A Return to Normalcy?

Spring is finally here, with its attendant mood-improving warmer weather and, in 2021, growing reasons to believe that the worst of the global pandemic may finally be behind us. As more of the US population is successfully (cross-fingers) inoculated against COVID-19, the combination of aggressive federal government stimulus spending and an unemployment rate that continues to recede from its extreme April 2020 peak is producing more widespread optimism about the economic path forward. And although a resurgent virus and severe winter storms may have recently slowed companies' capital spending and the pace at which individuals' elevated savings were being put to work, consensus forecasts are that consumers' spending will soon occur at rates not seen in several decades. A degree of societal and economic normalcy, it now seems, will be restored in 2021.

The Backdrop: An Improving Economic and Business Environment

Developments and reported outcomes of note across the three-month period ended March 31, 2021 included:

- Final data on how the US economy fared in the final quarter of 2020 (+4.3% annualized expansion) and for the full year (-3.5% shrinkage) confirmed that COVID-19 extracted a heavy burden on GDP, and that this damage was at its most severe during the year's second quarter.

- Other world economies released data showing how poorly they fared during the pandemic, with the Eurozone (-6.1%), UK (-10.1%), and Japanese (-4.9%) economies all shrinking more than the US. China (+2.3%) recorded net growth as it went into and came out of the crisis earlier. Global economies collectively shrank -3.5%, the worst such outcome calculated by the International Monetary Fund since it began compiling worldwide data over 40 years ago.

- Unemployment in the US (which had peaked at a post-Great Depression high of 15% in April) continued to recede, touching 6.0% in March. Unemployment in some sectors of the economy and sub-groups of the labor force, however, remained well-above pre-pandemic levels.

- The American Rescue Act, the $1.9 trillion fiscal stimulus package promulgated by the newly inaugurated Biden Administration, lifted overall planned COVID relief spending since last March to more than $4 trillion. Although academic and political views on the short- and long-term economic implications of such aggressive government spending policies vary, available data shows that to date individuals (on balance) have been using much of their stimulus checks to pay down debt or to increase savings.

- The Federal Reserve remained committed to using its accommodative monetary policies to support a continued economic rebound, indicating that it anticipates keeping short-term interest rates low through 2023. The Fed expects – and would be accepting of – some transitory increases in consumer prices this year as it pursues policies that it

expects will further reduce unemployment.

- Buoyed by low borrowing costs and influenced by changing workplace dynamics (working from home during COVID), low inventories, and population demographics, US residential real estate prices have risen more than +11% across the last 12 months.

Diverging Capital Markets

The obsession with color-coded COVID-19 maps and charts that we discussed in our annual market perspective is now notably absent from most people's daily news consumption. With their pandemic-related worries subsiding, many investors were instead captivated by a collection of daily outcomes that might best be categorized as having only a marginal bearing on capital markets and portfolios broadly.

- More erstwhile privately owned companies became public entities, using both traditional (selling shares in an initial public offering) and less traditional ("blank check" acquisitions by newly formed SPACs) means. SPACs alone have raised a record $100 billion of capital YTD. A stock market comprised of more companies is on balance a positive development for capital markets and investors alike; though perhaps the return expectations that buyers have for many of the market's newest players are overly optimistic.

- Groups of individual investors bid-up the prices of certain thinly traded stocks – GameStop was the posterchild of such activity – to levels that far exceeded any realistic underlying company intrinsic value.

- Bitcoin again surged (more than doubling, to a record high price of $61,000), amply rewarding speculators but in our view further reducing its utility as a surrogate currency.

Quarterly outcomes in the broad market segments across which most investment portfolio assets are typically allocated included the following:

- Reflecting concerns about potentially higher inflation as the economy recovers (and an attendant risk that the Fed would need to taper its bond buying and raise rates sooner than anticipated), prices declined in segments of the taxable bond market. This resulted in unexpectedly higher yields on longer-dated bonds (e.g., the 10-year US Treasury, on which the yield rose 81 basis points to 1.74%). General optimism about the post-pandemic economy, however, kept corporate bond credit spreads close to their recent multi-year lows. Broadly, taxable bond markets (-3.4%) produced their worst quarterly total return in 40 years; market yields remain stingy (1.61%)

- Yields on tax-exempt bonds rose during the quarter, though to a lesser extent (+8 bp for the market overall). The creditworthiness of certain issues and issuers was supported by expectations of rising tax and other revenues as well as COVID-related federal government support. The tax-exempt bond market produced a comparatively flat

quarterly total return of -0.3%; overall market yields also remained low (e.g., 0.70%) by historical norms.

