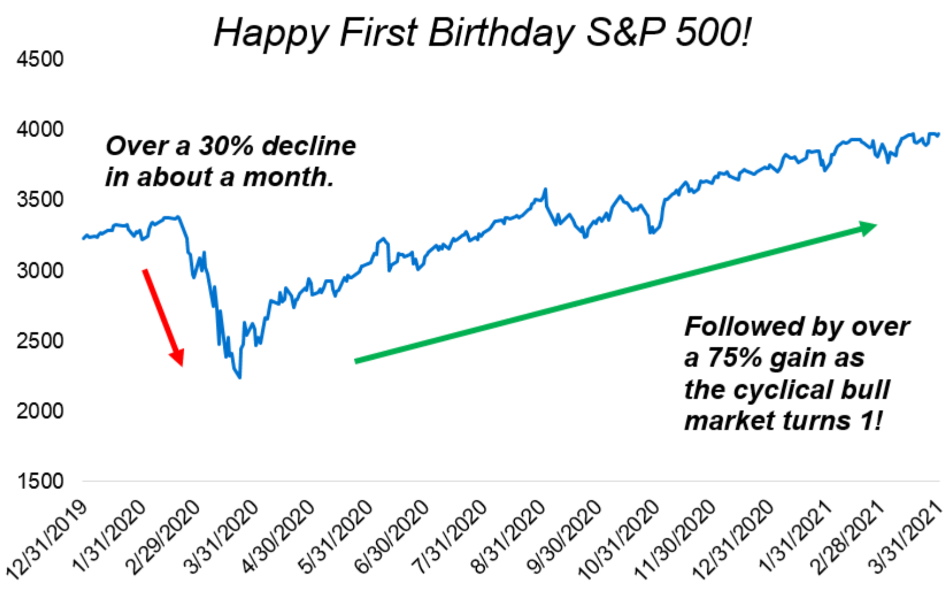
# The Beginning or the End?

*"Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."*

*– Winston Churchill (November 10, 1942)*

How does one define the beginning and the end? Perhaps one might think of the beginning and end of a movie, a book or a play. Others might think of the beginning and end of a day, a week, a month or a year. Still others may define it as the beginning and end of a lifetime or era.

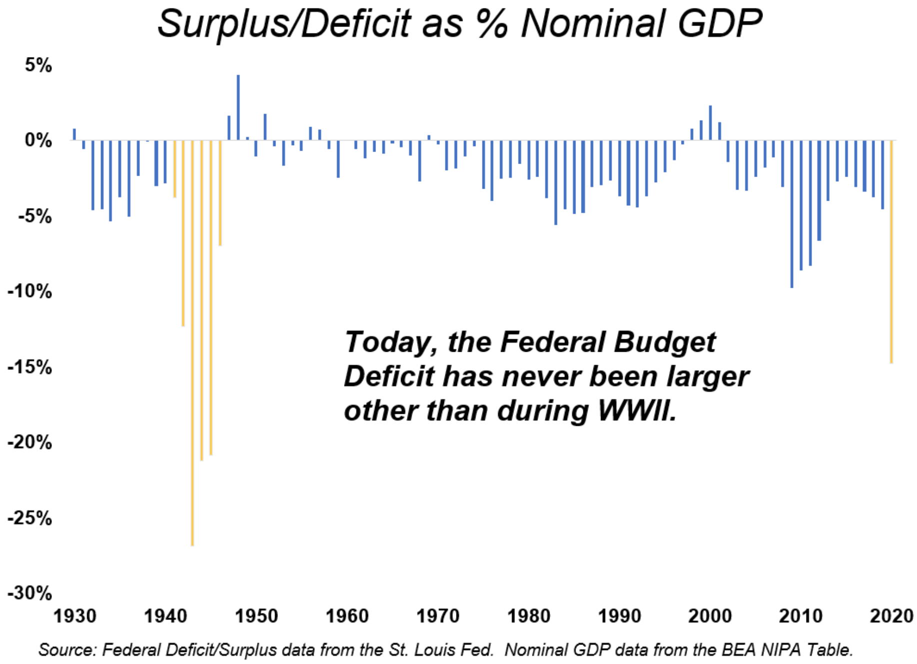
***The market can also have a beginning and end especially when it comes to cycles and – yes, even birthdays. Believe it or not, the market's new cyclical bull market turned one on March 23rd a couple of weeks ago.*** One year ago, that date marked the bottom for the S&P 500 after suffering one of the fastest drawdowns since 1950 – a decline of more than 30% in about a month. We knew very little about COVID back then and economies were on the verge of shutting down. And yet the market began to discount the future getting better. It was almost impossible to know at the time and certainly much of the market's response in the months that followed was influenced by the Fed and Washington flooding the system with liquidity, which helped buy time for science and the fundamentals to eventually catch up. As can be seen in the chart, the S&P 500 was back to new record highs as early as late August and continued to make new record highs up through year end. Roughly one year later and the S&P 500's price return is up over 75% off the lows, which ranks as among the fastest and strongest recoveries on record. So, is this the end?



