Market Commentary

As of March 31, 2021

Economy & Market Review

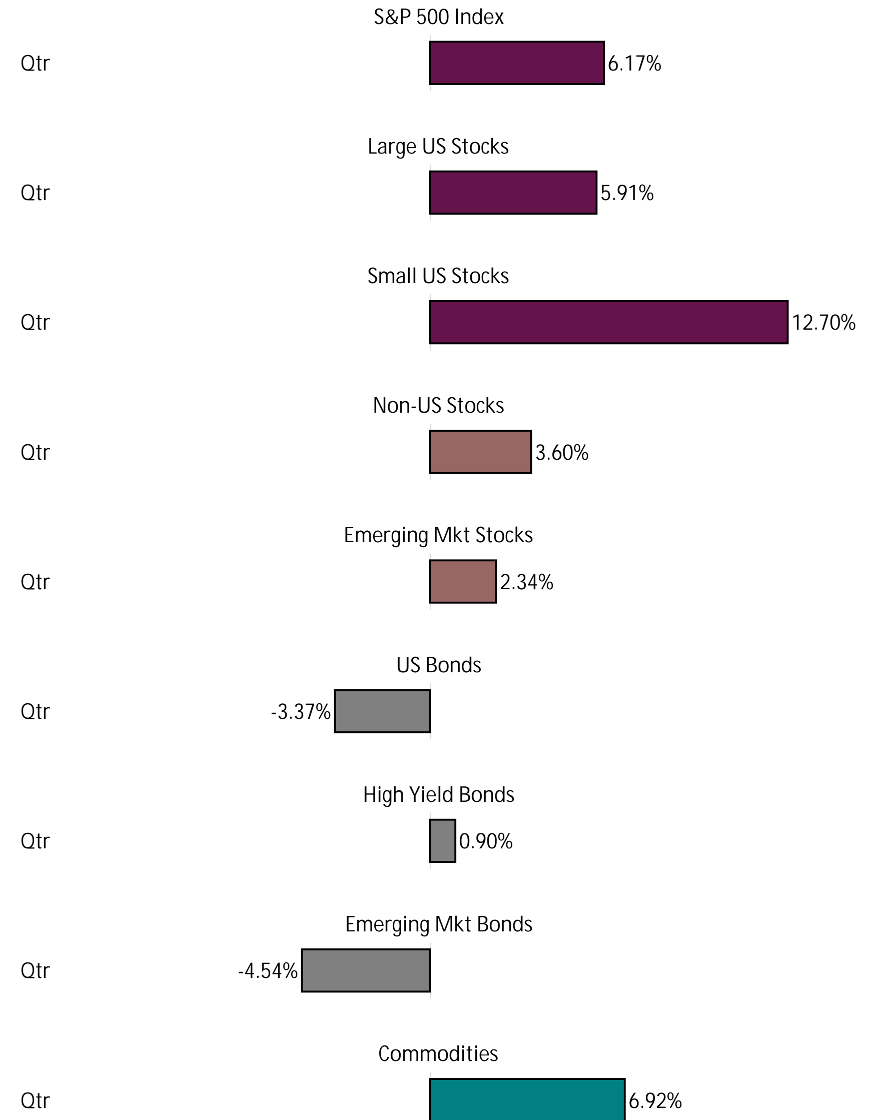
First Quarter 2021

Historically, springtime brings many emotions: hope, joy, and excitement just to name a few. The winter cold melts away and spring brings new beginnings. This spring feels particularly significant with the global population anticipating renewal of normalcy from the pandemic. With the hope that vaccines will provide reason for economic liftoff due to pent-up demand, markets have continued higher. The only asset class that struggled in the first quarter was bonds. As inflation expectations increased, bond investors believed rates were too low and therefore began pushing them higher. The Federal Reserve (Fed) controls rates at the short-end of the yield curve, but does not have as much control over the longer-end of the curve. When rates rise, previously issued bonds fall in price. Hence, the negative returns for many bonds and bond funds during the quarter. Overall, investors should feel pretty positive from a net worth perspective as assets have soared and interest rates on debt remain historically low. Not to mention, many households have been able to pay off debt and shore up their finances with multiple stimulus checks.

