INVESTMENT OUTLOOK

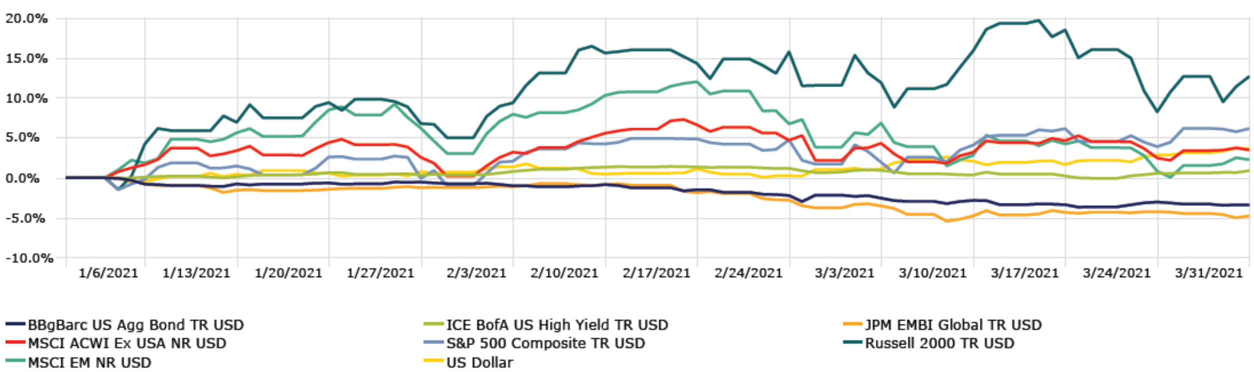
Q1 2021 Market Commentary

The end of winter has been greeted by both a change in weather and a change in the COVID-19 climate. Vaccination drives across the developed world have begun to level off case counts, while progress in some developing economies around the globe continues to be hampered by resurgences of the virus.

Global Markets Performance

Per Morningstar, the US stock market, as represented by the S&P 500, finished up 6.17% on the quarter, a substantial rise and a further nod to last year's 18.40% return. Smaller US stocks[1] rose by more than twice as much, up 12.70% for the quarter following a nearly 20% return last year. International stock markets[2] and emerging markets[3] rose but underperformed domestic equities during the quarter, ending up 3.49% and 2.29%, respectively. On the credit side, core bonds[4] sank -3.37% and high yield bonds[5] posted slightly positive returns, up 0.90% for the quarter, impacted by both higher risk-free rates and narrowed spreads[a]. Emerging market (EM) bonds[6] fell as well and ended the quarter down -4.74%, feeling the pinch from higher rates and a stronger dollar.

