Smith Group
ASSET MANAGEMENT

MARKET PERSPECTIVES

MARCH 31, 2021

Equity Market Summary

U.S. Equity Markets	1Q	1 Year
S&P 500	6.2%	56.4%
Russell 1000 Growth	0.9%	62.7%
Russell 1000 Value	11.3%	56.1%
Russell 2000	12.7%	94.9%
Russell 2000 Growth	4.9%	90.2%
Russell 2000 Value	21.2%	97.1%

Top/Bottom Sectors	1Q	1 Year
Energy	30.9%	75.2%
Financials	16.0%	67.5%
Industrials	11.4%	69.6%
Utilities	2.8%	19.4%
Technology	2.0%	66.6%
Cons. Staples	1.2%	28.4%

Non-US Equity Markets (in USD)	1Q	1 Year
MSCI AC World Ex U.S.	3.5%	49.4%
MSCI EAFE (Developed)	3.5%	44.6%
MSCI Emerging Markets	2.3%	58.4%
MSCI China	0.0%	44.3%
MSCI France	4.4%	50.5%
MSCI Brazil	-9.8%	46.5%

Non-US Regions (in USD)	1Q	1 Year
Developed Americas	9.9%	57.5%
Developed Asia	2.6%	43.9%
Developed Europe	3.9%	45.1%
Emerging Americas	-5.2%	50.3%
Emerging Asia	2.4%	61.2%
Emerging EMEA	8.1%	54.0%

Market Review:

Positive manufacturing and homebuilding momentum in the U.S. are now being joined by better numbers in service industries as vaccination becomes more widespread, the public begins to venture out, and businesses move to reopen or expand capacity. Weather related disruptions in February created some noise in the data, but as the quarter closed timely data was pointing to rising economic activity. In the U.S. the Markit flash services business activity index rose to an 80-month high, and both the Michigan Consumer Sentiment index and Conference Board Consumer Confidence readings are the highest since the beginning of the pandemic. In addition, timely mobility measures like TSA screenings and restaurant reservations have spiked higher. In Europe, the Citi Economic Surprise Index (CESI) hit an all-time high and ended the quarter a whisker from the top, the German IFO Business Climate index rose to its highest level since 2018, and the Markit flash composite index in the U.K. rebounded sharply after two months of contraction. The economic engines are revving up with plenty of fuel from both fiscal and monetary stimulus.

The world quickly transitioned from pandemic recession worries to pondering if inflation will prove to be transitory. Given rising consumer demand, excess liquidity, supply chain bottlenecks, a commodity price boom, and a host of more costly inputs, the inflation debate is certainly justified. Too much demand chasing too little supply is a key inflationary ingredient and the fiscal stimulus pipeline is poised to worsen that imbalance. So far, the Fed has taken the position that the current spate of inflation is transitory and full employment is a much more important mandate focus. The argument is that the current imbalances will eventually even out. Stimulus checks are a one-time boost to spending power and supply chains will eventually catch up. Capacity utilization at 74% is still well below what we used to see as inflationary so there may be some validity in that argument. But the precipitous selloff in treasuries indicates bond buyers are taking the risk seriously.

Stocks have been broadly unfazed by the bond market's woes with the S&P 500 returning 6.2% and the Russell 2000 12.7% for the quarter. But there is considerable rotation taking place under the surface. Large cap growth stocks as measured by the Russell 1000 Growth index finished the quarter almost flat, while their Value index counterpart rose 11.3%. Most of this was somewhat a function of how different sectors were performing. Sectors heavy with growthy companies like Information Technology and Consumer Discretionary were the laggards during the quarter, while Energy and Financials were the standout performers. One could argue that the former two were taking a rest after stellar performances in 2020 and the latter were just catching up after negative returns last year, but rising interest rates almost certainly had an impact of valuations for long duration growth stocks. Industries leading the momentum tables are now construction materials, airlines, and banks. But even within sectors value factors outpaced growth factors by a wide margin. For the quarter the top sector neutral market factors are low forward P/E, low trailing P/E, and low P/B, while the worst is high sales growth. The reverse is true for most of 2020. Clearly, there is some rotation taking place.

Market Outlook:

There is little argument that the U.S. economy is headed for some eye-popping growth numbers in 2021. Dual fiscal and monetary stimulus has pumped an unprecedented amount of liquidity into the system. The last time fiscal stimulus was this large was during World War II and the Fed balance sheet has ballooned by 90% since the pandemic started. Banks have more deposits than they know what to do with and have taken reserves for bad loans that are looking less likely to be paid off by the day. There is talk of massive cash hoards in private equity looking for real estate investments. Some consumers are hurting, and their March stimulus checks will find its way into the economy quickly. Others have found a way to push the savings rate well into the double digits, which can support future demand as consumer confidence continues to build. So far only the tip of the iceberg of pent-up demand for foregone favorites is emerging. Improving business confidence is translating into strong capital goods

(Continued on page 2)

(Continued from page 1)

shipments. Hiring generally follows quickly thereafter and it will get an extra boost as hospitality jobs pick up. As restaurants are allowed to add capacity, managers are bemoaning the lack of experienced staff as many that were laid off have found other jobs outside the industry and are not coming back. Current estimates for real GDP growth are running around 6%, but positive momentum in the global economy makes the range of potential outcomes wide. That number could actually prove conservative.

