Investment Commentary: First Quarter 2021

- The economic recovery has begun, but is it sustainable?
- Interest rates rise, signaling inflation or an economic recovery?
- Let the good times roll, at least for the stock market.

Introduction

With the first quarter of 2021 behind us, the economy is in full-blown recovery mode. According to the Wall Street Journal, real (after inflation) GDP forecasts are for 6% growth by the end of the year. This would result in net growth of 2% over the past two years…during a pandemic! The driving force behind this is over $5 trillion in emergency aid for Americans over the past year. In comparison, the stimulus package after the Great Recession totaled $840 billion. While the long-term ramifications of these actions will remain hotly debated, 2021 marks the beginning of a new path for the entire world, filled with equal levels of optimism and uncertainty.

Economic Review & Outlook

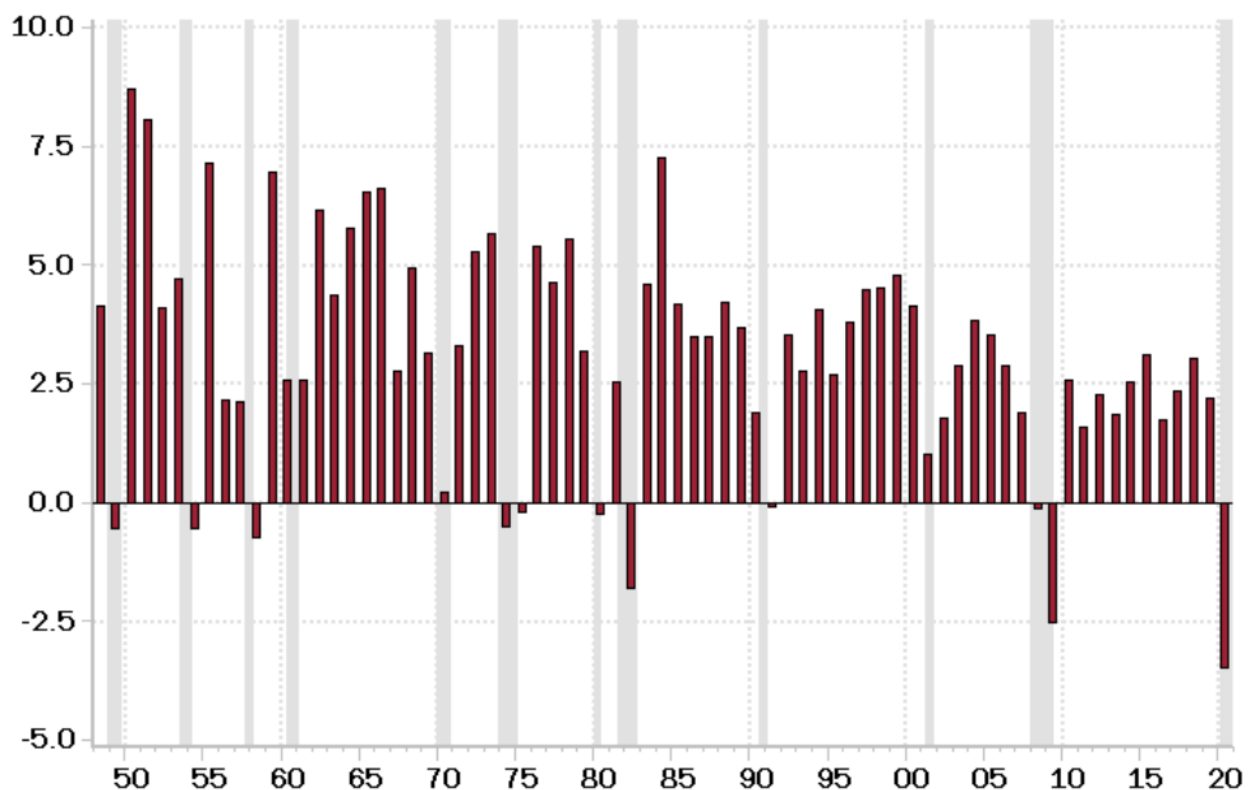
Before we discuss the economic outlook for 2021, let us review what happened in 2020. Real GDP contracted by 3.5% (see the chart to the right) and employment declined by 5.7%, both the worst in the post WWII era. Despite this devastation in economic activity, personal income ***increased*** by 6.3%, the largest since 2006. How is this possible? Government

transfers to the personal sector rose 36.5% last year. For comparison, during the global financial crisis of 2008 they were up 13.1%. After the dot.com bubble burst in 2000, government transfers increased 9.4%. These pale in comparison to the net increase of household sector income of $1.1 trillion in 2020.