Historical Performance



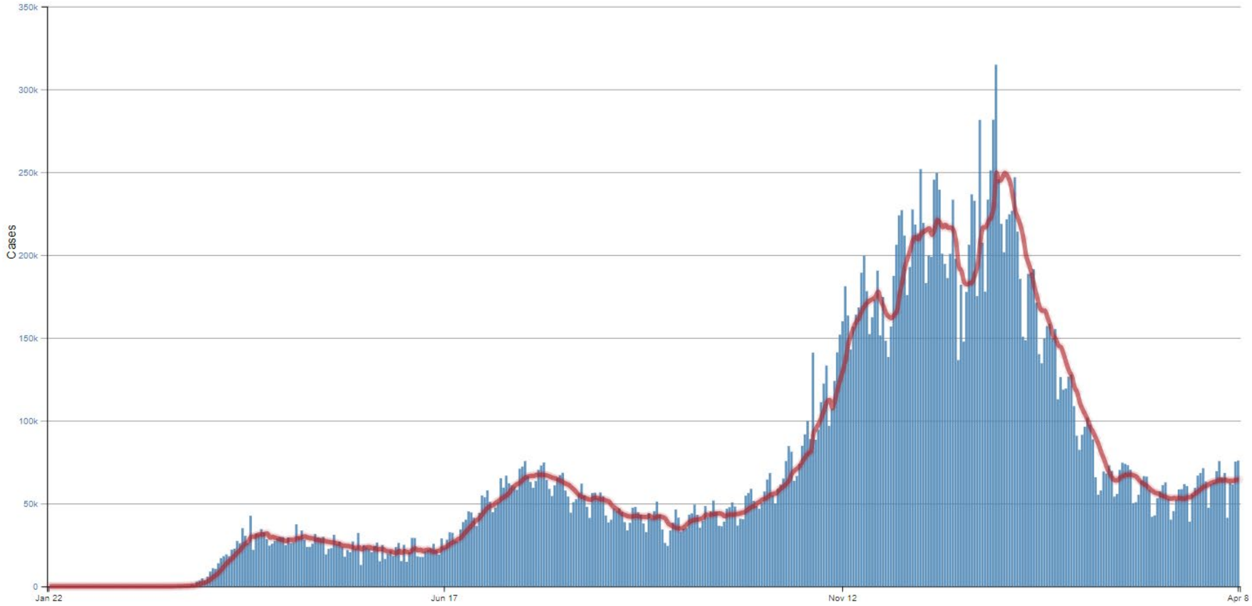
Calendar Year Returns

	YTD	2020	2019	2018	2017	2016
BBgBarc US Agg Bond TR USD	-3.37	7.51	8.72	0.01	3.54	2.65
ICE BofA US High Yield TR USD	0.90	6.17	14.41	-2.26	7.48	17.49
JPM EMBI Global TR USD	-4.74	5.88	14.42	-4.61	9.32	10.19
MSCI ACWI Ex USA NR USD	3.49	10.65	21.51	-14.20	27.19	4.50
S&P 500 Composite TR USD	6.17	18.40	31.49	-4.38	21.83	11.96
Russell 2000 TR USD	12.70	19.96	25.52	-11.01	14.65	21.31
MSCI EM NR USD	2.29	18.31	18.44	-14.58	37.28	11.19
US Dollar	3.66	-6.69	0.22	4.40	-9.87	3.63

COVID-19 Pandemic Update

The advent of the new year and the widespread rollout of vaccines in the US has led to a much different story in COVID-19 cases since our last missive three months ago. As of March 31st, the seven-day average of new cases in the US hovered around 63.5k, while that same number as of December 31st was approximately 188.5k[8]. Additionally, as of early April more than 20% of the US population has been fully vaccinated[9].

Daily Trends in Number of COVID-19 Cases in US



Source: Centers for Disease Control and Prevention[1].

As the situation in the US continues to improve, other countries are finding it harder to stamp out the virus. In particular, cases in Iran, India and Brazil have continued to increase, with Iran and India witnessing exponential growth. Brazil has not experienced the same degree of case growth, but virus-related deaths have increased significantly and imposed a massive strain on the country's emergency services not seen since the early days of the pandemic[10].

