1919 INVESTMENT COUNSEL
Complexity to Clarity

APRIL 2021

Investment Review and Outlook

KEY TAKEAWAYS

- Significant fiscal stimulus and a faster vaccine rollout than anticipated will fuel the road to economic recovery in 2021. A historic $1.9 trillion stimulus package extends benefits to millions of Americans struggling financially due to the pandemic, much of which should flow back into the economy through spending.

- Despite the potential strength of GDP growth, we expect only modest equity and fixed income returns due to the current high valuations of both asset classes. Concerns about rising interest rates and inflation may spark increased volatility in all financial markets.

- States and schools also were the beneficiaries of fiscal stimulus. President Biden has proposed a new package that includes additional funds for revitalizing aging infrastructure and decarbonizing the US economy through renewable energy initiatives.

Total Returns & Values As Of 3/31/21

	QTD Return	Price/ Value
Dow Jones Industrial Average	8.3%	32,982
S&P 500 Index	6.2	3,973
Russell 2000 Index	12.7	2,221
MSCI EAFE Index	3.6	2,208
MSCI EM (Emerging Markets)	2.3	1,316
Bloomberg Barclays US Aggregate	-3.4	105
Bloomberg Barclays Municipal Bond	-0.4	114
Gold (NYM $/ozt) Continuous	-9.5	$1,715.60
Crude Oil WTI (NYM $/bbl) Continuous	21.9	$59.16

Source: FactSet

THE ECONOMY

One Year On, Vaccines Take Hold

It has been over a year since the pandemic began, with widespread shutdowns implemented as a way to stem the outbreak. Fortunately, the ramping up of vaccine distribution nationally is bringing us closer to safeguarding the wellbeing of all Americans and boosting the health of the US economy. The recently approved $1.9 trillion American Rescue Plan, and pent-up savings that have occurred during the pandemic, create significant economic support.

Boosting Economic Health

The recent stimulus package extended unemployment benefits sorely needed by the millions of Americans who have suffered job losses. Today, there still are four million more people unemployed than there were before the pandemic. The stimulus package provides a $300 weekly benefit boost through Labor Day and offers a tax waiver on the first $10,200 of unemployment benefits for many Americans. It also extends the CARES Act pandemic unemployment assistance (for gig workers and those not traditionally eligible for aid) and pandemic emergency unemployment compensation (for the long-term unemployed) until early September.

These benefits may bridge the financial gap for many struggling Americans, and this money should flow back into the economy as consumer spending increases. The stimulus package also paid qualifying individuals (based on income levels) a $1,400 one-time stimulus payment.

Lessons Learned, State Aid Provided

The stimulus package included aid for states and schools, with ample provisions of $350 billion to states and $170 billion to schools. Lessons were learned during the 2008 to 2009 financial crisis when the state and local government sector, which represents 15% of GDP, struggled and hindered the economic recovery.

GDP Growth Like The 1980s

Growing confidence in the vaccine rollout, significant stimulus, and substantial savings by households and corporations have set the stage for a level of GDP growth not seen since the 7.8% GDP growth in the 1980s (the chart below shows a decade-by-decade overview). We expect GDP in 2021 to reach the 7% range as stimulus and reopening drive the recovering US economy.

GDP Growth Rates by Decade	
1980	7.8%
1990	5.6%
2000	4.0%
2010	4.0%
2020	-2.3%
Average	3.8%

Source: Federal Reserve Bank of St. Louis

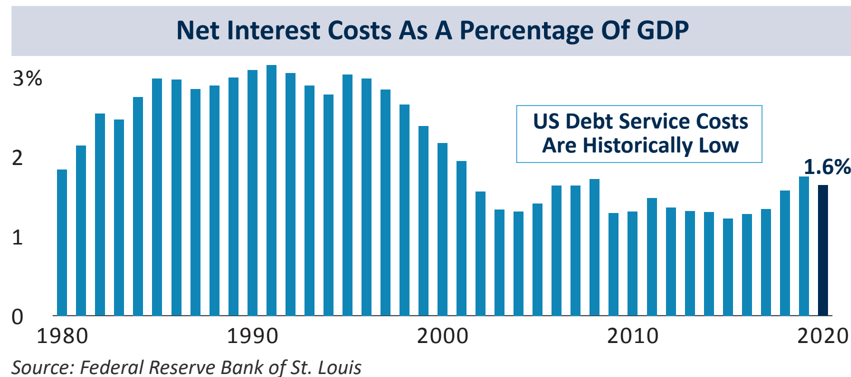
The effect of this robust growth on rising interest rates and stock prices bears monitoring. Rising GDP typically results in higher interest rates, as strong consumer spending may cause inflationary pressures to increase. This may have a dampening effect on stock market returns, impacting highly-valued growth stocks in particular.

