Q1 2021 Commentary

April 2021

"An open heart is an open mind."
– Dali Lama XIV

Q1 MARKET RECAP

Global equity markets continued to notch record highs in the first quarter as investors embraced better than expected corporate profits, increasing business activity, and improving COVID-19 vaccination progress. Nominal and real interest rates rose, particularly in the 5-year tenor and beyond, reflecting anticipation of a stronger economy. Consequently, fixed income returns were largely negative for the quarter. Low duration, high yield, and municipal bonds outperformed the BBgBarc U.S. Aggregate Bond Index (Figure 1). U.S. equities outperformed their foreign counterparts, small cap beat large cap, value continued to outperform growth, and commodities (except gold) ended the quarter on a strong note. S&P 500 constituents are expected to surpass pre-pandemic levels of revenues and earnings sometime in the first half of 2021 with growth accelerating into the second half of the year. Full year GDP growth estimates are now above 6%. While some of this can be attributed to base effects, it is clear the economy is heating up as we enter the second quarter.

Asset Class Returns

Asset Class	Benchmark	1-Wk	MTD	QTD	YTD
U.S. Large Cap Stocks	S&P 500 TR	2.8	1.2	1.2	7.4
U.S. Small & Micro Cap	Russell 2000 TR	3.3	1.5	1.5	14.4
Intl Dev Stocks	MSCI EAFE NR	0.5	0.7	0.7	4.2
Intl Dev Small & Micro Stocks	MSCI EAFE Small Cap NR	0.5	0.9	0.9	5.5
Emerging & Frontier Mkt Stocks	MSCI EM NR	2.4	1.7	1.7	4.0
Global Stocks	MSCI ACWI NR	1.2	1.2	1.2	5.8
U.S. Municipal Bonds	BBgBarc Municipal 1-10Y Blend 1-12Y TR	0.0	0.0	0.0	-0.2
U.S. Taxable Bonds	BBgBarc US Agg Bond TR	0.0	0.1	0.1	-3.3
U.S. High Yield Bonds	BBgBarc US Corporate High Yield TR	0.4	0.2	0.2	1.0
U.S. Bank Loans	S&P/LSTA Leveraged Loan TR	0.1	0.0	0.0	1.8
Intl Dev Bonds	S&P International Sov Ex-US Bond TR	-0.7	0.1	0.1	-6.3
Emerging & Frontier Bonds	JPM EMBI Global Diversified TR	-0.2	0.4	0.4	-4.2
U.S. REITs	MSCI US REIT NR	0.6	2.1	2.1	10.7
Ex U.S. Real Estate Securities	S&P Global Ex US REIT TR	0.3	0.2	0.2	2.6
Broad Commodity Futures	Bloomberg Commodity TR	1.0	0.5	0.5	7.4
Energy Partnerships	Alerian MLP TR	4.4	2.2	2.2	24.6
Gold	LBMA Gold Price AM	-0.8	1.8	1.8	-9.3

Figure 1, Asset Class Returns. Source: Springtide Partners and Bloomberg as of 03/31/2021.

INTEREST RATES

The Federal Reserve maintained its dovish stance forecasting no changes to key short-term interest rates well into 2022. The Fed is willing to let inflation run above its target 2% policy rate for the short-term, believing heightened inflation will be transitory. Despite increasing its internal economic growth projections, the Fed maintained its plan of purchasing $120 billion of treasuries and agency securities per month with total assets now above $7.5 trillion. Critics are calling the Fed's dovish stance as irresponsible, citing the belief that the U.S. economy can handle higher short-term interest rates without negative consequences and potential this has to mitigate or avoid significant asset bubbles.

The U.S. yield curve steepened throughout the quarter as bond market participants digested future growth prospects and became increasingly cautious about the Federal Reserve's stance on near-term inflation. Ending the quarter at 1.75%, the 10-Year U.S. Treasury Note offers a relatively attractive yield as compared to foreign developed sovereign bonds. Simultaneously, the U.S. dollar has strengthened relative to foreign currencies. These interest and exchange rate dynamics may attract foreign capital into the U.S and away from foreign and emerging markets, which would act as a headwind for future overseas investment returns. Longer term, economists expect the growing twin deficit in the U.S. (budget deficit and current account deficit) to negatively influence the U.S. dollar (Figure 2).[1] Investors have historically done well investing in real assets and non-U.S. dollar denominated assets during such an environment.