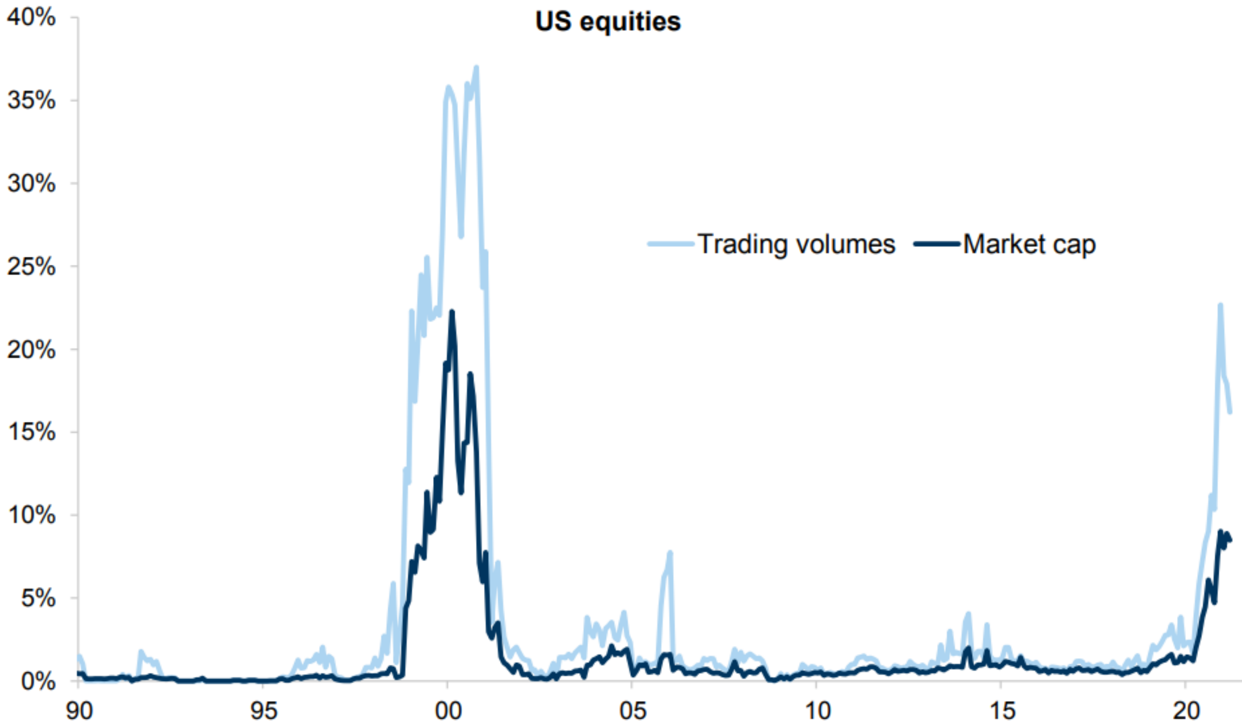
While new strains of the virus continue to emerge and present challenges to defeating it, the positive news for the time being remains that existing vaccines appear effective. Though they may not prevent mild symptomatic cases of COVID-19, the vaccines do appear highly responsive in preventing severe cases that could lead to hospitalizations and deaths, which should lead to a more manageable response[11].

Bubble Trouble?

As markets have continued to rise while real economies were hit hard by the pandemic, there has been growing concern that some markets are in or approaching bubble territory and could eventually pop. There are reasonable arguments for and against a market bubble, and we will briefly examine both.

Those calling for a current bubble point to indicators such as "widespread frothiness…risk-taking and leverage," according to NYU professor Nouriel Roubini[12]. The vast amount of liquidity from both the federal government's fiscal packages and the Federal Reserve's (Fed) market interventions have created an environment where investors are encouraged to borrow and invest. These conditions, in turn, have led to frothiness in certain markets such as retail stocks and cryptocurrencies.

Trading In Stocks With High EV/Sales Ratios Has Surged*



**LTM EV/Sales ratios of stocks with LTM revenues > 50 million USD.*
Source: Goldman Sachs Global Investment Research[13].

Those on the other side of the aisle, including analysts at Goldman Sachs, believe that there are pockets of excess in current markets but in general there is no bubble yet present. While there are certain hallmarks of bubbles such as increased market concentration, easy credit, and frantic speculation, two key characteristics remain missing: a late cycle economic boom and the presence of accounting scandals and irregularities. They further argue that while many see current US stock valuations as excessive, and indeed they are relative to history, the overall prices can be justified by the historically low levels of interest rates[13].

Whether certain markets or markets overall have entered bubble territory is the opinion of each individual investor. There are valid arguments on both sides, but we continue to encourage investors to refrain from market timing and to develop proper long-term strategic allocations and to rebalance your accounts to those targets as markets adjust.

