First Quarter 2021 Key Takeaways

Global stock markets celebrated the one-year anniversary of the pandemic-induced bear market low (March 23, 2020) with another strong quarter of returns. The S&P 500 Index gained 6.3% (iShares Core S&P 500 ETF), developed international stocks rose 4.5% (Vanguard FTSE Developed Markets ETF), and emerging-market (EM) stocks gained 4.0% (Vanguard FTSE Emerging Markets ETF).

The first quarter also saw a continuation of the "reflation rotation" trend that has been happening beneath the market surface over the past several months. Specifically, small-company stocks have trounced large-company stocks, and value stocks ("slow growth" stocks) have bested growth stocks.

The reflationary winds tore through the fixed-income markets as well. The benchmark 10-year Treasury yield jumped nearly 75 basis points from a year-end close below 1.00% to 1.74%, a 14-month high. Correspondingly, the core bond index lost 3.6% for the quarter.

To the surprise of many in light of the reflationary/inflationary market mood, gold had a rough quarter, declining 10%.

The primary variables that will determine the direction of the economy and markets remain COVID-19 developments and the fiscal/monetary policy response. These currently imply a base case for a strong economic rebound, particularly in the United States but also globally.

At the current vaccination rate, experts estimate the United States could achieve herd immunity by late summer. Controlling the pandemic will enable us to start getting back to normal lives, boosting economic activity.

The American Rescue Plan (ARP) Act, the massive fiscal stimulus enacted early in the new administration, will supercharge economic growth further. That should in turn feed into company earnings.

Longer-term interest rates have risen in anticipation of a higher-growth, more inflationary environment. That has hurt bond investors this year. Rates could rise further in the short run leading to greater bond price declines, but they should stay contained unless inflation spikes up *and* stays higher…

In the coming months, consumers will likely see year-over-year inflation increase, most likely to the 3%-plus range. But this is largely due to prices rebounding from the pandemic lows. I want clients to know that what really matters is meaningful, *sustained inflation*.

Given the potential for a broad, long-lasting shift to more stimulative fiscal and monetary policy – especially if The American Rescue Plan and forthcoming infrastructure package prove successful -- we could be looking at a return to an inflationary "regime" not experienced since the 1970s.

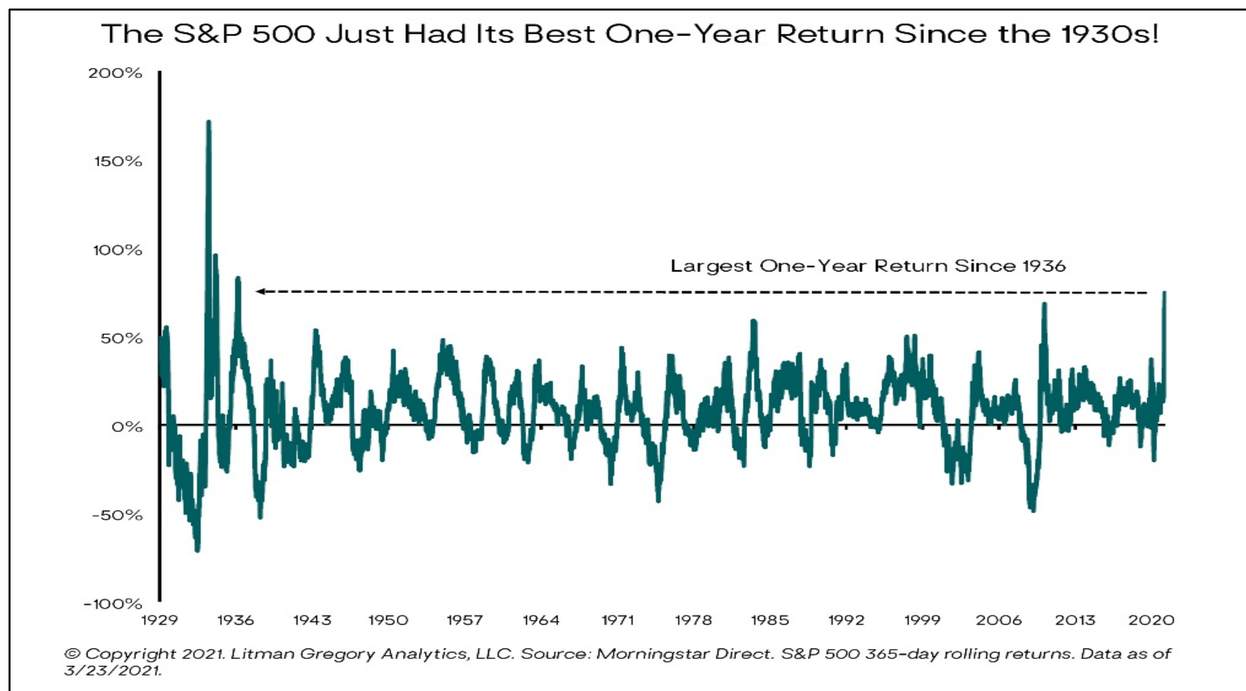
Simple portfolios consisting of U.S. stocks and bonds—won't work nearly as well over the next five to 10 years (at least). I expect many of the asset markets and market sectors that have been laggards over the past five to 10 years to continue their rebound.