Source: Factset

***As Churchill so aptly put it, we think it may not be the end but perhaps the end of the beginning. Cyclical bull markets are typically not short-lived events.*** In fact, looking back at the past eleven bull markets since 1949 suggest the average length is 64 months or about five years. So, in terms of duration, we're still in the earlier innings of the ballgame. However, it's also true that bull markets are not linear events meaning the first year carries pretty heady returns followed by a less steep and more volatile return trajectory in the subsequent years. As noted above, the S&P 500 has gained over 75% through its first year while cyclical bull markets have historically averaged 165% over their lifespan. So, by magnitude, we may be closer to being halfway through the cumulative returns that have been typical in similar periods. This implies that while returns are still likely to be had, the easy money has probably been made.

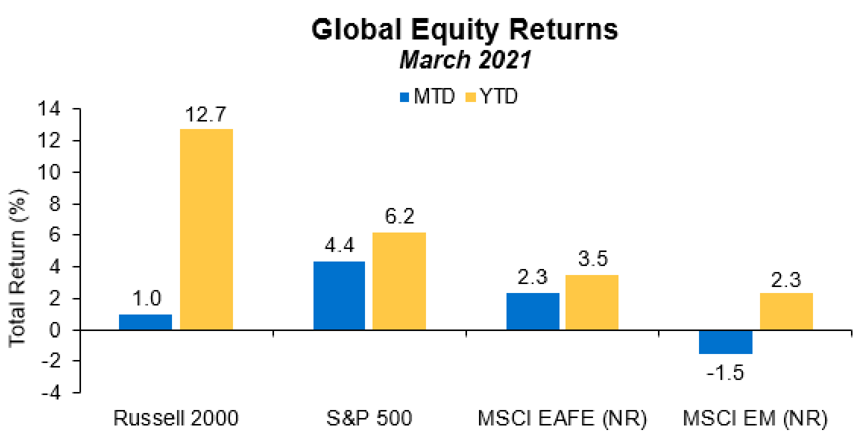
***We also thought the quote from the former British Prime Minister and famed WWII leader was especially apropos because some strategists have recently drawn parallels between today's backdrop and the WWII era.*** Commissioning certain industries to help in the development and distribution of the vaccine effort is one prominent reason. One might also draw the parallel because today's Federal budget deficit (relative to the size of the economy) has only been larger since – you guessed it – the ramping up of the war effort between 1941-1946. Clearly not everything in that period lines up. This was a world war, not a global pandemic. The composition of the US economy was also vastly different with manufacturing much larger than it is today. And the Fed's response was also unique – as policies were instituted to directly control both short-term and long-term interest rates in order to pay for the cost of financing the war. What we do think is important to note, however, is the connection between the deficit and inflation. The 10-year treasury yield was extremely stable under the Fed's influence, but inflation was not. The consumer inflation index or CPI went from averaging 0.9% from '35-'40 to averaging 6.1% from '41-'46. This isn't to say that we expect inflation to run rampant this time around, but we do think it surprises to the upside after a such a long period where it has surprised to the downside. We'll discuss in our outlook how this environment warrants a very different emphasis on what we think is new emerging leadership.