A Green New Deal

While the stimulus package provides immediate financial relief, an approved infrastructure spending plan would provide longer-term, productivity-enhancing benefits, including meaningful job creation. President Biden's $2 trillion plan to revitalize the economy includes a $500 billion proposal to transition US transportation away from fossil fuels towards lower carbon electric solutions. The plan also would fund reinvestment in bridges, highways, and other aging infrastructure nationwide. However, bipartisan support may be needed to pass some of this legislation, which may be challenging on the heels of the American Rescue Plan and the current political mood.

The Debt Cost Of Stimulus

Government intervention to mitigate the economic impact of COVID-19 has resulted in developed market government debt greater than that incurred during World War II, on a relative basis. While increasing US national debt is a concern, the historically-low interest rate environment is more conducive to government spending than in prior periods since debt service costs are correspondingly low. The government essentially is paying for the stimulus by refinancing bonds it sold years ago when borrowing costs were much higher than today. In fact, as the chart below shows, interest payments on national debt represented only 1.6% of GDP in 2020. Treasury Secretary Janet Yellen notes that current interest payments, on an absolute basis, are "no higher than they were back in 2007," despite national debt more than twice the size. There also are expectations that revenues derived from potential tax increases may finance some forthcoming spending measures.



Source: Federal Reserve Bank of St. Louis

Inflation Expectations Matter

Unprecedented levels of stimulus, and the potential for a rapid and robust economic rebound, spark inflation concerns. The worry is that a surge of consumer spending could strain businesses' ability to meet demand, thereby causing prices to jump. Supply chain constraints resulting from pandemic-related shutdowns may increase prices in the short term while businesses recover, but this should be a temporary issue.

While we do not expect a sustained rise in inflation, we are monitoring inflation expectations, which may fuel periodic volatility in the stock market and higher yields in the bond market. Currently, the 10-year Treasury is yielding approximately 1.7%, a relatively substantial increase from less than 1% at the start of 2021. Expectations for a rapidly rebounding economy and the potential for rising inflation are driving the rise in yields. Historically, however, the most significant driver of inflation in the US has been wage increases. Excess capacity in the labor market makes a wage/price inflationary spiral (rising wages lead to increased demand for goods, which fuels rising prices, resulting in further wage hikes) less likely.

A Potential Housing Slowdown

The housing market may be poised for a slowdown with limited supply, lumber shortages, and a dramatic rise in prices during the pandemic. Rising home prices and the potential for increasing mortgage rates, as well as rigorous credit requirements still in place from the prior financial crisis, may dampen the fervor as potential buyers are priced out of the market.

Lower-For-Longer

The Federal Reserve has signaled a tolerance for somewhat higher inflation with its policy of flexible average inflation (a 2% target, on average, over time) and a focus on full employment. We expect the Fed's lower-for-longer interest rate stance to persist. However, if there were indications that inflationary pressures were significantly increasing, over a sustained period, we expect the Fed would have to change course and hike rates, putting the brakes on economic expansion and risking a recession.

THE EQUITY MARKET

Work-From-Home Growth & Cyclical Reopening Trade

Investors remain focused on the prospects for a robust economic recovery fueled by stimulus and nationwide vaccinations, with inflationary

pressures and rising rates increasingly of concern. Growth stocks have dominated the market throughout most of the pandemic, including FAANG stocks and other high-growth information technology and communication services companies. The investor appetite for these companies is reflected in their notably high valuations. An important part of this valuation is not just near-term earnings and cash flows, but also what those earnings and cash flows may look like in five plus years, and against the potential backdrop of interest rates well above zero.

Interest rates are the key to all asset valuations while long-term earnings play an important role in valuing secular high-growth businesses. Lower interest rates increase the current value of these future earnings and cash flows, resulting in a valuation expansion for these companies that has been evident as rates declined to rock-bottom levels. Therefore, rising rates may lead investors to reconsider the relatively high valuations assigned to these companies, instead seeking more attractive value-oriented cyclical businesses. For growth companies that have benefited from the work-from-home environment, there is the question of the sustainability of their rate of earnings growth. Conversely, cyclical stocks often perform well during periods of strong economic growth, providing a degree of protection against higher inflation and rising interest rates. As cyclical growth slows, the relative appeal of businesses that can deliver sustainable long-term growth should return.

