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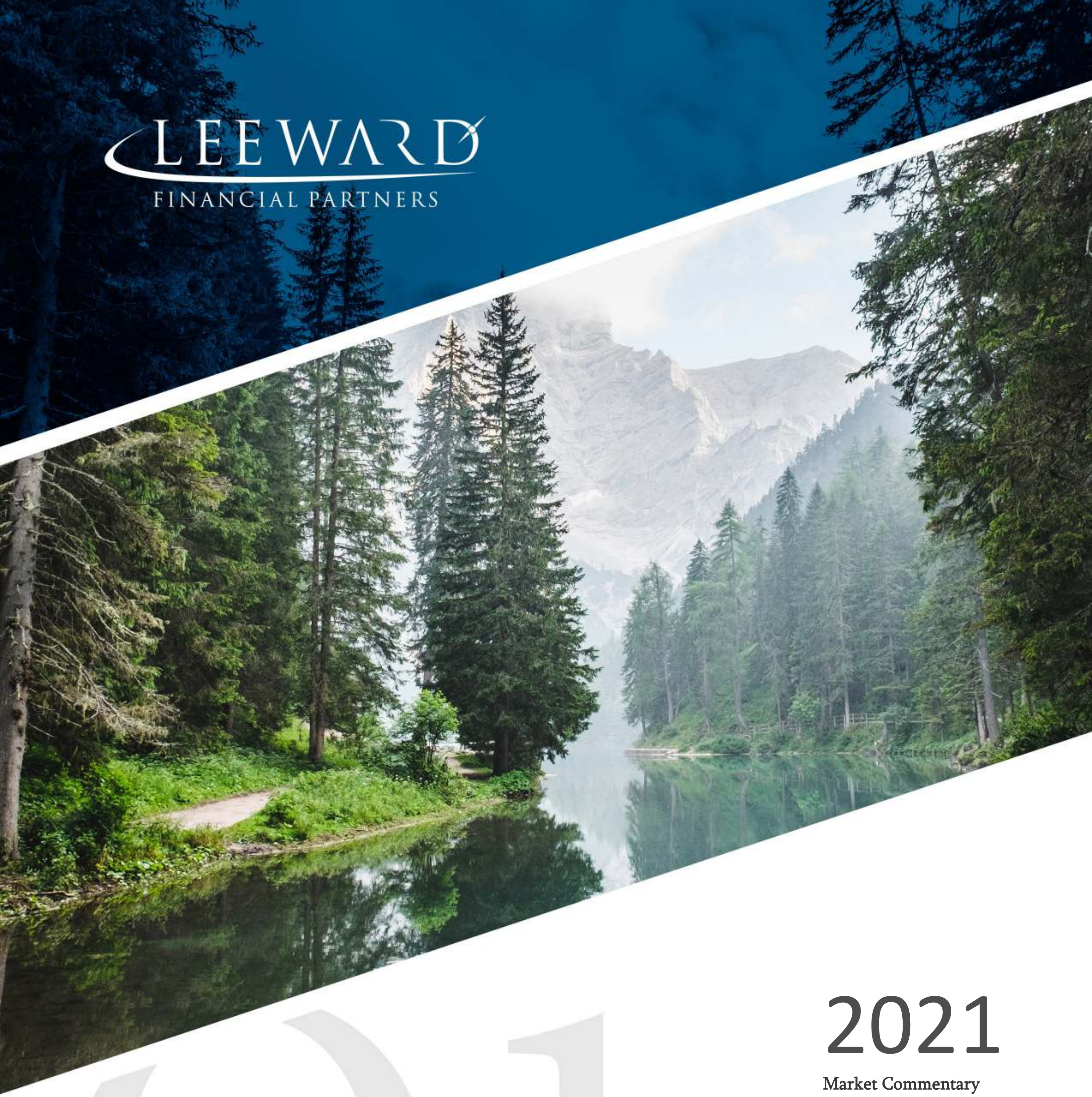

Q1 2021

Market Commentary

Government stimulus, vaccine shipments, and improving economic data push markets higher to start the year.

