more quickly.

The economy is set up for a strong second quarter and this could be good news for stocks. Service-related industries are expected to ramp up. Americans are expected to fly, attend sporting events, eat out in restaurants, stay in hotels and get back to the gym. In addition to Americans having the ability to attend these events, they also have the money to spend on these discretionary items, either because of enhanced unemployment benefits, recent stimulus or higher savings from lack of spending over the last year. Bank of America has forecasted second quarter GDP growth to be 10% and the median analyst forecast for second quarter growth is 9.3%. There is no question that some of this expected good news is already factored into the market, but most strategists believe there is still more room to the upside.

The market was also abuzz about President Biden's $2 trillion infrastructure and economic recovery package announced on March 31. The plan is geared at revitalizing U.S. transportation infrastructure, water systems, broadband and manufacturing. Before investors get too excited about the bill and rush into buying infrastructure-related stocks, the spending is proposed to be over the next 8 years. On the negative side of the bill, the President said he would aim to raise the corporate tax rate to 28% to fund the bill. The higher taxes and other proposed measures to stop off-shoring of profits would fund the infrastructure plan over 15 years. The President is working on the second part of the plan which will focus on improving education and expanding paid leave and health-care coverage. Whether or not this bill could be passed is still up for debate. The Democratic control is tight, and the GOP is unlikely to support higher taxes, despite both sides supporting infrastructure spending.

Another item on the President's agenda that could be a risk to the market is higher taxes, both corporate taxes as mentioned above but also higher taxes on individuals and families. The chatter about raising taxes has increased and it is expected that the President will outline his tax plan later this year. The 28% corporate tax was widely expected although not supported by Republicans. On the individual side, the President has said he wants to raise taxes on those families making over $400,000 annually. In addition to higher federal taxes, the President also wants to apply social security taxes on income earned over $400,000, known as the donut hole approach. Under current tax law there is a 12.4% (employee and employer) social security tax collected up to a ceiling ($142,800 in 2021). In Biden's tax plan the tax would restart at $400,000 creating a donut hole between the wage base and $400,000. This would eventually be eliminated as the wage base gets increased annually for inflation and will at some point in the future reach $400,000. President Trump's tax cuts are set to expire in 2025, even without President Biden passing legislation this year. Generally higher taxes are negative for the markets, but without more specifics on what is expected to get passed, it is difficult to forecast the markets' reaction. While we would expect any higher taxes to be effective in 2022, it should not be discounted that Washington will make them retroactive to the beginning of 2021.

The short-term outlook continues to look favorable for the economy and the market. The Fed continues to keep interest rates low and they say they are committed to this policy for the rest of the year and 2022. It will be worth watching their comments if the economy runs hot and inflation does find some momentum. The Fed has had lots of flexibility to keep rates low over the last decade because inflation has not been an issue, but if it does become problematic the Fed may not be able to keep the same interest rate flexibility. The federal government's budget deficit is approaching historical levels and is expected to surpass debt-to-GDP ratios post World War II. Nobody worries about these high debt levels until they become a problem. In the coming years, GDP is expected to revert back to pre-pandemic levels of around 2% growth and the cost to service debt is expected to increase because interest rates will be higher. While these are not today's problems, they will be problems of the future.

In the review section, we touched on some concerning areas of the market that have yet to cause any significant issues, but they are worth being aware of. These issues have caused banks to look at their exposures as well as their lending and trading practices. In addition to the retail investor's move into options trading and hedge-funds' leverage, the rise of special purpose acquisition companies (SPACs) and the selling of non-fungible tokens (NFTs) is a bit concerning. These areas of the market could be entertaining and they are attracting celebrities, professional athletes and other influencers, but we would caution against building a long-term investment plan around them, or even a short-term get rich plan around them.

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