Stembrook Market Review — First Quarter 2021

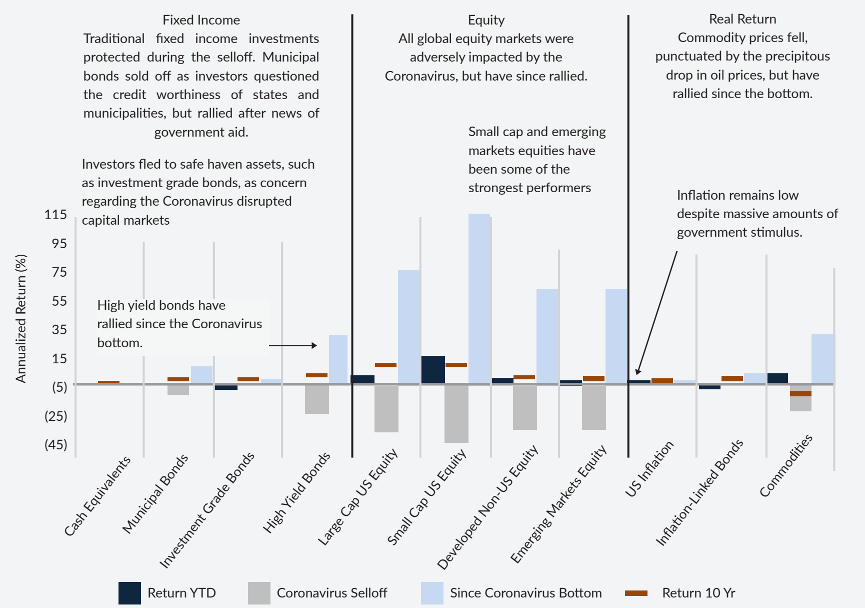
Global equity markets have rallied since the early November announcement that a highly effective COVID-19 vaccine had been developed.

Markets, which had already recovered from the initial selloff at the beginning of the pandemic, began to shift their focus from “COVID winners” to “vaccine winners.” The COVID winners included information technology and communication services sectors, two beneficiaries of an economy on lockdown as folks depended on services like Amazon and meal delivery apps to safely navigate the pandemic.

Cyclical stocks, or those whose revenue streams are linked to economic activity, tend to perform well when the economy is growing robustly. After the announcement of the vaccine, energy, financials, industrials and materials (vaccine winners) began to rally, as shown in the center chart below. At this point, some economies had already begun to recover. But markets, as they typically do, were looking ahead to even stronger economic growth and economies further reopening as vaccinations began to roll out. As folks begin traveling more and resuming social activities, we expect these companies to benefit from renewed economic activity. These sectors were already attractive from a valuation perspective when they began to out-perform, and they remain relatively attractive compared to the other parts of the market. Their strong performance has continued into the first quarter of 2021 and we expect this to continue with further reopening. The U.S. economy is expected to grow at a 5.4% annualized rate in the first quarter.[1]

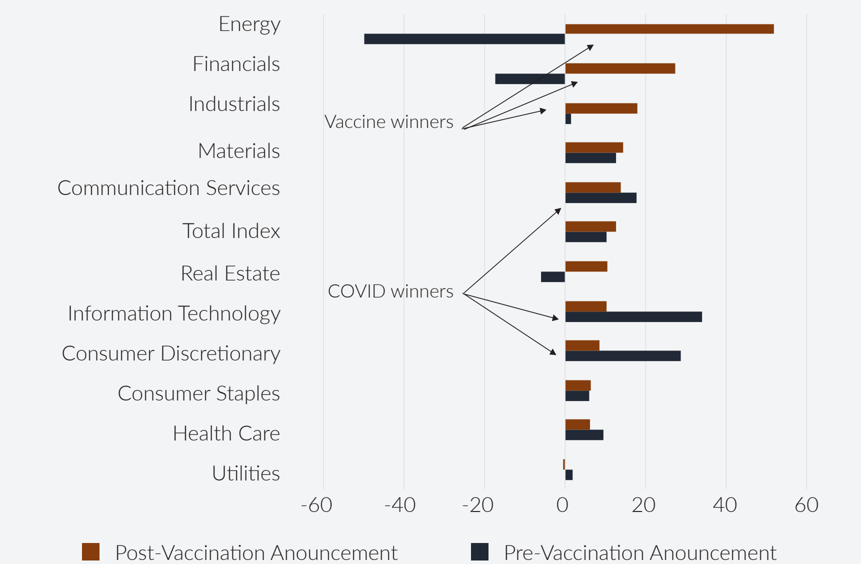
Our proprietary models forecast long-term, pre-tax returns ranging from 0% to 1% for fixed income-like asset classes and 7% to 9% for equity-like asset classes (see table on page 2). We maintain target weight allocations to equities and fixed income. Our more detailed observations and current portfolio positioning are outlined in the following comments.

