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Market Update

Q1 2021 Review and Outlook

Equities rallied as the economic outlook strengthened. Value and Small-cap outperformed Growth and Large-cap. International stocks lagged. Commodities rose and bond yields spiked.

PWM Research

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The Markets at a Glance

Asset Class	Representative Benchmark	Q1 Return	YTD Return
US Large Cap	S&P 500	6.2%	6.2%
US Small Cap	Russell 2000®	12.7%	12.7%
International	MSCI EAFE	3.5%	3.5%
Commodities	Bloomberg Commodity	6.9%	6.9%
Municipal Bonds	BBgBarc. Municipal	-0.4%	-0.4%
Taxable Bonds	BBgBarc. Aggregate	-3.4%	-3.4%
Cash	FTSE 3-Month T-Bills	0.0%	0.0%

Performance returns are as of 3/31/2021

Q1 Recap

Equity markets began 2021 in the same manner as they closed 2020: strongly, and with a decided tilt towards Value and Cyclical stocks. Vaccine momentum, burgeoning reopening progress, and ~$3 trillion in fiscal stimulus hitting the system provided the juice for continued risk-on sentiment this quarter, seen both in traditional risk assets (stocks, commodities) and non-traditional (cryptocurrencies, NFTs, SPACs, meme stocks).

The equity market rotation that began with the Pfizer vaccine announcement last year picked up steam in 1Q21, as Value (+11.3%) had its best relative quarter vs. Growth (+0.9%) since 2001. Cyclical sectors like Energy (+30.9%) and Financials (+16.0%) led. International equities were positive but underperformed, as pandemic flare-ups, vaccines woes, and a rising dollar offset some of the more favorable sector dynamics at play.

After a strong 2020, bonds sold off a bit as interest rates have increased. The broad US bond market, as measured by the Bloomberg Barclays Aggregate Index, fell 3.4% this quarter. The US Treasury yield curve steepened and the 10-Year yield rose to 1.74% from less than 1% at the start of the year.

The Circle of (the Market’s) Life

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One of the few universal truths about financial markets is that they are cyclical. From Growth vs. Value, Small-cap vs. Large-cap, and US vs. International to the broader business and commodity cycles. Markets are cyclical, mean reversion is common, and diversification remains a critical tool to prepare for shifts.

The first quarter of 2021 certainly contrasted from years prior. The post-Great Financial Crisis was an era of secular stagnation—defined by low growth and low inflation in developed economies. The decade was dominated by US Large-cap growth outperformance, meager GDP growth, low inflation, easy monetary policy, and the continuation of a ~40-year bull market for bonds. The recovery from the GFC was long but lackluster, which was reflected in the economic environment and asset class performance.

A Whole New World

It may be too early to identify a regime shift, but the market activity was markedly different from anything sustained over the previous decade. For instance, Value outperformed Growth by the most in twenty years, interest rates skyrocketed, and near-term inflation expectations ran to the highest levels since 2008.

The economic environment is quite different, as well. Real GDP for 2021 is forecast to be the highest since 1984 (with 2022 projections close behind), as nearly $3T in fiscal stimulus will hit the system. At the same time, vaccination efforts are picking up serious momentum in the US, and the nascent economic reopening is occurring. Commodity prices have soared alongside a burgeoning housing market - both oddities when compared with the secular stagnation of the 2010s. While these developments may be common in economic recoveries, the fiscal and monetary environment are meaningfully different today, and are a driving force for the unique market.

Everybody Wants to have a SPAC

Markets were anything-but-normal outside of the traditional asset classes, as well. Cryptocurrencies and NFTs were big stories in 1Q21, providing outsized returns and dominating the headlines. The rise of SPACs (which raised more money in Q1 than all of 2020) and the meme stock phenomena (e.g., GameStop) were emblematic of the euphoric market sentiment and waterfall of liquidity in institutional and retail markets. The term “bubble” could be heard in several corners of the market.

Infinity and Beyond?