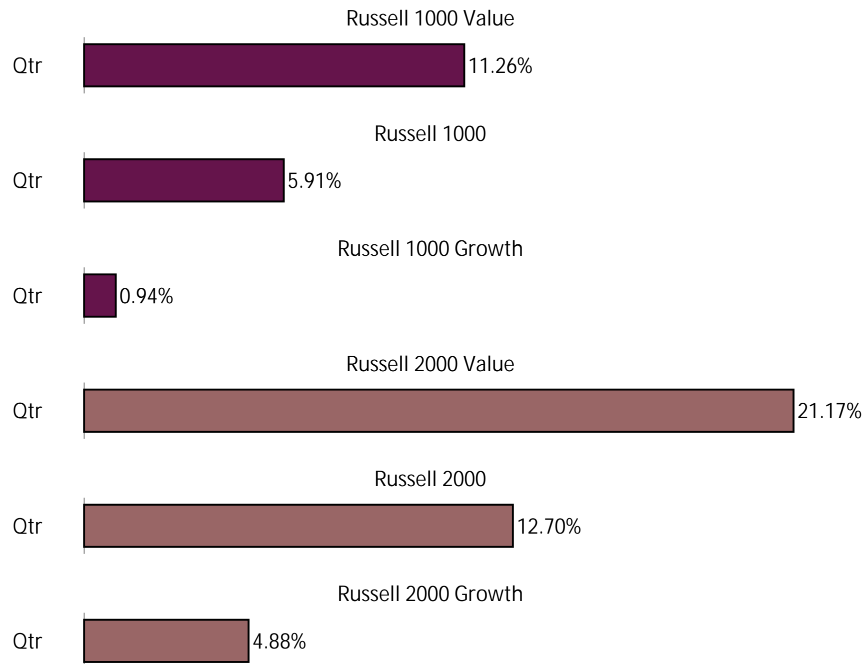
An encouraging March jobs report reduced the US unemployment rate from 6.7% last quarter to 6% currently, so employment seems to be moving in the right direction. At 57.6% employment to population ratio, the economy is still 3% below pre-pandemic levels or about 9 million jobs. Fed Chairman Powell and Treasury Secretary Yellen believe we are still a long way from full employment. Asset value growth has definitely outpaced the real economy. The economy needs growth in economic activity. The newest stimulus bill and forthcoming infrastructure bill will activate the "money machine", but it actually needs to bring about long-term growth. US growth, based on GDP, increased in the fourth quarter at an annualized rate of 4.3%, for the year as a whole, GDP shrank 3.5%, the most since 1946. Economic growth in the first quarter could hit 10%, according to a Federal Reserve tracker.

Spring is a time of change with rejuvenation and regrowth, but it is also a time that can bring storms and cause havoc. At times like these, it is important for investors to identify risk and take steps to mitigate it. One of the best ways to do this is through rebalancing a portfolio. Rebalancing sells the winners and buys investments that haven't done as well, basically buying low and selling high while at the same time reducing overall portfolio risk.