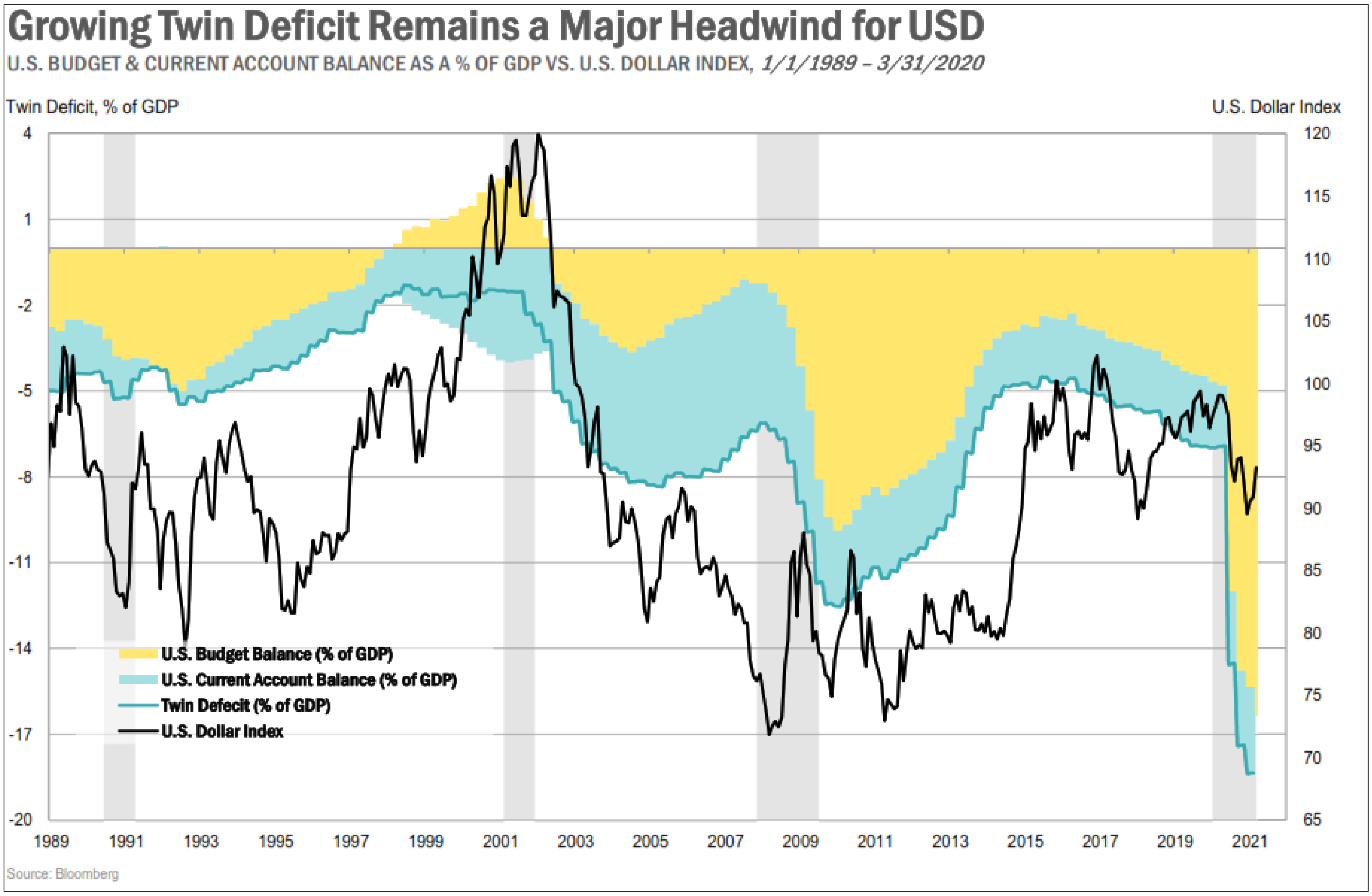

Figure 2, Growing Twin Deficit Remains a Major Headwind for USD. Source: Bloomberg.

[1] Springtide Partners. Market Dashboard 3.31.2021

U.S. ECONOMY

U.S. economic data improved throughout the quarter. ISM manufacturing data surprised to the upside in March reaching a 37-year high.[2] Consumer confidence continued to rebound, surpassing pre-pandemic levels seen in January 2020.[3] While still at an elevated level, the U.S. unemployment rate fell to 6% in March. Hard hit sectors such as leisure, hospitality, and education saw robust gains as large parts of the nation began easing pandemic related shutdowns.[4] Residential housing prices continue to climb across the U.S. The Case-Shiller National 20 City Index increased 11% year over year, driven by supply/demand imbalances and low mortgage rates.[5] Elsewhere, inflation continues to trend higher as global supply chains remain stressed, corporate inventory remains low, and food and energy prices have rebounded significantly.