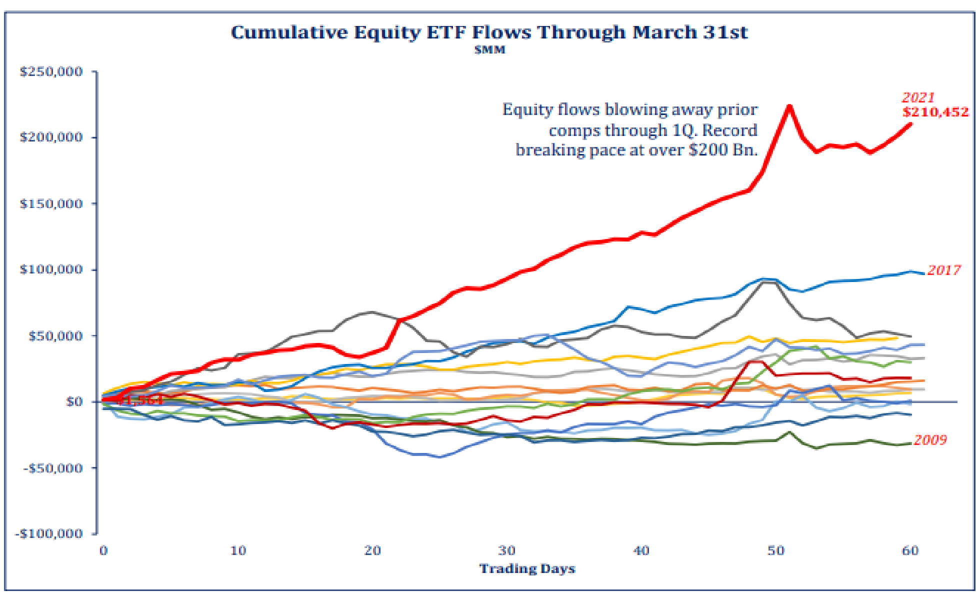
Further, perhaps spurred by rising rates, the blockbuster economic growth outlook, or simply FOMO, inflows into equity funds were historic by recent standards (see Figure 1). In the post-GFC world, trillions more flowed into fixed income and money market funds than into equities, and while a similar pattern played out during the early days of the corona-crisis, the trend quickly reversed. By almost every account, sentiment is as hot as it's been in the pandemic-era.

All of this excitement should come with a warning label. Despite the robust economic growth outlook and historic market breadth, elevated volatility and the occasional 10-20% correction are much more common in the second year off a bear market low. This risk seems especially likely given the strength and speed of the rally over the last year. And while investors should always be prepared for near-term volatility, the combination of a rapid rally and smoking hot sentiment give room for pause.

Be Prepared (by Diversifying)

Of course, all of this action brings us back to the case for diversification. Items like the Value/Growth rotation, bond selloff, and commodity boom occurred rapidly—catching these moves in real-time is both difficult and risky. A well-diversified portfolio benefits from the shifting asset class outperformance and provides balance with equity markets near all-time highs, and volatility likely.

Figure 1: Cumulative Equity ETF Flows by Year



Source: Strategas Research Partners

Equity Markets

US Equity Market Benchmarks

Equities	Representative Benchmark	Q1 Return	YTD Return
US Large	S&P 500	6.2%	6.2%
US Mid	Russell Midcap®	8.1%	8.1%
US Small	Russell 2000®	12.7%	12.7%
US Value	Russell 3000 Value	11.9%	11.9%
US Growth	Russell 3000 Growth	1.2%	1.2%
Dev. Int'l	MSCI EAFE	3.5%	3.5%
Emg. Int'l	MSCI EM	2.3%	2.3%

Performance returns as of 3/31/2021

Equities at a Glance

The first quarter of 2021 continued the narrative from the end of 2020: optimism surrounding vaccine distribution, accommodative fiscal and monetary policy, and high expectations for economic and corporate earnings growth launched equity markets higher. Investors continued to favor Value over Growth, Cyclical over Defensive, and Small-cap over Large-cap Equities. International equities were positive but lagged the US.

You've Got a Friend in Value

Value continued its recent outperformance over Growth, having its best relative quarter since 2001. In-line with the Value and Cyclical strength, Energy (+30.9%), Financials (+16.0%), and Industrials (+11.4%) were the top sectors. Rising commodity prices and an accelerating economic outlook boded well for these economically sensitive areas. In contrast, defensive sectors like Staples (+1.1%), Utilities (+2.8%), and Health Care (+3.2%) took a back seat. Also Info Tech, which had been the best performing sector last year, eked out a 2% gain in the first quarter. Elevated valuations, near-term economic growth prospects, and rising yields hurt the sector.

