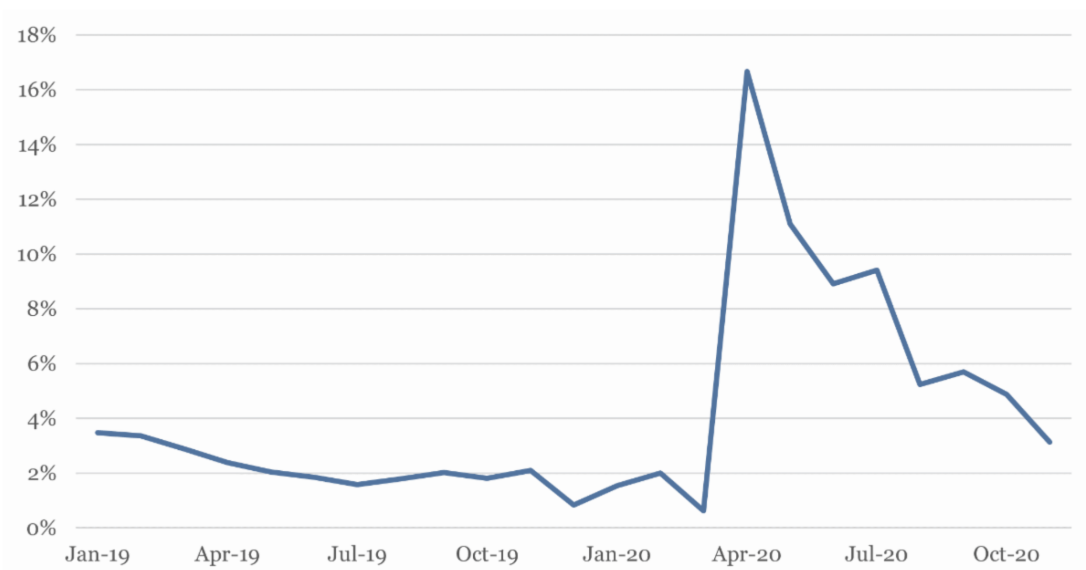
## GREAT EXPECTATIONS

The first month of 2021 progressed mostly as expected:

1. Economic data indicated signs of a COVID-related soft patch, rising interest rates put a headwind on fixed income returns, and inflation expectations crept upward.
2. Federal Reserve Chair Powell took steps to clarify expectations around future policy actions ("The economy is far from our goals…"[1]) and pushed back on any discussion about balance sheet tapering at the current time.
3. President Biden's $1.9 trillion fiscal package hit some roadblocks in Congress, but a full or scaled-down package remains likely.
4. Aggregate household income continued to run above pre-COVID levels (Fig. 1). Families also continued to accumulate a substantial amount of Federal aid as savings, pushing household net worth to all-time highs.
5. Vaccine distribution continued to steadily improve. The US currently administers over 1 million doses per day and is on track to reach herd immunity in mid-to-late summer[2].

**Fig. 1: Inflation-adjusted disposable personal income rose significantly in 2020 (year-over-year percentage change)**




**Source: Federal Reserve Bank of St. Louis, Mill Creek**

These developments leave us in a constructive place from an economic and market perspective. COVID infection rates have plateaued nationwide and current forecasts indicate they are likely to decline very quickly (things that grow exponentially also tend to decline exponentially) over the next two months[3]. Assuming those forecasts bear out, economic activity will coincidently pick up as infection rates decline. Additional fiscal stimulus will likely be added to a supply-constrained economy, creating even more pent-up demand for the second half of the year. All of these factors bode well for the economy, and in response the Bloomberg Weighted Average Real GDP forecast has been revised up to 4.3% for 2021.

### How Much Optimism is Priced In?

Expectations get priced into markets. In Bet With The Best: Strategies from America's Leading Handicappers (a book containing guidance that applies equally well to making portfolio decisions as to placing horseracing bets), "King of the Pick Six" Steven Crist says "even a horse with a very high likelihood of winning can be either a very good or a very bad bet, and the difference between the two is determined by only one thing: *the odds*."

