FINANCIAL MANAGEMENT STRATEGIES
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Biden's Proposals and Rising Vaccinations Boost Optimism for Post-Covid-19 Life
April 2021

My Dear Client:

The spring of 2021 has arrived with green shoots of optimism around us nearly everywhere we look: the Biden Administration's $1.9 trillion Covid relief bill; falling unemployment rates and elevated hiring (including the retail and the pandemic-hammered hospitality sectors; the red-hot housing market; accelerating GDP growth; and a few sprinkles of inflation (along with upward trending interest rates), too.

The 2021 equity markets picked up where they closed in 2020: strongly and with a decided tilt towards Value and Cyclical stocks. Vaccine momentum, reopening progress, and trillions in fiscal support to the economy fueled the risk-on sentiment this quarter that we saw in both traditional assets (stocks, commodities) and a host of newer non-traditional assets (cryptocurrencies, Non-Fungible Tokens -NFTs, Special Purpose Acquisition Companies- SPACs meme-stocks).

On the back of a strengthening near-term economic outlook, Value stocks (+11.3%) outperformed Growth (+0.9%) style handily across all asset sizes, and Small Cap (+12.7%) beat Large (+6.2%). This looks like the classic expected rotation that occurs in post-recessionary periods where Value and Small Cap typically make up for their significant trailing during the period of economic decline.

Aligned with the equity market rotation and spurred by high growth and inflation expectations, U.S. 10-year Treasury yields skyrocketed from 0.93% at year-end to as high as 1.77% in March.

The U.S. economy sustained its recovery in 4Q20 – with real GDP +4.3% – and into the new year. Labor markets continued their steady improvement though remained well off pre-Covid levels (and will likely remain that way until vaccination-led reopening allows service sector employees to return en masse). February data was choppy, partially due to the gap between fiscal spending ending and restarting, weather issues, and supply-side bottlenecks.

But forward-looking data looks relatively robust. U.S. consumer confidence spiked to a Covid-era high, and higher frequency data show that mobility and consumer spending are rapidly improving. The nearly $3 trillion in Covid relief in 1Q21 – much of its direct support in the form of refund checks and unemployment payments – should continue to boost retail spending in the next quarter or two.

While fiscal support is undoubtedly one of the bullish cases for buying risk assets, increased government spending has begun to stir inflation fears. Five-year forward inflation expectations closed 1Q21 around their highest level since 2008. We should also keep an eye ***on*** the frequent euphoria around the newer list of non-traditional assets. Time will eventually show if their public adoption was the beginning of the end (a bubble) or the start of a multi-year stock market climb.

Domestic equity market

Value continued its recent stretch of outperforming Growth style investing, turning in its best relative quarter since 2001. Similarly, smaller-cap names continued outperforming Large and Mega-cap stocks that dominated most of last year. Small-Cap Value led all domestic style box categories with +21.2% for the first quarter.

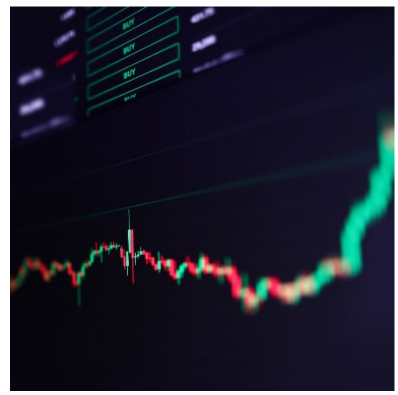
As we did in 4Q20, looking deeper into the capitalization sizes showed the smaller the size, the bigger the returns. Small Cap broadly was up 18.2% for the quarter while Micro Cap was up 23.9 %, compared with Mega Cap rising 5.1% and Large Cap going up 6.2% during the first quarter. I discussed possible reasons for this trend. It seems the answer is that investors now firmly believe this year that economic activity will return to a form of normalcy and that smaller caps are much cheaper than larger caps.

The Value and cyclical stock performance above is reflected in the strength of a few of the 11 Standard & Poor's sectors: Energy (+30.9%), Financials (+16.0%), and Industrials (+11.4%) were the top-returning sectors during the quarter. Rising commodity prices coupled with a strong growth outlook for 2021 bode well for these market areas that previously saw significant challenges. That backdrop also created a strong quarter for Materials (+9.1%), Real Estate (+9.0%), and Communication Services (+8.1%).

Sectors sensitive to rising yields and therefore defensive such as Utilities (+2.8%) and Consumer Staples (+1.1%), took a back seat, while Information Technology (+2.0%) took a respite from its torrid 2020 pace. Elevated valuations, near-term economic growth prospects, and rising yields hurt the Tech sector, which had been one of the preeminent beneficiaries of the Covid-19 pandemic economy.

Interestingly, the Consumer Discretionary sector was positive (+3.1%) yet far from the top performers. This was perhaps a result of return moderation in many tech-enabled retail stocks this quarter, the slow ramp-up ahead of higher returns for the sector in coming quarters, or maybe that these stocks are already priced for the economy's "return to normalcy."

International markets



International equities, both Developed (+3.6%) and Emerging (+2.3%), were positive on the quarter, though they lagged their domestic counterparts. A combination of a stronger USD and some pandemic-specific pain points caused International to lag. However, local currency Developed markets bested the S&P on the back of a more cyclical sector profile.

Sweden (+18.3%) and The Netherlands (+15.7%) led on the Developed side, while South Africa (+12.9%) and Taiwan (+12.7%) did well in the Emerging Markets. China (-0.2%) lagged compared with other countries despite a strong Growth outlook and virus response; the Tech-heavy nature of the country's economy remained a weight on returns in this quarter, similar to US Large Cap tech. There was still a continuing adverse effect on tech companies in China as the antitrust investigations into Alibaba and its founder Jack Ma are only recently resolved.

