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INVESTMENT ADVISORS

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INVESTMENT REVIEW AND OUTLOOK

A Constructive Quarter

In contrast to the turbulent start to the year, the first quarter was remarkable for the progress made on many fronts. COVID vaccinations continued to ramp globally, and in the U.S. over 74 million residents had received 2 doses by mid-April, according to the Center for Disease Control (CDC). The effects of vaccinations and other measures have had a positive impact on new COVID cases and fatalities in the U.S. which have declined 60% and 70% respectively from their January peak levels, according to the CDC.

The economy continued to rebound in the quarter. Congress passed, and the president signed, a $1.9 trillion COVID relief package in early March and stimulus checks were distributed shortly thereafter. As state economies began to re-open, measures of employment improved throughout the quarter with nonfarm payrolls expanding by over 2 million since the start of the year and the unemployment rate in the U.S edged down to 6% during the month of March.

The stock market took its cue from the strengthening economy. The broad stock market, as measured by the S&P 500, had a total return of 6.2%. However, economically sensitive sectors of the market led the way and traditional value stocks outpaced growth stocks: The S&P Value Index returned 10.8% while the S&P Growth index returned 2.1%. Similarly, the bond market keyed off the reviving economy during the quarter and this was most evident in the interest rates quoted for longer maturities; the yield on the 10-year U.S. Treasury Bond rose from 0.87%, at the start of the year, to 1.7% on March 31. While the rise in interest rates appears small in absolute terms, it represents a doubling of the rate of interest on a 10-year maturity, therefore impacting bond prices which move inversely with interest rates. As a result, the total return, including interest received, for the Barclays U.S. Aggregate Bond Index was -3.4% for the first quarter.

Supercharged

Given the extraordinary fiscal and monetary policies undertaken over the last year, it is not an exaggeration to say that we can expect the U.S. economy to be "supercharged" in the months ahead. To place events in perspective, it is estimated that the recently implemented $1.9 trillion relief plan will equate to 9% of U.S. GDP in 2021. The U.S. Treasury distributed a combination of stimulus payments and tax refunds that total $422 billion in the month of March *alone,* according to Strategas Research. In addition, the Federal Reserve has continued to grow its balance sheet via the purchase of U.S. Treasury and mortgage-backed securities. In the last 12 months, the Fed has grown the assets on its balance sheet by over 90%, or over $3.5 trillion.

The current fiscal and monetary stimulus is reaching the economy at a moment of significant pent-up demand from consumers and businesses. Forward booking for airlines and hotels have surged in recent months, according to industry trade groups. Retail sales for the month of March increased over 26%, according to MasterCard. Surveys of capital spending plans by businesses have also shown a rebound and are estimated to grow 20% in the year ahead, as reported by the Federal Reserve Bank of St. Louis.

The combined impact of these factors is showing up in broad measures of economic activity, and consensus forecasts for GDP growth in 2021 have been rising steadily. In mid-March, the Federal Reserve increased its forecast for real GDP growth in 2021 to 6.5%. Wall Street economists are now estimating GDP growth of over 10% in the first half of the year.

A Bifurcated Stock Market

We have written recently about the composition of the stock market and some of our concerns about the narrow group of stocks leading the market, as well as the signs of increased speculation. In that light, the first quarter brought some encouraging developments. The leadership of many traditional economic sectors, such as industrial and financial, during the quarter was a vindication for fundamental value investors. By the same token, the quarter saw a correction in several areas that had witnessed signs of speculation. An index of newly public Special Purpose Acquisition Companies (SPACs) has declined over 50% since its peak in February, according to data compiled by Strategas. Similarly, mid-February appeared to be a peak for other speculative sectors such as "meme" stocks (companies that have seen a surge in trading volume and price unrelated to fundamentals but due to increased activity on social media platforms such as Reddit).

Despite what we view as a healthy shakeout in some of the more speculative sectors, we remain very much in a bifurcated stock market, in our opinion. There continues to be a stark contrast in valuations between the high growth sectors of the market and the more traditional industries. In the high growth sectors, established companies (defined as companies that have been in business longer than 7 years and have annual revenues >$1 billion) often trade at a multiple of 25-30x *revenues*. By contrast, traditional sectors of the economy such as industrial, health care and financial, trade between 14-18x *earnings* and have dividend yields, on average, of over 2.0%.

Since the stock market is a discounting mechanism, there has always been a contrast in valuation between higher and lower growth industries. This is as it should be. What is remarkable today is the spread in valuations as illustrated above. There are several reasons for this differential. Many years of low interest rates and accommodative central bank policies have increased the valuation premium for consistent growth companies. Additionally, the ongoing evolution of our economy towards knowledge-based industries which, by their very nature, will be valued at a premium to more traditional businesses.

Nevertheless, our sense is that a narrowing of the valuation differentials has begun. One step in this process is the recent increase in interest rates, which will serve as a governor on ultra-high valuations. Another aspect of the process is the ongoing economic recovery which has served to improve the fortunes for more economically sensitive industries. Finally, from a historical perspective, the divergence in returns between growth and value investing has been a cyclical phenomenon for decades. While the outperformance of growth in this cycle has been extreme, there is a large body of historical evidence which argues for narrowing of the performance differential in the months and years ahead.

Good Visibility, But Proceed with Caution

Due to the factors cited above, the economic outlook for 2021 appears clear and robust. Indeed, some industries, such as semiconductors, are reporting shortages due to a resurgence of demand; hotel occupancy and advance bookings trends have reached their highest levels since the onset of the pandemic, according to industry trade associations. Whether robust retail sales, increased demand for travel or reports of spot shortages, signs of the strengthening economy abound.

Similarly, the stock market appears to be benefitting from a surge of investor interest and investor cash. Following years of declines, the Investment Company Institute has reported a significant increase in weekly inflows into equity mutual funds. Partially because of this trend, stocks have been reaching new highs, while at the same time, measures of stock market volatility have receded to levels last seen in 2019.

We are encouraged by the strong rebound in the economy and a buoyant stock market is always a welcome development. However, experience has taught us that, just when it appears there are no clouds on the horizon, a measure of caution is warranted. Topics of concern are not new, but they bear repeating. We are living in a period of unprecedented monetary and fiscal policies. Throughout history there have been consequences for such largess, often in the form of higher inflation, higher interest rates and/or currency depreciation. A second area of concern is the recent increase in geopolitical tensions. While there are always regions of the globe that are unsettled, the increased assertiveness of Russia and China in cyberspace, the Ukraine and the South China Sea mark an escalation, which will likely require a more energetic response from the U.S. and our allies. Finally, stock market speculation remains a concern. Although some of the excesses have abated, Initial Public Offering (IPO) activity continues at elevated levels, and the valuations for many emerging growth stocks looked stretched based on our analysis. Individual investor sentiment, often a contrarian indicator, has reached bullish levels last seen December 2019, according to the Association of Individual Investors.

We have taken steps in client portfolios to address some of the risks and opportunities that we have discussed in recent letters. Over the last year we have added to our holdings in sectors that we feel represent sound fundamental value, including health care, financials, and industrials. We remain committed to the faster growing and innovative sectors of the economy, but we have reduced exposure where we felt valuations were at a premium. Our balanced portfolios remain underweight fixed income with a duration below the benchmark. For portfolios where income is a consideration, we have added modestly to equity holdings with above-average dividend yields and below-average valuations. Our holdings of gold iShares reflect our ongoing concern about extraordinary global central bank policies.

As always, we welcome your comments and questions.