First Quarter 2021

Quarterly Letter to Clients

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The first quarter of 2021 marked one year since the onset of the Covid-19 pandemic, which started one of the most unexpected and challenging years in modern history. According to the CDC, Covid-19 was the third leading cause of death in the U.S. last year, behind heart disease and cancer. However, there are good reasons for optimism as we move into the second quarter of 2021. Several vaccines have been approved and, as they are dispersed, the pandemic should draw closer to an end. Herd immunity, achieved through both direct exposure and inoculations should pave the way for accelerating growth as shuttered businesses start to reopen across the country.

Fiscal and Monetary Policy

While the pandemic may be moving closer to an end, America's political landscape did not improve after the 2020 election. However, it did bring some clarity as to this Administration's plans for supporting the economic recovery. Congress, with the Biden Administration's blessing, moved quickly to pass the $1.9 trillion American Rescue Plan Act, bringing the total stimulus since the pandemic's onset to approximately $5.3 trillion, or 25% of GDP. Congress also unveiled a proposed $2 trillion "infrastructure" plan, with spending on fixing roads and bridges, broadband internet, and significant spending on a slew of other items not related to infrastructure. This proposal would be paid for over 15 years by raising the corporate tax rate to 28% from 21%. The impact of a tax increase would be immediate, whereas the infrastructure investment would be gradual. If passed, it would put the U.S. corporate tax rate back near the top of the pack among major economies at a time when the economy is already struggling.

The Fed continues to play an essential role in the economic recovery with its accommodative monetary policy. The current policy includes near-zero short-term borrowing rates and $120 billion a month in bond purchases. As the economy heals, the central bank should start to roll back some of its help, but that is expected to happen very gradually and with complete transparency. However, it's unclear what actions the Fed intends to take if inflation zooms ahead of their expectations. Even with the economy recovering faster than expected, the Fed is not expected to raise interest rates in 2021.

Economy
The Fed's March Summary of Economic Projections showed a more positive outlook by predicting that GDP could increase by 6.5% in 2021, marking a significant jump from the anticipated 4.2% growth in December. Increasing economic activity, employment, vaccinations, and recent fiscal policy led to a faster than expected recovery during the first quarter. Despite the rosier outlook, Federal Reserve Chair, Jerome Powell, maintained that the Fed would continue to keep interest rates near zero and maintain its asset purchasing measures. Growth of 6.0% or more would mark the fastest growth in four decades.

Nonfarm payrolls have increased for three consecutive months, helping the unemployment rate to decline from 6.7% to 6.0% during the first quarter. Hiring was broad-based across most industries, but the most significant job gains were concentrated in the leisure and hospitality sector as pandemic-related restrictions eased in many parts of the country. However, this is still far from the 3.5% pre-pandemic unemployment rate. There are still approximately 9.7 million people without jobs, and 18.1 million that are still receiving some type of unemployment benefits.

With lockdown restrictions easing and Americans receiving additional cash thanks to the fiscal stimulus programs, consumer confidence jumped to the highest level in twelve months. This suggests that economic growth may continue to strengthen. In March, the index increased by 19.3 points to 109.7, well above the market expectation of 96.9. However, consumers also expressed concerns regarding the risk of rising inflation due to higher gasoline prices, which could reduce spending.

Higher mortgage rates are starting to impact both refi and purchase activity in the housing markets, as fewer applicants can benefit from lower borrowing costs. Furthermore, historically low housing inventory, in conjunction with rising lumber prices, is putting upward pressure on home prices. Overall volume for mortgage applications declined for five consecutive weeks as the quarter came to an end.

According to the latest survey in March, manufacturing expanded at the fastest pace in 37 years. However, suppliers are still struggling to meet increasing rates of demand. In February, the Polar Vortex added to existing supply chain disruptions caused by an uneven reopening of the economy, resulting from shutdowns and bottlenecks. Extended lead times, wide-scale shortages of critical basic materials, rising commodity prices, and difficulties in transporting products are affecting all segments of the manufacturing economy.

Inflation continues to be a key focus and the market is starting to fear it may get out of hand. The Fed expects inflation to be transitory, as year-over-year comparisons to readings a year ago were subdued in the pandemic's early days. Supply chain issues, including but not limited to the Suez Canal bottleneck, along with trillions of government stimulus and rising prices for food, gasoline, and real estate, all point to the possibility of more inflation ahead. The market-implied inflation rate is currently 2.4% versus the latest CPI reading of 1.7%. Higher inflation would most likely put upward pressure on interest rates and act as a headwind to stock returns.

Stocks

The stock market continues to provide strong returns as investors flush with cash are diving headfirst into risk assets in the name of 'no other alternative.' More money has poured into stock-based funds over the last five months than the previous 12 years combined. According to Bank of America, $569 billion has flowed into global equity funds since November, compared with $452 billion going back to the beginning of the 2009-2020 bull market.

The Dow Jones Industrial Average, Standard & Poor's 500, and NASDAQ indexes were up 8.3%, 6.2%, and 2.8%, respectively, during the first quarter of 2021. It's hard to find an asset class or sector that isn't trending higher. The current sentiment is that asset prices only go up. Many of the riskiest stocks have been the best performers (i.e., those with large valuations and no revenues). However, the rally that started last year has broadened. 'Value' stocks have outperformed 'Growth' stocks since April 2020, as investors have started to reposition their portfolios for a cyclical recovery in anticipation of rising rates and infrastructure spending.

The S&P 500 earnings recession appears to be over, as earnings have climbed above pre-pandemic levels. According to FactSet, profits and revenues are expected to leap higher by 23.8% and 6.3%, respectively, when first-quarter results are reported. This is on the back of easy comparisons from a year ago. Nonetheless, earnings growth is what long-term investors would like to see drive stock returns going forward.

The S&P 500 currently trades at 23.1x forward earnings, which exceeds its five and ten-year averages. This, along with the strong performance of 'speculative' assets (i.e., bitcoin, non-fungible tokens, SPACs, and IPOs) could be a tell-tale sign that bubbles are forming, which should warrant caution. However, most market pundits justify stretched valuations as inexpensive when compared to the low returns expected in cash and fixed income securities. As a result, fundamentals continue to take a back-seat to fiscal and monetary policy, which help support current valuations.

Bonds
The bond market saw rates rise during the first quarter of the year after economic data surprised to the upside, signaling stronger growth and higher inflation fears. The benchmark 10-year Treasury yield jumped 81 basis points, from .93% to 1.74% (14-month high). With the Fed anchoring short-term rates near zero, the yield curve steepened. Against this backdrop, fixed-income returns were broadly negative in the first quarter. The Bloomberg Barclays U.S. Aggregate Bond Index returned -3.37%, its worst quarterly result on record. Demand for high yield corporate debt caused spreads to tighten to just 302 bps, the narrowest level since 2007, while the junk-bond market yield sank below 4.0% for the first time ever.

We continue to resist the temptation to gravitate to popular securities and chase short-term returns. Instead, we are focused on searching for stocks that meet our investment standards while providing a margin of safety. As such, we will continue to apply our disciplined investment philosophy by customizing your portfolio to meet the purpose of the funds invested with the goal of generating returns across all market cycles. Your portfolio's fixed income portion is structured to emphasize capital preservation and stable cash flows while providing a source of funds for future cash needs. The equity portion is constructed to provide a combination of capital appreciation and dividend income, focusing on the long-term objective for the account. Thank you for your business. If you have questions or comments, please don’t hesitate to contact us.