# Insights: April 2021

## Market Overview and Performance

If you had asked us at the end of 2020 what we would venture as a guess for the return level of equities during the first several months of 2021, we couldn't say with honesty that we would have projected a +11% return for the S&P 500 by the end of April. That being said, we similarly would not have had much confidence in suggesting that U.S. Treasury bonds in aggregate would fall over -4% during the first three months, that Gold would decline by over -10% and that the energy sector would race higher by some +30%. These are outsized moves in both directions and to a large degree reflect the unique historical times we are living in. Due to the pandemic, the entire globe was thrust into a sudden and severe deflationary shock. With substantial improvement in the treatment and containment of the virus, signs of economic recovery are abundant and the resulting optimism is hard to argue against. In fact, the largest concern in the market right now is the possibility of the economy and risk asset markets overheating.

J.P Morgan Chairman and CEO Jamie Dimon recently reflected this optimism in his most recent shareholder letter published earlier this month, stating, "I have little doubt that with excess savings, new stimulus savings, huge deficit spending, more QE, a new potential infrastructure bill, a successful vaccine and euphoria around the end of the pandemic, the U.S. economy will likely boom. This boom could easily run into 2023 because all the spending could extend well into 2023. The permanent effect of this boom will be fully known only when we see the quality, effectiveness and sustainability of the infrastructure and other government investments." As we have written about in the past, we share the view that the potential exists for levels of economic expansion that many of us have never experienced previously in our lives. Of course, nothing moves up in a straight line however. As always, thank you for reading our latest Insights.

| | ***Quarter to Date March 31*** | ***Year to Date March 31*** |
|---|---|---|
| ***Equity*** | ***Total Return % (USD$)*** | ***Total Return %*** |
| S&P 500 Index | 6.17 | 6.17 |
| Russell 2000 Index | **12.70** | **12.70** |
| MSCI EAFE Index | 3.48 | 3.48 |
| MSCI Emerging Markets Index | 2.29 | -1.16 |
| ***Fixed Income*** | | |
| Barclay's U.S. Aggregate Bond Index | **-3.37** | **-3.37** |
| Barclay's U.S. Aggregate Credit Index | **-8.39** | **-8.39** |
| Barclay's U.S. Aggregate Corporate High Yield Index | 0.85 | 0.85 |
| Barclay's Municipal Bond Index | -0.35 | -0.35 |
| ***Macro Measures*** | | |
| Gold | **-9.47** | **-9.47** |
| Crude Oil | **21.93** | **21.93** |
| CBOE Volatility Index | -14.73 | -14.73 |
| USD Dollar Index | 3.67 | 3.67 |

## **Current Theme –** Rapid Success with the Vaccine Roll-out in the U.S. and Most of the Globe has Boosted Investor Confidence Pushing Risk Assets Dramatically Higher

### With Stimulus Still Abundant and Pent-Up Consumer Demand Starting to be Unleashed, Concerns of Overheating Begin to Appear

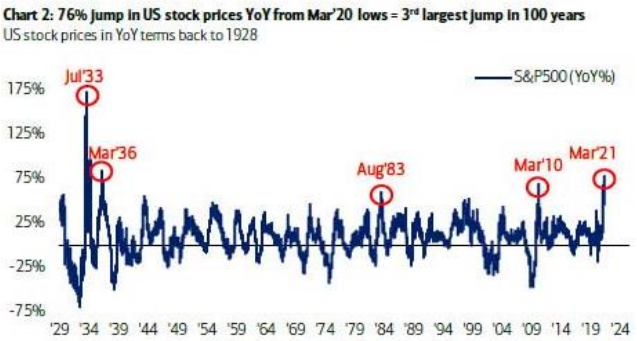
If all went well with a large stimulus package and an aggressive strategy to combat the virus, we thought perhaps the S&P 500 could hit 4000, up about +6%, during the first three months of the year. As it happens, that scenario played out, however the market did not stop there. The S&P has charged further ahead in April, gaining over +11% for the year and now has not experienced a -5% pullback in over 6 months.