With that in mind, what does the economy have in store for 2021? To say this is unpredictable is an understatement. Six to nine months ago there was a lot of fear and uncertainty as it related to the development of the vaccine and the re-opening of the economy. But there was actually tremendous ***certainty*** around a host of other major issues. We all knew massive stimulus packages would continue to be passed and remain a major focus of the economic recovery all over the globe. Likewise, monetary policy was all but guaranteed to be massively accommodative as Federal Reserve Chairman Jerome Powell assured politicians, “there is no limit” to what they can do. While the timing of producing an effective vaccine against COVID-19 was unknown, it was expected to be accomplished. Given massive fiscal and monetary support, and measures to combat COVID, employment would unquestionably see a major rebound after the largest decline since the Great Depression.

CHART 1: Real GDP

United States
(year-over-year percent change)



Shading indicates recession
Source: Haver Analytics, Rosenberg Research

Fast forward to today and there is a whole new set of uncertainties around what the rest of 2021 will look like. Can incomes continue to rise if government support is removed from the equation? The employment situation has somewhat plateaued, and we still have around 8.4

million less jobs when compared to pre-pandemic levels. The Federal Reserve may still have "no limit", but with interest rates on the rise, will we see more repercussions of their unprecedented actions?

Despite these questions surrounding incomes, the job market, and whether fiscal and monetary stimulus are still viable options to spur growth, most economists are extremely confident that a sustainable economic recovery has begun. The narrative is that "pent-up demand" is pretty much a foregone conclusion and will propel this economy to levels well above where things were before the pandemic started. While this certainly is possible, there are some interesting numbers to be aware of before concluding these predictions are guaranteed.

Pre-pandemic, service industries such a lodging, travel, casinos, theme parks, events, restaurants/bars, etc. only represented 6% of consumer spending and 4% of GDP. Given such a small weighting it will take a pretty sizeable recovery in these areas to drive GDP materially higher in 2021. It is also important to consider that extra spending in these industries will come at the expense of many durable goods purchased in 2020 related to home improvement, online shopping, technology upgrades, etc. How many of us plan to remodel our home again? This segment of GDP grew 6.4% in 2020, so simply breaking even in 2021 would likely be a victory given the unprecedented demand last year. Thus, while 2021 is all but guaranteed to be a recovery year, if government support is curtailed meaningfully, the economy could have difficulty living up to forecasts as 2022 approaches.

