

1984

“Who controls the past controls the future.”

– *Nineteen Eighty-Four: A Novel by George Orwell (June 8, 1949)*

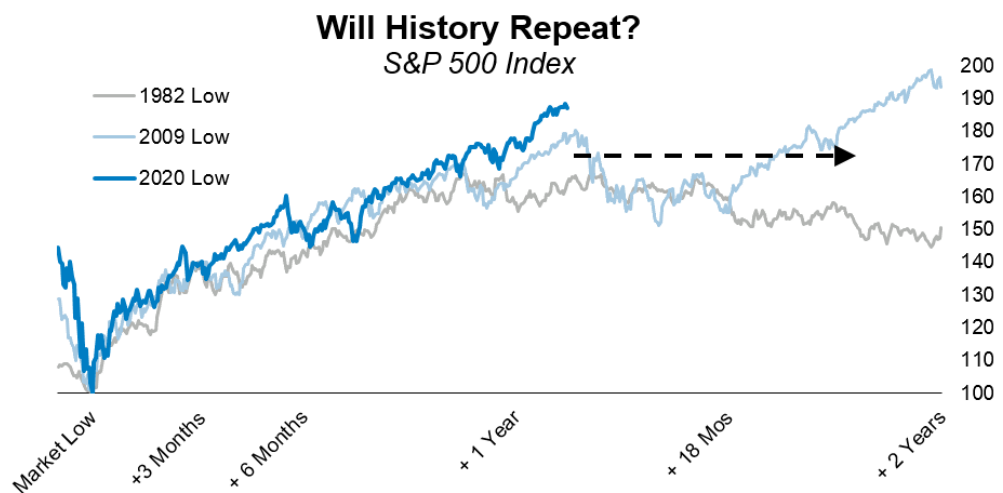
Let’s go back to 1984 – a year rich in pop culture. That year launched the first MTV video music awards with Michael Jackson selling over 37 million copies of his album *Thriller*. Popular movies included *Ghostbusters*, *The Karate Kid* and *The Terminator*. And the space shuttle *Challenger* completed a successful mission which included the first un-tethered astronaut spacewalk. It was also the title of a famous novel published 35 years earlier that discussed the warnings of a totalitarian society where privacy was effectively extinct and revisionist history was on display. Channeling our inner most Orwell, let’s try to be half as insightful about what lies ahead.

So what happened in the markets back then and why is it relevant today? Coming out of the ‘81-’82 recession was the beginning of one of the fastest cyclical bull market recoveries, ranking up there with – you guessed it – ‘20-’21 (in addition to ‘09-’10). While not perfect analogues –

as can be seen below – the price action was remarkably similar through roughly the first 12 months of recovery.

As we’ve noted in prior writings, the second year of a cyclical bull market tends to get more challenging with a pick-up in

volatility. To that point, those other two analogues both saw some consolidation activity following the first year of strong returns. This generally happens as investors begin to shift their perspective from belief to reality. As a result, the return trajectory becomes less steep and is driven by actual earnings growth (as opposed to multiple expansion in the lead up). **Because markets are typically discounting mechanisms, they tend to outperform the economy towards the end of a recession but have to digest those gains as the economy eventually recovers and catches up.** We think that dynamic could play out again this time around as well.



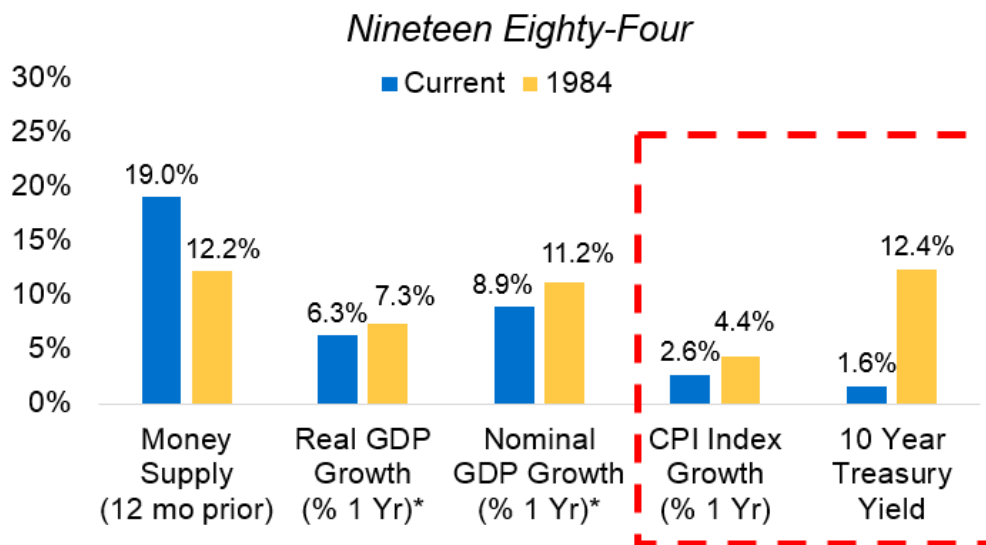
Source: Yahoo! Finance, FFWM Research. S&P 500 Index values indexed to 100 as of 8/12/82, 3/9/09 and 3/23/20. Prices updated through 4/30/21.