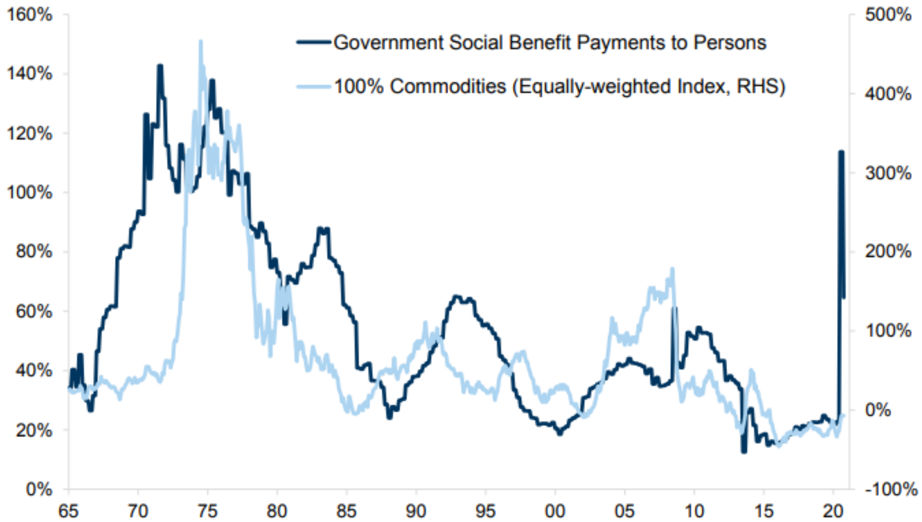
Inflation Nation

In tandem with discussion of potential bubbles, there has been increased chatter of rising inflation. Much of this began after the Fed's announcement of average inflation targeting (AIT)[b] in the second half of 2020 but has taken on new urgency as interest rates in the US have since risen.

Analysts at J.P. Morgan argued in March of this year that there are several impetuses for higher inflation going forward, with two among them changing demographics and less globalization as well as higher public debts[14]. Arguments for the former include a lower working age population due to aging in many countries and a continuation of the nationalist movements such as 'Made In America.' A lower supply of available workers and higher costs from localized production could lead to higher labor and production costs and ultimately prices.

Further, higher and higher public debts could see governments put pressure on their central banks to keep interest rates low in order to lessen interest burdens on those debts[14]. The more the national debt increases, the more difficult it will be to raise rates, and the longer rates stay low the more probable it is that inflation could pick up.

The Last Time Government Support Grew This Rapidly Was During The 1960s



Source: Goldman Sachs Investment Research[15].

While we can't know with certainty whether inflation will in fact rise and to what degree it could, we do have empirical evidence of which environments most support stock markets. Per the work of strategists at Goldman Sachs, the best returns for equities since 1929 have tended to occur when inflation is low and rising or high and falling[15]. Similarly, but in the other direction, these situations have not typically been very supportive of fixed income returns.

Looking Forward

Whether we are discussing bubbles and excessive valuations or interest rates and the potential for changes in inflation, it's important to remember that history can be educational, but it can never be a perfect guide.

We believe that it's important to try to understand where we are in markets so that we can make critical decisions that affect our long-term strategic allocations. But we also believe that it's important to understand that we cannot know the future of markets to any precise degree.

As Mark Twain once said, 'history never repeats itself but it rhymes.' As it goes in life, so it goes in markets. If you believe your financial situation has changed or you have yet to develop a long-term plan for your investments, we encourage you to reach out to your financial advisor and take the next step.

As of March 31st, 2021.

References:

Smaller US stocks[1] – as represented by the Russell 2000 TR Index

International stock markets[2] – as represented by the MSCI All Country World ex-USA Index

Emerging markets[3] – as represented by the MSCI Emerging Markets TR Index

Core intermediate bonds[4] – as represented by the Bloomberg Barclays US Aggregate Bond Index

High yield bonds[5] – as represented by the ICE BofAML US High Yield Index

Emerging market bonds[6] – as represented by JPM Emerging Market Bond (EMB) Global Index.

Morningstar performance data[7] – sourced from Morningstar Direct, 2020.

Coronavirus data[8] – sourced from CDC, "Trends in Number of COVID-19 Cases and Deaths in the US Reported to CDC, by State/Territory," 10 April 2021. https://covid.cdc.gov/covid-data-tracker/#trends_dailytrendscases.

US vaccination progress[9] – sourced from US News & World Report, "CDC: 20% of U.S. Population Fully Vaccinated Against Coronavirus," by Cecelia Smith-Schoenwalder, 9 April 2021. https://www.usnews.com/news/national-news/articles/2021-04-09/cdc-20-of-us-population-fully-vaccinated-against-coronavirus.