It's a Small World After All

As with 4Q20, the market rewarded Small-cap stocks. Small-cap Value led domestic style box categories with a +21.2% return in Q1. One of the most talked-about market stories this year involved the Small-cap company, GameStop. The stock, which had been heavily shorted by hedge funds, rallied over 900% in the quarter and became the most notorious of the "meme" stocks.

Under the Sea of the USD

Outside the US, Developed International (+3.6%) delivered positive returns. A combination of a stronger USD and pandemic-specific pain points were headwinds, though local currency returns bested the S&P on the back of a cyclically-oriented sector profile. Sweden and the Netherlands rallied over 11% in USD terms in the quarter thanks to strong performance from industrials and semiconductors. In contrast, Denmark (-3%) and Switzerland (-2%) were laggards due to a concentration in Health Care. Like US markets, defensive sectors were the worst performers internationally.

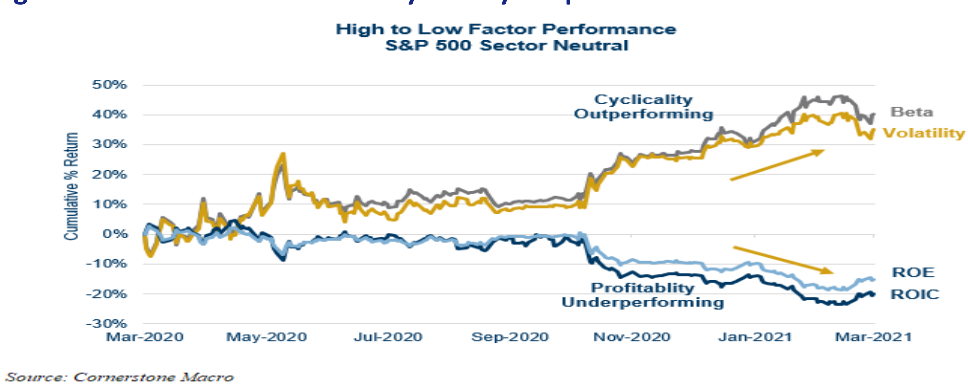
A Roller Coaster Ride of Relations

After a strong start to the quarter, Emerging Markets (+2.3%) trailed US and developed international markets. Taiwan (+10.9%) performed well thanks to Taiwan Semiconductor, which benefits from the global shortage in semiconductor chips. South Africa (+12.1%) also posted strong returns thanks to its cyclical exposures (e.g., Financials, Materials). On the flip side, China (-0.2%) trailed as global markets rotated toward value. Additionally, China's policymakers have taken steps to slow its economy after easing all last year. Chinese equities may also be reacting to a continuation of frayed relations with the US. The Biden Administration has not reversed any of the Trump era measures against China and has continued to engage with Taiwan, a country the US cut diplomatic ties with in 1979. President Biden's team has been critical of China's human rights violations, which European allies are likely to address, too.

Reflection

Life may be soon back to normal in places where vaccines have been widely distributed. Yet many countries are struggling to manage outbreaks. The EU's vaccine rollout was mismanaged and citizens have had concerns about the side effects from the AstraZeneca vaccine. As a result, many European countries are under lockdown. Brazil and India are also battling to contain the virus and obtain more vaccines. Many countries are currently in a precarious position. If countries make progress on vaccine distribution and containment of the virus, we could see revitalized economies and markets outside the US, as well.

Figure 2: Factor Performance — Cyclicality Outperforms



Source: Centerstone Macro

Fixed Income

U.S. Fixed Income Benchmarks

Fixed Income	Representative Benchmark	Q1 Return	YTD Return
Taxable	BBgBarc. Aggregate	-3.4%	-3.4%
Treasury	BBgBarc. Treasury	-4.3%	-4.3%
Corporate	BBgBarc. Corporate	-4.7%	-4.7%
High Yield	ICE BofAML US HY	0.9%	0.9%
Municipal	BBgBarc. Municipal	-0.4%	-0.4%
Int'l	BBgBarc. Global Agg.	-4.5%	-4.5%