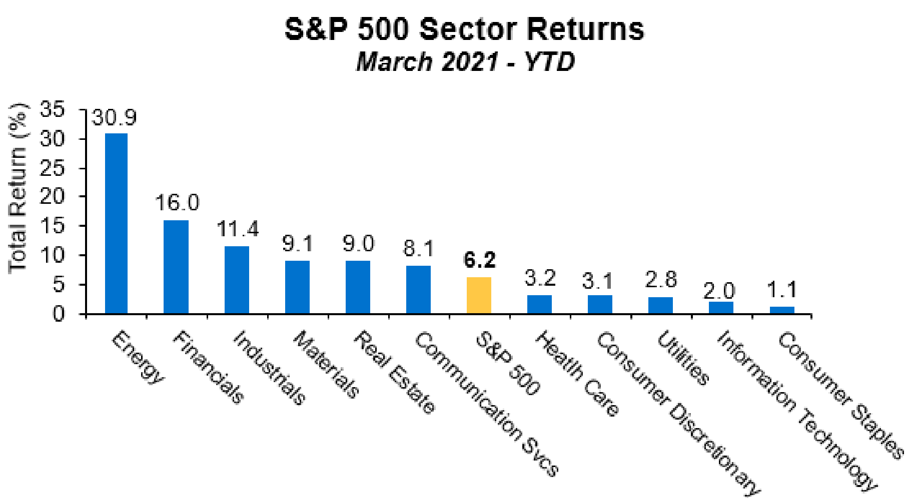
Source: Federal Deficit/Surplus data from the St. Louis Fed. Nominal GDP data from the BEA NIPA Table.

Through the first quarter of the year, market dynamics have reflected an investor preference for reflationary assets. Stocks have outperformed Bonds. Real assets like Commodities and Real Estate have done even better. Small Cap Stocks have outperformed Large Cap Stocks and Cyclically Value sectors have offered leadership – a significant change from the past decade.

## Stocks

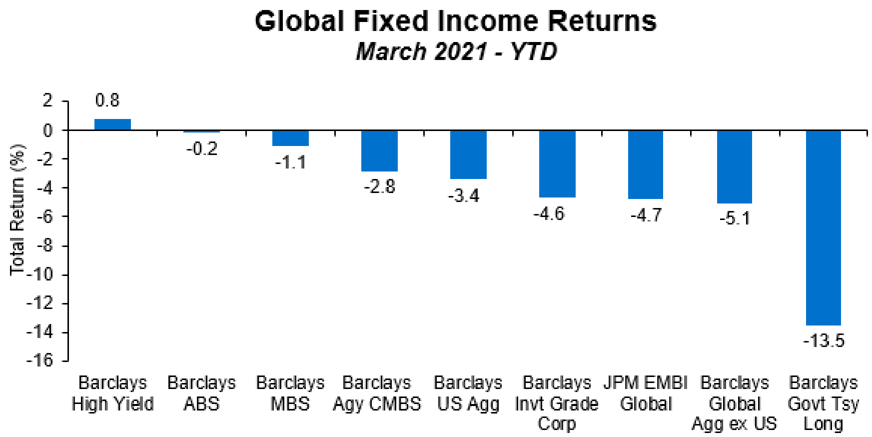



Global equities posted positive returns year-to-date as did all eleven sectors of the S&P 500. US markets have outperformed International markets thus far – helped by a counter trend rally in the dollar. Investors generally preferred the more cyclical areas through the first quarter of the year though some defensive pockets (Utilities and Staples) did better in March. This was perhaps an indication that rising rates would start to force the Fed to pull back on ultra accommodative policy. So far, that's not been the case. Year-to-date leadership has resided in US Small Caps (Russell 2000) as well as the more Cyclical Value sectors including Energy, Financials, Industrials and Materials. More defensive areas (Health Care, Utilities and Staples) and more expensive sectors (Technology and Discretionary) lagged the most.