Global Market Performance



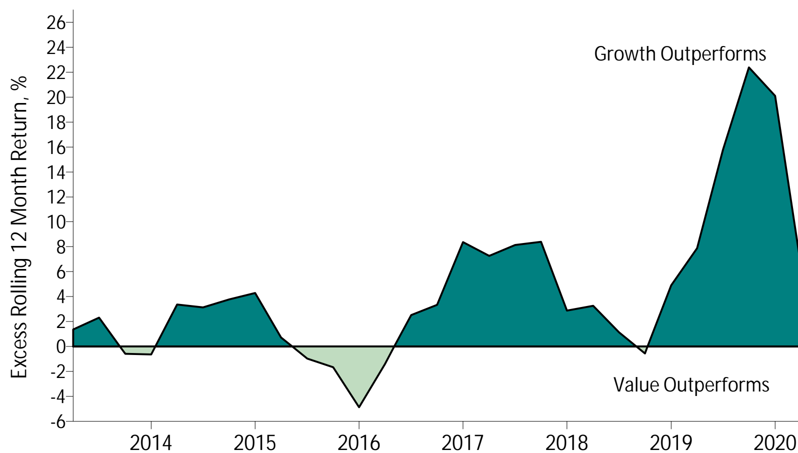
U.S. Equity Markets

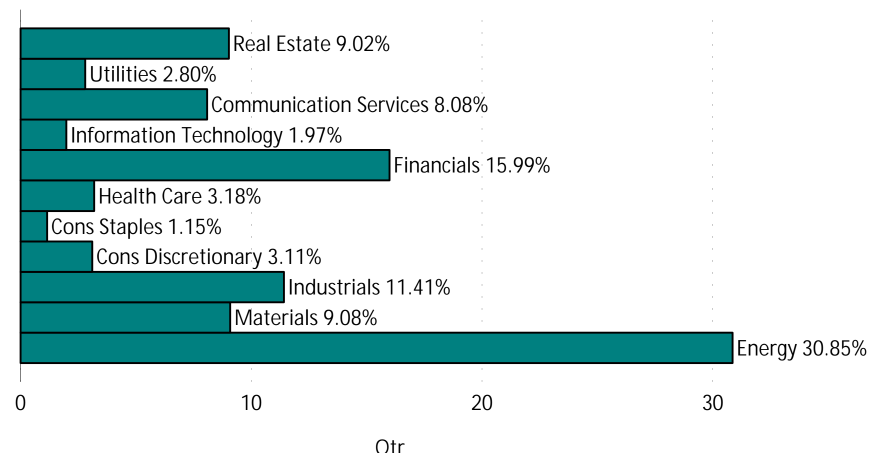


The S&P 500 Index of large cap stocks increased 6.2% during the quarter increasing 56.4% over the last year. Small Cap stocks as measured by the Russell 2000 Index performed even better up nearly 12.7%. A change in leadership that started late last year and continued for most of the first quarter occurred as value stocks have easily outperformed growth recently. The renaissance of value stocks was impacted by the increase in both rates and expected economic activity. Increased rates helped financials and improved economic activity helped other cyclical value oriented industries.

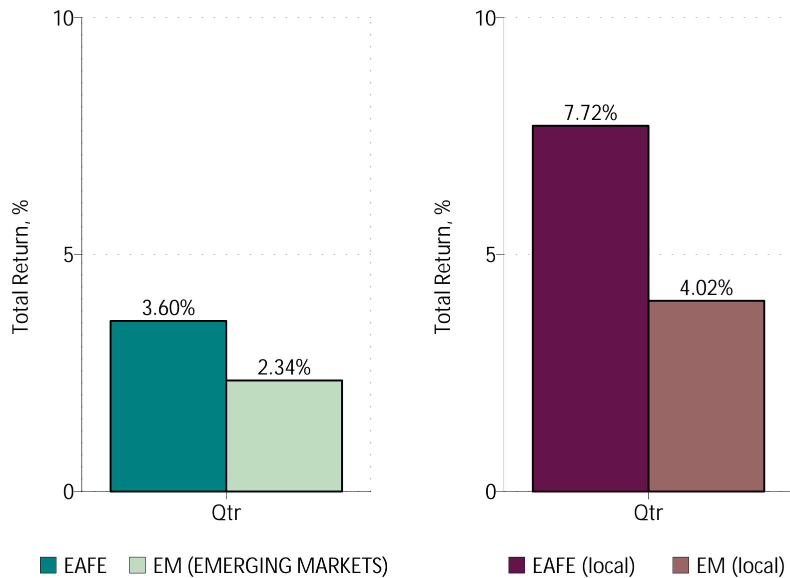
Currently at 21.9x forward price-to-earnings multiple, domestic equity valuations remain at elevated levels historically. Usually at these elevated valuations, investors' future return expectations might need to be tempered. For instance, both JP Morgan and Crandall Pierce show subsequent 5-year annualized returns hovering near zero to slightly below zero for S&P 500 returns at this valuation level.