A Rebound For Financials

We expect a disproportionately positive impact on near-term earnings for sectors that will benefit from the reopening of the economy, such as financials, industrials, energy, and materials. Already this year, we have seen a rebound in investor interest in these sectors, including the attractively-valued financial sector. Banks are the beneficiaries of ample liquidity from commercial and consumer deposits, and poised to benefit when expected loan growth materializes. As interest rates rise, net interest margins (the amount a bank earns on loans compared with the amount it pays on deposits) will expand. For large banks, the release of unused pandemic-related loan loss reserves may fuel higher near-term earnings as well.

The Impact Of An Economy In Transition

In 2021, realistic expectations for the equity market are key. We are in a transitional period with high expectations for a strong economic recovery, rich equity valuations, and an environment where inflationary expectations and consternation about rising interest rates are concerns. Equity investors may react, or overreact, to headline news around these dynamics as economic variables change, resulting in market volatility. Likewise, there is uneasiness that inflation will rise as economic growth accelerates and remain elevated long enough to force the Fed to tighten monetary policy. More recently, those concerns have led some investors to reduce exposure to the technology sector and other high-growth companies.

IN 2021, REALISTIC EXPECTATIONS FOR THE EQUITY MARKET ARE KEY. WE ARE IN A TRANSITIONAL PERIOD WITH HIGH EXPECTATIONS FOR A STRONG ECONOMIC RECOVERY...

An Equity Market In Transition

As our economy reverts to a “normal” post-pandemic environment, style leadership within the equity market should transition as well. A possible rotation from growth to value stocks may spark episodic spikes in volatility. Some of this volatility will be fueled by the struggle between higher corporate profits, which boost the equity market, and high yields which may dampen equity prices. These effects may be exacerbated by speculative interest and day-trading by individual investors. The gamification of investing has not abated. Future regulation may be on the horizon to counter some of this speculative behavior, including greater scrutiny of payment for order flow used by brokerage platforms to process investor trades via high-frequency trading firms.

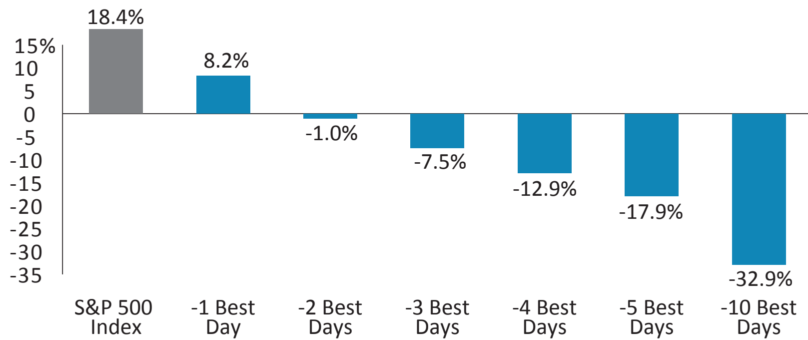
Reversion To The Historical Average

It is important to remember that the stock market, as represented by the S&P 500 Index, has produced above-average annual returns (averaging

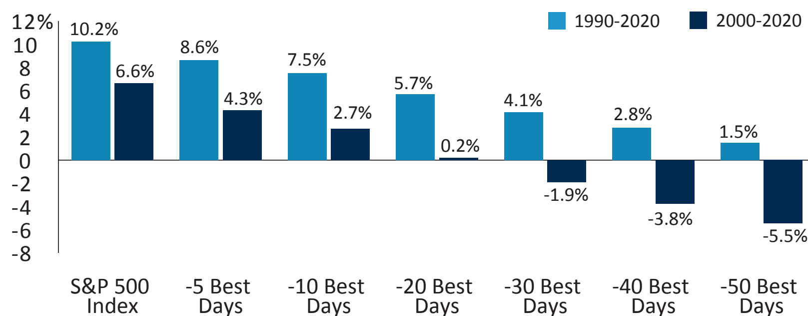
13.6%) over the last ten years. Market performance will revert towards the historical average (10%), if, as we expect, stocks return below-average, single-digit returns for several years. As the following charts illustrate, we stress that it is time in the market, not market timing, that is the long-term recipe for success and wealth accumulation.

