



# OUR VIEW



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## First Quarter Review

U.S. stocks continued gaining ground in the first quarter, supported by progress in vaccinating Americans and optimism about economic reopening. The segments of the market expected to benefit from a reopening of the economy in 2021 outperformed those that benefited from the "stay home" economy in 2020, continuing the trend that began late last year.

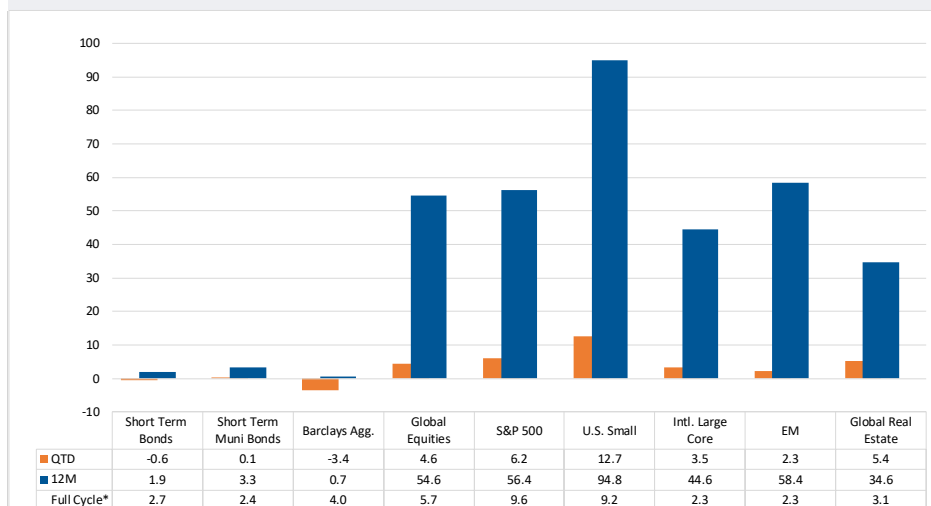
Global equities, as represented by the MSCI All Country World Index, rose by 4.6% for the quarter. The S&P 500 gained more than 6%, while U.S. small company stocks gained nearly 13%. Developed international stocks, as measured by the MSCI EAFE Index, rose by nearly 4%. The MSCI Emerging Markets Index gained about 2%.

In sector terms, the S&P 500's energy sector gained more than 30% for the quarter; the financial services sector gained nearly 16%. In contrast, the technology sector trailed with returns of approximately 2%. The rotation in sector leadership was reflected in value performance relative to growth. The small cap Russell 2000 Value Index outperformed its growth counterpart by more than 16%, while the large cap Russell 1000 Value Index outperformed its growth counterpart by more than 10%.

The bond market fell during the quarter. Optimism about economic growth and worries about inflation were catalysts for rising bond yields. 10-year Treasury yields rose from less than 1% at the start of the year to 1.74% at the end of the quarter, leading to a decline of more than 3% for the Bloomberg Barclays Aggregate Bond Index. Shorter-term and municipal bonds fared somewhat better than intermediate and long-term bond holdings.

## Quarter To Date Returns

3/31/2021



\* Full Cycle is the annualized return from October 2007 peak to present.



TFC client portfolios rose in absolute terms and relative to client benchmarks during the first quarter. U.S. small company value holdings were standouts during the quarter, contributing to absolute and relative returns. TFC's innovation and growth-oriented holdings, last year's biggest winners, generally trailed the market during the first quarter. TFC's bond holdings were slightly down for the quarter.

## Market Outlook

The quarter ended with the unveiling of President Joe Biden's infrastructure plan, fallout from the meltdown of the Archegos Capital family office, and continued debate about inflation expectations.

Some of the concerns dominating headlines to start the quarter are likely to fade while others may have greater impact. Concerns about mounting government debt, inflation, and rising interest rates dominate the headlines, but may influence markets more in future years than in 2021:

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- **Government Debt:** Despite the substantial rise in government debt, debt servicing costs as a percentage of GDP are far below the levels of 20 years ago. Worries about the impact of the \$1.9 trillion American Rescue Plan may be misplaced, as much of the spending is temporary and will not have a lasting impact on GDP growth, the output gap, or inflation. Most of the Biden Covid-relief plan is more aid than pure stimulus, as relief that keeps spending from declining more than would otherwise be the case. Only about \$500 billion of the American Rescue Plan should be thought of as pure stimulus, such as the \$1,400 stimulus checks and tax credits paid regardless of earned income. Biden's proposed infrastructure plan would have a longer-lasting impact on economic growth, interest rates and inflation, but the implications of the tax and spending elements of the plan will be uncertain until the hotly debated plan is brought to a vote later this year.
- **Inflation:** Inflation should rise because of year over year comparisons to pandemic-depressed levels as the economy reopens. Pent-up demand may also lead to temporary supply/demand imbalances. For example, flight demand may return before airlines can restore their operations to pre-pandemic levels. The Fed has clear plans to look through a temporary rise in inflation caused by transitory factors such as low base effects and temporary supply bottlenecks. Longer-term, it is likely that inflation will remain under control until the economy gets closer to full employment. According to Alpine Macro, if nonfarm payrolls persistently grow at 500K per month, it will take until late 2022 to return to the prior peak in employment. A return to the pre-pandemic trend of employment is not projected to occur until mid-2024.
- **Interest Rates:** Optimism about the economic recovery is the primary driver behind rising rates, which is "good" news. Although 10-year Treasury yields rose dramatically during the first quarter, yields remain below pre-pandemic levels. Higher interest rates represent good news for savers but are less favorable news for more speculative growth stocks. Bond yields could still rise from here, but the higher-risk collision between mounting government debt and the bond market is likely to be delayed until the Fed "tapers" its purchases of Treasury securities.

We have more concerns about the booming market for IPOs, popularity of "meme" stocks, rising margin balances, and rich valuations for unproven companies:

- **IPOs and SPACs:** According to Bloomberg, last year's dollar value of IPOs was the highest since 2007 and above the peak of the dot com boom. 80% of last year's IPOs had negative



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earnings, about the same percentage as was the case in 2000. A significant percentage of IPOs were of Special Purpose Acquisition Companies (SPACs), otherwise known as “blank check” companies. Many SPACs have yet to complete a deal and are trading below their offering price.

- **GameStop and “meme” investments:** The wild ride in GameStop and other “meme” stocks is fueled by social media, zero commission trading and derivatives. Since April 2020, GameStop has traded as high as \$483 and as low as \$2.83, dizzying volatility for a company that continues to lose money.
- **Leverage:** According to Alpine Macro, margin debt is at record levels as a percent of GDP. The demise of Archegos Capital shows the dangers of holding highly leveraged, concentrated positions and is a reminder that some forms of borrowing can be hidden from the view of regulators and counterparties.
- **Small Companies, High Valuations:** Historical data shows that paying a high multiple of price to sales produces inferior returns over long periods. More than 400 U.S. companies with market cap of more than \$250 million began the year trading at a valuation greater than 10 times sales. Companies with the combination of high valuations and profits that are not expected to materialize until far in the future may be the most vulnerable to rising interest rates.

Continued progress containing Covid-19 should provide a supportive environment for equities, amplified by monetary support from the Federal Reserve and abundant government spending. The segments of the market hardest-hit by the pandemic are likely to benefit from a gradual recovery to pre-pandemic levels of economic activity. The economic recovery and steepening yield curve should also help bank stocks. The “FAANGs” may be relatively vulnerable to a correction in 2021 after a spectacular 2020, but we think a collapse is unlikely given their strong market positions and cash flows. In contrast, although some of tomorrow’s big winners will be found among the large group of speculative and highly priced smaller companies, many will fail. Selectivity is important in the more speculative segments of the market, looking beyond themes and “memes” to identify companies with strong balance sheets, a proven product pipeline, and a viable path to profitability.

European stocks, which are more export-centric and cyclical than U.S. stocks, should benefit from economic reopening and from fiscal stimulus that will be more meaningful in the second half of 2021. However, the pace of economic reopening has been slowed by the well-chronicled shortcomings in the European Union’s approach to acquiring Covid vaccines. Although European manufacturing is rebounding strongly, consumption is lagging. We’re reasonably optimistic about the prospects for emerging markets stocks, but expect distinct winners and losers among emerging markets countries and companies. As is the case with small company stocks, we think selectivity in emerging markets is important, as there is no longer a “rising tide” that lifts the entire emerging markets asset class.

Short-term bond yields should continue to be restrained by central banks, while longer-term bond yields may continue to drift upward.

## Portfolio Positioning

TFC is positioned in line with long-term strategic targets for stocks, expecting a continued recovery for the global economy and for corporate profits. Diversification within the equity portfolio continues to be important because the rotational shifts we have seen in recent years are happening so quickly. Diversification must be emphasized not just across sectors, but also across market cap,



geographies, asset classes, and within asset classes. Just as important as diversifying is thoughtful rebalancing to trim back on areas that have outperformed and add to areas that underperform.

We are positioned cautiously within bond portfolios, with a core of short-term, high quality fixed income holdings that will provide safety and liquidity but unfortunately not a lot of coupon income in a low-rate environment. We expect the municipal bond market to further recover in 2021, and expect incremental income relative to government bonds from our corporate and mortgage-backed bond holdings.

We are optimistic that we will be able to see you in person at a later time in the year.

As always, we welcome your comments and questions.

Sincerely,

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Please do not hesitate to call us if you have any questions.

Notice dated March 23, 2021