Performance returns as of 3/31/2021

A Taper-less Tantrum

The broad US bond market, as measured by the Bloomberg Barclays US Aggregate Bond Index returned –3.37%, its worst quarter since 1981. Progress on vaccine distribution, unprecedented fiscal expansion, accommodative US Federal Reserve measures, and prospects for material pent-up demand lifted growth and inflation expectations during the quarter. US Treasury yields jumped sharply higher in a move reminiscent of "taper tantrum" of 2013. The 10-Year yield rose to 1.74%, touching levels last seen prior to the pandemic. With the front end of the curve well-anchored by the Federal Reserve, intermediate and longer dated yields rose, and the 2s/10s curve to hit its steepest level since 2015.

Fixed income markets experienced significant volatility as the market voiced concerns over an economy that may be overheating. Fed officials have remained on hold and have persistently expressed a need to see sustainable inflation moderately above the 2% average inflation target "for some time" before any monetary policy initiatives would be adjusted. This has put the market at odds with the Fed as pricing of expected rate hikes has been pulled forward, with an initial hike off the zero-lower-bound expected in Dec 2022, with three additional hikes by the end of 2023.

The glass is certainly half full in terms of growth and inflation but as seen in Figure 3, investors do not have a great track record pricing in the Federal Funds rate and typically overshoot.

The Game has not Stopped for Credit

The US Treasury sell-off spilled over to corporate bonds which produced –4.7% returns, marking its worst quarter since 2008. Despite the general underperformance across the fixed income landscape, risk-on areas held up better than high-quality fixed income securities. High Yield corporate (+0.8%) and High Yield municipal bonds (+2.1%) were two of the only fixed income sectors in the black last quarter as the economic environment painted a better backdrop for riskier debt. Within the high yield complex, demand for yield surpassed any fundamental or valuation concerns, as lower-rated CCC rated debt outpaced BB and B-rated securities. Across investment grade corporate credit, the access to capital markets remains uninterrupted. 1Q21 ended with close to $400B of new supply as corporate issuers pulled forward future issuance due to fears of even higher funding yields later in the year. Robust new issuance has pushed the duration, or interest rate sensitivity to 8.5 years, a 0.5 year increase since March 2020.

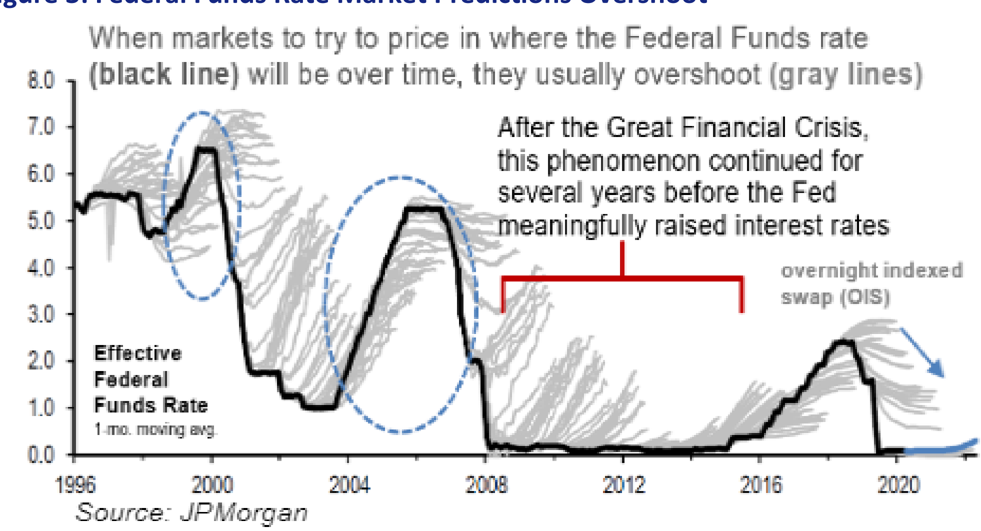
Bare Necessities of Securitized

It was a mixed bag across the securitized market in Q1, with high quality Asset-backed Securities delivering decent returns (-0.16%) while Commercial Mortgage Backed Securities (-2.1%) still suffered from COVID-19 stress and cash flow uncertainty. The swing higher in rates also weighed on Agency MBS during the quarter (-1.1%).

