March 2021 Market Overview

March Benchmark Returns	MTD	QTD	YTD
EQUITY BENCHMARKS			
iShares Core S&P 500 ETF	4.6%	6.3%	6.3%
Vanguard Russell 1000 ETF	3.8%	6.0%	6.0%
Vanguard Russell 1000 Value ETF	5.9%	11.4%	11.4%
Vanguard Russell 1000 Growth ETF	1.8%	1.1%	1.1%
Vanguard Russell 2000 ETF	1.4%	12.8%	12.8%
Vanguard REIT	5.1%	8.6%	8.6%
iShares MSCI ACWI ETF	2.9%	4.9%	4.9%
Vanguard FTSE Developed Markets ETF	2.8%	4.5%	4.5%
Vanguard FTSE Emerging Markets ETF	-0.7%	4.0%	4.0%
FIXED-INCOME BENCHMARKS			
Vanguard Total Bond Market ETF	-1.3%	-3.6%	-3.6%
Vanguard Intermediate-Term Tax-Exempt	0.5%	-0.3%	-0.3%
iShares TIPS Bond ETF	-0.3%	-1.7%	-1.7%
ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index	0.2%	0.8%	0.8%
S&P/LSTA Leveraged Loan Index	-0.0%	1.8%	1.8%
ALTERNATIVE BENCHMARKS			
HFRX Global Hedge Fund Index	-0.1%	1.3%	1.3%
Bloomberg Commodity Index	-2.1%	6.9%	6.9%
SG Trend Index	1.1%	4.0%	4.0%
3-Month LIBOR	0.0%	0.1%	0.1%

Global stock markets celebrated the one-year anniversary of the pandemic-induced bear market low (March 23, 2020) with another strong quarter of returns. The S&P 500 Index gained 6.3%, developed international stocks rose 4.5%, and emerging-market (EM) stocks gained 4.0%.

From the low on March 23, 2020, these benchmarks are up an astonishing 80.6%, 74.8%, and 74.6%, respectively. In fact, the S&P 500's one-year return from the low was its best since 1936.

The first quarter also saw a continuation of the "reflation rotation" trend that has been happening beneath the market surface over the past several months. Specifically, smaller-company stocks have trounced large caps, with the Russell 2000 Index gaining another 12.8% in the first quarter. And value stocks maintained their new-found edge over growth stocks: The Russell 1000 Value Index Vanguard Russell 1000 Value ETF returned 11.4% versus 1.1% for its large-cap growth index counterpart. More meaningful than the value versus growth performance discrepancy was the outperformance of cyclical (meaning more economically sensitive) stocks. Energy and financials were the top-performing sectors in the S&P 500. In contrast, utilities, consumer staples, and health care—considered "defensive" sectors—were among the worst, registering just slightly positive returns. After a stellar 2020, the technology sector was also one of the bottom performers for the quarter.

As we will discuss in detail below, the reflationary winds tore through the fixed-income markets as well. The benchmark 10-year Treasury yield jumped nearly 75 basis points from year-end to close the quarter at 1.74%, a 14-month high. Correspondingly, the core bond index lost 3.6% for the quarter. This is its worst quarterly performance since 1981 and the fourth-worst return in the index's history back to 1976. Core municipal bonds did better with a loss of only 0.3% for the quarter.

Finally, to the surprise of many in light of the reflationary/inflationary market mood, gold had a rough quarter, declining 10%. This is actually not that surprising in hindsight though, as the price of gold tends to be inversely correlated with real (inflation-adjusted) interest rates. Along with nominal bond yields, real yields also rose in the first quarter, with the 10-year TIPS yield increasing roughly 40 basis points from negative 1.0% to negative 0.6%. The U.S. dollar, which is also typically inversely correlated with the price of gold, halted its multi-month decline and posted a roughly 3% gain for the quarter (depending on which dollar index one uses).

The Macro Backdrop

Any discussion of the economic and market outlook is obviously contingent on the course of the Covid-19 virus and the efforts to control it. While many parts of the world continue to struggle with variants of the virus, pressure on the healthcare system and efficient vaccine distribution, the US seems be on track on these metrics.

Beyond that, any discussion has to begin and end with the extraordinary policy response to the pandemic. Suffice it to say, U.S. monetary and fiscal policy are both highly supportive of an economic recovery.

