Q1 2021 MARKET RECAP

APR 7, 2021

With Q4 2020 GDP coming in just above 4%, the output gap has now closed down to nearly -3% and looks to narrow further if Q1 2021 blue chip estimates of around 5% GDP growth come to fruition. Our Q1 2021 estimate is a bit higher around 6%, up from 5% in Q4 2020 as the massive additional $1.9 trillion stimulus bill will send $1,400 checks to the vast majority of Americans, further strengthening the consumer balance sheet and likely increasing consumer spending as the economy reopens. Many of these checks hit bank accounts in March, so their effects will be felt in Q1 but have probably not been incorporated into many estimates yet, meaning there may be more room to the upside. For the full year 2021, U.S. GDP forecasts are around 6.5%, which would be the strongest full year reading in nearly 40 years. While the National Bureau of Economic Research has yet to call an end to the recession that began in March, we feel that the end of the recession will be backdated to the end of Q2 2020, making it one of the shortest recessions on record. For reference, the definition of a recession is 2 consecutive quarters of negative GDP growth, so this recession would just barely meet the minimum requirements.

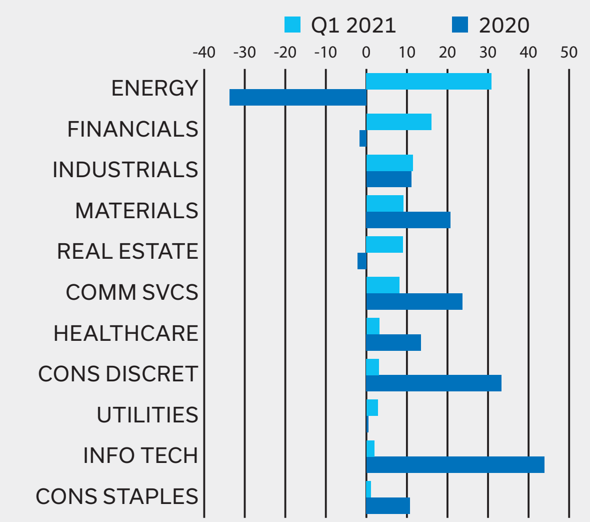
SECTOR ROTATIONS

Markets were largely positive but more moderate in Q1 2021 after strong Q4 gains. The S&P 500 was up +6.17%, ahead of the MSCI ACWI at +4.68%. Developed Markets rose +3.60% while Emerging Markets gained +2.34%. Notably, Value outperformed Growth by the biggest quarterly margin (9.8%) since Q1 2001. Rotations of this nature typically last 5-6 quarters on average, so there is the possibility for more room to run in favor of Value over Growth in the coming quarters. A key question in this dynamic is the ability of Growth to compete in a rising rate environment. Historically, Value has generally outperformed Growth in periods of rising rates, or at least the two have performed similarly. If rates continue moving up from their current levels in the coming quarters, Growth's period of outperformance could certainly pause for a bit. In addition to a rotation into Value, we have also seen a rotation into small cap stocks. Small cap stocks (Russell 2000) have outperformed large cap stocks (Russell 1000) by nearly 25% over the past 2 quarters. That's the biggest 2-quarter delta ever by a factor of nearly 2x (FactSet). Rotations of this nature are not new, despite the size of this one, as small cap stocks often outperform coming out of a recession, as they are more directly levered to the domestic economy.

Another major topic of discussion in Q1 was the move in interest rates, as the U.S. 10-year Treasury yield came into the year at 0.93% and ended the quarter at 1.75%. Historically, a move higher of around 100 basis points in the 10-year US Treasury has been the norm, so this move was not out of place. However, the speed of the increase was of some concern as the yield did rise 55 basis points in 1 month, which is over a 2 standard deviation event. Additionally, the spread between the 10yr yield and the Fed Funds Rate is currently right around 170 basis points. Historically, this spread has widened to between 200 to 300 basis points before the Fed acts by raising rates and tops out at 300 to 400 basis points. Still, the result of rising yields was a negative return on the Bloomberg Barclays US Aggregate Bond Index, which ended the quarter down -3.37% and was the index's biggest negative quarter since Q3 1981.