(Heigh-Ho) High Hopes For Municipals

Municipal bonds returned –0.4% in Q1, outpacing taxable peers by 3.0%. Amid trillions in fiscal stimulus and better-than-feared state and local tax revenues, the outlook for municipal bonds held up fairly well. Lower quality and shorter duration instruments fared best. As mentioned above, High Yield Municipal fixed income was one of the best performing sectors across the entire market. Hopes are high for municipal debt going forward with improving fundamentals and higher demand expected should corporate and personal tax rates rise.

Figure 3: Federal Funds Rate Market Predictions Overshoot



Appendix Definitions and Disclosures

Benchmark and Asset Class Definitions

S&P 500 Index (Large Cap / U.S. Stocks): A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally $7 billion plus market cap) companies having growth and value characteristics.

Russell 3000® Growth Index (All Cap Growth / Growth Stocks): Measures the performance of the 3,000 largest U.S. companies based on total market capitalization with higher price-to-book ratios and higher forecasted growth values.

Russell 3000® Value Index (All Cap Value / Value Stocks): Measures the performance of the 3,000 largest U.S. companies based on total market capitalization with lower price-to-book ratios and lower forecasted growth values.

Russell 1000® Growth Index (Large Growth): Measures the performance of those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values. These are equity securities of large capitalization ($7 billion plus market cap) companies having growth stock characteristics (high price to earnings, high return on equity and low dividend yield.

Russell 1000® Value Index (Large Value): Measures the performance of those Russell 1000® Index companies with lower price-to-book ratios and lower forecasted growth values. These are equity securities of large capitalization ($7 billion plus market cap) companies having value stock characteristics (low forecasted price-to-earnings ratio, low price-to-book ratio, high dividend yield).

Russell Midcap® Index (Mid Cap / Mid Core): Measures the performance of the 800 smallest companies of the Russell 1000® Index, which represent approximately 31% of the total market capitalization of the Russell 1000® Index. These are equity securities of middle capitalization ($2-7 billion plus market cap) companies having growth and value characteristics.

Russell 2000® Index (Small Cap / Small Core): Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equity securities of small capitalization (<$2 billion plus market cap) companies having growth and value characteristics.

Russell Micro Cap Index (Micro Cap): Measures the performance of the 1,000 smallest companies in the Russell 2000® Index, which represent approximately 3% of the total market capitalization of the Russell 3000® Index.

MSCI EAFE Index Net (International / Developed Markets): A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. As of May 27, 2010 the MSCI EAFE Index consisted of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

FTSE 3-month T-bill Index (Cash): This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively.

Bloomberg Commodity Index (Commodities): Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Sub-indices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs

MSCI Emerging Markets Index Net (Emerging Markets): A free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of May 27, 2010 the MSCI Emerging Markets Index consisted of the following 21 emerging market country indices.

MSCI Country Indices (Country-Specific Markets): To construct an MSCI Country Index, every listed security in the market is identified. Securities are free float adjusted, classified in accordance with the Global Industry Classification Standard (GICS®), and screened by size and liquidity. MSCI then constructs its indices by targeting for index inclusion 85% of the free float adjusted market capitalization in each industry group, within each country. By targeting 85% of each industry group, the MSCI Country Index captures 85% of the total country market capitalization while it accurately reflects the economic diversity of the market. This includes the MSCI Japan Index. International indices.

BBgBarc Aggregate Bond Index (Taxable Bonds / Bonds): Comprised of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years.

BBgBarc Global Aggregate Bond Index (Global Bonds): Provides a broad-based measure of the global investment-grade fixed income markets. The three major components of this index are the U.S. Aggregate, the Pan-European Aggregate, and the Asian-Pacific Aggregate Indices. The index also includes Eurodollar and Euro-Yen corporate bonds, Canadian government, agency and corporate securities, and USD investment grade 144A securities.

BBgBarc Muni Bond Index (Municipal Bonds): Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, part of a transaction of at least $50 million, issued after December 31, 1990 and have a year or longer remaining maturity.

BBgBarc U.S. High Yield Bond Index (High Yield): Covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (e.g., Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

BBgBarc U.S. Treasury Bond Index (Treasury Bonds): Comprised of U.S Treasury securities with at least one-year maturities.

Appendix Definitions and Disclosures

GICS

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