Of course, there are still things that could dampen emerging animal spirits. COVID-19 could very well be persistent as new mutations develop. Some areas of the U.S. are seeing an increase in cases as businesses begin to open and the European experience has lagged that in the U.S. The pandemic story may continue to ebb and flow and the path toward normalization could prove meaningfully different than currently expected. Supply chain bottlenecks are also rising as a significant risk. Automobile and smartphone manufacturers have had to delay production due to semiconductor shortages. The plastics industry is scrambling for raw materials. The backlog at the ports of Long Beach and Los Angeles is the worst in 40 years with the ocean view from Palos Verdes turned into a container ship parking lot. Hopefully these issues prove temporary, but if they persist supply chain issues could be an impediment to the high rates of potential output.

Inflation, interest rates, and earnings growth are the three ingredients determining the trajectory of stock prices over the next couple of years. Over the past year we have often noted that when you discount growing earnings at a rate close to zero you come up with some astonishing valuations. But now with economic growth accelerating and the potential for rising rates that equation has some moving parts. The resulting tug of war between rising interest rates, fast economic growth, and possibility of surging earnings adds complexity to the calculation.

Earnings expectations are the bright spot for the market. Current consensus expectations are for S&P 500 earnings to be 26% higher in 2021 than in 2020, tacking on an additional 15% in 2022. And notably, those expectations have been consistently rising since July. Just in the last three months, 2021 expectations have risen more than 5% and the trajectory is still further upward. This is normal for earnings expectations when GDP growth accelerates during an economic recovery. Actual 2010 earnings (see Exhibit #1) were revised 16% higher from the low point of expectations after the 2009 recession and 10% higher than the consensus nadir when economic growth finally accelerated in 2004 after the 2000 recession. Given the explosive GDP growth potential it would not be out of the question to see earnings growth significantly higher than current estimates. While not always the case, high nominal GDP growth can translate into high revenue growth, leading to healthy earnings growth. Examples are 1993 (see Exhibit #2) where nominal GDP growth of 5.2% led to 29% earnings growth, 1994 where 6.3% GDP yielded an 18% earnings bump, and a 2004 GDP 6.6% expansion pushed earnings up 24%.

Exhibit #1

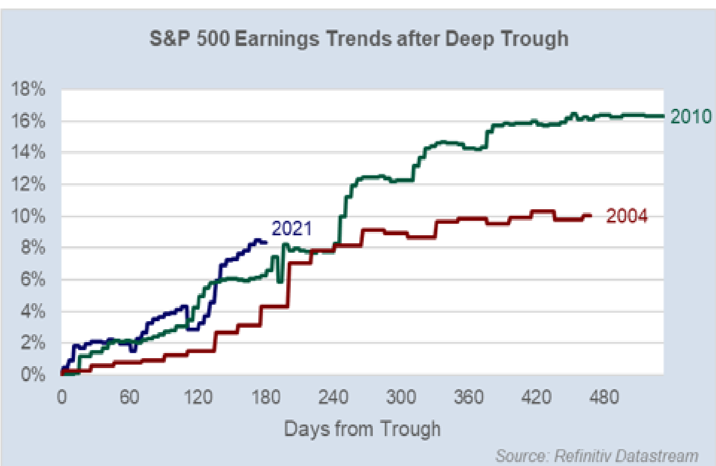


Exhibit #2: Earnings in high GDP growth years			
	GDP Growth		S&P 500 EPS Growth
	Nominal	Real	
1993	5.2	2.8	28.9
1994	6.3	4	18.0
1997	6.2	4.4	8.3
1999	6.3	4.8	16.7
2000	6.5	4.1	8.6
2004	6.6	3.8	23.8
2005	6.7	3.5	13.0
2006	6.0	2.9	14.7
2021	6+???	6+???	???

Of course, we would be remiss if we did not acknowledge the potential for a corporate tax increase in 2022 or the potential for a growth hiatus when stimulus eventually runs dry. But for now, earnings momentum is on the upside and serves as a tailwind for stock prices.