Iran, India, Brazil COVID-19[10] – sourced from Associated Press, "Countries worldwide hit new records for virus cases, deaths," by Michelle Smith, 9 April 2021. https://apnews.com/article/countries-worldwide-hit-new-records-coronavirus-cases-deaths-29b18a267fbe972766403f8de0fee415.

Variants and vaccines[11] – sourced from PBS News Hour, "Analysis: How worried should you be about coronavirus variants? A virologist explains his concerns," by Paulo Verardi, 8 April 2021. https://www.pbs.org/newshour/health/analysis-how-worried-should-you-be-about-coronavirus-variants-a-virologist-explains-his-concerns.

Nouriel Roubini on bubbles[12] – sourced from MarketWatch, "'We're seeing widespread frothiness, risk-taking and leverage,' warns 'Dr. Doom' on state of stock-market," by Mark DeCambre, 6 April 2021. https://www.marketwatch.com/story/were-seeing-widespread-frothiness-bubbles-risk-taking-and-leverage-warns-dr-doom-on-state-of-stock-market-11617719690.

Goldman Sachs on bubbles[13] – sourced from Goldman Sachs, "Bubble Puzzle," 22 March 2021. https://publishing.gs.com/content/research/en/reports/2021/03/22/d95d93f0-abea-42e1-9d62-3f536f1cba98.pdf.

J.P. Morgan inflation[14] – sourced from J.P. Morgan, "Is inflation coming back: What the great demographic reversal means for inflation and interest rates," 10 March 2021. https://markets.jpmorgan.com/research/ArticleServlet?doc=GPS-3674985-0.

Glossary:

Spreads[a] – the difference in bond yields of the same maturity but differing qualities, e.g. corporate bonds vs. US government bonds.

Average inflation targeting (AIT)[b] – targeting a specific level of inflation that averages an annual % over time; for example, the Fed's 2%.

Short and long-end interest rates – as represented by the 1-month and 10-year US Treasury rates.

Blue wave – refers to the US Democratic party possessing a majority in the House of Representatives and Senate and controlling the White House.

G4 non-financial corporate debt – debt issued by corporations not operating within the financial sector, e.g. banks. G4 refers to the US, the Euro area, the UK, and Japan.

Phase Three trials – per the CDC, in Phase 3 the vaccines are "given to thousands of people and tested for efficacy and safety." After Phase Three trials are approved, vaccines can be issued to the general public.

Options – a contract that gives the buyer the right, but not the obligation, to buy or sell the underlying asset at a specified price prior to a specified date

Blue chip – typically large capitalization, well-known brands.

Fiscal spending & budget deficits – fiscal spending relates to all government expenses, and a budget deficit implies a government is spending more than it is receiving from taxes, interest, etc.

Liquidity vs Solvency – liquidity relates to having enough cash on hand to continue operating in the short term, while solvency relates to the long-term and whether or not equity is sufficient to continue operating.

Repos (repurchase agreements) – in repurchase markets, borrowers needing cash offer lenders collateral, generally in the form of safe bonds (such as US Government bonds), and in return receive a short-term loan. Repo agreements can be as long as one year, but are generally three months or less, and the most popular tenure is an overnight loan.

Federal funds rate – the interest rate that banks charge other banks for lending them money from their reserve balances (held at the Federal Reserve) on an overnight basis.

Agency mortgage bonds – mortgage securities that are issued by government-sponsored entities (GSEs) like Fannie Mae or Freddie Mac, or guaranteed by a government agency like Ginnie Mae.

Strategic asset allocation – the long-term asset class goals for an investor which specify on average, how much of your money should be invested into stocks, bonds, etc.

Goldilocks – describes an economy that's neither too hot as to spur rapid inflation or too cold to cause a recession; it characterizes an economy operating in an optimal state from a macroeconomic standpoint.

Yield curve – the graphic representation of US Treasury securities as defined by their yield and time to maturity.

One-month & ten-year rates – on the US government yield curve, the securities issued with maturities of one month and ten years, respectively. The US Treasury also issues securities between one month and ten years, and longer than ten years.

Asset location – the tax-arbitrage strategy of placing high-tax exposure assets in low tax-paying accounts, and vice versa. The theoretical benefit is to lower taxes from investments and compound higher long-term capital.