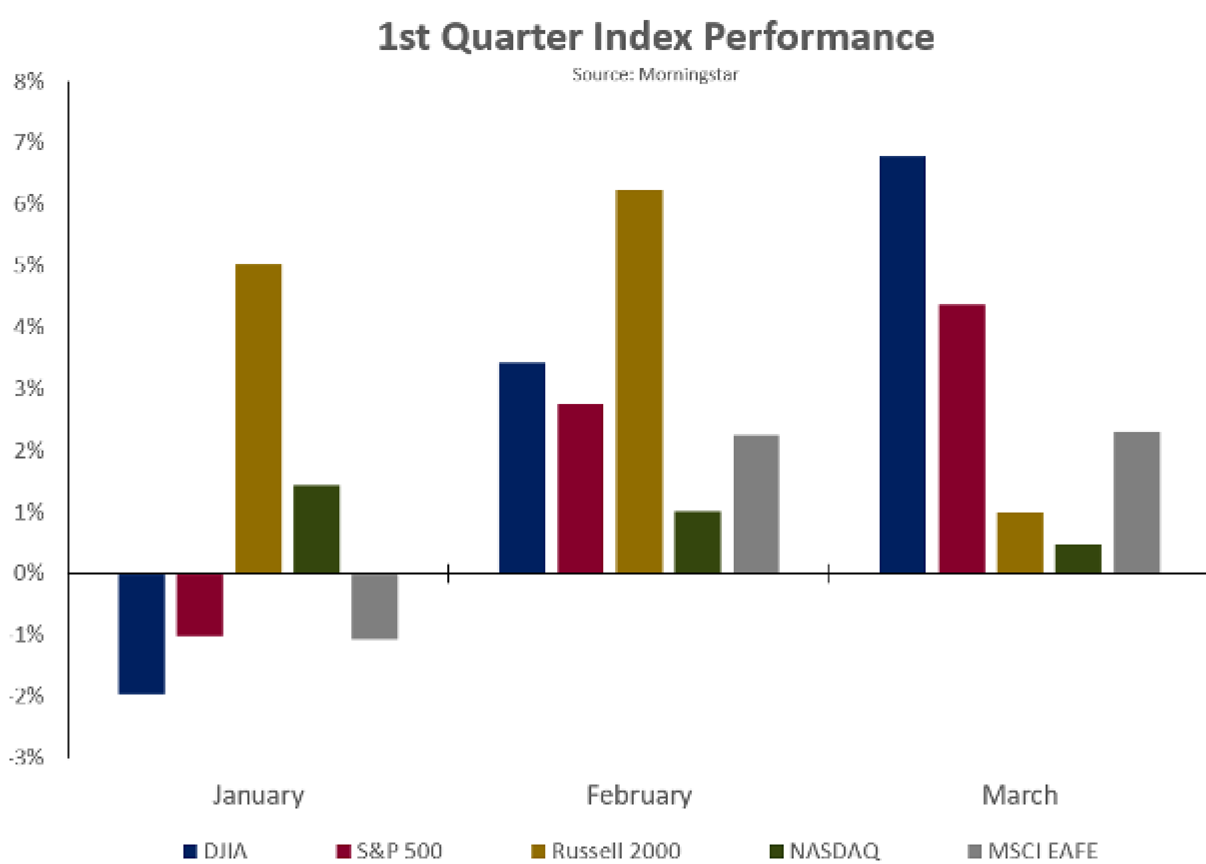
Bond Market Review & Outlook

After a strong 2020, the bond market stumbled out of the gate with yields rising sharply to begin the year. The 10-year U.S. Treasury began the year with a yield of 0.93%. It closed the first quarter at 1.7%. This caused most bond indexes to fall, led by the Barclays U.S. Treasury 20+ Years Index declining 14.0%. The core Barclays U.S. Aggregate Index fell 3.4%. The top performing bond segment was the Barclays High Yield U.S. Corporate Index, returning a positive 0.6%. What is most interesting about this performance is that it is the exact opposite of how these indexes performed last year, with U.S. Treasuries the clear winner and high yield the laggard.

With inflation concerns escalating, many investors are becoming increasingly concerned about how much further rates could rise. Although the Federal Reserve believes inflation concerns are temporary, investor fears could put further pressure on bond prices, causing some to question the role of bonds in a portfolio. Before assuming this outcome is guaranteed, we'd like to remind investors that timing the bond market is just as difficult as timing the stock market. We will discuss the ***possibility*** versus the ***probability*** of rising interest rates in our April client update. Click here [1] for an advance look at this very important topic.