Just like they ended 2020, Energy, Financials and Industrials continued as the best performing sectors during the first quarter of 2021. In a quarter with above average returns, all sectors provided positive performance. As it appears we are in the midst of reflation, cyclical sectors were the best performers. Consumer Staples and Utilities were two defensive sectors that lagged the overall market.



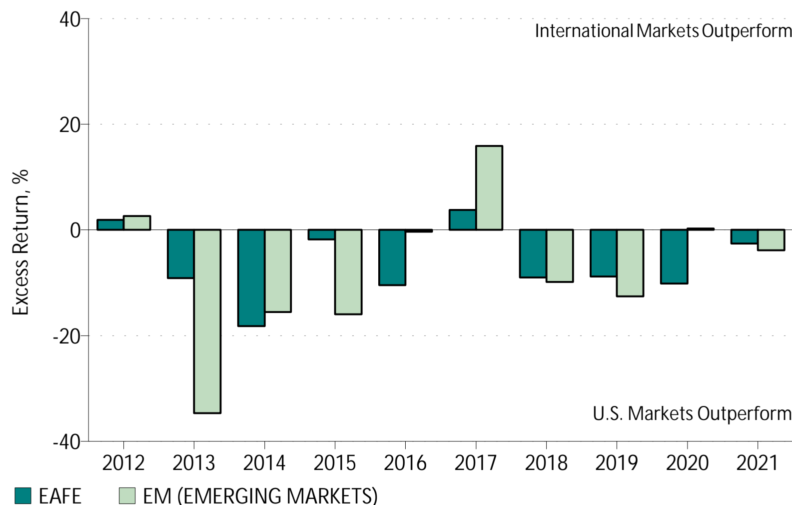


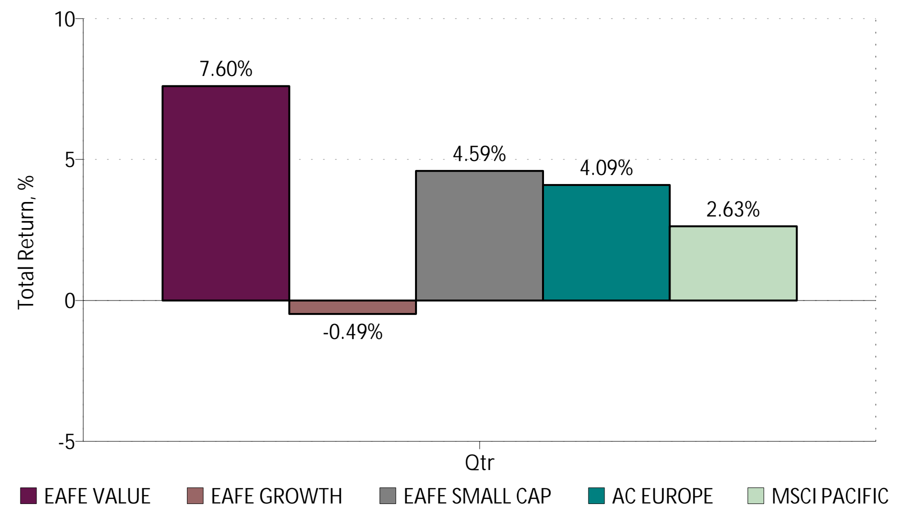
International Equity Markets



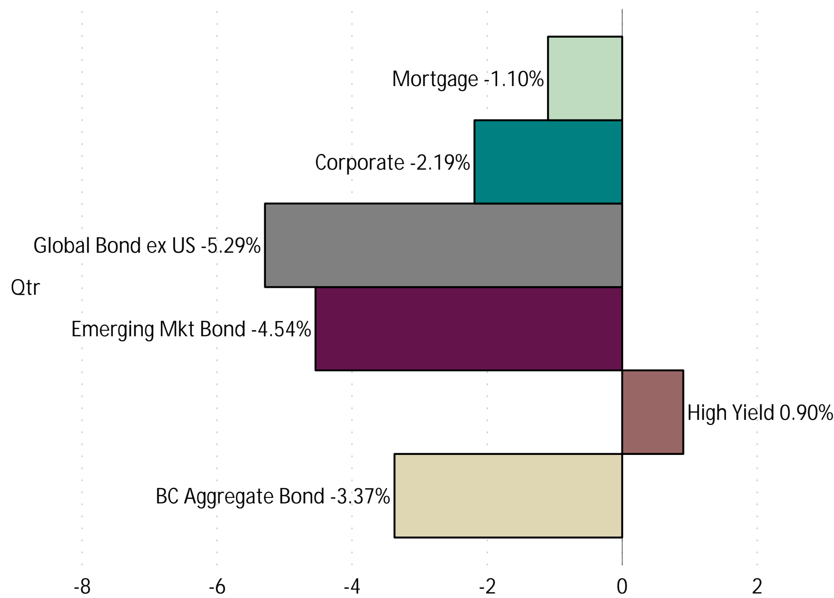
After a huge fourth quarter 2020, emerging markets (EM) trailed both foreign developed and the US S&P 500 during the first quarter. The MSCI Emerging Markets Index was up 2.3% for the quarter. A strong dollar was an impediment for both emerging market and foreign developed stocks. The combination of strong liquidity, easy financial conditions and higher levels of disposable income is a nice mix for ongoing earnings growth. Also, most EM countries are in a fairly healthy position as EM countries have used less fiscal support than developed markets.

Developed equity markets (MSCI EAFE Index) also lagged US markets by over 2.6% during the quarter and have not outperformed the US equity markets since 2017. Quarterly return for the MSCI EAFE Index was 3.6%. Similar to the US, value continued its outperformance compared to growth during the quarter but still trails growth over the last 10 years. With substantial stimulus and the anticipation of a dramatic earnings recovery, continued cyclical upside may deliver reasonable returns. However, Europe has been slow to roll out vaccines and has had persistent fits and starts with lockdowns, both of which may undermine some of the opportunities.