First Quarter Market Recap

Global stock markets celebrated the one-year anniversary of the pandemic-induced bear market low (March 23, 2020) with another strong quarter of returns. The S&P 500 Index gained 6.3% (iShares Core S&P 500 ETF), developed international stocks rose 4.5% (Vanguard FTSE Developed Markets ETF), and emerging-market (EM) stocks gained 4.0% (Vanguard FTSE Emerging Markets ETF).

From the low on March 23, 2020, these benchmarks are up an astonishing 80.6%, 74.8%, and 74.6%, respectively. In fact, the S&P 500's one-year return from the low was its best since 1936. Clearly, it paid not to panic and get out of the markets last spring, despite the natural fear, anxiety, and uncertainty everyone was feeling at the time.

The first quarter also saw a continuation of the "reflation rotation" trend that has been happening beneath the market surface over the past several months. Specifically, small-company stocks have trounced large-company stocks, with the small-company Russell 2000 Index (Vanguard Russell 2000 ETF) gaining another 12.8% in the first quarter versus the Russell 1000 Index return of 6.0%. And value stocks (think "slow-growth" stocks) maintained their new-found edge over high-growth stocks: The Russell 1000 Value Index (Vanguard Russell 1000 Value ETF) returned 11.4% versus 1.1% for its large-cap growth index counterpart. Meanwhile, the small-cap value index soared 21.3% for the quarter (Vanguard Russell 2000 Value ETF) while the Russell 2000 Growth index returned "just" 4.84%.



Looking at it from another perspective, cyclical (meaning more economically sensitive) stocks were the strongest performers. Energy and financials were the top-performing sectors in the S&P 500, gaining 30.9% and 16.0%, respectively. In contrast, utilities, consumer staples, and health care—considered "defensive" sectors—were among the worst, registering just slightly positive returns. The technology sector was also one of the bottom performers for the quarter.

The reflationary winds, discussed in more detail below, tore through the fixed-income markets as well. The benchmark 10-year Treasury yield jumped nearly 75 basis points from a year-end close below 1.00% to 1.74%, a 14-month high. Correspondingly, the core bond index lost 3.6% for the quarter (Vanguard Total Bond Market ETF). This is its worst quarterly performance since 1981 and the fourth-worst return in the index's history back to 1976. Core municipal bonds did better with a loss of 0.3% (Vanguard Intermediate-Term Tax-Exempt) for the quarter.

On the flipside, floating-rate loans, which benefit from reflation, gained 1.8%. The high-yield bond index was up 0.9% (ICE B of A Merrill Lynch U.S. High Yield Cash Pay Index) for the quarter, while in February its yield dropped below 4% for the *first time ever*.

Finally, to the surprise of many in light of the reflationary/inflationary market mood, gold had a rough quarter, declining 10%. I guess in hindsight, this is not that surprising, as the price of gold tends to move in an inverse relationship to real (inflation-adjusted) interest rates. Along with nominal bond yields, real yields also rose in the first quarter, with the 10-year TIPS yield increasing roughly 40 basis points from negative 1.0% to negative 0.6%. The U.S. dollar, which is also typically inversely correlated with the price of gold, halted its multi-month decline and posted a roughly 3% gain for the quarter (depending on which dollar index one uses).

First Quarter Portfolio Performance & Key Performance Drivers

On the equity side, our overweight to U.S. value-oriented stocks through the Schwab U.S. Dividend ETF (SCHD) was a positive, the fund ended the quarter with a 14.28% gain versus an S&P 500 Index gain of 6.35% and a gain of 1.10% for the U.S. Large Growth index (Vanguard Russell 1000 Growth ETF).

