Shearwater Creek Investment Matters

1st Quarter 2021 Market Update

From Absolute Fear to Speculation

<u>1st Quarter 2021 Review</u>:
On the heels of a larger than expected $1.9 trillion American Rescue Plan Act passed in March and an accelerated vaccine rollout, U.S. stocks posted solid gains in Q1 2021, pushing all major indexes to new record highs. As the third wave of the virus abated, many states began to reopen partially or even fully. As they did, hiring resumed, particularly in the hospitality and leisure industry. Monthly payrolls registered gains in January and February and weekly unemployment claims hit pandemic-era lows. Manufacturing and housing remained strong although severe winter weather and the near collapse of the Texas power grid in February slowed growth temporarily.

The economic rebound and lingering supply chain bottlenecks caused price pressures in some parts of the economy, but overall inflation data remained muted. February's Core Personal Consumption Expenditures Index (ex- food and energy) increased +1.4% year over year but is still well below the Federal Reserve's 2% inflation target. Both Fed Chair Jerome Powell and Treasury Secretary Janet Yellen testified before Congress that they saw little danger of an overheating economy. Some argued that inflation was more pronounced in asset prices.

In the U.S., the market rotation from tech and growth to value stocks that started late in 2020 continued with mid- and small-cap stocks outperforming large-cap and value stocks easily outpacing growth. The Russell 2000 lead all major U.S. equity indexes up +12.70% followed by Dow Jones Industrial Average (+8.29%,) Russell Midcap (+8.14%,) S&P 500 (+6.17%) and finally Nasdaq 100 (+2.78%.) Energy shares within the S&P 500 Index recorded an overall total return (including dividends) of nearly 31% as oil prices hit their highest levels in nearly two years. Conversely, consumer staples and information technology shares returned under 2%.

Separately, a “short squeeze” organized on social media led to rapid increases in some thinly traded shares in late January and briefly spurred volatility in the broader market. Money also flowed into special purpose acquisition companies (SPAC’s).

Meanwhile, global and international markets also posted gains in the first quarter as optimism about economic growth overcame uncertainty with renewed coronavirus-related lockdowns. The MSCI Europe index was up +4.21%. The European Central Bank (ECB) left its key interest rates unchanged and announced it will step up bond purchases. The ECB also raised its 2021 forecast for Eurozone economic growth to 4% from its 3.9% estimate in December. It also expects inflation to reach 1.5% up from 1% due to temporary supply disruptions and higher energy prices.

Chinese stocks posted a quarterly loss of -0.43% after peaking in mid-February. Volatile global markets and the rise in U.S. Treasury yields were among the headwinds that contributed to China’s declines. Shares of China’s online leaders fell amid heightened government scrutiny of the internet sector. Tech stocks came under renewed pressure at quarter-end when the Securities and Exchange Commission said it would implement a law passed by the Trump administration to delist U.S.-listed Chinese companies that do not comply with U.S. audit requirements.

Longer-term U.S. Treasury yields moved sharply higher in the quarter, with 10yr U.S. Treasury yields jumping from 0.93% to 1.74%. Additional fiscal and monetary stimulus fueled both hopes of improving economic growth and worries about potential inflation. High yield corporate bonds managed a modest positive return, thanks to favorable corporate earnings and higher coupons. Municipal bonds also proved relatively resilient as investors welcomed increased federal support for state and local finances.

2021 Market Outlook:

Repeating a theme we mentioned last quarter, the recovery in prices of virtually every asset class from a year ago has been swift and dramatic. We've transitioned from a period of absolute fear and uncertainty in March 2020 into a period now where speculation is widespread and valuations by many measures are historically high. In our view, we're not quite in a bubble, however valuations are expensive under all but the most optimistic scenarios. Current conditions can persist for a while, but sustained gains will be harder to identify.

Going forward, there are four key themes worth mentioning. First, we think the road ahead will be bumpy with frequent bouts of volatility as we continue to adjust to a new normal and as the economic recovery is priced into financial markets. The next phase of the rebound, when services reopen, employment grows, and overall activity improves, should benefit risk assets. However, we seem to be moving quickly from early-stage to late-stage asset behavior judging by the rise in inflation-sensitive assets such as cyclicals and commodities. Second, politics and the Biden administration's emerging priorities will remain in the spotlight especially with his infrastructure spending bill and how he intends to fund it. Third, investors need to be creative in the search for yield in this low rate environment. Rising demand, higher commodity prices, low inventories and wage pressures, among other factors, could push up inflation and inflation expectations sooner than the market expects. In addition, we expect more bouts of the market challenging the Federal Reserve (Fed) by driving real yields higher. Fourth, disruption caused by new technologies will continue, which in turn should create style dispersions, such as we've seen recently with stronger returns in value stocks, in particular.

This is a time to be careful, as there are clear signs of speculation in markets.

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Here's a performance recap of major market indexes for Q1 2021:

Equity Indexes:	Q1 2021
S&P 500	6.17%
Dow Jones Industrial Average	8.29%
Nasdaq Composite (Principal Return)	2.78%
Russell Midcap	8.14%
Russell 2000	12.70%
MSCI All Country World	4.68%
MSCI Europe	4.21%
MSCI Emerging Markets	2.34%
Bond Indexes:	
Bloomberg Barclays U.S. Aggregate	-3.37%
Bloomberg Barclays Global Aggregate Ex-USD	-5.29%
Credit Suisse High Yield	1.35%
J.P. Morgan Emerging Markets Bond Global	-4.74%

Note: Returns are for the periods ended March 31, 2021. The returns include dividends and interest income based on data supplied by third-party provider RIMES and compiled by T. Rowe Price, except for the Nasdaq Composite Index, whose return is principal only. Sources: Standard & Poor's, LSE Group, Bloomberg Barclays, MSCI, Credit Suisse, Dow Jones, and J.P. Morgan (see Additional Disclosures).

Sources: [1]Thomson Reuters. Past performance is no guarantee of future results. Yields may be lower or higher than quoted above. Yields fluctuate as market conditions change. An index is unmanaged and not available for direct investment. The indices are presented to provide you with an understanding of their historic long-term performance and are not presented to illustrate the performance of any security. Large Cap = S&P 500 Index (The S&P 500 index is weighted by market value, and its performance is thought to be representative of the stock market as a whole.), Mid-cap = Russell Midcap Index (The Russell Midcap Index measures performance of the 800 smallest companies (31% of total capitalization) in the Russell 1000 Index, with weighted average mark et capitalization of approximately $6.7 billion, median capitalization of $3.6 billion, and market capitalization of the largest company $13.7 billion.), Small-cap = Russell 2000 Index (The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index.), DM Ex-U.S. = MSCI EAFE Index (The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. & Canada.), Emerging Markets = MSCI EM Index (The MSCI Emerging Markets Index is an index created by Morgan Stanley Capital International (MSCI) designed to measure equity market performance in global emerging markets.), Bloomberg Barclays U.S. Aggregate Bond Index (The Bloomberg Barclays US Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type.), ICE U.S. Treasury 20+ Year Bond (The ICE U.S. Treasury 20+ Year Bond Index measures the performance of Treasury securities and is selected by a Market Value process.), Markit iBoxx USD Liquid High-Yield Bond Index (Consists of liquid USD high yield bonds, selected to provide a balanced representation of the broad USD high yield corporate bond universe. The index is used as a basis for tradable products, including ETFs.)

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