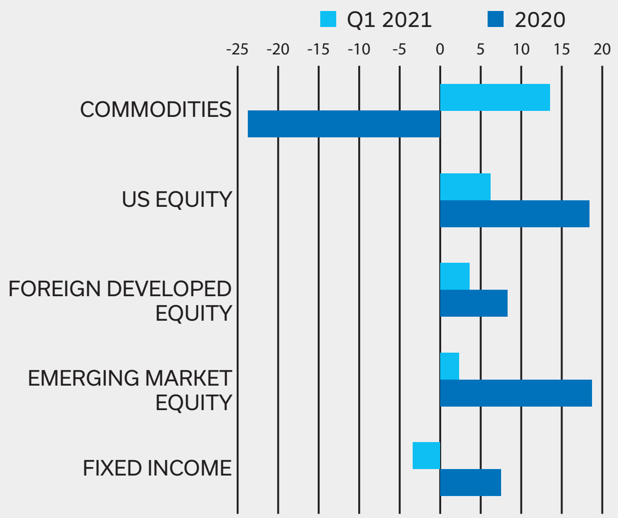
Another topic was inflation, as investors are becoming increasingly worried about it along with rising rates. While we agree that inflation will likely increase in coming months, we feel that it will be primarily due to base effects, or the fact that last year at this time we had just entered the pandemic and inflation declined which makes the year-over-year comparisons we use to measure inflation look higher than they actually are. A prime

Sector Returns, % return
As of 3/31/21



Source: Morningstar Direct

Asset Class Returns, % return
As of 3/31/21



Source: Morningstar Direct

example of this base effect is oil prices, which went negative last year, so simply looking at year-over-year comparison will look scary, even if the current $60-65 prices are not very high relative to history. A good defense against inflation is productivity, which has been quite strong in recent quarters. On a year-over-year basis, the last 3 quarterly readings have been 3 of the 4 strongest gains since Q2 2010. Improving productivity can help moderate prices, especially as manufacturing processes are streamlined with technology and costs are reduced accordingly. We do not see this trend stopping anytime soon, as the advances in areas like robotics and artificial intelligence have been exponential.

Outside of rates and inflation, the battle against COVID-19 is turning in our favor. Pfizer, Moderna, and Johnson & Johnson all have vaccines that are being distributed across the country. If you recall, at the end of 2020, the forecast was for one half of all Americans to be vaccinated by April. Now, the forecast is for all adult Americans to be vaccinated by May. That's a remarkable acceleration and has gone hand in hand with a precipitous decline in new cases, hospitalizations, and deaths (Our World in Data). The U.S. is now vaccinating over 3.1 million people per day, roughly 45x the number of new COVID-19 cases. The UK is ahead of the U.S., in part because they chose the single-dose option to get people vaccinated (which is now known to be very effective as well), while Europe continues to lag as they have been slower on the vaccine distribution and remain in full lockdown in some places. Domestically, we anticipate a broad reopening of the economy as we enter the summer months and the strength of the consumer will be on display as people are able to get back to their normal lives. Many metrics, like foot traffic, for example, still have considerable room for improvement. Remember, the consumer accounts for two-thirds of the U.S. economy. Of the $1,400 coming via stimulus checks, roughly 60% is expected to be saved or invested, which is bullish for the economy.

AN OVERALL POSITIVE OUTLOOK

Looking ahead, as we said above, we expect Q1 2021 GDP to be around 6%, which would be a very strong reading historically. Global trade continues to rebound and domestically, we are looking at what the new normal will be for the U.S. economy as the reopening occurs. The $1.9 trillion stimulus bill will provide another welcome boost to consumer spending and some of that money may very well find its way into equity markets as well. Our year-end price target for the S&P 500 remains at 4,200 with a 20x multiple on earnings of $210 for 2022. In an average year, we see a 12% decline from peak to trough. While we did not get a decline of nearly that magnitude in the S&P 500, the NASDAQ did decline over 10% from mid-February to early March before moving higher into the end of the quarter. Multiples have been cited as a concern as they are at elevated levels, but if you look at the valuations relative to other peaks, we are not at those extremes, and we feel that we may very well see multiple contraction in the coming quarters as earnings improve.

We hope that you and your loved ones are healthy and safe and please let us know if we can answer any questions that you may have.

Sincerely,

Kim David Arthur
CEO and Portfolio Manager