To be sure, the U.S. economy is benefitting from a fiscal tailwind. On the heels of the American Rescue Plan that authorized additional stimulus payments to qualifying taxpayers, the Biden Administration recently released a $2+ trillion infrastructure-spending plan calling for significant investment in roads and transportation, water infrastructure, energy, and telecommunications. The Biden Administration proposed that partial funding for this bill would come from increasing the corporate tax rate to 28%. If this bill passes in its current form, the U.S. will again be top of the list for highest combined corporate tax rate among all OECD countries.[6]

GLOBAL ECONOMY

Globally, the response to the COVID-19 pandemic has been incongruent. Policy responses varied significantly from country to country, ranging from the Sweden model (no lockdown) to New Zealand (strict lockdown). Fiscal support has varied considerably as well; additional spending and foregone government revenue in response to COVID-19 ranged from almost 15% of GDP for advanced economies to 3-4% for low-income countries (Figure 3).[7] While a generous fiscal spending policy does not guarantee a sustained economic recovery (see Brazil), it can positively influence short-term GDP growth as we are seeing in the U.S.

COVID-19 Fiscal Stimulus by Country

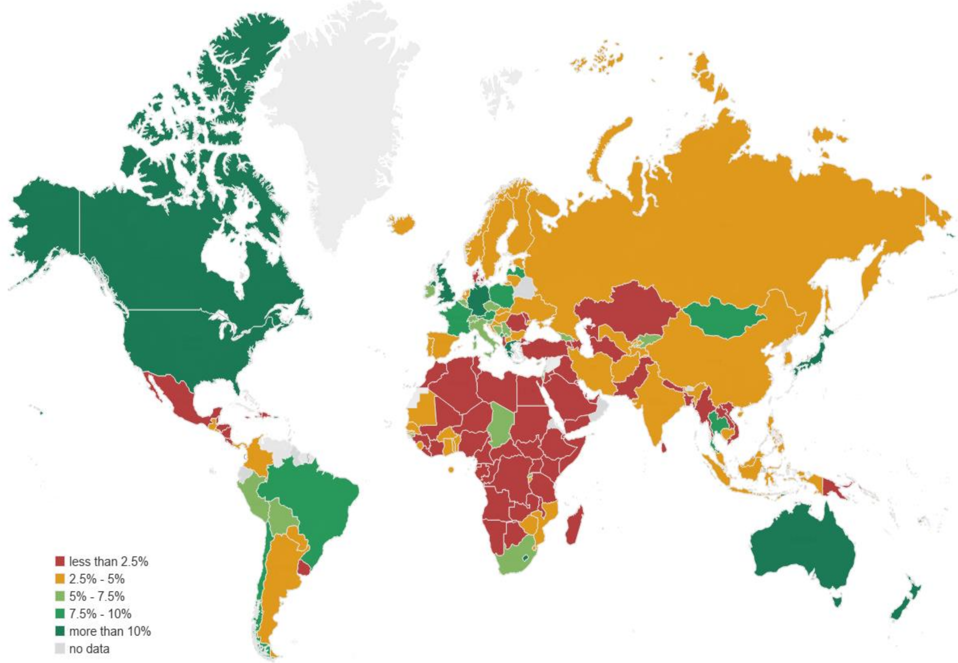

Figure 3: COVID-19 fiscal stimulus by country as a percentage of 2020 country GDP. Source: International Monetary Fund. As of April 2021.

[2] ISM Report on Business. https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/march/. Accessed 4/6/2021
[3] The Conference Board Consumer Confidence Index® https://conference-board.org/data/consumerconfidence.cfm. Accessed 4/6/2021
[4] US Bureau of Labor Statistics. *The Employment Situation – March 2021*. https://www.bls.gov/news.release/pdf/empsit.pdf. Accessed 4/5/2021
[5] S&P Case Shiller 20 City Composite Index. https://www.spglobal.com/spdji/en/indices/indicators/sp-corelogic-case-shiller-20-city-composite-home-price-nsa-index/#overview. Accessed 4/5/2021
[6] Tax Foundation. *President Biden's Infrastructure Plan Raises Taxes on U.S. Production.* https://taxfoundation.org/biden-infrastructure-american-jobs-plan/. Accessed 4/6/2021
[7] International Monetary Fund. Database of Fiscal Policy Responses to COVID-19. https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19. Accessed 4/6/2021

Figure 4: JPM Guide to the Markets. Source: U.S. Data as of March 31, 2021.

VALUATIONS

Valuations remain above average for most public companies. The forward price-to-earnings ratio for the S&P 500 ended the quarter at 21.88x as compared to a 25-year average of 16.64x (Figure 4).[8] On a relative basis, value oriented equities continue to look attractive relative to growth equities. Investors have many reasons to be bullish right now. Growth is accelerating, pandemic related restrictions are rolling off, and the consumer has considerable pent up demand. That said, given current equities valuations, investors may be wise to temper future return expectations.

At PCM, we are actively looking for low correlated strategies that offer compelling risk/return potential. As always, we encourage investors to stay diversified, rebalance portfolios regularly, and focus on their long-term planning goals. Thank you for your continued trust and business.

Sincerely,
The Private Capital Management Team

[8] JPM Guide to the Markets – U.S. Data are as of March 31, 2021