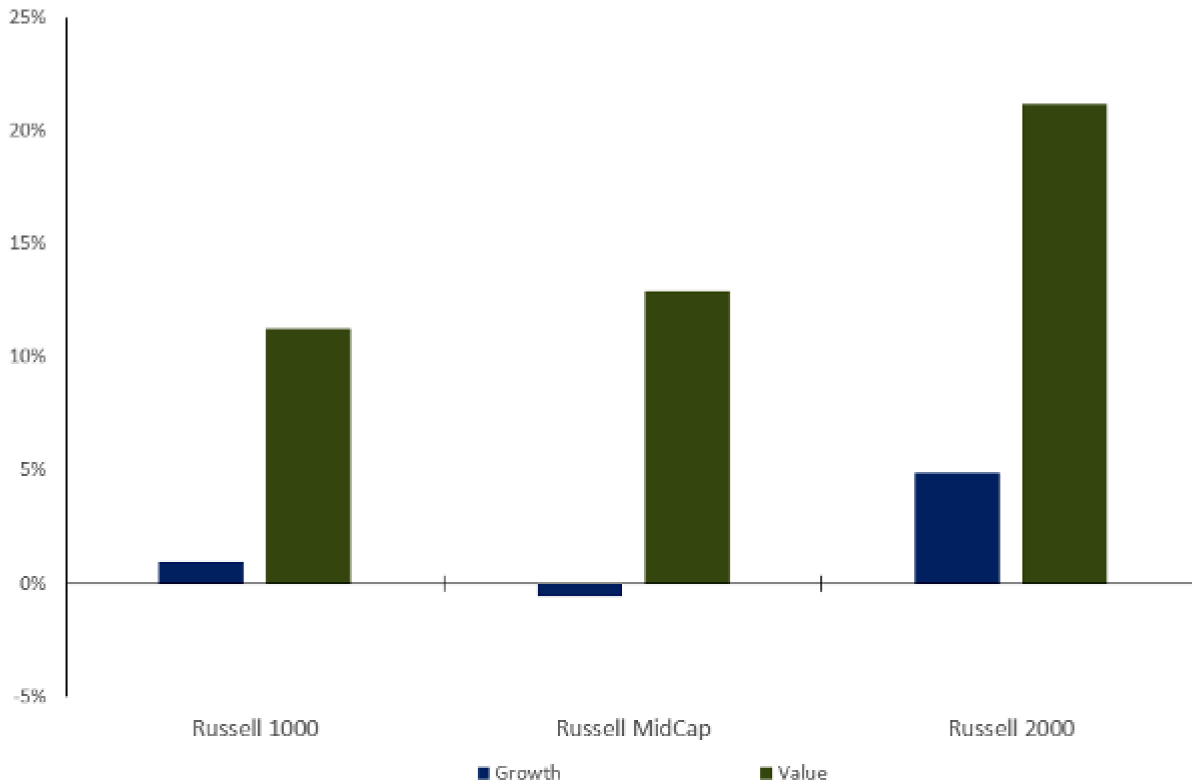
Stock Market Review & Outlook

Stocks have not lost any of their luster from 2020 as investor excitement and euphoria seem to have carried over into the new year. Both the Dow Jones Industrial Average and S&P 500 delivered strong gains of 8.3% and 6.2%, respectively. Small caps are the talk of the town right now rising 12.7% as measured by the Russell 2000. The NASDAQ continues its strong run returning 3.0%. Finally, international stocks are holding their own, up 3.5% as measured by the MSCI EAFE.



The continued strength of the stock market is not surprising given the optimism surrounding an economic recovery this year. Instead, what is most interesting about the continued push higher in stocks is the rotation of top performing stocks and sectors. Last year's losers have become this year's winners; energy and financials are the prime examples. These two sectors were among the worst performers in 2020. This year energy stocks are up 30.6% and financials 15.9%. A stark contrast to technology up 2.1%.

As you can see from the Russell Style Index Performance chart, value stocks trounced growth stocks in the first quarter with small cap value the standout performer to start the year. This caught many investors by surprise as this segment of the market has been the biggest laggard over the past couple of years. With investors more and more comfortable overloading their portfolios with growth stocks, the sudden change in leadership with little warning should remind investors of the importance of remaining well diversified. Value stocks have underperformed for the better part of a decade, so it is by no means too late to make sure your portfolio has ample exposure to this segment of the market. While there are no guarantees the value outperformance will continue, keep in mind that outperformance by growth stocks has been going on for years. Students of history are well familiar with the phrase "reversion to the mean", which could be just beginning for value stocks.



Alternative Investments & Hybrids Review & Outlook

Alternatives got off to a solid start with the Morningstar Multi-Alternative category up 2.1% for the quarter. Hybrid managers, which allocate among stocks and bonds, posted strongest returns. Likewise, commodities, and particularly energy products, were up as well. The S&P Real Assets Index, which includes real estate, commodity, and infrastructure assets, returned 3.3% for the quarter, led by a continued recovery in real estate assets on the back of rebounding economic activity. As inflation expectations have risen, so has investor interest in real assets and real estate. Many of the underlying assets in this space benefit directly from inflation via price appreciation or in the case of infrastructure assets, inflation measures are often built directly into their contractual cash flows. Over the past 30 years, private timberland, farmland, infrastructure, and real estate have generated strong returns when annual inflation has been greater than two percent. These types of assets can provide valuable diversification to investor portfolios.

Conclusion

As the world economy reopens and life begins to find a new rhythm, investors begin the year full of optimism. The vaccine rollout combined with more stimulus to start the year has many firms on Wall Street raising their year-end price targets for the S&P 500. The accelerating growth, pent-up demand narrative is resulting in high levels of investor confidence. According to the American Association of Individual Investors, the first quarter ended with a greater than 2 to 1 ratio of bulls to bears. The historical average is 1.2 to 1. Often, high levels of bullish sentiment have led to market pullbacks. As 2021 progresses, we caution investors from becoming too complacent that the bull market will roll on indefinitely - so be prepared for some unexpected hiccups along the way by remaining well diversified.

Wealth Management Team
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