So why else is 1984 relevant?

Today most private forecasters for economic growth are calling for US real GDP to grow at a clip of over 6% with nominal growth (incorporating inflation) up almost 9%. **As can be seen in the table below, the last time real GDP averaged growth above 6% was 1984.** Nominal GDP growth averaged over 11% that year.

While forecasters (including the Fed) **are expecting rapid real economic growth this year, it's surprising how disconnected both inflation (CPI) and interest rates (10 Year Treasury Yield) are from 1984 like levels.** And yet money supply growth (measured from twelve months prior) is over 50% higher today than it was back then. All of this is not to say that we think a 10 Year Treasury Yield of 12% is likely. 1984 isn't a perfect analogue as that year saw a very active Fed raise rates by over 200 bps from March to August only to have to cut rates by more than 300 bps from September to December.

However – using that year as a barometer – **we do think it's reasonable for inflation and interest rates to move higher than current levels (and expectations).** To paraphrase the quote from Mark Twain, “history doesn't necessarily repeat, but it does tend to rhyme”.

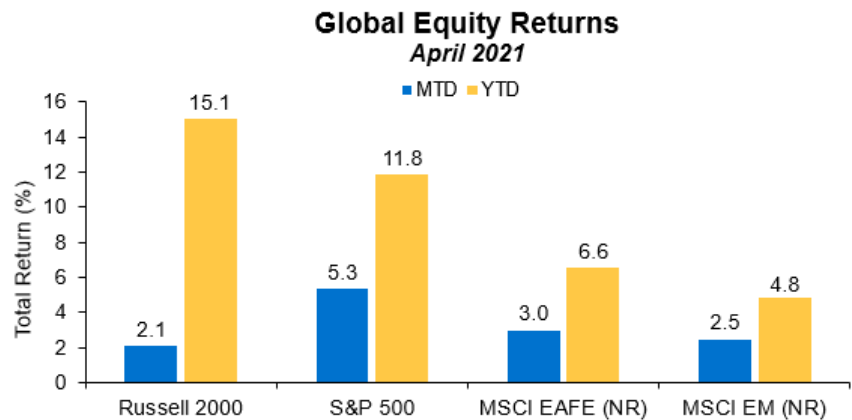


*Source: Factset; 1984 data and current Money Supply is calculated as the averaged result over the entire year. *Current GDP Growth rates are forecasts from the Bloomberg consensus of private contributors as of 5/4/21.*

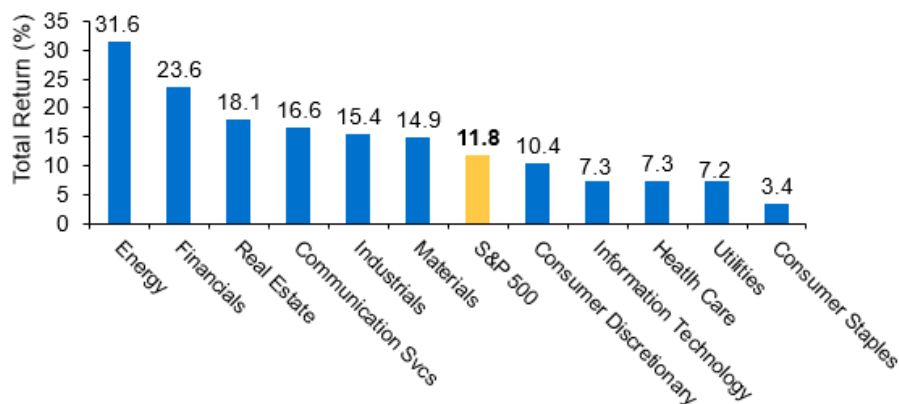
Through the first four months of the year, market returns have indicated a reflationary bias. Real Assets have outperformed Stocks and Stocks have outperformed Bonds. Commodities, Real Estate, Small Cap companies and Cyclical Value sectors have done best while interest rate sensitive Bonds have suffered the most.