***Upward Channel Remains – No -5% Pullback in 6 Months***


*Source: Refinitiv*

In fact, as Bank of America points out, the +76% annual return for the period ended in March of 2021 was the third largest 12-month gain over the past 100 years. Large gains like this by their nature make some people nervous about the prospects of future returns,

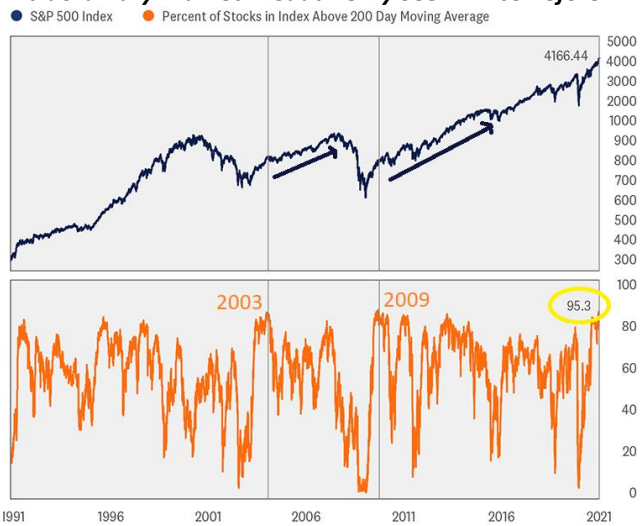
***+76% Gain Over Past 12 Months 3rd Largest in 100 Years***




*Source: BofA Global Research; Bloomberg*

however, there are some important dynamics occurring within the market that need to be taken into account. Perhaps most notable is that fact that this rally has been extraordinarily broad based. While only a handful of large cap tech names have driven the market higher in previous years, today, almost every segment of the equity market is participating in the upward trend to varying degrees. As the chart below highlights, *over 95%* of S&P 500 stocks are trading above their 200-day moving average.

***Extraordinary Market Breadth Only Seen Twice Before***




*Source: LPL Research; Bloomberg*

To simplify, this means that virtually every stock is moving higher, but the extent of this measure has only been seen two other times – late 2003 and late 2009. And contrary to what some might think, these readings marked the start of extended bull periods for stocks and not market tops.

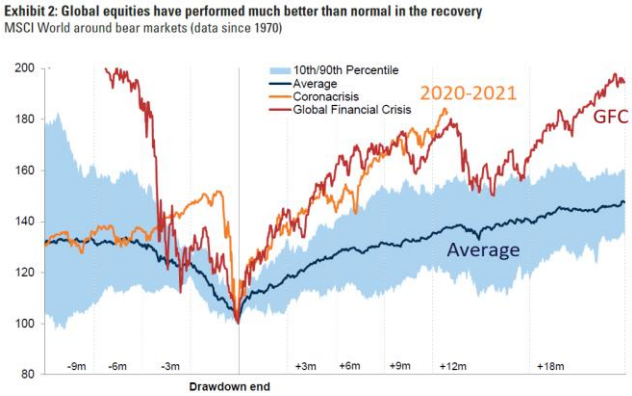
***2009 Rally Ran to April 2010 Before Consolidation Period***


*Source: All Star Charts*

While comparing the path of any one year to another is generally not of much value, looking back at similar periods can be instructive, particularly when the

market experiences extremes as it did last year. The previous graph charts the path of the S&P 500 from the low of March 2009 through the end of 2010. As one can see, the Index bottomed in March of 2009 as the events of the Global Financial Crisis (GFC) unfolded before sharply rallying all the way into April of 2010, a gain of about +82 percent. Following that amazing run, the market proceeded to consolidate over the next five months before notching new highs by the end of the year.

