



POST OAK PRIVATE WEALTH ADVISORS

ADVISORY, CONSULTING & INVESTMENT MANAGEMENT

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Quarterly Market & Economic Commentary

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The month of March, as the saying goes, comes in like a lion and goes out like a lamb. A similar description may be apt for the 1st Quarter of 2021. It started with the chaos of the January 6 Capital Hill riot, followed by a crippling ice storm in February and the shutdown of the Suez Canal by a massive container ship in March. But the quarter ended on a rising wave of optimism. More Americans are getting COVID-19 vaccines, which holds the promise of helping us put the pandemic behind us. The economy appears ready to break out of the blocks, with regional business restrictions loosened just as many people receive another stimulus payment.

The optimism is beginning to show in the financial markets as well; stocks had a positive quarter overall, with a 5.5% gain for the S&P 500 Index. Company earnings continue to impress as many firms flex their market strength or begin to see light at the end of the coronavirus tunnel. But as I'll discuss in this quarter's report, there are many areas of concern with potential of increasing the risk investors face in the markets.

Rates rise on inflation fears

The biggest market news in the 1st Quarter was the dramatic rise in interest rates, especially among longer duration bonds and Treasuries. The benchmark 10-year U.S. Treasury note began the year below 1.0% but rose steadily through the quarter before peaking at 1.745% on March 31. Remember that bond prices move in the opposite direction of interest rates, so many bond investors saw sharp drops in the value of their fixed income holdings during the quarter. The Bloomberg Barclays Aggregate Bond Index, a benchmark for the U.S. bond market as a whole, fell 3.3% during Q1.

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Fueling the rise in interest rates were growing fears about inflation. President Biden's signature on the latest coronavirus-relief bill pumped \$1.9 trillion of new fiscal stimulus into the economy.

That's a huge injection of money at a time when the economy is already growing at a good clip, with economic growth and job creation expected to rebound in the coming months as more Americans get vaccinated and restrictions on in-person gatherings are eased across the country. As I finalize this quarterly review, President Biden announced plans for a \$2 trillion infrastructure bill, which would if passed as proposed provide even more stimulus. We'll have to wait and see what the appetite is for passing such a massive bill. The financial markets will be interested in either outcome, it could further raise the stakes of inflation concerns.

Econ 101 tells us that a surge in demand, especially from pent-up consumers with fresh stimulus funds in hand, could create a surge in prices for all sorts of goods and services. Recent inflation readings do show prices are rising—the annualized inflation rate of 1.7% in February 2021 was the highest rate in a year, but the core rate (excluding food and energy prices) remained a modest 1.4%. Both measures of inflation are still below the Federal Reserve's stated 2% inflation target.

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Recent statements from Fed chair Jerome Powell seemed to indicate they will likely let inflation run above this target rate before the Fed would consider tightening monetary policy.

While overall inflation may still be low, certain product categories have seen steep price increases over the past year. Take lumber prices, for example, which hit all-time highs in March and are up 188% since the start of the pandemic. According to the National Association of Home Builders, the rise in lumber prices has added \$24,000 to the average price of a single-family home. Inflation has also been present in markets for other basic materials such as steel, copper and even plastics. Energy prices were on the upswing in Q1 as well, with West Texas Intermediate crude rising from \$48 per barrel at the start of the year to \$66 in early March. The U.S. nationwide average for gas prices also spiked this past quarter, closing in on \$2.95 per gallon by March 31.