His point in an investment context: even if an investment ultimately makes money, the size of any expected return is affected by market participants' collective expectations — the odds, if you will – at the time it is undertaken.

### Current Positioning

We have emphasized *expectations* in this commentary to explain why — despite the very positive economic outlook — we are not jumping headfirst into risk assets. We hope, and it is likely, that markets will produce good returns this year, but much of the positive news discussed earlier has already been priced in. Downside risks lurk around every corner, and as we said in our Annual Perspective[4], the outlook hinges on COVID[5].

We maintain tactical positions in areas we are more confident about exploiting an actual mispricing. One example – our decision to reduce duration in taxable fixed income portfolios. Rates have risen steadily since we originally published this view in early December 2020[6], but (in our opinion) still do not fully reflect the reflation that is likely over the next 2-3 years.

Our equity portfolios are also slightly tilted toward US equities relative to the global benchmark. That position creates some underperformance risk from a relative standpoint if a robust global recovery leads to a dollar decline versus more-cyclical currencies (Fig. 2), but we have offset that risk by also overweighting global small cap and emerging market Asia equities.

We also believe it is increasingly important for investors to — when they are able —diversify outside of publicly traded stocks and bonds. The investment opportunity set is increasingly moving toward private markets, and we consider non-traditional assets, which include private credit, private equity, and hedge funds, to be core parts of a well-diversified portfolio. We also see many more instances of speculative behavior in public markets than private markets at this juncture.

**Fig. 2: The US Dollar declined in late 2020 leading to outperformance by international equities**


**Source: Bloomberg, Mill Creek**

### Irrational exuberance?

It is clear to us that certain parts of the public equity market are experiencing speculative behavior. One ongoing anecdote: participants on a Reddit forum called “Wall Street Bets” banded together to execute a short squeeze on GameStop (Ticker: GME). A short squeeze occurs when investors that have taken a short position in a stock – betting that the price will decline — are forced to buy shares (thereby driving the price even higher) to cover losses. GME traded from $40 to over $480 per share over the course of a week and continues to trade in a very volatile fashion.

There are numerous examples of similar behavior in the current market and they are not without precedent. Even so, the biggest risk these one-off events present to most investors is FOMO – Fear Of Missing Out. Fear not. Some readers might recall that Volkswagen briefly became the world’s most valuable company during a short squeeze in 2008. The stock

**proceeded to decline over 90% and continues to trade 80% off its highs from that period. This time is not different. It rarely is.**

**More broadly, it is not obvious to us that irrational exuberance has infected the overall market. Yes, equity valuations are elevated, but the equity risk premium — the expected return on stocks relative to bonds — remains elevated and nowhere near the levels seen during the dot-com era (Fig.3). Only a few stocks accounted for all of last year's market gains, and this narrowness in leadership means significant parts of the market are trading at very fair multiples. For these reasons, and others, we continue to believe our globally diversified philosophy for constructing portfolios is well-positioned in today's environment.**

**Fig. 3: The US Equity Risk Premium remains elevated**


Source: Shiller Data Library, Bloomberg, Federal Reserve Bank of Cleveland, Mill Creek

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[1] https://www.facebook.com/Reuters/videos/live-federal-reserve-chair-jerome-powell-participates-in-a-virtual-event-with-pr/232228785171789/
[2] https://covid19-projections.com/path-to-herd-immunity/
[3] https://covid19-projections.com/infections/us

[4] https://www.millcreekcap.com/wp-content/uploads/2021/01/Mill-Creek-Annual-Market-Perspective-2021.pdf
[5] Known global risks include vaccine resistant strains, trade disruptions, and political instability, among others.
[6] https://www.millcreekcap.com/wp-content/uploads/2020/12/Taxable-Fixed-Income-What-Hath-COVID-Wrought.pdf

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