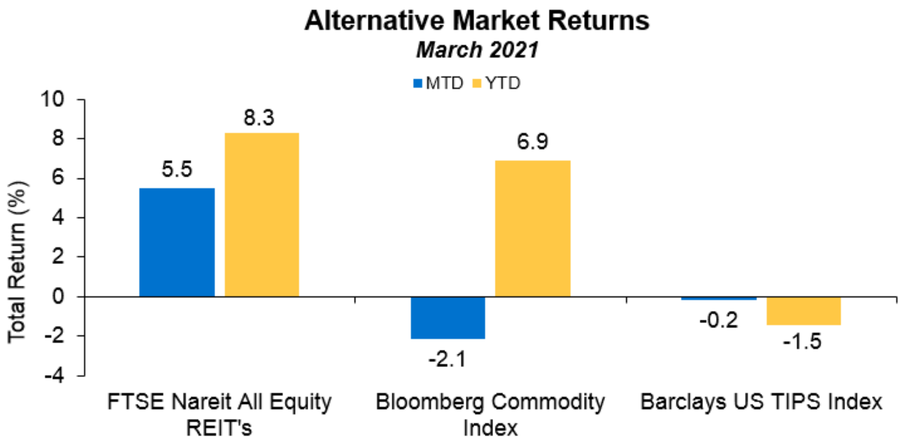


**Bonds**

Bond returns have produced negative returns year-to-date. Long-term interest rates started to trend higher last August though the pace picked up noticeably since the start of this year. Meanwhile, short-term rates remained anchored by the Fed – resulting in a Yield Curve that has steepened to its highest level since mid 2015. This is also consistent with a breakout in inflation expectations to levels we haven't seen in over a decade. As a result, the more interest rate sensitive areas of the bond market have been underperformers to start the year, including long-duration Treasuries (Govt Tsy Long), Emerging Market Debt (EMBI Global) and Investment Grade Corporates (Invt Grade Corp). Securities with shorter durations and more sensitivity to equities have outperformed, including Securitized Assets (ABS, MBS, CMBS) and High Yield.




**Alternatives**




Alternatives posted mixed returns. Treasury inflation protected securities (TIPS) were held back by the rise in longer dated interest rates though outperformed nominal Treasuries given increasing inflation expectations. Publicly traded real estate (REIT's) posted among the best returns for the month and year as relative valuations have become increasingly attractive. Commodities have also posted strong results for the year though returns cooled some in March. Still, higher year-to-date Energy, Industrial Metal and Agriculture prices remain consistent with the market's message of budding cost pressures on the rise.

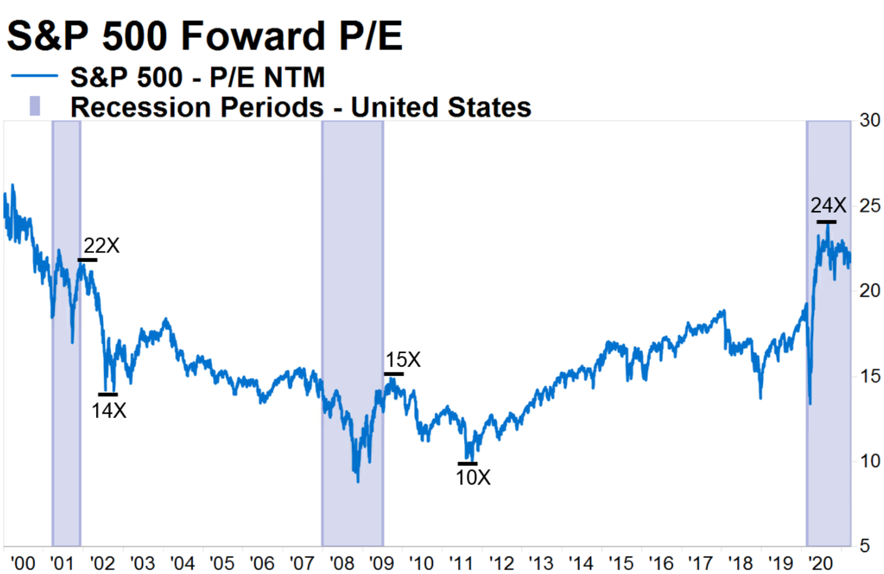
## Market Outlook

***Our outlook for this year remains unchanged and best defined by the phrase "From Red Lights to Green Lights".*** Coming into this year with some visibility on having a medical solution to the medical problem, we thought we'd likely see a fundamental backdrop that was improving from the dark days of 2020.