***Global Equity Recovery Has Bettered Past Recoveries***




*Source: Goldman Sachs Global Investment Research*

The current rally has been roughly +85% at this point and as the chart above from Goldman Sachs highlights, the S&P 500 has roughly reached the point when the market began to consolidate after the GFC. To be clear, the reasons behind both the declines and recoveries in these two years are very different, but All Star Charts found very similar patterns in 2004, 1982 and 1976. Regardless of the year, the 2020 recovery has been far better than the average bear market rally dating back to 1970 as Goldman illustrates.

***Q1 Earnings Growth Rate Best Since Q1 2010 at +45%***


*Source: Facset*

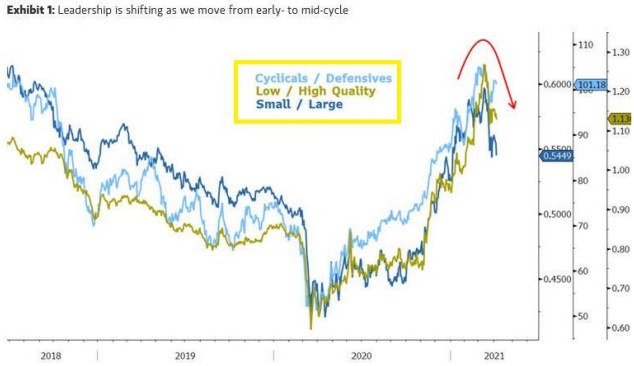
We are by no means trying to say that the market will go down simply because of a similar overlay chart, however, the recovery trade is clearly priced into the market so a new catalyst, or at the very least, some justification for current price levels will have to emerge. Thankfully, what was widely anticipated to be an incredibly good earnings season based simply on the math of lapping the depths of the crisis last year, has exceeded all expectations. As the previous chat from Factset shows, S&P 500 earnings growth has exploded from what was estimated to be around +20% in March to +45% by the end of April. Incredible.

***Q1 Earnings Revisions +15% versus Historical Avg of -4%***


*Source: Factset; BofA US Equity & US Quant Strategy*

That +45% growth is the highest since Q1 2010 and while some might say the period is an "easy comp", the 24% surprise rate is the highest on record as is the 87% beat rate. Importantly, the absolute earnings numbers are quite high. As the chart above highlights, quarterly earnings are up to roughly $43 bringing the full year number close to $180. This keeps valuation in check at around 23x as the "E" (earnings) in the P/E ratio elevates more rapidly than the Price does.

***Recovery Trades Peaked in Late Q1 and Have Retrenched***

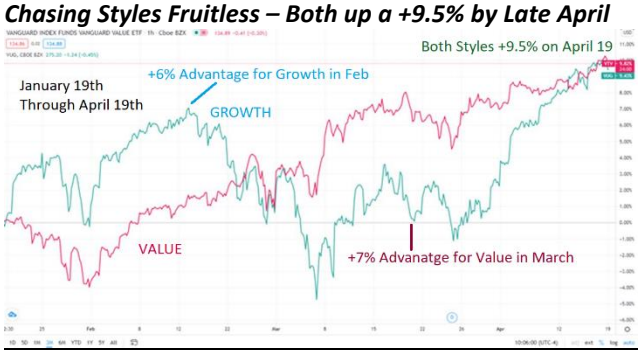



*Source: Morgan Stanley Investment Research*

As we have discussed, the strength of the market has been broad, but the last several weeks have witnessed

a shift in the character market leadership. As the previous chart highlights, the early recovery plays of cyclical over defensive, low quality over high quality and small cap over large cap exhausted itself in mid-March with the three trends all turning lower.