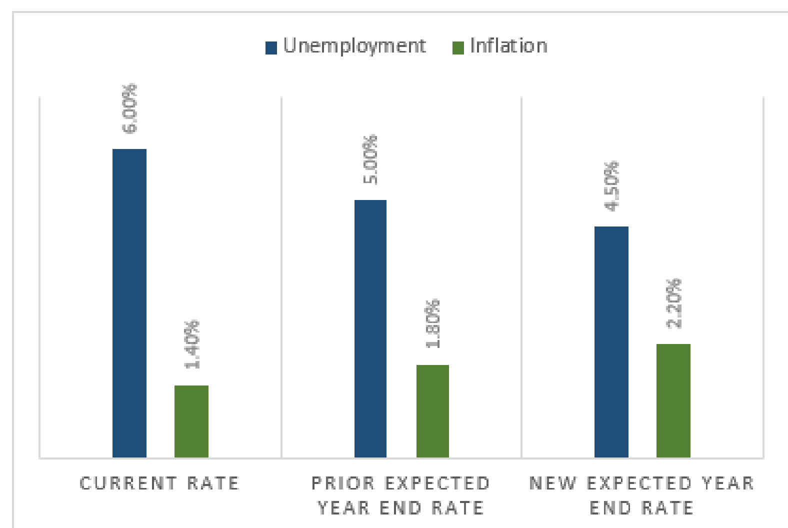
Starting with monetary policy, at its recent Federal Open Market Committee (FOMC) meeting in mid-March, the Federal Reserve reinforced its commitment to its new monetary policy framework (introduced last fall) and its highly accommodative current stance. Unlike in the past when the Fed would start raising interest rates to *preempt* higher inflation based on its *forecasts*, the Fed says it will now wait to see *actual sustained* core inflation readings above its 2% average inflation target (AIT) before starting to tighten.

Consistent with its new AIT framework, the Fed continues to emphasize it is seeking to achieve not just "full employment"—as measured by the headline unemployment rate—but a "broad-based and inclusive goal" of "maximum employment," which puts additional focus on harder-hit segments of the labor force, such as minorities, women, and low-income workers. Fed governor Lael Brainard highlighted the influence of this new approach recently writing, "The assessment of shortfalls from broad-based and inclusive maximum employment will be a critical guidepost for monetary policy, alongside indicators of realized and expected inflation."

After the March FOMC meeting, Fed chair Jerome Powell summed up the Fed's current stance as follows: "The economy is a long way from our employment and inflation goals, and it is likely to take some time for substantial further progress to be achieved. We will continue to provide the economy the support that it needs for as long as it takes."

As such, the Fed kept its policy interest rate (the federal funds rate) unchanged at near-zero percent and gave no indication it is planning a reduction (or tapering) any time soon in its $120 billion per month quantitative easing (QE) asset purchase program. Moreover, the median FOMC member (11 out of 18 members) still does not expect the Fed to even start raising rates until at least 2024.

This is despite the Fed sharply increasing its median forecast for 2021 U.S. GDP growth to 6.5%—driven by the accelerating vaccine rollout, declining virus spread, and the passage of the $1.9 trillion American Rescue Plan (ARP) in March. In contrast, at the Fed's December FOMC meeting three months ago, its median 2021 GDP growth forecast was 4.2%.



The Fed's latest forecast of the year-end unemployment rate dropped to 4.5%, compared to their prior forecast of 5.0%. (The headline unemployment rate currently stands at 6.0%.) Finally, the Fed increased its forecast of core inflation to 2.2% for 2021, from 1.8% previously. (Core PCE inflation is currently running at 1.4% year over year.)

Moving to fiscal policy, the big news was the passage of the $1.9 trillion ARP, equivalent to roughly 9% of U.S. GDP. While most observers expected the Biden administration to enact a large fiscal package, many were surprised Congress passed the full $1.9 trillion initially proposed. Adding in the prior two pandemic-relief fiscal packages passed in March and December 2020, the total fiscal stimulus equates to more than 25% of GDP. This is a huge number and roughly five times the fiscal response during the 2008 Great Financial Crisis. It also contributed last year to the largest federal budget deficit since World War II, at 15% of GDP. The 2021 budget deficit is projected to be the second largest, at 10% of GDP.

Not all of the $1.9 trillion will be immediately spent; a meaningful portion of it will go into household savings and to pay down debt (and apparently, some to betting on Reddit stocks via Robinhood). According to Oxford Economics, Americans have accumulated $1.8 trillion in excess savings in the 11 months since the start of the pandemic. Oxford estimates this could rise to $2.5 trillion by this summer. That's a lot of *potential* pent-up spending—more than 10% of GDP.