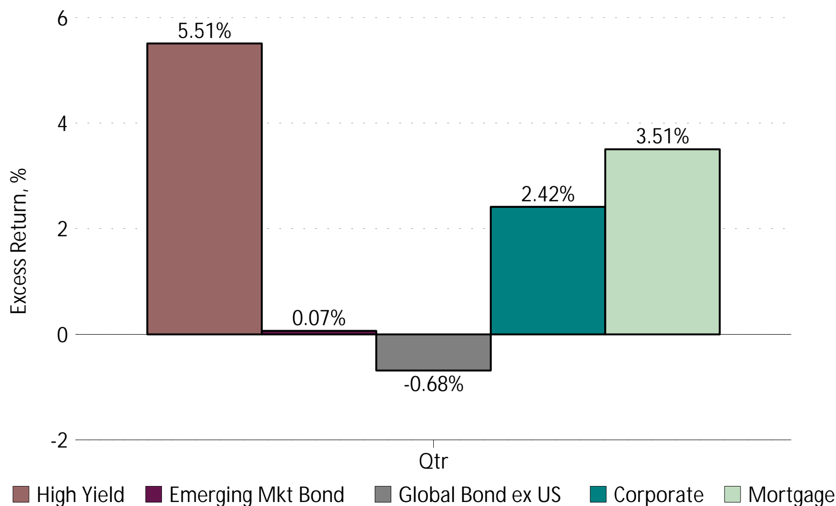


Fixed-Income Markets



As mentioned earlier, bond owners had a rough start to the year. In the first quarter, the 10-year Treasury yield increased 0.82% to end the quarter at 1.74%. With a quicker vaccine rollout than anticipated, investors' views were focused on higher growth and increased inflation expectations. Following a fairly strong 2020, the Bloomberg Barclays Aggregate Bond Index ended the quarter down 3.4%, the worst quarterly return since 1981. All fixed income segments ended the quarter with negative returns except High Yield. High yield Corporates benefited from both a 40% lower duration than the Aggregate Index and a 0.50% credit spread tightening during the quarter.