Another bright spot was the performance of our bond-alternative fund, the J.P. Morgan Hedged Equity fund (JHQAX), which turned in a performance of 4.47% for the quarter, well above the negative quarterly performance turned in by most bond funds.

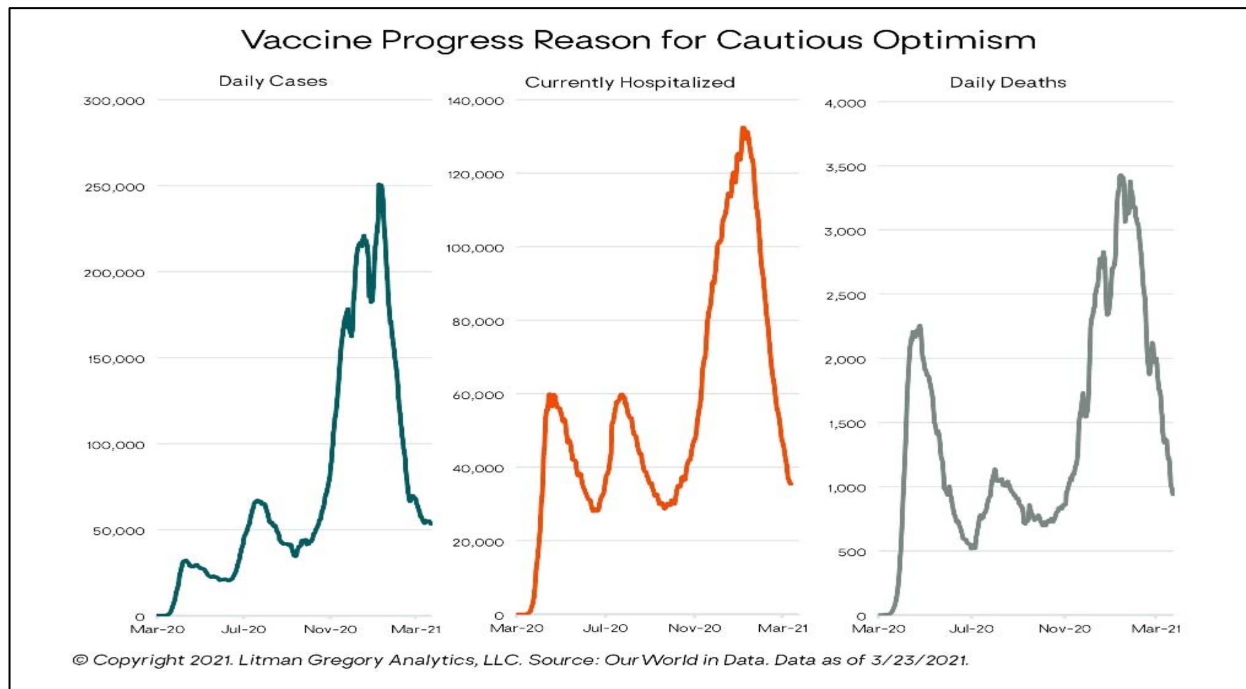
Our overweight to Emerging Market stocks relative to U.S. stocks was a negative, as EM's recent run of outperformance reversed late in the quarter. Our active EM fund manager, the Invesco Developing Markets fund (ODMAX), earned 0.75% for the quarter, significantly below returns for U.S. stocks.

The broad reflationary market trends in the first quarter had a negative impact on the performance of Broadwing's bond holdings, all of which were negative for the quarter, ranging from -0.27% to -4.16%.

Investment Outlook

The primary variables that will determine the direction of the economy and markets remain COVID-19 developments and the fiscal/monetary policy response. These currently imply a base case for a strong economic rebound, particularly in the United States but also globally. This will support the fundamentals underpinning higher-returning asset classes (stocks, credit sectors of the bond market)—as long as interest rates do not move sharply higher.

At the current vaccination rate, experts estimate the United States could achieve herd immunity by late summer. Controlling the pandemic will enable us to start getting back to normal lives, boosting economic activity.



The American Rescue Plan (ARP) Act, the massive fiscal stimulus enacted early in the new administration, will supercharge economic growth further. That should in turn feed into company earnings. Yet the Federal Reserve continues to reiterate that it will not preemptively raise interest rates. It intends to wait till it sees inflation above its 2% target for an extended period of time, a new policy that suggests this economic cycle has plenty of room to run.

So high economic growth, strong earnings growth, but low interest rates? Equity investors couldn't ask for more. The main threat is our old friend valuation risk. However, stocks remain reasonably attractive *relative* to bonds.