Stocks

Global equities posted another strong month of returns to tack on additional gains to their year-to-date totals. US markets and Small Caps (Russell 2000), in particular, have taken the prize thus far. International markets (MSCI EAFE and EM) have lagged both for the month and for the year as vaccination rollouts (and COVID case improvements) have been slower than that witnessed in the US. However, as the dollar has started to weaken and as vaccines become more widely available, we think there may be an opportunity for International markets to catch up. Meanwhile, S&P 500 sectors continue to reflect an investor preference for Cyclical Value exposure with Energy, Financials, Industrials and Materials all outperforming for the year thus far. Conversely, more traditional Defensives (Health Care, Utilities, Staples) and pandemic beneficiaries (big cap Tech and Discretionary) have lagged as progress towards an economic recovery continues to benefit the former more than the latter.



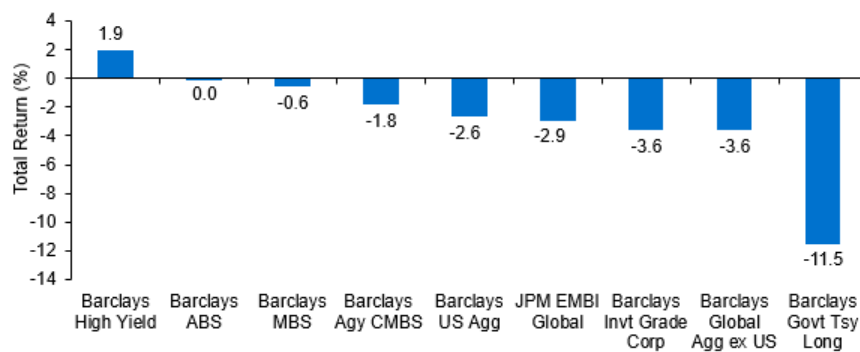
S&P 500 Sector Returns
April 2021 - YTD



Bonds

Bonds 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 despite some modest give back in April. Meanwhile, short-term rates remained anchored by the Fed – resulting in a Yield Curve that has steepened to its highest level since mid 2015 (albeit slightly less steep than in March). 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 so far this year, including long-duration Treasuries (Govt Tsy Long), Investment Grade Corporates (Invnt Grade Corp) and Emerging Market Debt (EMBI Global). Securities with shorter durations and more sensitivity to equities have outperformed, including Securitized Assets (ABS, MBS, CMBS) and High Yield.

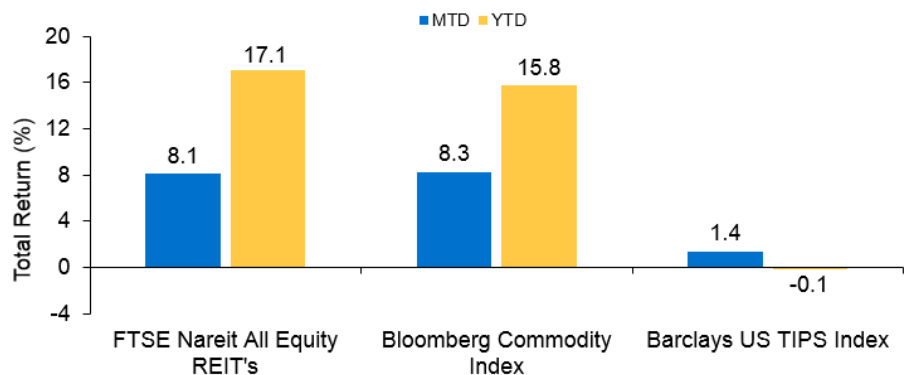
Global Fixed Income Returns
April 2021 - YTD



Alternatives

Alternatives posted mostly strong returns for the month and year. Treasury inflation protected securities (TIPS) were held back by the rise in longer dated interest rates though outperformed nominal Treasuries given increasing inflation expectations.

Alternative Market Returns
April 2021



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 both the month and the year. Rising Energy, Industrial Metal and Agriculture prices remain consistent with the market's message of budding cost pressures on the rise.

Market Outlook

Our business cycle outlook this year continues to be best defined by the phrase “From Red Lights to Green Lights”.