Market leadership overseas as measured by the MSCI EAFE indexes was the same as domestic, with the value style's +11.5 beating growth (+3.9) and Small Cap (+8.5%) and leading Large Cap investing (+ 7.9%) during the first quarter of 2021.

Historically, Emerging Markets do well in an environment of steadily rising interest rates when the dollar (USD) is weaker. When sourcing of goods and services become a challenge, input prices tend to rise and margins are squeezed or prices (inflation) are passed through to the consumer – think timber shortage for housing or semi-conductor shortage for computer processors. When inflation increases, many of these economies are deeply commodity-based and do benefit. While the dollar did strengthen for a portion of the first quarter, the fiscal spending and debt pace that the U.S is on seems contrary to a short- or mid-term strong dollar period. A weak USD has usually benefited these economies.

Bond markets

The broad U.S. bond market, measured by the Bloomberg Barclays Agg Index, fell 3.4% in 1Q21 as rising rates, rising inflation expectations, and strong near-term growth prospects hurt fixed income. The dramatic move spelled carnage for fixed-income markets: Long-duration and high-quality debt were especially weak; further, the Bloomberg Barclays Treasury Index turned in its worst quarter since 1980.

The rise in interest rates was particularly rapid despite the low base of 0.93% on the 10-Year at the end of 4Q20. It moved as high as 1.77% in March – representing a once-in-a-decade occurrence. Rate volatility has been heightened over the last year (alongside equity market volatility), and 1Q21 was no exception.

While there was general underperformance across the fixed income landscape, risk-on areas held up better. High Yield Corporate (+0.8%) and High Yield Muni (+2.1%) were two of the only fixed-income sectors in the black last quarter as the economic environment painted a better backdrop for riskier debt. Global bonds (-5.3%), Investment Grade Corporates (-4.6%), and Treasuries (-4.3%) were among the weaker performing areas. Duration was hit especially hard, as long rates skyrocketed; the Bloomberg Barclays U.S. Aggregate 10+Year Index fell 10.4% for the quarter as long-term Treasuries entered a rare bear market.

Despite a continued rally in March, the USD appears headed for a cyclical decline as other currencies appear undervalued, and the U.S. budget and current account deficits climb unabated to record highs. The difference between U.S. rates and the rates of other developed economies serves as a magnet to attract capital flows into the U.S. The position of the Federal Reserve is well established, with Mr. Powell as chairman affirming holding short rates steady at the current low level until inflation firms up around a two percent plus level.

The size of future fiscal initiatives such as infrastructure is giving pause, to a wide array of investors about the Fed's powers to restrain inflation beyond 2021 (as evidenced by the action in long-dated Treasuries). Combined with the recent upward surge in U.S. rates and volatility, risk levels appear to be rising despite continued Fed intervention in the markets. This fascinating tug-of-war will continue.

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A Look Ahead

The second quarter of 2021 begins with optimism that should grow this spring after the Covid -19 winter. Among the many items that could or could not be left behind from that winter is the 30-year subduing of measured inflation by the U.S. Federal Reserve Board. Unfortunately, there is no shortage of talented prognosticators with differing views. Rather than guessing the answer to the inflation question, we observe the market trends in real-time and respond accordingly – and *<u>be comfortable taking large gains off the table through portfolio rebalancing</u>*.

In general, Small Cap stocks have significantly thumped Large Mega Cap stocks for the past year more than 30%. From March 31, 2020, to March 31, 2021, the S&P Small Core was up 95.3% compared with the S&P 100 rise of 54.4%. Additionally, the negative 2020 total returns for both Real Estate (-5.7%, per Dow Jones REIT Composite) and Commodities (-3.1%, per Bloomberg Commodities index) seemed to indicate potential good selective opportunistic investment opportunities in both sectors. Though easily explained by the record low interest rates in the U.S., the rise in stock valuations doesn't mean that embedded risk levels or volatility also have to stay subdued.

There is an old saying: When the Fed is not worried about inflation, the market should be worried.

My portfolio recommendations, consistent with those of the past year, offer further adjustments to enhance your asset allocations. Maintain a risk-balanced focus and multi-asset class approach, evaluate opportunities and be ready to invest when more significant short-term declines occur. Consider:

- Maintaining overall equity allocation to portfolio targets and below maximum range;
- Raise cash from Large Cap growth stocks and private U.S. equity distributions for increasing investments in Emerging and International stocks;
- Increase allocations to Small Cap and Mid Cap;
- Underweight overall fixed-income portfolio allocations and maintain diverse, high-quality bond portfolios and proven opportunistic credit strategies for yield;
- Seek niche, opportunistic and secondary illiquid private investments, including some V.C.;
- Investigate Real Estate opportunities surfacing in private and public space (logistics, warehouses, data centers and so on), along with Infrastructure; and
- Continue prior asset allocation adjustments in public equities~~,~~ further rebalancing – and when assets aren't cheap, *cash* inside your portfolio is still a good idea.

We will maintain disciplined, pragmatic approaches and patience to strategically deploy capital, riding the Fed's wave without reaching for extra risk to your portfolio to meet our long-term objectives and goals.

Lastly, many investors' interest in the "E" for the environment (as well as in "S" for social and "G" for governance) of ESG continues to grow. Please know that this has and always will be a deep part of our firm's DNA that we can happily talk about at length.

It is a pleasure to serve you, and I look forward to continuing our work together. Stay safe and healthy.

Appreciatively,
Walid L. Petiri

Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board.