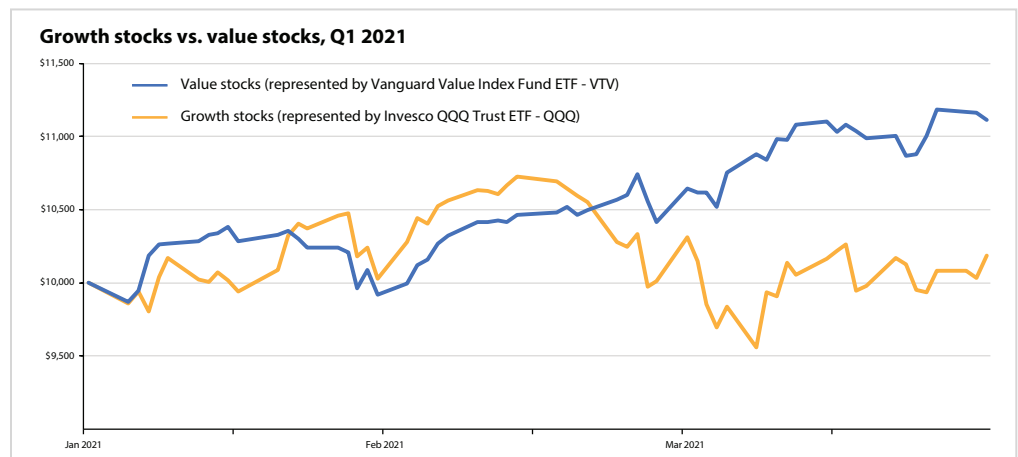
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Of course, interest rates change frequently and bonds accordingly rise and fall in value. But significant declines in bond values are notable in that many investors aren't accustomed to seeing them. Interest rates have been in a secular downtrend since the 1980s, so bond investors have generally only seen their holdings appreciate over this time, although short-term drops have occurred during this 40-year supercycle. A continuation of rising rates and falling bond values will put pressure on the traditional 60/40 equity/bond portfolio; the bond portion of this model is meant to temper volatility in the equity portion, but bonds are likely to become volatile should interest rates keep climbing.

That being said, it's also possible that all this concern about rising interest rates may be overblown. This quarter's jump was eye-catching, but bear in mind rates are coming off of historic lows. While predicting interest rate movements is as difficult as predicting moves in the stock market, the elements do seem to be in place for rates to continue to rise over the near term.

Rising rates rattle equities, too.

Stock investors aren't immune to the effects of higher interest rates either. That's because rising rates can increase a company's cost of capital and potentially squeeze profitability and earnings. The impacts may be especially acute for firms in capital-intensive industries or that rely heavily on leverage such as real estate investment trusts. Growth stock investors in particular got spooked by the jump in interest rates in the 1st Quarter. The S&P 500 Growth Index turned in a tepid 2.1% return for Q1, underperforming the S&P 500 Value Index, which gained 10.7% for the quarter.



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It wasn't just higher interest rates causing jitters in among stock investors during the quarter. In January, stock markets made headlines in the mainstream media due to the mania over GameStop, AMC Entertainment and other heavily shorted, out-of-favor stocks. For most long-term investors, the craze flew under the radar, but it did contribute to a perception of higher risk in the stock market and an increase in investor trepidation. Equity markets are pricey right now with valuations well above historic averages, so any whiff of higher risk is likely to rattle investors.

The good returns for value stocks relative to growth could be the beginning of a rotation in outperformance, but that remains to be seen. Such a shift wouldn't be unusual, given growth stocks' strong run over the last ten years starting at the end of the financial crisis. The latest performance trend for value stocks could be short term. We've seen rotational head fakes in this rally before, with value stocks showing promise only for growth to reclaim its momentum. Earnings continue to power equity returns, as they typically do, and it's growth companies that are delivering the strong earnings that investors desire. The strong uptrend

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in earnings growth in recent quarters justifies stocks' elevated valuations. The recent pullback, particularly among the previous stock market leaders, has brought their price multiples into much more reasonable territory.

Growth stocks take a breather

When we talk about growth stocks, we're generally talking about technology companies like Apple and Google, communication services like Facebook and consumer discretionary firms like Amazon. Tech sector performance was negative in Q1 and has flatlined since last October, even with robust earnings growth; Q4 earnings for S&P 500 technology stocks grew 16.0% compared to 2.9% for the S&P 500 as a whole, with 91% of tech firms beating their Q4 earnings estimates according to FactSet. Q4 earnings for Apple, Microsoft, Google, Facebook and Salesforce all bested analyst expectations. Most impressive of all was Amazon, whose Q4 earnings were nearly two times Wall Street estimates. What a great quarter for current CEO Jeff Bezos to announce his retirement from daily management duties at the company as he makes his move to Executive Chairman of Amazon's board.

Even as returns for many of the constituents in these sectors disappointed in the 1st Quarter, other areas of the equity market turned in stellar performance. Leading the pack was energy, which soared over 30% on rising oil prices. Financial stocks gained 16% benefiting from rising interest rates, which tend to boost banks' profits from lending but can also pose significant tail risk. Utilities, whose high yields become less attractive in a rising rate environment, gained only 2.8% during the quarter. Consumer staples also eked out a small quarterly gain of 1.2%, representing the worst sector performance for the quarter.