The counterbalance to explosive earnings growth is rising interest rates in response to the inflation scare that has justifiably gripped the bond market. In fact, the sharp escalation has produced a 20% drawdown, or a bear market, in 30-year Treasury bonds. The only historical incidence of this is 1994 when the Fed took their target rate from 3.0% to 5.5% and the whole yield curve shifted up in response. But S&P 500 earnings also grew 18% that year and the index traded in a range ending the year with a +1.3% total return. The differences with today are that the Fed was tightening in 1994, which shifted the whole curve up, while today the Fed is dovish and only the long end is rising. In 1994 M2 money supply growth slowed to 0.3%, while today it is in excess of 25%. The inflation scare is likely only getting started so interest rates are not apt to reverse any time soon and could easily still go a bit higher. While we expect this to be a drag on valuations, it is not clear that it would be enough to offset

(Continued on page 3)

(Continued from page 2)

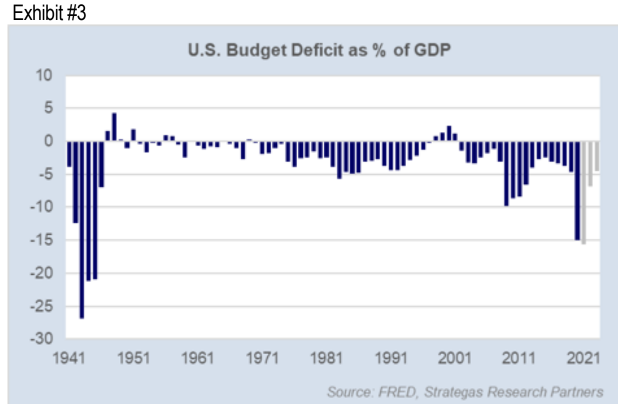
the tailwind of rising earnings expectations.

The extremes associated with the present economic cycle means there is not a deep data set from which to draw robust conclusions about outcomes, so we are mostly left with a few historical perspectives to gain some context. In addition to those previously mentioned a few others have been floating into conversations. One is the period during the Spanish Flu, January 1918 to June 1919, which saw the Dow Jones Industrial gradually rising 13% through October 1918, giving back about half that in the 4th quarter as the death rate peaked, then rallying to a gain of 43% for the full period. Of course, World War I ended about the same time the death rate peaked so an apples-to-apples comparison with the current pandemic is difficult.

Some hope the U.S. will repeat the "roaring 20s" when Gross National Income per capita grew at an annualized rate of 3.2% (that compares to 1.1% in the 2000's) and the Dow Jones Industrial average rose 441% from the trough in 1921 to the peak in 1929. After all they followed a similar pandemic. But the unfettered growth did not start for a full two years after the pandemic ended and the U.S. experienced a depression in the interim. Much of the economic growth was driven by mechanization of manufacturing and exceptional productivity growth. Average annual labor productivity grew by 5.4% and capital productivity by 4.2%. Labor productivity has improved over the last couple of years but is still running less than half that level so we would have to find much more labor savings. Yet the market boom was driven by speculation and manipulation, while being fueled by rising leverage. Margin requirements were 10-15% until they were raised in 1928 and the rising market was too much of a temptation for many investors to not take advantage of them. This period is interesting but probably not a great analogy for the current situation.

Others have suggested a look at the only other time where the fiscal stimulus has been close to that seen at present. That would be during World War II when the budget deficit went from -3% in 1940, to -14% in 1942, then -29% in 1943, and was still -21% thru 1945 (see Exhibit #3). There was a high level of coordination between fiscal and monetary policy. The Fed effectively pegged the entire yield curve to stabilize markets and reduce the cost of paying for the war, which led to a significant expansion of its balance sheet. The S&P 500 return between 1942 and 1945 by year was 20.1%, 25.6%, 19.5%, and 36.3%. Big budget deficits can create all kinds of woes down the road but the sugar high at the time was quite rewarding at least for stock investors in the early 1940's.

Exhibit #3



In the near-term, there will be a tug-of-war between growth, inflation, and interest rates. As people get vaccinated and new COVID-19 infections abate the range of possible financial outcomes has narrowed somewhat but is still wide. Explosive economic and earnings growth is possible but not pre-ordained. The debate between transitory or systemic inflation will rage on for the foreseeable future and interest rates will respond accordingly. We think that rates could go higher before they stabilize but would not bet the house on it. However, as seen in 1994 higher rates do not necessarily mean lower stock prices when earnings growth is still high.

In 2010 there was much handwringing about the end of a bull market that was just getting started. Today we have similar apprehension about the market. Worry at this stage of a recovery is quite common and logical. The landscape early in an economic expansion is rife with pitfalls that could undo it. While skepticism and caution are desirable investor traits, they sometimes can lead us to focus on near term issues at the expense of seeing the duration to reach the endgame. Measuring from the last peak in economic activity the current cycle is only five quarters old. The full term of economic expansions post World War II on average has lasted 26 quarters. Other than the Fed induced double dip in 1981 the shortest was 11 quarters, while the longest was 48 quarters. The Fed seems very committed to not creating a double dip in this expansion, and the bull market associated with it is probably still quite young. Valuations will adjust and leadership will rotate. The market may even take a breather. But barring another calamity the odds favor several more years of a positive trend before the next major bear market.