WAYPOINT ADVISORS

A CARY STREET PARTNERS COMPANY

Market Perspectives **First Quarter 2021**

Discretion is the Better Part of Valor

For the past 4 months, the increased pace of vaccinations has led the way for reopening of the US economy and a comeback for market sectors most hurt by the pandemic. In fact, market watchers have placed stocks into two categories: COVID-winners and COVID-losers. COVID-winners are primarily technology companies or companies that leverage technology to deliver their services (Amazon, Facebook, Netflix, Google, Zoom).[1] COVID-losers are companies that depend on human interaction (hotels, restaurants, cruise lines, airlines, commercial real estate). As we get closer to herd immunity and COVID restrictions are lifted, investors have started to look past the economic reopening. The easy money betting on recovery has largely been made, particularly in the US. There is still significant stimulus that has yet to flow through markets; however, determining the future winners and losers will become much more nuanced. Remember that markets typically recover ***before*** the economy.

Accelerating Economic Recovery

Economies all over the world are revving up and will be in overdrive for many months as countries reopen.[2] Trillions of dollars of monetary stimulus (central banks keeping rates low and buying bonds in the marketplace) continue to be a tailwind for economic recovery. Fed Chairman Powell, in a recent interview, indicated that the Fed will support the economy until it "has all but fully recovered."[3] Because one of the Fed's primary missions is to maximize employment, one can expect continued Fed monetary support until we see employment numbers back to pre-pandemic levels.

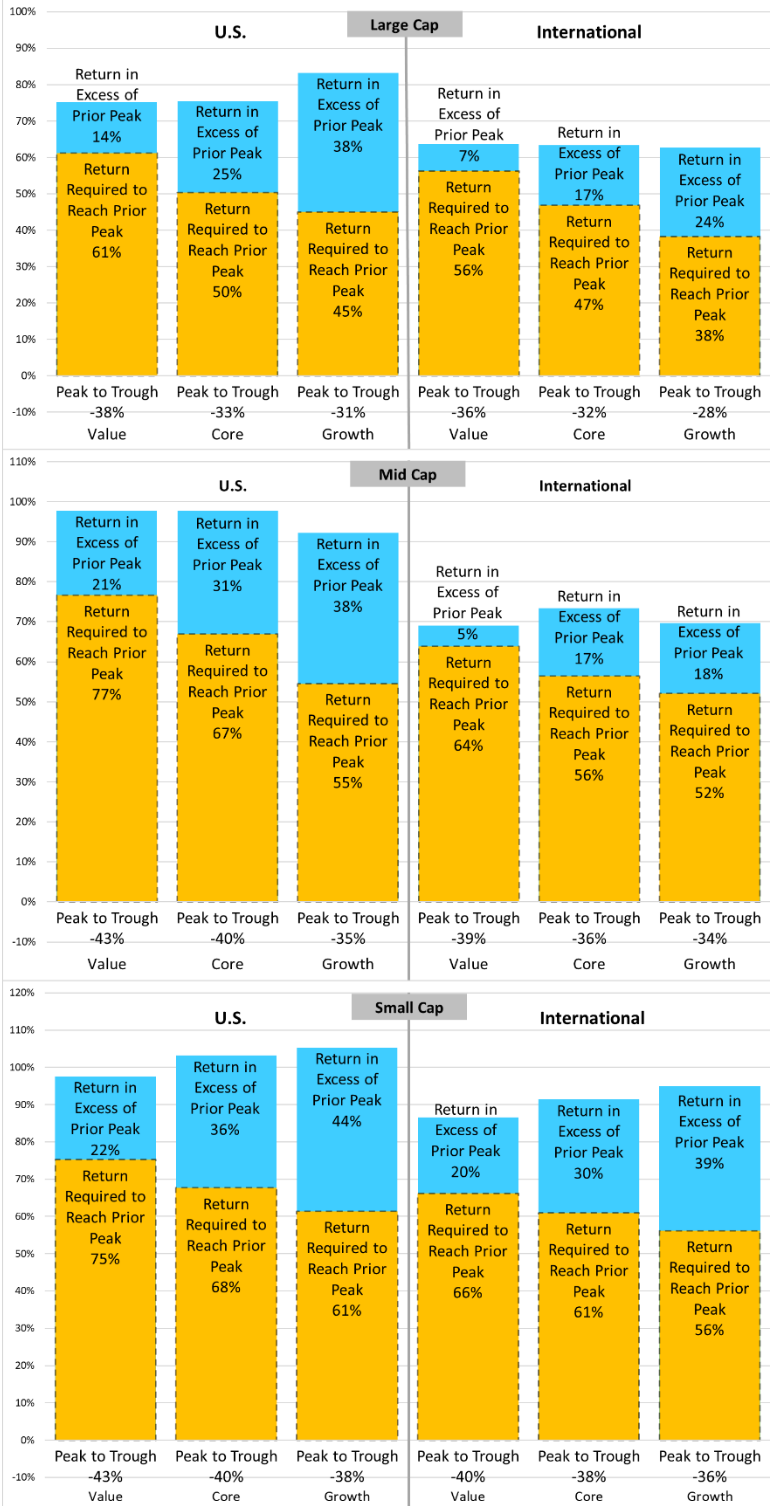
Global fiscal stimulus in the form of direct checks and tax relief has also helped avert a depression in Japan, Germany, Italy, and the US. It has sustained those who lost their jobs and businesses that had to curtail operations. Trillions of dollars have been spent in this effort.[4]