S&P 500 sector performance as of 3/31/2021	Q1 2021 return
Energy	30.8%
Financials	16.0%
Industrials	11.4%
Materials	9.1%
Real Estate	9.0%
Communication Services	8.1%
Health Care	3.2%
Consumer Discretionary	3.1%
Utilities	2.8%
Technology	2.0%
Consumer Staples	1.1%

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We do urge caution as it relates to many of the “reopening” plays such as airlines and hotels that have gained so much attention. Many of these companies are now priced for perfection and assume the economy will resume exactly as it was prior to the pandemic. Moreover, the balance sheets of several companies have been altered with large amounts of debt that could make meeting earnings expectations difficult, even if demand did return to pre-COVID levels.

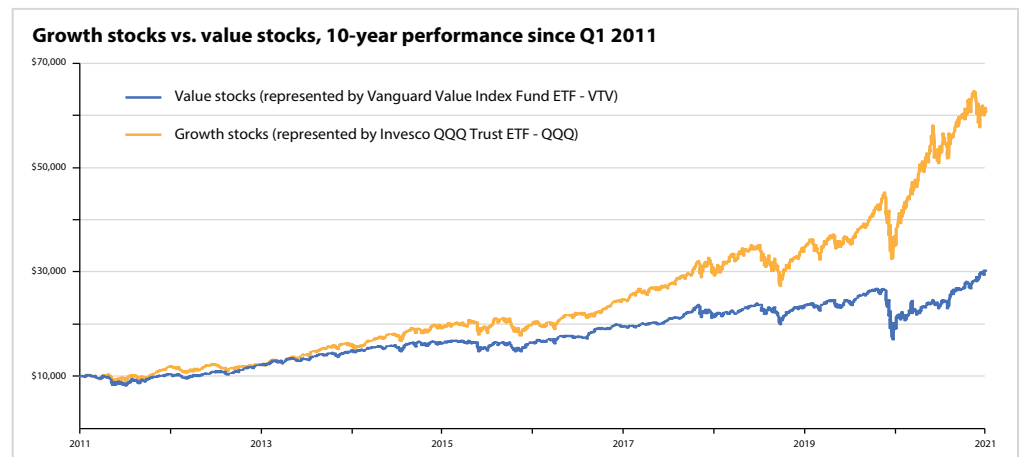
Is the rotation for real?

Another reason why the recent rotation into value could be another head fake is the ongoing adoption of tech-driven efficiencies. The COVID-19 pandemic accelerated many trends that were already in place, including remote work, online retailing, telemedicine and more. After a year of adapting to the new normal, we’re not likely to go back to business as it was before, especially for transactions that technology has made easier or simpler or more efficient. Take document signing, for example. It may be hard to believe that fax machines are still being used in our modern age, but they are prevalent in government and many businesses such as health care. The rapid adoption of electronic signature technology during the pandemic may be the death knell for the 1990s

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technology. Ontario’s provincial government is finally axing the fax by the end of this year. This seismic shift not only in consumers’ daily activities but also in how companies large and small find efficiencies and earnings growth will most certainly continue

From an investment standpoint, it seems likely that the longer-term trend favoring growth stocks will continue beyond the pandemic. Tech company innovations have drawn increased sales for their products and higher profits for their bottom lines. And investors want earnings—that’s why growth stocks have outperformed value over the last decade. (See chart below.) With that said, the renewed interest in more value-oriented companies is generally positive in my opinion as it broadens the range of the market. That would be a welcome development after the lopsided market dominance of growth stocks in recent years.



There’s opportunity in uncertainty

The market volatility and unforeseen events we saw in 2020 and even in Q1 of 2021 serve as a reminder of the value of following a prudent, disciplined approach to equity investing. There are often periods of uncertainty, whether in the short-term direction of the market as whole or among

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select sectors or asset classes. Interest rates and inflation matter, but so does earning growth. History has demonstrated time and time again that companies with the strongest balance sheets most often reward investors for their patience with inflation-beating returns.

We are, I believe, living in a remarkable time. As acclaimed investor Sam Altman wrote in a recent paper, “This technological revolution is unstoppable. And a recursive loop of innovation, as these smart machines themselves help us make smarter machines, will accelerate the revolution’s pace.” The path from here is full of uncertainty, including opportunities for change but also opportunities for creating wealth. That makes this an incredible time to be an investor.

Past performance does not guarantee future results. There is no guarantee that any investment strategy or account will be profitable or will not incur loss. Investors should consider the investment objectives, risks, charges and expenses that make up this investment strategy carefully before investing. Investing involves risk, including the possible loss of principal. Share price, principal value, and return on investments will vary, and you may have a gain or a loss when you sell your investment.

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