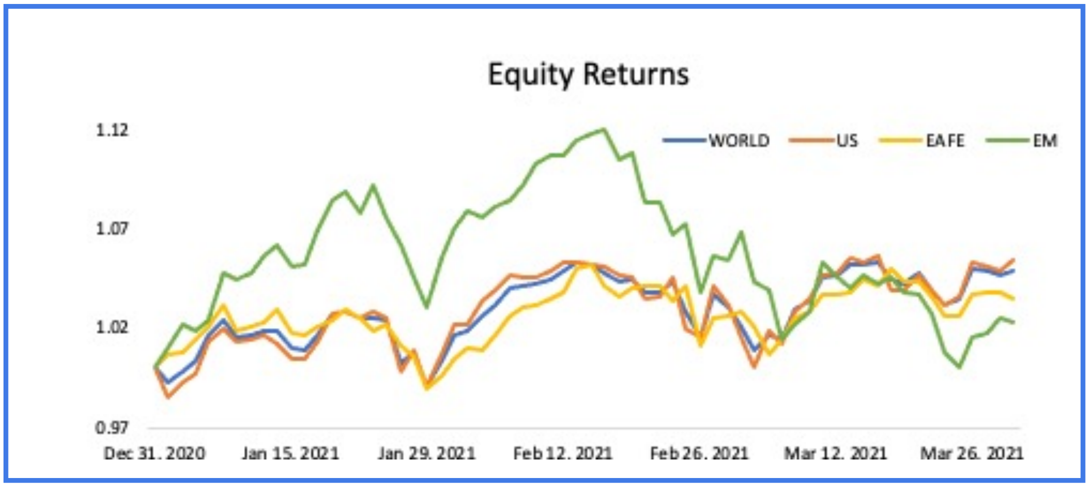
SOWELL AFFINITY

2021 Q1 market review commentary

2021 Q1 Summary

The first quarter of 2021 can be summarized as one of optimism and anxiety. Optimism as vaccines roll out and anxiety over variants and fear of inflation. Despite this, equity markets globally advanced in the first quarter of 2021 on optimism of economies reopening as vaccination supplies increase and more of the population get vaccinated and aggressive fiscal and monetary policy. Interest rates also climbed on expectations of higher inflation as result of monetary and fiscal policy.

The US equity market led all other major market equity in the first quarter. The fiscal and monetary policy in the US, one of the more aggressive policy amongst developed economies, along with success in vaccine roll out has been the main impetus to this outperformance. The emerging market equities lagged the developed markets. Lack of adequate vaccine supply and a late start to vaccinations has dimed some of the hope of a quick economic recovery in some developing economies.



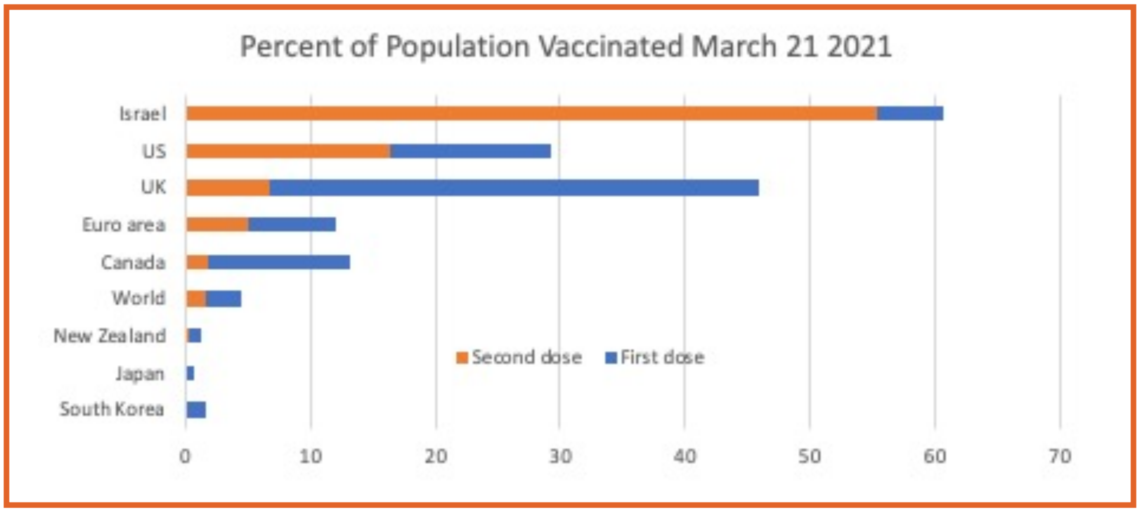
Source: MSCI

Looking at a longer-term performance, comparing the US equity market with other regions, US equities have outperformed over the last 10 years. Much of this can be attributed to the performance of a few now familiar names, primarily in the technology service such as Apple, Amazon, Alphabet, etc. There are no real counterparts to these companies in foreign markets.