Historical Market Returns



Historical market returns as of March 31st, 2021. Note that looking backwards at recent returns is not a reliable method for predicting future returns.

S&P 500 Sector Performance



Cyclical oriented equities rallied after news of an effective COVID-19 vaccination was announced in November 2020.

Economic Backdrop

- **After a pause in the fourth quarter of 2020, economic activity is expected to accelerate in the first quarter of 2021, with real GDP growth expected to increase by 3.6%.[1]**
- Central banks have been doing their part to help support economies through the pandemic. While still low in relative terms, global inflation is expected to tick up to 1.9% in the first quarter.[2]
- Despite a stronger global economy, there are still areas of weakness in developed economies. The Eurozone economy is expected to contract by -2% and the Japanese economy is expected to contract nearly -4%.[1]
- Emerging markets' economies bounced back vigorously in the first quarter, GDP growth grew by over 9%.[1] This robust growth was punctuated by very strong growth in China, which is expected to increase by 18% in the quarter. The breadth of economic growth in emerging economies was not widespread, as 10 of the countries are expected to contract in the quarter.
- Despite the pandemic, global business confidence remains at an elevated level, as managers look through to a rebounding economy, post pandemic. Both services and manufacturing purchasing manager's indices remain above 50. A level above 50 indicates expansion, while a level below 50 indicates contraction.[3]

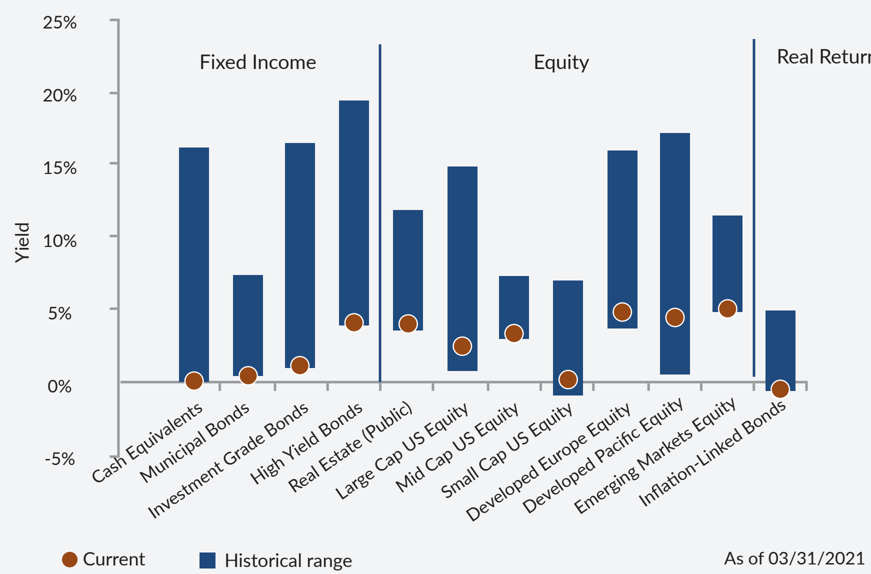
Expected Market Returns and Risks
7-10 Year Horizon