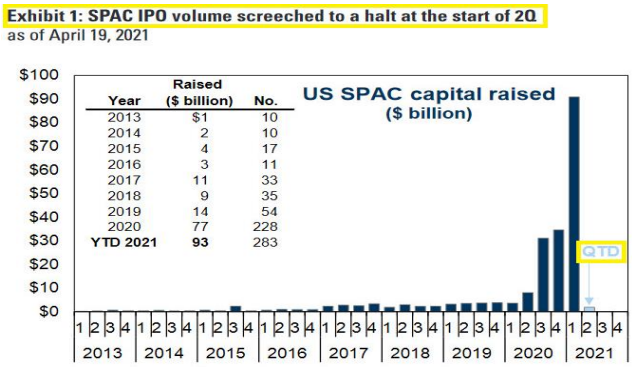
***Chasing Styles Fruitless – Both up a +9.5% by Late April***




*Source: Seeking Alpha; Vanguard; Russell*

Similarly, attempting to trade a broad Value over Growth approach has been a whipsaw adventure. Both styles pulled far ahead of the other at various points over the last three months, but both have ended at the same spot, up almost +10% by mid-April.

***Speculative SPAC Flow Has Collapsed – Only 10 in April***

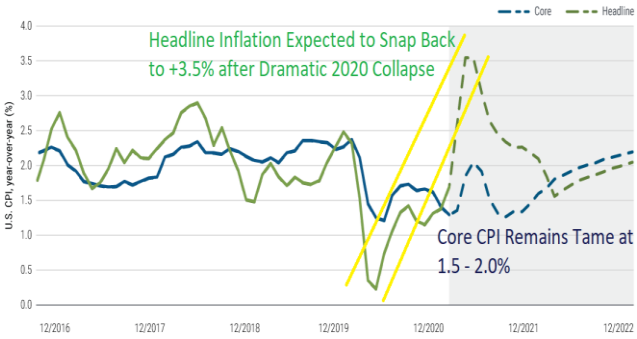



*Source: Dealogic, Goldman Sachs Global Investment Research*

We have also seen some of the speculation discussed in our January Insights letter reverse course. For example, the highly volatile Bitcoin experienced a -24% drawdown in April alone. And as seen above, the land-rush into SPACs, which seek deals to take speculative companies pubic, has ground to a halt. And low-quality companies with extreme valuations are no longer being chased. Bespoke Investment has calculated that there are 137 stocks with billion dollar market caps at the end of 2020 that are now down -50% from their 52-week highs. This includes no revenue and "Meme" stocks.

With some of that type of froth removed, investors are worried about two things right now – the potential for rising inflation and new tax increases.

***Spiking Headline Inflation a Temporary Factor***




*Source: PIMCO*

As PIMCO points out above, a headline inflation number may reach the 3.5% level due to the "beach ball underwater" effect of the deflation shock last year. However, this is likely to be temporary as they anticipate the number to fall back in line with the core measure which has been anchored in the 1.5% to 2% range. This core level is what the Fed focuses on.

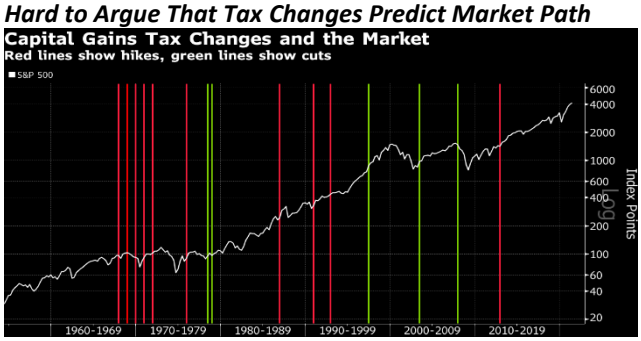
***5 Year Inflation Expectations at 2.5%; 10 Yr Even Lower***


*Source: Bloomberg*

The Market generally shares this view as evidenced by the fact the 5 year Breakevens, a measure of inflation expectations, has settled around 2.5%. If real worry took hold, longer term measures like 10 year levels would be moving higher as well - not the case at the moment. We will readily admit that there are pockets of inflation happening in many areas, again due to the deflation shock of 2020. With no demand, supply chains seized up. We are now seeing the repercussions of those actions now with the prices of things like food produce,

lumber, used cars and homes all moving noticeably higher. But these supply issues will be resolved and importantly for investors, the Federal Reserve is no-where near reducing asset purchases or raising rates as "the economy is far from our goals" according to Chairman Powell on April 28th.