Source: MSCI

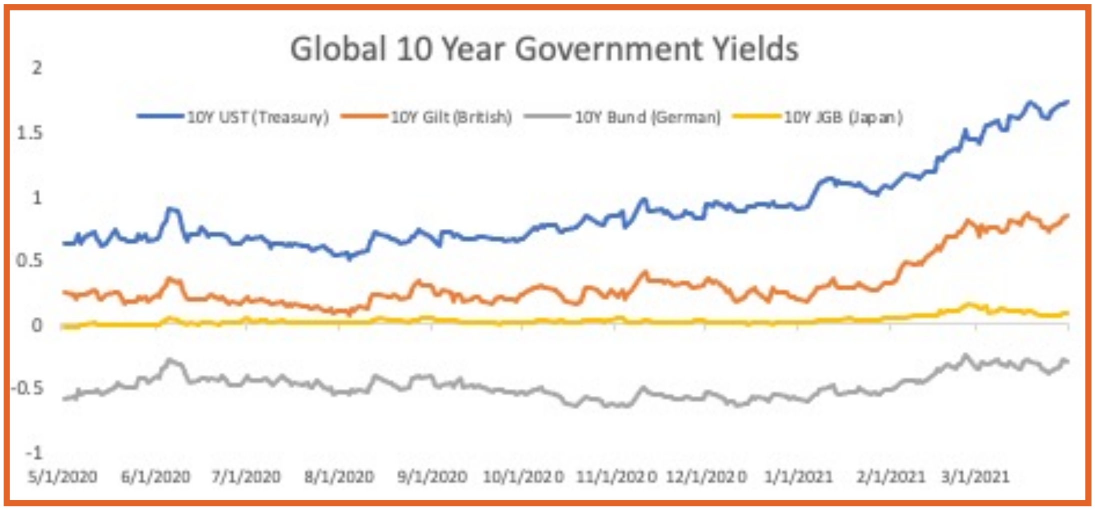
The roll out of vaccines has been a challenge for most countries. The delivery and the inoculations of the vaccine has been inconsistent across countries. As of the end of March 2021, Israel leads the way in percent of population vaccinated. The UK and the US have had the worst of the virus outcomes in major economies, but they have effectively reversed their situations by making headway in percentage of vaccines administered.

Source: Refinitiv



Bond yields rose in most major economies as investors see an end to the pandemic. The US curve has risen the fastest as longer maturities are incorporating rising inflation worries. Inflation expectations have risen the last couple of months as fiscal stimulus packages around the world raise fear of rising prices. Rising interest rates are also a function of improving economies and as economic conditions improve, rate will likely continue to increase.

Source: Refinitiv



Looking ahead, vaccination rates in continental Europe have lagged the US and the UK by about half (around 33% per 100 inhabitant's vs 66%). This is important as vaccination is not a regional issue but a worldwide one. Europe has experienced an increase in incidents lately but product deliveries and cutting the bureaucracy have reversed the trend. For example, in Germany, vaccines could only be administered in state-run clinics and patients had to be "invited" (for lack of a better term) to be eligible. Now any doctor can administer the vaccine and eligibility requirements have been relaxed.

Something that gets mentioned but has not been truly part of the conversation is the potential resurgence of inflation. Last year, because of Covid-19 production, distribution and everything else along the economic supply chains was disrupted and financial results and guidance were thrown for a loop. Similarly, we may see a lot of unexpected factors affecting the financial results of companies' higher material costs and supply availability. Copper, a material bellwether of industrial production, is reaching an all-time high of $4.50/lb. from a resurgence in demand from China. On the other hand, auto companies worldwide are shutting down production due to a lack of semiconductor chips. Conversely, as vaccination rates increase, and quarantine restrictions are relaxed, pent up demand from excess savings will create some inflationary pressure.

We are already seeing it in the US. Coca-Cola reported higher input costs from high fructose corn syrup to packaging materials. On the demand side, retail sales in March surged. The US Commerce Department survey showed sales surged 9.8%. Food and drink spending increased 13.4% and clothing sales shot up 18.1%. However, considering this Fed Chairman Jerome Powell has stated that an interest rate hike will not likely happen until 2022.

2021 Q1 US Market Recap

In the first quarter of 2021, the stock market, as represented by the S&P 500 Index, produced a return of 6.2%. While this return was favorable, subsets of the market produced higher returns. The S&P SmallCap Index generated a return of 18.2% during the quarter, and the S&P Midcap Index experienced a 13.5% return during the same period. For the twelve-month period ending on March 31, 2021, as the market rose from the lows reached during onset of policy responses to the COVID pandemic, the S&P 500 Index produced a return of 56.4%, the S&P Midcap Index returned 83.5%, and the S&P SmallCap Index returned 95.3%.