But the ARP should still produce a big short-term boost to GDP growth—and economists (as well as the Fed) have been revising up their 2021 forecasts accordingly.

However, the effect on GDP growth will be temporary as the relief programs are set to expire later this year. Without additional stimulus, the positive fiscal growth impulse this year will turn into a fiscal drag next year—what some are calling a "fiscal cliff." That budding fear is starting to sound like an addiction to stimulus.

The Wall Street consensus is also expecting extremely strong corporate earnings growth in 2021, as shown in the chart to the right. S&P 500 Index operating earnings per share (EPS) are forecast to increase 41% this year, which would be the second-highest EPS growth rate in over 70 years. (The highest was in 2010, at 47%.)

What About Inflation?

Before turning to our outlook for the financial markets, we'd like to spend a bit more time on what we view as the key economic risk over the next several years: inflation. Part of us would be satisfied summing up the debate on inflation with the words of the great investor Howard Marks, who recently wrote, "Is inflation a threat anytime soon? The answer's clear: who knows?"

But while we all know that to be true—*nobody knows* what the future will bring, not even economists or highly paid Wall Street strategists —we thought it would be helpful to summarize both sides of the argument.

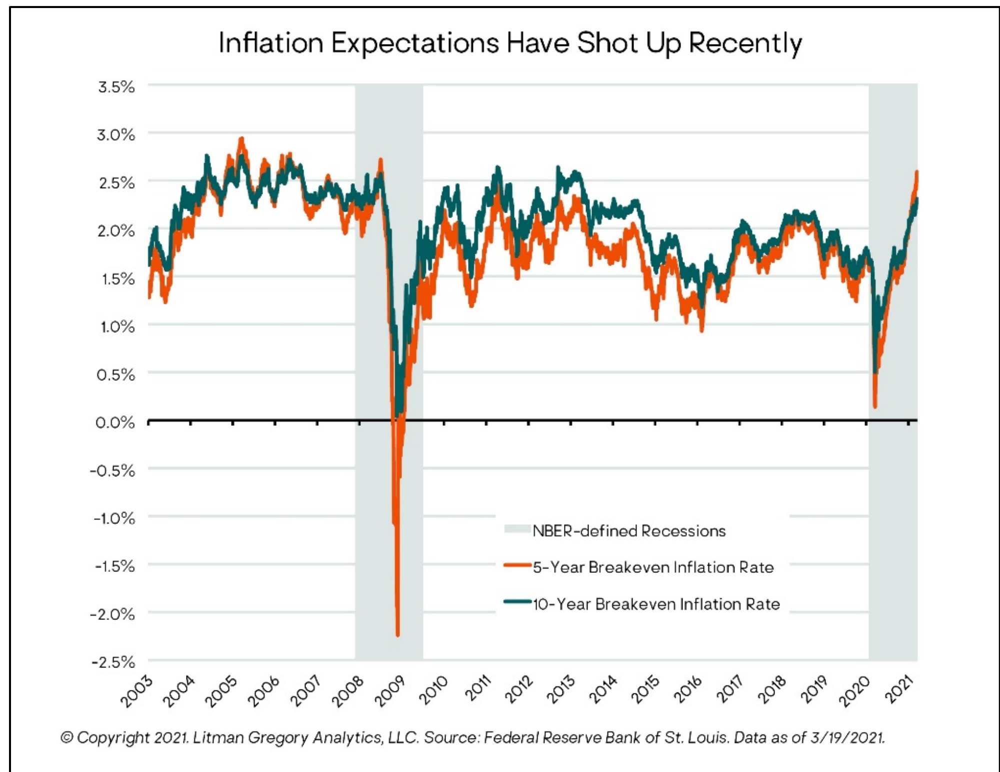
First, in a sense, inflation is more of a risk now because it has been so immaterial for most of the past 20 years. This has led policymakers, consumers, businesses, and investors to become complacent about it (at least up until very recently), as reflected in very low interest rates and bond yields, and very high stock market valuations.

The primary catalyst for the recent sharp uptick in inflation fears is the combination of the positive macro factors we discussed above: (1) the expected reopening of the economy as the pandemic is brought under control, (2) ongoing highly accommodative monetary policy, and (3) unprecedented fiscal stimulus/support and the prospect for more to come from the new administration and Congress.