Speaking of bonds, longer-term interest rates have risen in anticipation of a higher-growth, more inflationary environment. That has hurt bond investors this year. Rates could rise further in the short run leading to greater bond price declines, but they should stay contained unless inflation spikes up *and* stays higher…

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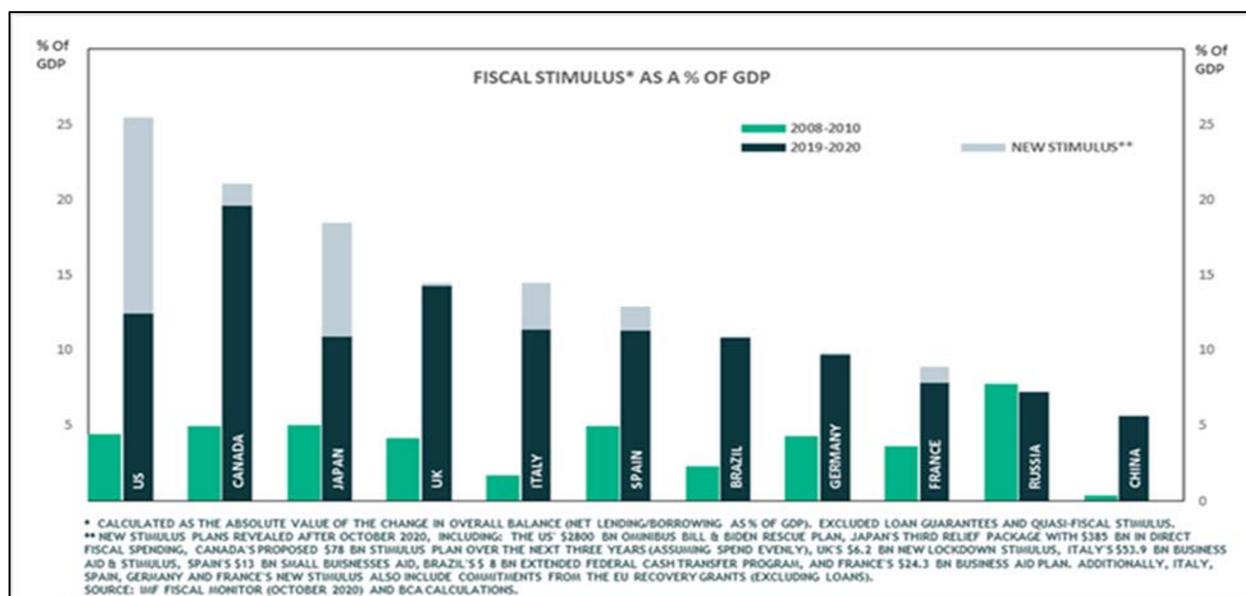
What About Inflation?

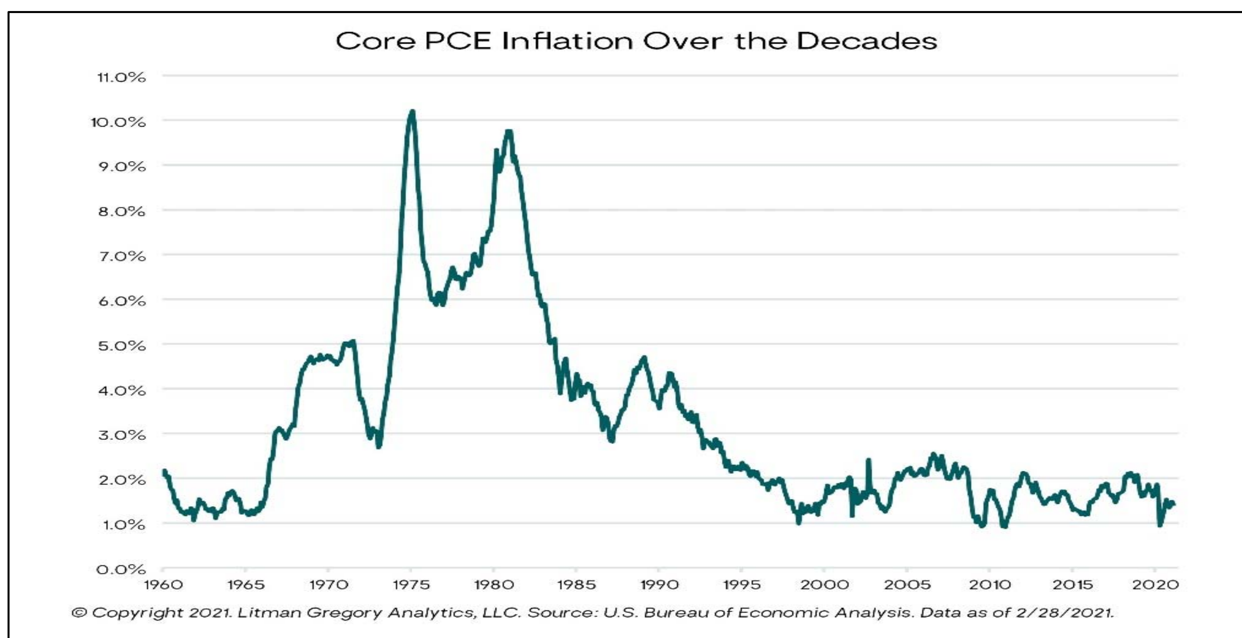
Inflation has been at the top of investors' list of concerns lately. Governments all over the world have passed large fiscal stimulus packages in the wake of the pandemic. There is a lot of *potential* pent-up spending. Add in an expected economic rebound from the pandemic, and the Fed doing everything it can to stoke a healthy level of inflation, it's no wonder investors and consumers are worried about maintaining their purchasing power. An inflation spiral similar to what took place in the late 1970's would be bad for stocks, bonds, and pocketbooks.