As the vaccination rollout continues, US COVID cases have improved materially. While variants remain a risk (amid subpar vaccination rollouts elsewhere like in Europe), having a medical solution to the

Indicator	2019	Red Lights	Green Lights
		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.

medical problem should allow for a more open global economy this year. Over the past 12 months, markets have been anticipating a strong recovery in economic and corporate profits as noted in the table above. First quarter earnings season isn’t complete, but so far results are living up to those lofty expectations with earnings per share growth tracking to be up over 40% year over year, according to Factset estimates. Meanwhile, real US GDP registered an impressive 6.4% annualized growth rate in the first three months of this year.

It’s important to remember that markets have moved in advance of this, significantly outperforming last year’s depressed economy. This year, the economy will come back online and we can’t help but wonder if that relationship flips. As we noted earlier, the second year of a cyclical bull market tends to see a less steep return trajectory amid higher volatility. That’s because investors transition from belief to reality and expectations close in on a peak rate of growth narrative. **In short, we think the cyclical bull market continues but the easy money has been made and a midcycle slowdown may lie ahead. In such an environment we think managing portfolio risk becomes important while still remaining positioned for a reflationary environment as noted in the table below.**

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

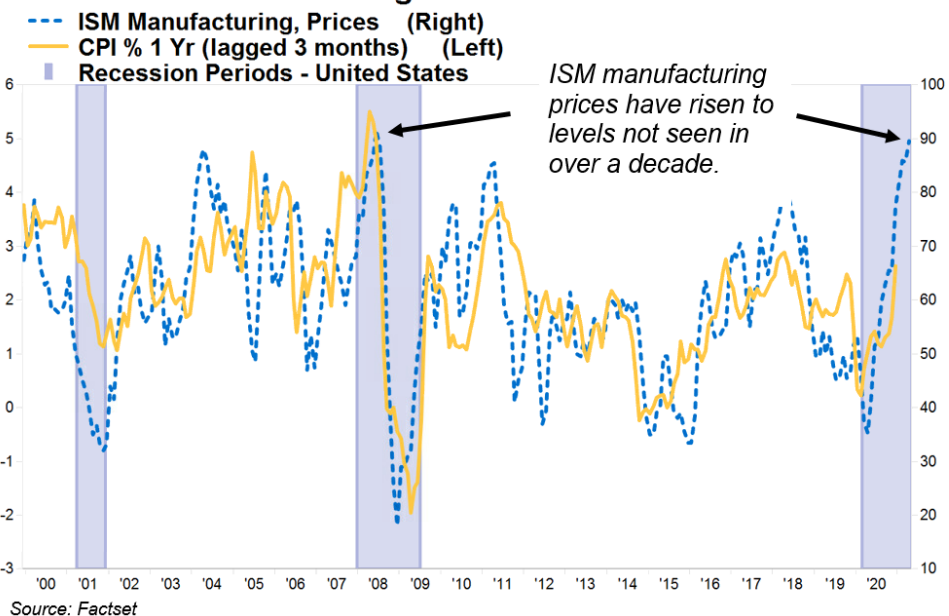
Source: FFWM Research

We've highlighted this **"Reflation Reset" investment theme** (improving nominal growth coming from a combination of real growth and inflation) **in past writings and we still think the above 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.

In addition, most of our leading inflation indicators still suggest an upside inflationary bias.

As can be seen in the chart at right, the ISM manufacturing survey indicates that input prices are now increasing at levels last seen over a decade ago when consumer inflation (as measured by the CPI) was much higher. Various

CPI vs ISM Manufacturing Prices



regional surveys, small business owner reports, inflation expectations, unit labor costs, capacity utilization rates, delivery times and import indices all show similar trends.

With elevated valuations, we expect returns to be dominated by earnings growth from here. This means pro-reflation assets are still favored – cyclical and earnings leverage is preferred – **though there could be bumps along the way** as we approach the peak rate of growth in earnings, GDP and liquidity.

As such, we remain deliberate in emphasizing a reflationary bias in client portfolios while also controlling overall portfolio risk. Accordingly, we continue to trim some of our OW to risk assets (via Equities) while bolstering our inflationary hedges (Real Assets including Real Estate and Commodities) and maintaining diversification with lower volatility assets (via US Core Fixed Income and Diversified Alternatives).

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 within our (UW) US Large Cap exposure (though recently have shifted some of that value tilt toward higher quality companies).

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 remains a beneficiary of a weaker dollar environment.

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

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