Market-based measures of short- to medium-term inflation expectations have shot up since year-end. For example, as shown in the chart on the next page, the five-year "breakeven inflation rate" (the difference between the five-year nominal Treasury yield and the five-year inflation-protected Treasury, or TIPS, yield) hit a 13-year high recently, at just above 2.5%. The 10-year inflation breakeven is around 2.3%, a seven-year high.

Inflation *expectations* can be a key driver of actual inflation. If people act on their belief that future inflation will be higher, it can lead to a self-fulfilling cycle of actual higher inflation. Consumers pull forward their

spending to buy while prices are (expected to be) lower, businesses do the same and may also raise prices to maintain profit margins, workers demand higher wages to compensate for higher inflation, businesses raise prices further to offset their higher input costs, inflation readings increase leading to expectations of yet more inflation coming down the pike, etc.



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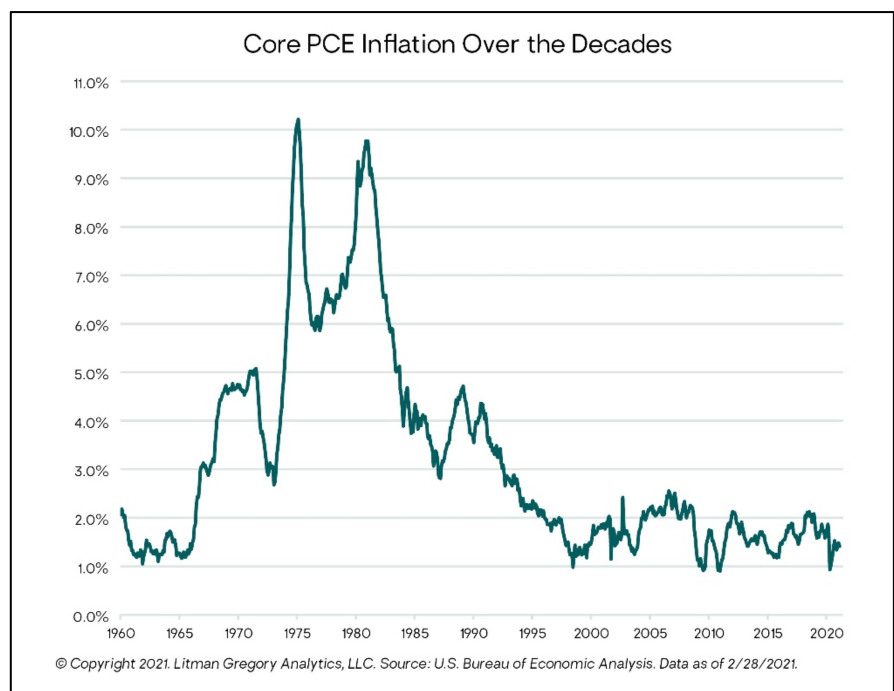
This is why the Fed is so focused on trying to anchor inflation expectations at around their 2% core target. But it doesn't want them anchored too low either, as that increases the risk of a deflationary spiral. Digging out of a deflationary hole can be even harder and more damaging to an economy than halting an inflationary spiral, particularly for an economy with as much debt as we have now. Getting the inflationary porridge just right is the Fed's eternal challenge.

One final matter to ponder is whether or not we are measuring inflation correctly. Most people report today that costs are rising more than 2%. The housing market seems out of control and other asset prices are high (i.e., richly valued stocks). In the basket of goods and services that are used to measure the CPI a true reflection of the cost of living?



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We will continue to monitor these developments because a move from gentle inflation to mid-single digit inflation would be mark a sea change for financial plans and investment assets. This could play out due to a combination of political factors (for example, the rise of populism) and fiscal and monetary policies that are targeted to reduce inequality, maximize employment, and reduce the real (after-inflation) debt burden for both households and the federal government—all of which would likely be inflationary.

What Does This Mean for Markets?

Moving from the macro to the markets, we believe that overwhelming amount of fiscal and monetary stimulus will continue to buoy equity and other risk assets. It is hard to see what will change the course of this accommodation, but we would be remiss if we didn't note two broad market risks: (1) rising interest rates, and (2) high U.S. equity valuations (our old friend).

Interest Rate Risk

As we noted above, Treasury yields have moved sharply higher this year. All else equal, higher interest rates are negative for equity valuations as they reduce the present value of future (discounted) corporate profits. And of course, rising bond yields correspond directly to falling bond *prices*, hence the negative year-to-date returns for core bonds and Treasuries.