1Q 2021 Market Commentary

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Light at the end of the pandemic tunnel

Markets had a solid start to 2021. January saw additional stimulus pass, covid cases plateau, and vaccine shipments begin in earnest. In February, economic data began to reflect January's positive developments, coaxing markets higher. As the quarter progressed, new risks began to emerge. Interest rates started to increase, inflation began to appear, and pricing spikes occurred. New Covid-19 variants cropped up as well, raising doubts about long-term vaccine efficacy. Markets consolidated temporarily due to these new stresses but soon shrugged off concerns as risks were quickly overshadowed by positive financial data. Retail sales, manufacturing, unemployment, and job growth all significantly beat estimates in March, priming the U.S. economy to surge in the months ahead.

Equity returns were up broadly in the first quarter. Small-capitalization companies shined most brightly, notably outpacing their large-cap counterparts. Conversely, fixed-income performance suffered, hampered by rising interest rates. In the U.S., the S&P 500 Index appreciated 7.3%, and the Nasdaq grew 4.3%. International markets split the difference, up 5.9%. The Russell 2000 Index (a comprehensive small company index) was up 11.9%. The cyclical company component of the Russell 2000 was especially impressive, returning over 20% in the quarter. Fixed income asset classes were mostly negative. Long-term bonds – which have the most negative exposure to rising rates – suffered greatly, down -10.2% for the quarter. The U.S. Aggregate bond Index was down -3.5%. Riskier credit issues fared better. High yield securities, for example, were up 6.4% to start the year.

At the sector level, investors moved out of digital stay-at-home securities and into companies benefiting from the economy reopening. Leading sectors for the quarter included Energy (+31.1%), Financials (+18.6%), and Industrials (+12.5%). Sector laggards were Technology (+1.4%), Staples (+1.9%), and Consumer Discretionary (+4.3%).

The Fed Remains Supportive

The Federal Reserve Bank's (Fed) March meeting caught many investors by surprise. In the meeting, the Fed raised its internal 2021 U.S. GDP forecast to 6.5% (up from 4.2%) and lowered year-end unemployment forecasts to 4.5% (down from 5.2%). These are historically significant revisions. It has been over 30 years (1984) since the U.S. economy grew above 6%. Despite the positive revisions, the Fed reiterated its accommodative stance. The Bank will continue to purchase additional securities in the open market and maintain its forecast to not raise lending rates until 2024.

The Fed's actions are remarkable. Inflation risk and favorable economic factors have not prompted the Fed to signal rate hikes. Instead, Chairman Powell expressed his comfort with higher inflation in the near term and views inflation increases to be transitory. The Fed has pledged to endure moderate inflation to cut unemployment further and appears committed to projecting any action that could tighten policy well in advance of implementation. This strategy is positive for market growth and builds confidence in sustained economic expansion, albeit at the risk of rising federal debt and long-term structural challenges.

Firing on all cylinders.

The U.S. economy is recovering. Positive economic data increased throughout the quarter, with retail spending, employment, and manufacturing each exhibiting substantial gains. Fueled by additional fiscal stimulus and lingering pandemic uncertainty, consumers have gone on a spending spree. Retail sales were up 9.6% in March, far ahead of 6.1% expectations. Job growth checked in at 916,000 new jobs (vs. 675,000 estimate), supported by significant increases in restaurant and leisure positions. Unemployment benefits, while still elevated, hit their lowest level in 13 months. Manufacturing has accelerated. For example, March's Philadelphia Fed Manufacturing Survey produced its highest reading in 50 years.

These factors suggest the U.S. economy has significant momentum going into the summer. Consumption is expected to increase, manufacturing is healthy, and labor markets are improving. Pent-up demand for travel and services should bolster additional growth. The ability to spend on travel, restaurants, and events alone could add as much as 4.0% to GDP. Eventually growth will slow and financial improvements will get priced into market expectations. When this happens, markets may consolidate; however, we do not anticipate a major correction in the near-term.