***Hard to Argue That Tax Changes Predict Market Path***




*Source: Bloomberg*

What should we make of the recent proposal to raise taxes then? Two messages we would stress: first, there is almost no chance a tax increase of the levels being discussed will be made into law, and second, the market isn't actually impacted by tax changes. To point one, Goldman Sachs believes something more akin to 25-28% is more realistic and BCA Research estimates that nothing will even be implemented until 2023 due to the mid-term elections. Regarding point two, the chart above overlays tax changes, both higher and lower on the S&P 500 sine the 1960's - there is no discernable pattern. Similarly, the following two charts show that capitals gains increases do not preclude the market from moving higher. LPL Research found that the four most recent tax increases on average did not impede gains, particularly during the most recent periods in 1987 and 2013.

***Higher Capital Gains Taxes Do Not Force Market Selling***

**Higher Cap Gains Haven't Hurt Stocks Lately**

S&P 500 Index Performance After Increases In Capital Gains Taxes

| Date Of Higher Capital Gains | Old Rate | New Rate | S&P 500 Index Returns: Three Months Before | Next Three Months | Next Six Months | Next Twelve Months |
|---|---|---|---|---|---|---|
| 1/1/2013 | 15.0% | 23.8% | 1.5% | 6.7% | 10.5% | 25.3% |
| 1/1/1987 | 20.0% | 28.0% | 5.4% | 19.1% | 24.0% | 0.3% |
| 10/4/1976 | 36.5% | 39.9% | 0.5% | 1.6% | -5.6% | -7.7% |
| 12/30/1969 | 27.5% | 36.5% | -1.6% | -1.7% | -20.4% | -0.6% |
| Average | | | 1.4% | 6.4% | 2.1% | 4.3% |
| Median | | | 1.0% | 4.1% | 2.4% | -0.2% |
| % Positive | | | 75.0% | 75.0% | 50.0% | 50.0% |

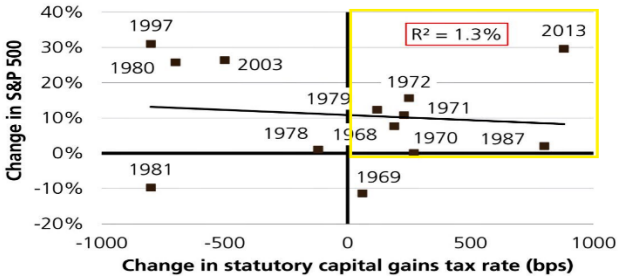
*Source: LPL Financial; Ned Davis Research; Factset*

UBS Research even suggests that out of the last eight times capital gains taxes were raised, the market was higher seven times by as much as 30% in 2013.

***Little Relationship Between Cap Gains Change and Returns***

Fig. 1: No apparent relationship between changes in capital gains tax rates and market returns

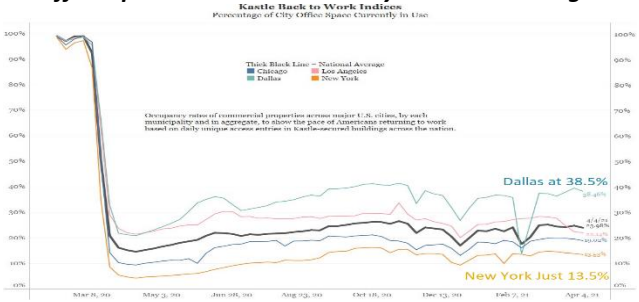
Change in the capital gains tax rate (in basis points) and S&P 500 returns




*Source: Liz Ann Sonders; UBS; Factset*

While taxes are somewhat "tomorrow's" problem, today's issue remains the handling of COVID. Thankfully, the vaccine rollout in the U.S. has been well implemented and many service oriented areas like restaurants and air travel are on the road to recovery.