- US equities (+6.3%) continued their strong, virtually uninterrupted recovery since bottoming just over 12 months ago (on March 23, 2020) during the very early days of the COVID-19 pandemic. Earnings trends were mostly positive: overall fourth quarter revenues and profits exceeded expectations and were only -5% below the prior year (S&P 500 Index). There was, however, a marked change in market leadership: growth stocks (+0.9%) took a long-anticipated backseat to their value stock (+11.2%) counterparts; smaller company stocks (+12.7%) led all other market segments for much of the period before giving way to some profit-taking in March.

- Non-US equities (+3.5%) underperformed on balance, reflecting less optimism about the speed with which other global economies might rebound from the pandemic and, relatedly, the unexpected strength of the USD (+4% to +7% versus most other world currencies). China equities (-0.2%), which now comprise nearly 40% of emerging market indices, advanced strongly until concerns about rising government intervention and regulations in this market precipitated a sharp late quarter sell-off.

Past Is Prologue?

A year ago, across a series of white papers sharing a common theme and title ("The Long and Winding Road to Recovery"), we detailed our perspectives on the challenges facing the US and global economies, and the implications for inflation, interest rates, and bond and stock markets. We cautioned that the difficult environment seemed certain to produce continued capital market anxieties throughout 2020 and possibly beyond, creating ample reasons for investors to be concerned about their portfolios.

In hindsight, and fortuitously for investors, the aggregate snap-back of the US economy across 2020's final two quarters traced the V-shaped path that we (and others) had believed was unlikely in the face of an unchecked and novel global pandemic. As 2021 unfolds, prospects of continued low interest rates and generous government stimulus spending – combined with the roll-out of efficacious COVID-19 vaccines – have produced a sustained optimism within capital markets and among investors. The "this, too, shall pass" sentiment that we offered a year ago as a reason not to make radical changes to well-considered portfolio asset allocations has proven to be less Pollyanna-ish than it may have then seemed.

As much as we grew to dislike the overused adjective *unprecedented* to describe global events of 2020, it may apply equally well – yet positively – to the economic and market environments of 2021. Although an estimated average unemployment rate of 5.7% this year is suggestive of an economy still in need of mending, consensus forecasts of +5.6% growth in US GDP in 2021 would be the second fastest (lagging only 1984) yearly growth rate in 50 years. Similar (but less robust) bounce-backs are predicted for other major world economies, too. A very strong economy is projected to propel corporate revenues and profits much higher (e.g., +40% on the

S&P 500 Index), in the process offsetting not only the lower (but not horrific) results produced in 2020 but eclipsing the all-time high earnings of 2019 by a healthy margin.

It is possible – though we caution not a certainty – that the combination of a robust economy and a sustained rise in consumer price inflation forces the Fed into an interest rate posture that it less accommodative than it plans (i.e., keeping short-term interest rates at current low levels into 2023) and upon which many short-run capital market prices are predicated. Such eventualities – prospectively higher sustained inflation and lower bond prices resulting from a bounce-back of yields from their all-time lows – remain among the potentially problematic risks facing investors across the balance of 2021. Equally worrisome: any material shortfall of per share earnings versus already generous expectations poses a challenge to prices given already elevated US stock market valuations.

The past year demonstrated, once again, that capital markets can often react in contrary ways to what might rationally be expected. The economy experiences a worst-in-generations contraction, but stocks soar +63% to new highs. The government continues its recent debt binge, but most interest rates fall to all-time lows. We learned, once again, that "markets are not the economy." With equally good reasons to be cautiously optimistic and to be guardedly pessimistic currently, we do not believe there are any particularly obvious portfolio re-positionings or reallocations to stake out. Insulating fixed income portfolios against some – but not all – of the risk of higher long-term interest rates by somewhat shortening portfolios' durations remains appropriate. And staying the course within equity portfolios – a strategy which for us means broadly spreading assets across growth and value stocks, small and large stocks, US and Non-US stocks – is still the best way to enjoy the long-term benefits that inure from risk-taking and not missing out on unexpected positive upturns in global capital markets.

INVESTMENT STRATEGY TEAM
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