As of 31-Mar-21
Expected Risk and Return – 7-10 Year Horizon

		Pre-Tax Annualized Return	After-Tax Annualized Return	Volatility[1]
	Inflation	2.3%	2.3%	3.1%
Fixed Income	Municipal Bonds	0.6%	0.6%	4.4%
Fixed Income	Inflation-Linked Bonds	1.6%	0.9%	5.6%
Fixed Income	Investment Grade bonds	1.4%	0.7%	6.7%
Fixed Income	High Yield Bonds	1.1%	0.3%	13.2%
Equity	Broad Market US Equity	7.0%	5.4%	16.9%
Equity	Developed Non-US Equity	7.7%	5.9%	21.4%
Equity	Emerging Markets Equity	9.3%	6.0%	29.6%

A sampling of return expectations produced by our models. Expected returns are projections and are not guaranteed.

Yields Across Assets Classes



Yields are an indicator of future returns. Orange dots show current yields, blue bars show historical ranges. Bond yields are generally low versus historical range.

Equities

- **Global equites had mixed returns in the first quarter, one notable difference in the dispersion of returns was between growth and value stocks. Global value stocks were up 9.0%,[4] while global growth stocks were up by just 0.3%.[5]**
- Within the U.S., small cap stocks outperformed larger companies. The S&P 600 (small cap) index finished the quarter up 18.2%.[6]
- After a strong year in 2020, Emerging Markets equities took a breather in the first quarter, up 2.2%, as an increase in long-term interest rates in the U.S. put pressure on the asset class.[7]

Fixed Income

- **It was a challenging quarter for fixed income investors as 5 and 10 year treasury yields increased by 0.6% and 0.8% respectively.[8]**
- Investment grade bonds in the U.S. fell by -3.4% in the first quarter, as interest rates increased.[9]
- High yield bonds outperformed investment grade bonds, up 0.9% for the quarter.[10]

Global Asset Class Returns

Asset Class Name	Last 10 Years	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Large Cap US Equity	S&P 500 11.4%	Infl-Indx Bnd 14.0%	EM Eq 18.2%	Small Cap 41.3%	Real Estate 31.8%	Real Estate 2.8%	Small Cap 26.5%	EM Eq 37.3%	CPI 2.0%	S&P 500 31.5%	EM Eq 18.5%
Small Cap US Equity	Small Cap 9.8%	Real Estate 9.2%	Real Estate 17%	S&P 500 32.4%	S&P 500 13.7%	S&P 500 1.4%	HY Bnd 17.5%	Intl Eq 25.0%	Inv Grd Bnd 0.0%	Real Estate 28.7%	S&P 500 18.4%
Real Estate (Public)	Real Estate 7.8%	Inv Grd Bnd 7.8%	Intl Eq 17.3%	Intl Eq 22.8%	Inv Grd Bnd 6.0%	CPI 0.8%	S&P 500 12.0%	S&P 500 21.8%	Infl-Indx Bnd -1.8%	Intl Eq 22.8%	Infl-Indx Bnd 13.1%
High Yield Bonds	HY Bnd 5.6%	HY Bnd 4.5%	Small Cap 16.3%	HY Bnd 7.4%	Small Cap 5.8%	Inv Grd Bnd 0.5%	Commod 11.4%	Small Cap 13.2%	HY Bnd -2.1%	Small Cap 22.7%	Small Cap 11.2%
Developed Non-US Equity	Intl Eq 4.9%	CPI 3.0%	S&P 500 16.0%	Real Estate 1.9%	Infl-Indx Bnd 4.6%	Intl Eq -0.2%	EM Eq 11.3%	Real Estate 8.7%	Real Estate -4.0%	EM Eq 18.6%	Intl Eq 8.4%
Emerging Markets Equity	EM Eq 3.1%	S&P 500 2.1%	HY Bnd 15.4%	CPI 1.5%	HY Bnd 2.5%	Infl-Indx Bnd -1.4%	Real Estate 8.6%	HY Bnd 7.5%	S&P 500 -4.4%	HY Bnd 14.3%	Inv Grd Bnd 7.5%
Inflation-Linked Bonds	Infl-Indx Bnd 3.4%	Small Cap 1.0%	Infl-Indx Bnd 7.2%	Inv Grd Bnd -2.0%	CPI 1.3%	Small Cap -2.0%	Infl-Indx Bnd 3.6%	Inv Grd Bnd 3.5%	Small Cap -8.5%	Infl-Indx Bnd 10.6%	HY Bnd 7.1%
Investment Grade Bonds	Inv Grd Bnd 3.2%	Intl Eq -12.1%	Inv Grd Bnd 4.2%	EM Eq -2.6%	EM Eq -1.8%	HY Bnd -4.6%	Inv Grd Bnd 2.6%	Infl-Indx Bnd 3.0%	Commod -13.0%	Inv Grd Bnd 8.7%	CPI 1.3%
Inflation	CPI 1.5%	Commod -13.3%	CPI 2.0%	Infl-Indx Bnd -9.4%	Intl Eq -4.5%	EM Eq -14.8%	CPI 2.8%	CPI 2.1%	Intl Eq -13.3%	Commod 5.4%	Commod -3.5%
Commodities	Commod -5.9%	EM Eq -18.4%	Commod -1.1%	Commod -9.5%	Commod -17.0%	Commod -24.7%	Intl Eq 1.6%	Commod 0.7%	EM Eq -14.5%	CPI 2.1%	Real Estate -5.1%