US Treasuries had a particularly poor first quarter as they only have interest rate risk and therefore were impacted more by the quick rise in rates. The long-end of the yield curve increased even as the short-end was anchored by the Fed. Fed Chair Powell does not expect economic activity to "produce substantially higher prices or that the effects will be persistent." The Fed still doesn't anticipate increasing rates until at least 2023 and will allow inflation to run hot. On the other hand, bond investors now see the first federal funds rate hike in December 2022, a full year ahead of Fed consensus. Many areas of the economy are already seeing price increases such as housing and building materials. If these price increases are allowed to be recognized as inflationary, continued bond market volatility may result.



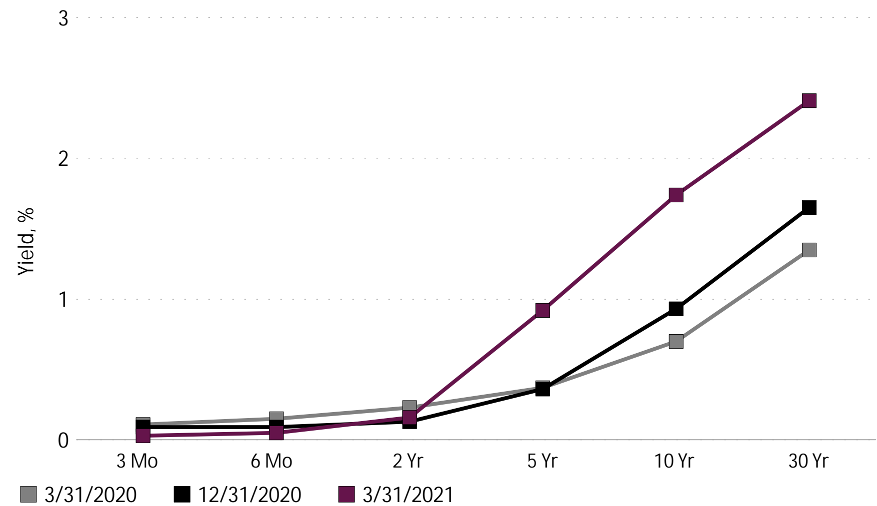
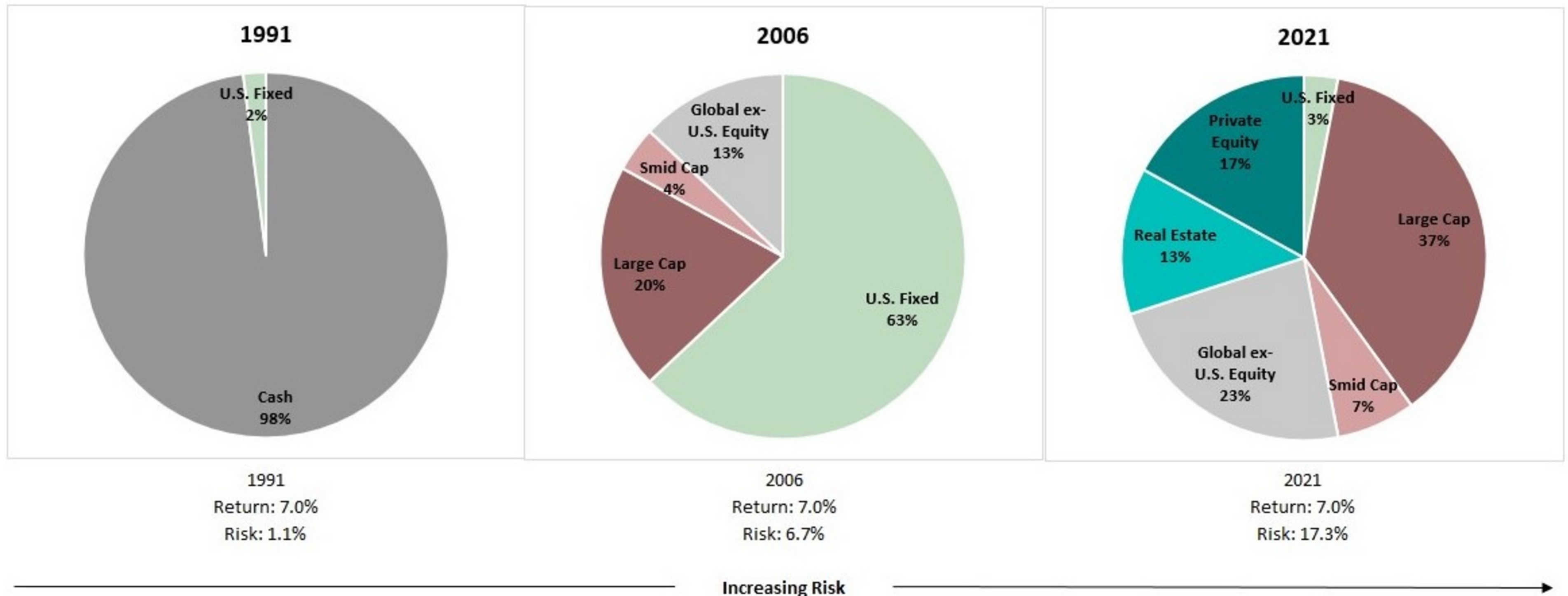