Market Timing Can Be Costly

S&P 500 Index Performance Less the Best Days in 2020



S&P 500 Index Performance Less the Best Days Over Decades



The Impact On Account Value (starting with $1 million)

	1990-2020	2000-2020
S&P 500 Index Value	$20,449,760	$3,838,091
Less 5 Best Days	$12,916,92	$2,424,459
Less 10 Best Days	$9,369,348	$1,758,592
Less 20 Best Days	$5,529,936	$1,042,815
Less 30 Best Days	$3,514,866	$669,231
Less 40 Best Days	$2,332,995	$447,935
Less 50 Best Days	$1,587,607	$307,535

Source: Morningstar and 1919 Investment Counsel

THE FIXED INCOME MARKET

The Yield Curve Steepens

Due to lower rates abroad and strong domestic demand from investors seeking higher yields, corporate bonds continue to attract interest. Low yields on the short end of the yield curve and inflation expectation-driven higher yields on the long end have steepened the curve. We expect the curve to steepen further and remain defensive regarding future purchases, favoring the 7-to-10 year range for corporate bonds. As a result of the recent stimulus package, increased Treasury issuance in longer-dated maturities is likely, which will put pressure on the prices of longer term bonds. It is challenging to find relative value in the bond markets given ample liquidity and demand for yield in the context of historically low Treasury yields.

Inflation Expectations Drive Yields

Inflation expectations continue to push bond yields higher despite the Fed's recent reassurance that any higher inflation likely would be short-lived. Investors seem unwilling to hold longer-term bonds without an increase in yield sufficient enough to compensate them for potential principal erosion due to the possibility of higher inflation.

The Fed continues to stress that it will keep short-term rates near zero through 2023 and maintain its $120 billion a month purchase program of Treasury bonds and mortgage-backed securities. Fed Chairman Jerome Powell said the measures "will ensure that monetary policy will continue to deliver powerful support to the economy until the recovery is complete." Fed officials recently raised their forecast for GDP growth, anticipating that vaccinations and trillions of dollars of stimulus will propel the US economy to its fastest expansion since the 1980s. Yet the Fed stressed it still needs to see significant improvement and sustained rising inflation before prompting a policy change to increase rates.

More Muni Bond Issuance On The Horizon?

A $2 trillion infrastructure plan will benefit the municipal bond market and may potentially herald increased issuance in what has been a supply-constrained environment. We also may see growing investor appetite for municipal bonds from high-income earners (those with over $400,000 in annual income) should tax rates increase, as well as from the business community, if corporate rates rise. However, Senate Minority Leader McConnell has stated that Republicans would not support higher taxes to enable the passage of President Biden's infrastructure plan.

PRESIDENT BIDEN'S COMMITMENT TO A LOWER-CARBON ECONOMY MAY LEAD TO MUNICIPAL BOND ISSUANCE FOR INVESTMENT IN RENEWABLE ENERGY AND INFRASTRUCTURE PROJECTS...

President Biden's commitment to a lower-carbon economy may lead to municipal bond issuance for investment in renewable energy and infrastructure projects, including the electrification of transportation and revitalizing aging infrastructure. Enhancements to the Affordable Care Act may mean more bond issuance for hospitals and healthcare facilities, while a commitment to universal pre-K may spur future school bond issuance. In addition, if the Biden administration reverses the 2017 Tax Act decision to prevent municipalities from refinancing debt with tax-free municipal bonds (they are now required to use taxable municipal bonds), there should be robust tax-free refinancing issuance in the municipal bond market.

Tax Season Positioning

Tax season is upon us, and investors often liquidate municipal bond funds in order to pay their taxes. Now that the tax deadline has been extended into mid-May, we may see some short-term municipal bond selling. However, this supply may be offset by demand from high-income investors buying municipal bonds to shelter investment income from future taxes.

Fortunately, state revenues were not as impacted by the pandemic lockdown as initially expected. Accordingly, credit quality remains high as states have weathered the pandemic storm. As the economy recovers, specific municipal issues such as airport bonds should firm with increased passenger traffic.

LOOKING FORWARD

High valuations, market speculation, rising interest rates, robust economic growth, and higher inflation expectations are all part of an economy and markets in transition. As the reopening progresses, higher corporate profits competing with higher bond yields, may lead to periodic spikes in volatility and market pullbacks.

The returns of most asset classes may be modest for the foreseeable future until valuations become more compelling. After strong five-year returns and an expansion in valuations, we expect several years of below average stock market performance to result in a reversion closer to the long-term average.

While expectations for equity and fixed income returns in the near term are muted because of current high valuations, over a longer time horizon, equities still offer greater return potential. However, high-quality bonds and cash equivalents continue to play an important role in mitigating volatility and funding cash flow and liquidity needs.

We remain focused on helping you meet your goals and appreciate the trust you have placed in us during this challenging time.

The views expressed are subject to change. Any data cited herein have been obtained from sources believed to be reliable. The accuracy and completeness of data cannot be guaranteed.