| | | Red Lights | Green Lights |
|---|---|---|---|
| **Indicator** | **2019** | **2020** | **2021 e** |
| GDP (yoy) | 2.3% | -2.4% | 6.5% |
| Unemployment Rate | 3.6% | 6.7% | 4.5% |
| S&P 500 EPS (yoy) | 3% | -19% | 38% |
| COVID Cases | N/A | 19.1m | ? |

*Source: Factset; 2020 readings and 2021 S&P 500 EPS growth estimate are as of 1/1/21. 2021 GDP and Unemployment Rate estimates are projections produced by the Federal Reserve as of March 2021. COVID case count from www.coronavirus.jhu.edu as of 12/28/20.*

***As the narrative evolved, the backdrop has too and is suggestive of quite a strong recovery in economic growth and corporate profits.*** In past writings, we've highlighted the drivers here to be predicated on (1) easy comparisions from depressed conditions last year (2) vaccinations leading to a much more open economic environment and (3) historic policy stimulus that well exceeds money supply growth like anything we've seen since the 1960's. Economic forecasts from the Federal Reserve released in March were upgraded to 6.5% GDP growth and a 4.5% unemployment rate compared to projections of 4.2% GDP growth and a 5.0% unemployment rate released just a few months ago in December.



*Source: Factset*

***Last year, markets outperformed the economy and we can't help but wonder if that flip flops this year.*** As we noted earlier, cyclical bull markets are typically not short lived events but things get more difficult after the first year. That's because markets typically discount improving fundamentals in year one. As can be seen in the chart above, price to earnings ratios spike late in a recession (shaded regions) as prices begin to anticipate an improvement in the earnings backdrop. ***As the economy begins to turn, the return composition of a cyclical bull market changes from multiple expansion to earnings growth.*** As such, price to earnings ratios typically contract coming out of recessions. That is to say that earnings growth accelerates faster than prices. In this way, the environment shifts from belief to reality. Some companies might come through with better fundamentals while some might disappoint. Volatility can often times result even though returns are still to be had.

***Reflation Reset***

| Advantaged | Disadvantaged |
|---|---|
| International Markets | Domestic Markets |
| Commodities / Real Estate | Fixed Assets |
| Economically Sensitive Sectors | Defensively Oriented Sectors |
| High Operating Leverage | Low Operating Leverage |

*Source: FFWM Research*

***We've highlighted our "Reflation Reset" investment theme in past writings and we still think the market implications hold true.*** A federal budget deficit today that only rivals that of World War II, along with de-globalization trends, and a Fed that is willing to allow more inflation than they have in the past are all structural reasons to support this theme. At the same time, a cyclical recovery in economic growth and corporate profits is taking shape. ***With elevated valuations, we expect returns to be dominated by earnings growth from here. This means pro-reflation assets are still favored – cyclicality and earnings leverage is preferred.*** And with an inflationary setup that we haven't seen in quite some time, areas that have been less popular over the past decade may slowly become more popular.

***It's these areas that continue to be emphasized in client portfolios consistent with the thesis above.*** <u>At the same time it's important to remember that market volatlity may become more prevelant so controlling overall portfolio risk becomes critical</u>. As a result, earlier in the quarter, we trimmed some of our OW to risk assets (trimming Equities and adding to Bonds, Real Estate and Commodities) as Equities may have to deal with some indigestion in year two of a cyclical bull market – though our overall cyclical bias remains unchanged.

***Within equities***, our OW's continue to favor a pro-reflation bias. Previously, we've increased our exposure to an EW in International Developed Markets to complement our OW to Emerging Markets. We've also previously increased our US Small Cap exposure to an OW and have shifted toward more of a cyclical value sector tilt especially within our US Large Cap exposure.

***Within fixed income,*** to mitigate some portfolio risk, we remain UW the most cyclical parts of the bond market (High Yield and Emerging Market Debt) but our US Core managers are OW investment grade credit and UW (defensive) treasuries. We also continue to carry a shorter duration bias (less interest rate sensitivity). Our US Core Fixed Income exposure remains an OW supplemented by our UW position in International Fixed Income which has benefited from a weaker dollar trend over the past year.

***Within alternatives,*** we recently added to real assets as a way to bolster inflationary hedges. As such, we are now EW to Real Estate and OW to Commodities. Rounding out our exposure, we're also OW to Diversified Alternatives which provide some hedge against market volatility.