Chart of the Quarter



16x the Risk

Due to historically low interest rates and the influence of Federal Reserve actions, general expectations about future returns on fixed income investments are low. Equity market return expectations also reflect concerns about stretched or excessive valuations. When considering the uncertainty of a post-pandemic world, investors face one of the most difficult environments for investing in years.

Just consider the historically reasonable return expectation of 7%. Over the last 30 years, the risk one would have to take to achieve a 7% return would have gone from keeping 98% in cash in 1991 (2% in bonds), to holding 97% in risky assets (stocks and private markets) in 2021. Let me say it another way ... portfolios today are more complex and expensive (due to alternative sources of return) and would require an investor take 16 times the risk than they would have had to take in 1991.

Clearly, the early 1990's was a very different time, with significantly higher yielding cash and fixed income returns. To assume that today we have to take 16 times the risk to achieve a reasonable 7% rate of return on our money is provocative. Realizing that potential "outcomes" influence the decisions we make as investors and advisors, we would warn that a focus on returns, to the exclusion of risk, seems a less sensible strategy when pursuing the 7% outcome.

Periodic Table of Investment Returns

2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Annualized Return
					Small Cap Stocks 21.31%	Emerging Mkt Stocks 37.75%		Large Cap Stocks 31.43%			
	Emerging Mkt Stocks 18.63%				High Yield 17.49%	International Stocks 27.77%		Small Cap Stocks 25.52%	Gold 24.61%		
	International Stocks 17.39%				Large Cap Stocks 12.05%	Large Cap Stocks 21.69%		International Stocks 22.13%	Large Cap Stocks 20.96%		
	Large Cap Stocks 16.42%		Large Cap Stocks 13.24%		Commodities 11.77%	Small Cap Stocks 14.65%		Emerging Mkt Stocks 18.90%	Small Cap Stocks 19.96%	Small Cap Stocks 12.70%	12.22
Real Estate 15.99%	Small Cap Stocks 16.35%		Real Estate 12.49%		Emerging Mkt Stocks 11.60%	Gold 12.66%		Gold 18.43%	Emerging Mkt Stocks 18.69%	Commodities 6.92%	-5.73
Gold 8.93%	High Yield 15.58%	Small Cap Stocks 38.82%	US Bonds 5.97%		Real Estate 8.76%	60/40 Blended Index 12.07%		60/40 Blended Index 16.50%	60/40 Blended Index 12.24%	Large Cap Stocks 5.91%	14.28
US Bonds 7.84%	60/40 Blended Index 11.09%	Large Cap Stocks 33.11%	60/40 Blended Index 5.51%		Gold 8.10%	Intl/EM Bonds 10.41%		High Yield 14.41%	International Stocks 11.13%	International Stocks 3.60%	5.63
Intl/EM Bonds 5.88%	Real Estate 10.94%	International Stocks 15.78%	Small Cap Stocks 4.89%	Real Estate 15.01%	60/40 Blended Index 7.85%	Real Estate 7.62%		Intl/EM Bonds 9.98%	Intl/EM Bonds 7.90%	60/40 Blended Index 2.95%	7.61
High Yield 4.38%	Intl/EM Bonds 10.60%	60/40 Blended Index 14.85%	High Yield 2.50%	Large Cap Stocks 0.92%	Intl/EM Bonds 5.77%	High Yield 7.48%		US Bonds 8.72%	US Bonds 7.51%	Emerging Mkt Stocks 2.34%	4.13
Large Cap Stocks 1.5%	Gold 8.26%	Real Estate 13.94%	Intl/EM Bonds 2.08%	US Bonds 0.55%	International Stocks 5.01%	US Bonds 3.54%	Real Estate 8.35%	Commodities 7.69%	High Yield 6.17%	Real Estate 2.09%	9.84
60/40 Blended Index 0.49%	US Bonds 4.22%	High Yield 7.42%	Gold 0.12%	60/40 Blended Index 0.11%	US Bonds 2.65%	Commodities 1.70%	3-month T-Bills 1.87%	Real Estate 5.35%	Real Estate 1.17%	High Yield 0.90%	6.55
3-month T-Bills 0.1%	3-month T-Bills 0.11%	3-month T-Bills 0.07%	3-month T-Bills 0.03%	3-month T-Bills 0.05%	3-month T-Bills 0.33%	3-month T-Bills 0.86%	US Bonds 0.01%	3-month T-Bills 2.28%	3-month T-Bills 0.67%	3-month T-Bills 0.03%	0.62
Small Cap Stocks (4.18)%	Commodities (1.06)%	US Bonds (2.02)%	Emerging Mkt Stocks (1.82)%	Intl/EM Bonds (2.42)%			Gold (0.93)%		Commodities (3.12)%	US Bonds (3.37)%	3.40
Commodities (13.32)%		Emerging Mkt Stocks (2.27)%	International Stocks (3.44)%	Small Cap Stocks (4.41)%			High Yield (2.26)%			Intl/EM Bonds (4.91)%	3.53
International Stocks (13.33)%		Intl/EM Bonds (4.13)%	Commodities (17.01)%	High Yield (4.64)%			Intl/EM Bonds (3.17)%			Gold (10.41)%	1.82
Emerging Mkt Stocks (18.17)%		Commodities (9.52)%		International Stocks (5.25)%			60/40 Blended Index (3.71)%				
		Gold (27.33)%		Gold (12.11)%			Large Cap Stocks (4.78)%				
				Emerging Mkt Stocks (14.60)%			Small Cap Stocks (11.01)%				
				Commodities (24.66)%			Commodities (11.25)%				
							International Stocks (13.78)%				
							Emerging Mkt Stocks (14.25)%				