Investment Update

First Quarter 2021

In a refreshing change, the first quarter was largely uneventful after the astonishing assault on the Capitol in early January. Other items of note were Johnson & Johnson and AstraZeneca joining the mix of vaccine suppliers around the globe; volatility in certain individual stocks spiking driven by retail investor interest; and the grounding of a supermax tanker in the Suez Canal gumming up already strained global supply chains. The continued semiconductor chip shortage is an example of the difficulties the manufacturing economy faces in returning to pre-pandemic output. In an odd counterpoint to what the economy faced a year ago when consumers were willing, but unable to spend, there is currently an inability to produce enough of what consumers would like to buy.

Equity Markets (Total Return)	1stQ'21	1-Year	3-Year
Dow Jones Industrials	8.3%	53.8%	13.6%
S&P 500	6.2%	56.4%	16.8%
S&P Mid-Cap	13.5%	83.5%	13.4%
S&P Small-Cap	18.2%	95.3%	13.7%
MSCI All-Country World	4.7%	55.3%	12.6%
MSCI Foreign Developed Markets	3.6%	45.2%	6.5%
MSCI Foreign Emerging Markets	2.3%	58.9%	6.9%
US Bond Markets (Total Return)	**1stQ'21**	**1-Year**	**3-Year**
Barclays US Treasury	-4.3%	-4.4%	4.1%
Barclays US Municipal	-0.4%	5.5%	4.9%
Barclays US Corporate Investment Grade	-4.6%	8.7%	6.2%

As we predicted, the tenuous economic environment kept the Biden administration initially focused on providing another round of stimulus without complicating the discussion with how to pay for it, but tax increases for companies and high-income individuals are on the table now that the parameters of a large infrastructure bill are being socialized. It may be that the total spending from these bills will prove unnecessary, and that is at least part of what has pushed bond yields up recently. Nevertheless, we believe there is a good argument for much of the true infrastructure spending proposed. Taxing more of a company's earnings makes its shares less valuable, but neither the idea of, nor the scope of the rate increases are a surprise, and investors appear to be taking them in stride so far. Ideas like taxing capital gains at ordinary income rates, or eliminating the step-up in cost basis of assets at one's death are more radical. Nonetheless, if either or both were to become increasingly likely, we would revisit our existing capital gains realization plans for clients.

The S&P 500 was up solidly for the quarter despite weakness in technology, but well behind the small-cap S&P 600 whose sector weightings are skewed towards more cyclical industrial and financial companies. With one year since the March 23rd bottom for the S&P 500, we persistently see year-over-year returns for many stocks that would normally be expected from a small handful of high-flying growth stocks.

The Fed continues to signal that it will keep its targeted short-term rates at or near zero for several more years, but there was a notable increase in longer-term bond yields as the benchmark 10-year Treasury went from just under 0.95% to nearly 1.80% late in March. A wide range of programs

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were implemented last year to support the economy and financial markets. Some, such as the Fed purchasing corporate bonds, have already been quietly wound down despite having played a critical role. Rent forbearance is one measure that keeps getting extended, and it seems there will be a real reckoning when tenants will have to start paying their rent, not to mention back rent. The unwinding of monetary stimulus will be difficult primarily because investors will eventually become overly concerned with exactly when and how quickly the Fed will start raising interest rates. Thus, we expect a spurring of volatility in financial markets when the Fed begins to use even moderately hawkish language to describe its intent. We saw this dynamic play out with the so-called taper tantrum in 2013, several years before rates even increased for the first time after the financial crisis, and again with the late 2018 stock market selloff.

Well before it becomes necessary for the Fed to raise rates based on current conditions, markets will usually anticipate future growth above and beyond an initial post-recession bounce and drive longer-term rates higher to protect against the possibility of accelerating inflation. It is mildly surprising that investors across all asset class have had to factor in higher longer-term yields so soon after the end of a recession, and so quickly, but we think that the recent increase in yields will probably flatten out. Higher borrowing rates will start to tighten financial conditions in many areas of the economy, in effect doing some preliminary work for the Fed. Also, yields on U.S. debt are relatively attractive for global investors, and their demand will provide a further check on rising interest rates.

It is impressive that S&P 500 fared as well as it did in the first quarter as increasing bond yields contributed to a rotation out of growth stocks. Regardless of how favorably one might view a company's positioning and prospects, a larger portion of the value of growthier companies tends to be attributable to their future cash flows, and those cash flows are worth less today when discounted by higher risk-free rates in valuation models. Also, with more clarity on where the economy and pandemic are headed than we had say six months ago, investors who need to be fully invested by mandate have become less likely to simply park capital in areas like technology, ironically viewed as safe havens during the pandemic. Finally, the rotation back-and-forth between targeted "pandemic plays" and "reopening plays" over short periods has been a persistent theme for a year, but in the first quarter momentum shifted more persistently from the former to the latter.

The business of companies whose stocks performed the best during the pandemic all will likely continue to succeed to some degree in a new normal world, but their stocks are unlikely to enjoy quite the same support from investors who drove a long arc of outperformance when few other businesses were thriving. Their futures were probably never bright enough to support the stock prices at their peaks, and they have all fallen. Short-term investors have now shifted their focus to stocks in businesses most highly levered to a return to normal. We prefer a more balanced approach as we think their futures are similarly not as bright as their current valuations would suggest, given it will take many portions of the economy like travel quite some time to truly return to normal.

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