In the coming months, consumers will likely see year-over-year inflation increase, most likely to the 3%-plus range. But this is largely due to prices rebounding from the pandemic lows. I want clients to know that what really matters is meaningful, *sustained inflation*. The jury will still be out, even after the next couple of months, as to whether this higher inflation will be transitory or the beginning of a longer-term trend. My leaning at the present time is that inflation should not be an *imminent* concern. Here's why:

- GDP growth will sharply rebound this year, but we won't be close to full employment for at least a few years. Wage spiral inflation can't really take hold as long as there is slack in the labor market.
- The size of the fiscal stimulus that's been issued is staggering, but it is a one-time injection.
- Also, not all of it will be spent or spent right away. A meaningful portion will be saved and some will go to paying down debt.
- Finally, offsetting structural disinflationary forces such as demographic trends and technology adoption have not gone away or, in the latter's case, have accelerated during the pandemic.

Still, given the potential for a broad, long-lasting shift to more stimulative fiscal and monetary policy – especially if The American Rescue Plan and forthcoming infrastructure package prove successful -- we could be looking at a return to an inflationary "regime" not experienced since the 1970s. If such an environment should come to pass, portfolios with exposure to gold, commodities, physical real estate, leveraged loans, and Treasury inflation-protected securities ("TIPS") will fare better for that exposure. Broadwing's more conservative portfolios have some of these "hedges" in place.



This reinforces my belief that what has worked so well for decades—simple portfolios consisting of U.S. stocks and bonds—won't work nearly as well over the next five to 10 years (at least). I expect many of the asset markets and market sectors that have been laggards over the past five to 10 years to continue their rebound. Reflation favors non-U.S. stocks and more cyclically-sensitive or value ("slow growth") equity sectors. Reflation also increases the potential for rising rates and inflation, both negative for core bonds. I'm partly accounting for this in portfolio positioning, but I'm presently evaluating the tradeoffs of further reducing core bond exposure. Broadwing's portfolios tilt toward stocks that will benefit from higher economic growth. And I've diversified into bond-alternative strategies that should outperform core bonds in a reflationary environment.

Partnering with You

This quarter I want to focus on the details of the aforementioned ARP Act that are most likely to impact you. As I've discussed in recent emails on the topic, the bill includes more than a new stimulus check. It adds new money and expands eligibility for the Paycheck Protection Program launched by last year's stimulus package. Money has also been directed toward a new small business grant program targeting eating establishments. For families, ARP expands the child & dependent care tax credit, and the child tax credit, a portion of which should be paid in advance later this year (exactly how is still undecided). For employees, unemployment compensation has been enhanced and extended.

In other news, the IRS recently pushed back the tax-filing deadline to May 17. If you haven't already filed, you now have more time prepare. I'm here to assess your situation and help you determine what actions to take to benefit from changes in the tax rules, so please reach out to me.

I thank you for your continued trust in me and invite you to reach out to me with any questions about the new laws and tax deadline or the markets and your portfolio.

Best regards,
Kelly D, Kane, ChFC, CFP!