Inflation, interest rates, and taxes

As we come full circle on the pandemic-induced economic cycle, inflation, rising interest rates, and tax policy are all converging to challenge investors. The current debate in the market is not if rates are rising (they are), if inflation is present (it is), or if taxes are increasing (they will), but by how much and what effect these factors will have. Higher interest rates could impact pricing power and lead to sustained inflation. Higher taxes have the potential to reduce cash flows, curb spending, and become a headwind to future growth.

Rising from historic lows in 2020, 10yr treasuries increased from 1.09% to 1.74% in the first quarter. This change caught many investors by surprise. If rates continue to move higher or are perceived to be permanent, then inflation risk would be significant. This last occurred in 4Q 2018, when rates briefly moved above 3%, causing markets to fall by almost 10%. We currently do not anticipate a repeat of 2018 but instead view interest rate risk as transitory. The economy is recovering in 2021, and higher inflation is normal during recovery periods. Supply chains become constrained and imbalances in raw materials cause temporary price increases. We would become more concerned if price increases were demand-driven – as they were in 2018 – because this type of imbalance takes longer to resolve. Additionally, in 2018 interest rates moved higher than the U.S. GDP's 2% growth, a negative sign for financing risk. This year we expect U.S. GDP growth to be over 6%, materially higher than current interest rates and leaving room for temporary rate increases.

Taxes are less of an issue than rising interest rates. We view higher taxes as inevitable, but believe current increases appear manageable. Submitted tax legislation has not increased dramatically in 2021, and President Biden's "Made in America Tax Plan" is primarily as advertised. Currently, corporate rates are proposed to increase from 21% to 28%, and income tax rates on high earners are projected to revert to 2016 levels. Generally, tax adjustments are less impactful on economic activity than interest rate changes. We believe income tax changes will affect financial planning, but this is individual-specific and does not impact the broader economy.

Portfolio Positioning

At the end of last year, we began to reduce our positions in growth holdings and increase exposure to cyclical assets and small-capitalization securities. Throughout the first quarter, we continued this trend. We further reduced technology and are now only modestly over-weight in the sector. We made additional purchases in small-caps and recovery areas, adding to consumer service, consumer cyclical, and financial sectors. The net results of our equity adjustments are broadly balanced portfolios that are positioned to take advantage of the improving economy.

Our current fixed income positioning remains focused on short-term bonds, both in treasuries and corporate issues. For clients with higher exposures to fixed-income investments, we sold our remaining long-duration assets. We also slightly increased credit risk in selective areas. Both solvency and default risk have gone down as the economy has recovered, making the risk-reward of lower quality bonds more attractive. Longer-term, we anticipate remaining underweight in fixed income as rising rates continue to be a headwind.

Outlook and Conclusion

Markets have had a solid start to the year. Between stimulus checks, market performance, better weather, and finally getting a vaccine appointment, the optimism is palpable. Company balance sheets are strengthening, and consumer confidence is increasing. The outlook for 2021 should continue to improve as tailwinds align to serve up a blockbuster year for growth. Rising interest rates remain the bogeyman, that while manageable, will not go away anytime soon. Tax increases are coming but will be more important for individual financial planning than for market appreciation.

How much further markets rise in 2021 will depend on the sustainability of economic growth when stimulus subsides. So far, financial data and price performance have been better than expected. Second-quarter corporate earnings reports should continue this trend. As always, we are monitoring threats closely. Economic growth is susceptible to a spike in inflation, and rotational trading could make markets choppy. Even so, we do not see a significant market correction near-term. If the environment changes, we will adjust to protect assets. Looking ahead, we are cautiously optimistic, zeroed in on the light at the end of the pandemic tunnel.

Thank you for your partnership. We look forward to connecting with many of you over the next several weeks.

Sincerely,

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