Returns are arranged in columns, by year. Each color represents a different asset class. Each year, the leaders and laggards tend to shift. Diversification across a range of asset classes can smooth returns and enhance growth.

Current Positioning

We have **sold our high yield bond position** in tax-deferred portfolios as yields have fallen back to normal levels and prices increased by over 18% during our holding period. We are going to begin selling the position in our taxable portfolio in a tax-efficient manner.

We maintain our **overweight to developed non-U.S. and emerging market equities,** where valuations and long-term return potential remain attractive.

We also maintain our **underweight to large cap U.S. equities.**

We favor **lower priced, value-oriented equities, both in the U.S. and abroad,** which tend to outperform the broad market over time, with less volatility. These investments outperformed in the first quarter.

We maintain a **slight overweight to inflation-linked bonds** for taxable and tax-deferred investors.

We have removed high yield bonds and inflation-linked bonds from our strategic target allocations for both taxable and tax-deferred investors. This decision is part of an ongoing effort to transition our neutral positions closer to published benchmarks.

We continue to focus our efforts on helping you meet your financial objectives by following our disciplined investment approach. Our approach uses return and risk models, incorporating fundamental valuations and tax-efficient strategies. This investment discipline is tailored to your individual situation in our continuing effort to craft and implement your customized investment solution.

As always, we thank you for placing your trust in our investment management and advice and welcome your questions and comments at any time.

Peter D. D'Agati, CFA

Thomas Kosinski

Endnotes and Sources:

Text:

(1) Bloomberg, Stembrook Research: GDP measures are based on the most recent annualized quarterly, seasonally-adjusted data. Statistics are stated in inflation-adjusted terms. Aggregate Statistics are weighted by each country's GDP translated into USD. Where available, official estimates are used. Where official estimates are not available, GDP data is based on Bloomberg Contributor Forecasted GDP. Emerging Markets measures are based solely on Bloomberg Contributor Forecasted GDP. As of 3/31/21.

(2) Bloomberg, Stembrook Research: Aggregate inflation statistics are weighted by each country's GDP translated in to USD. As of 3/31/21.

(3) Bloomberg: Markit Global Purchasing Managers Index for Manufacturing and Service. As of 3/31/21.

(4) Bloomberg: MSCI ACWI Value Total Return. 12/31/20-3/31/21.

(5) Bloomberg: MSCI ACWI Growth Total Return. 12/31/20-3/31/21.

(6) Bloomberg: S&P 600 Total Return. 12/31/20-3/31/21.

(7) Bloomberg: MSCI Emerging Markets Total Return. 12/31/20-3/31/21.

(8) Bloomberg: 5 and 10 Year U.S. Treasury Yield. 12/31/20-3/31/21.

(9) Bloomberg: Bloomberg Barclays U.S. Aggregate Bond Index Total Return. 12/31/20-3/31/21.

(10) Bloomberg: Bloomberg Barclays U.S. Corporate High Yield Bond Index Total Return. 12/31/20-3/31/21.