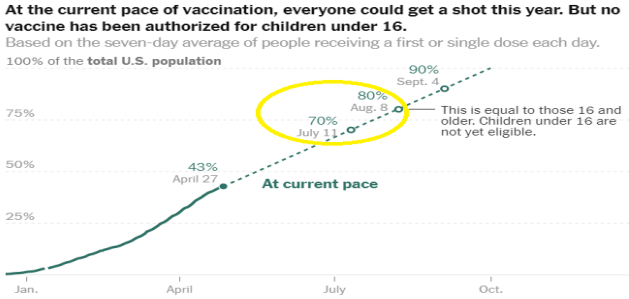
***US Office Space in Use Still down by -76 % on Average***




*Source: Kastle; Bianco Research*

However, workers have largely not retuned to offices which has many economic consequences – some good, some bad. The good news on the horizon is the U.S. vaccination rate may reach the critical 75% level by July which would go a long way toward full recovery.

***If Rate Continues US Will Hit 75% Vaccinated by Late July***




*Source: The New York Times*

## Going Forward

As we stated in our opening comments, we were very optimistic about the potential for a strong start to the year given the huge of amount of liquidity in the system, ongoing direct stimulus payments, massive pent-up savings, the re-opening of a consumer driven economy and the retreat of the tragic COVID virus due to the vaccine rollout. We were by no means alone in this thinking and risk assets have responded by overshooting what we thought was a reasonable expectation for gains during the first several months of the year. We are encouraged that much of the unreasonable behavior in the markets has subsided – "Meme" stocks, SPACs, Crypto fever and hedge fund managers blowing themselves up by levering their capital 8 times over for example. However, with gains approaching +12% for just the first four months of the year, our risk management and portfolio construction discipline compelled us to lock in a certain levels of profits as the S&P 500 approached the 4200 level. Equity prices are led by earnings, so to justify the roughly 22-23 times Price/Equity ratio that the S&P 500 has maintained since mid-2020, annual earnings of $180 will have to be achieved. We believe that this will prove to be the case, but we also believe that there is little doubt the recovery trade has been fully priced into markets. Further catalysts will be needed to push the market higher and those may not emerge until sometime later in the coming months.

While we are still ardent believers in long-term investment commitments and broad diversification to achieve superior risk adjusted returns over time, we did take profits in selected equity positions during the last week of April. Conversely, we continue to be buyers of names which we view as trading at discounts to their long-term value, namely in the financial, industrial and consumer sectors. With that said, we never reduced our exposure to the large capitalized technology and communication names which were out of favor during the recovery trade enthusiasm, but have since proved their incredible earning power and sustainability of their business models. In fact, we have been able to identify several strong cash generative businesses across industry groups that have proven that their business can succeed in both challenged economic environments and recovery periods simultaneously. As such, we have had strong conviction against chasing thematic areas of the market that may outperform temporarily for one reason or another.

Small and mid-cap stocks have delivered outsized returns since the election last November. These companies are more levered to the US economy and benefit from the re-opening dynamics. In general, these companies do best when the rate of improvement is highest, not necessarily when the expansion as a whole takes hold. We therefore reduced some exposure to these market cap segments.

We continue to believe that compelling opportunities exist within non-US exposure. In fact our dedicated Japan exposure in particular has been very additive over the past twelve months. Despite the lagging vaccine response in Europe and some emerging markets, a global economic recovery in the second half of the year when the rate of improvement in the US wanes somewhat makes these areas attractive.

Within fixed income, we continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We also favor municipal bonds and short-term corporate bonds based on the belief that the opportunity in these segments provides a better relative value. Fixed income allocations have been very challenging for investors thus far this year with quarterly declines experienced for the first time in decades. While the prospect for returns remains muted in treasuries for example, we do believe that allocations to other areas can offer better results and diversification benefits.

Our measured allocation to gold has continued to serve as a non-correlated asset despite the recent declines. Broader commodity exposure has proven to be beneficial this year and we may increase exposure as supply issues and increased trade provide tailwinds.

Thank you for taking the time to read our thoughts and opinions on the markets and we look forward to speaking with you soon.