The COVID related policies produced a steep decline in economic output of roughly 5% at a seasonally adjusted annual rate (SAR) in the first quarter of 2020 and an approximately 32% decline at a SAR in the second quarter of the year. A rise in the unemployment rate to nearly 15%, a level not seen since the Great Depression, accompanied the declines in economic activity. The steep declines in output were followed by a 33% increase at a SAR in the third quarter, a 4.3% increase in the fourth quarter of the year, and an estimated 6.2% increase in the first quarter of 2021.

By the end of the first quarter, a broad-based economic recovery had been underway for three quarters, and while the unemployment rate had not returned to its pre-pandemic lows of about 3.5%, it had fallen to 6% from the highs of one year ago. The pace of the recovery was uneven across states as each state developed it own response to the pandemic. In California (8.5%) and New York (8.9%) the rate of unemployment was well above the national average, while the unemployment rate in Florida (4.7%) was well below the national average. With a widening of the distribution the COVID-19 vaccine, restrictions on economic activity are likely to abate and the unemployment rate will likely decline further.

As the economic recovery progressed, the various broad stock market indexes rose to record highs. Simultaneously, market leadership changed. For much of the last few years the market's rise was driven by a small group of large capitalization growth stocks. By the fourth quarter of 2020, small capitalization stocks were producing higher returns than were large growth stocks. There were relative return reversals along the Growth/Value continuum as well. The S&P 500 Value Index returned 10.8% in the first quarter of the year while the S&P 500 Growth Index produced a return of 2.1%.

The reversal of the relative return differentials began at about the same time the November elections took place. The elections produced a new administration that brought with it promises of policies that included increased tax rates and increased regulations in contrast to the outgoing administration which had established lower tax rates and fewer regulations. The new administration has promised also to look more favorably on foreign trade with trading partners like China. The policy mix of higher tax rates, more regulations, and freer trade sets up the possibility for a change in the nature of the economic recovery. On balance, this mix of policies would favor companies that avoid the new regulations and increased tax rates by moving production and sales overseas or by avoiding scrutiny by regulators. The burden of increased regulations and increased tax rates may never materialize but given the high price earnings ratios for stocks of large capitalization growth companies, the threat that the burden may become real will weigh on the performance of these stocks.

To buoy economic activity in the face of COVID driven restrictions, fiscal policy has included a substantial increase in government spending and direct payments to individuals. The new administration has promised more of the same. The Fed has joined the effort to stimulate growth by helping to finance the increase in spending. The dramatic growth in assets held by the Fed began with the Great Recession and the Fed's efforts to help forestall a worsening crisis. From 2009 through the end of the first quarter, the Fed added more than $4 trillion to its balance sheet. Prior to 2009 the monetary base was approximately $900 billion, by the end of March of 2021 it had reached nearly $5.5 trillion. The new administration has produced a spending and cash payment package that will add trillions of dollars to the Fed's balance sheet should the fed choose to monetize the concomitant increase in government debt.

Under normal circumstances, an increase in the monetary base of the size experienced since 2009 would be expected to bring about an increase in the rate of inflation. Thus far, no significant increase in the inflation rate has materialized, in large part because the velocity at which money circulates has declined substantially. The inflation rate has averaged less than 2% since the Fed began expanding its balance sheet. There are some early signs that inflation may rise above the 2% level in the near future. The Fed has indicated it is willing to finance more spending if the inflation rate remains below 2%. A rise above that level might bring about a reduction in the Fed's willingness to add to its balance sheet and an increase in short-term intertest rates. Should the Fed show a reluctance to expand the base, the economic recovery might stall.

The current administration has indicated it will push for both more spending and an increase in tax rates. The spending, if financed by the Fed, is expected to help stimulate economic activity, however the net impact of the new policy mix is unclear. It is not usual for policy makers to advocate for an increase in tax rates while the economy is operating well below a full employment level.

Interest rates have remained relatively stable over the last year. The yield curve shows no evidence bond market participants assign a high probability to a reemergence of inflation. If interest rates do start to rise either as a result of increases in the rate of inflation or unanticipated increases in real economic growth, the resolve of holders of stocks will be tested. The price to earnings ratio for the S & P 500 on trailing twelve months earnings stood at roughly 40 at the end of March. The historical average for this metric is close to 19 or 20. With the current elevated valuation, the stock market cannot withstand much bad news.

Currently, the outlook for real economic growth and corporate profits is favorable. The Fed expects real GDP growth in 2021 to be close to 6.5% on a year-over-year basis. Consistent with that estimate, the consensus forecast calls for an increase in corporate profits to fall in a range of up 20% to up 25%. The primary risk facing the market is the possibility that poorly conceived economic policies will derail the economic recovery and the increase in corporate profits.