Charts:

Expected Market Returns and Risks, 7-10 Year Horizon: As of 3/31/21.

Source: Stembrook Research.

(1) Volatility is measured in terms of Standard Deviation. Standard deviation is the statistical measurement of dispersion about an average, which depicts how widely a stock or portfolio's returns varied over a certain period of time. Investors use the standard deviation of historical performance to try to predict the range of returns that is most likely for a given investment. When an investment has a high standard deviation, the predict- ed range of performance is wide, implying greater volatility. If an investment's returns follow a normal distribution, then approximately 68 percent of the time they will fall within one standard deviation of the mean return of the investment, and 95 percent of the time within two standard deviations. For example, for a portfolio with a mean annual return of 10 percent and a standard deviation of two percent, you would expect the return to be between 8 and 12 percent about 68 percent of the time, and between 6 and 14 percent about 95 percent of the time. Source: Morningstar.

Yields Across Asset Classes: As of 3/31/21

Sources: Cash Equivalents Yields since March 1976. Ibbotson, Federal Reserve Bank, Thomson Reuters, Municipal Bond Yields since March 1988. Barclays Capital, Charles Schwab, BofA Merrill Lynch, Standard & Poor's/Investortools Municipal Bond Indices, Investment Grade Bond Yields since March 1976. Barclays Capital, High Yield since December 1984. BofA Merrill Lynch, Barclays Capital, Real Estate (Public) Earnings Yield since March 1976. NAREIT all Equity, Large Cap U.S. Equity Earnings Yield since March 1976. Standard & Poor's, BARRA, Mid Cap U.S. Equity Earnings Yield since June 1991. Standard & Poor's, BARRA, Small Cap U.S. Equity Earnings Yield since December 1993. Standard & Poor's, BARRA, Developed Europe Equity Earnings Yield since March 1976. MSCI Europe, Standard & Poor's Europe 350, Developed Pacific Equity Earnings Yield since March 1976. MSCI Pacific, S&P/Citi PMI Asia Pacific, S&P Asia 50, Emerging Market Equity Earnings Yield since December 1998, Inflation-Linked Bond Real Yield to Maturity since March 1997. Citi Yield Book, Federal Reserve Bank. Note: Yields are not perfect predictors of future returns and should not be used in isolation.

S&P 500 Sector Performance: As of 3/31/21.

Source: J.P Morgan Research, Bloomberg. S&P 500. Pfizer and BioNTech announced on November 6th, 2020 that their vaccine was over 90% effective in preventing COVID-19 in their global trial. Pre-Vaccination Announcement, 12/31/19—11/6/20. Post-Vaccination Announcement 11/9/20-3/31/21

Historical Market Returns: As 3/31/21.

Coronavirus selloff: 2/19/20-3/23/20 Since Coronavirus Bottom: 3/23/20-6/30/20. Source: Bloomberg, Stembrook Research.

Indices: Bloomberg Barclays U.S Treasury Bills 1-3 Month Total Return, Bloomberg Barclays Municipal Bond 5 Year (4-6) Total Return, Bloomberg Barclays U.S. Aggregate Bond Total Return, Bloomberg Barclays U.S.

Corporate High Yield Total Return, FTSE All Equity REIT Total Return, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Total Return, MSCI EM (Emerging Markets) Total Return, Consumer Price Index – U.S., S&P 10 Year U.S. TIPS Total Return, Bloomberg Commodity (Total Return) Index.

Global Asset Class Returns: As of 12/31/20.

Source: Thomson Reuters, Bloomberg, Stembrook Research.

Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Bloomberg Barclays U.S. Treasury Bills: 1-3 Month Index, Citigroup Inflation-Linked Index, S&P 10 Year US TIPS Index, Bloomberg Barclays U.S. Aggregate Bond Index, BofA Merrill Lynch U.S. High Yield Cash Pay, Bloomberg Barclays U.S. Corporate High Yield Index, Dow Jones Wilshire REIT Index, FTSE All Equity REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones AIG Commodity (Totl Ret) Index, Bloomberg Commodity Index.

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Additional information is available upon request.