But for equities, other factors also matter: the *level* from which rates are rising, the rapidity (or graduality) of the increase, whether the interest rate rise is due to improved economic growth expectations or due to rising inflation concerns (are we in a reflationary or an inflationary regime?), and what consensus expectations or assumptions are already being incorporated in current equity prices.

With nominal rates still at very low levels, real (inflation-adjusted) yields still negative, and a sustained rise in inflation over the near term *not* being our base case, we don't view a sharp and sustained rise in interest rates from current levels as a likely outcome.

This is not to say that Treasury yields can't increase further from here. But absent evidence of sustained inflationary pressure, and given the Fed's commitment to keeping the fed funds rate at zero, we don't expect yields to rise so much or for such a sustained period (yet) that they would trigger a bear market in stocks or other long-term-return-generating assets.

Valuation Risk

Absolute valuations for the U.S. stock market haven't meaningfully changed over the past three months; they still look expensive relative to historical averages across a wide range of metrics. However, the *relative* valuation of U.S. stocks versus bonds—taking into account current bond yields—is still reasonably attractive, although less so as bond yields have risen during this period.

Low bond yields are typically associated with low inflation environments. So, one might expect absolute equity valuations to *generally* be higher when inflation is low (but not so low as to reflect a deflationary scenario, which would be very bad for stocks). The table below shows this has historically been the case, with the sweet spot for the S&P 500 Index valuation multiple, represented by the Shiller price-to-earnings (P/E) ratio in this example, occurring *on average* when the inflation rate has been between 1% and 3%.

Inflation Bucket	AVG. Shiller P/E	Median Shiller P/E
Less than 0%	15.3	15.3
0% to 1%	19.0	19.0
1% to 2%	23.3	22.7
2% to 3%	24.2	23.4
3% to 4%	20.7	19.7
4% to 5%	16.8	17.4
5% to 6%	15.5	16.2
6% to 7%	11.6	10.9
7% to 8%	10.6	10.1
8% to 9%	10.8	10.0
9% to 10%	10.7	11.0
Greater than 10%	9.4	9.1

Source: Robert J. Shiller, U.S. Bureau of Economic Analysis. Inflation is headline CPI. Rows highlighted in red indicate inflation / valuation sweet spot.

Not surprisingly, the underlying monthly data points reveal a wide range of historical outcomes around the average P/E for each inflation bucket. It makes sense that low inflation doesn't *automatically* equate to higher valuations; there are so many other variables that also impact valuation. But the data do indicate that if the market *is* going to have a higher-than-average multiple, it at least *needs* lower inflation: low inflation and low interest rates is necessary but not sufficient.

Therefore, one's views on valuation risk are to some degree tied to one's views on interest rate and inflation risk. And those, in turn, tie to some degree to one's views on the prospects and timing for controlling COVID-19; an economic recovery; closing the labor market gap; rising wage pressures; fiscal, monetary, and regulatory policy actions; and geopolitical events—to name a few—*and* the inter-relationships and feedback loops between human/herd psychology and behavior and these variables, against a constantly evolving global structural backdrop.

Closing Thoughts

These are extraordinary times in the financial markets. We are actually living through the greatest experiment that the world has seen economically. While we don't see a rapid change, we are hard pressed not to have concerns about a paradigm shift away from the low inflation, low-rate environment of the past forty years. This causes us to be more cautious about fixed income exposure and liquidity although the stability of some bond exposure remains important for risk management.

As we've have noted many times, what has worked so well for the past 10, 20, 30, 40 years—a simple 60%/40% U.S. stocks/core bonds balanced model—won't work nearly as well over the next five to 10 years (at least), even without an upsurge in inflation. We are already accounting for this in our portfolio positioning. As the macroeconomic regime evolves, we will tactically, but prudently, adapt and adjust our portfolio exposures based on our assessment of the risks and potential returns.

In the meantime, we believe the most likely scenario over the next year at least is a reflationary one, enabling solid returns from global equities and decent to solid returns from credit-oriented fixed-income strategies. We also expect our diversifying and lower-risk alternative strategies funds to outperform core bonds.

We believe our portfolios are well positioned for further gains this year as the U.S. and global economy continue to recover. We expect many of the asset markets and market sectors that have been laggards over the past five to 10 years to continue to rebound as part of the broad reflation rotation described above. We also believe this environment offers excellent opportunities for active management across both equities and fixed income to add value relative to core market indexes.