Monetary and fiscal stimuli in combination with the record setting speed of development, approval and distribution of the COVID-19 vaccines underpin the elevated economic growth statistics we expect to see for the remainder of 2021 and 2022.

All Broad Categories of Stocks Have Recovered – Some More Than Others

Markets responded with a dramatic rebound through Q1 2021. Growth stocks led the way from the bottom with US large cap returning 75%, international 65% and emerging markets 68% since their troughs in 2020.[5] However, this past

[1] CNN Business, 12/30/2020. https://www.cnn.com/2020/12/30/business/winners-losers-2020-business/index.html
[2] The IMF recently increased their estimate of global GDP growth to 6% for 2021. The Q2 US GDP growth is expected to be 9.5%. Unemployment in the US has been declining with the most recent survey indicating a 6% unemployment rate and job openings increasing 4.9% in February. Euro area unemployment has remained steady at 8.3%.2 Purchasing manager surveys are showing large increases, particularly in the manufacturing surveys. Source: JP Morgan Daily Economic Briefings 4/5-6/2021.
[3] National Public Radio interview, 3/25/2021. https://www.npr.org/2021/03/25/980868555/transcript-nprs-full-interview-with-fed-chairman-jerome-powell
[4] McKinsey & Company, https://www.mckinsey.com/featured-insights/coronavirus-leading-through-the-crisis/charting-the-path-to-the-next-normal/total-stimulus-for-the-covid-19-crisis-already-triple-that-for-the-entire-2008-09-recession
[5] Source: Morningstar, Waypoint Advisors. US large cap – Russell 1000 Total Return, international – MSCI ACWI ex USA Net Return, emerging markets – MSCI Emerging Markets Net Return.



[6] quarter saw a rotation into value oriented and small company stocks in the US with both categories seeing double digit returns while growth returns slowed. This rotation reflects investors' optimism about the current and anticipated economic recovery from the pandemic due to the speedy vaccination of people. The market's recovery has been so dramatic that inflation and concerns about valuations have become much-discussed topics. In spite of this, the Fed has indicated that it intends to keep interest rates low and will continue its bond purchasing program for many months to come.

The US recovery is a bit ahead because, with the exception of the UK, countries outside the US have been slower to vaccinate their populations due to limited supply of vaccine and questions about the side effects of the AstraZenenca vaccine. Consequently, international markets are recovering at a slower pace and have not yet seen as dramatic a rotation into value (cyclical) stocks as we have experienced in the US. Another point to make is that value stocks make up a larger percentage of total overseas equities.[7] International value stocks are also less expensive than their growth counterparts. This bodes well for higher equity returns in the future as international markets catch up.

The charts to the left illustrate the broad market recovery that has occurred. The gold areas indicate the percentage rise each category needed to return to its market peak before the pandemic. The blue areas indicate the excess return above the 2020 peak. Growth stocks lost less than value stocks on the downside, so had less to make up. Consequently, they have returned more on the upside. Looking deeper into the US large cap value category, energy and commercial REITs are the only two sectors of

[6] Source: Morningstar, Waypoint Advisors. US indices used: Large Cap Value – Russell 1000 Value, Large Cap Core – S&P 500, Large Cap Growth – Russell 1000 Growth, Mid Cap Value – Russell Mid Cap Value, Mid Cap Core – Russell Mid Cap, Mid Cap Growth – Russell Mid Cap Growth, Small Cap Value – Russell 2000 Value, Small Cap Core – Russell 2000, Small Cap Growth – Russell 2000 Growth. International indices used: Large Cap Value – MSCI ACWI ex USA Value, Large Cap Core – MSCI ACWI ex USA Large, Large Cap Growth – MSCI ACWI ex USA Growth, Mid Cap Value – MSCI ACWI ex USA Mid Value, Mid Cap Core – MSCI ACWI ex USA Mid, Mid Cap Growth – MSCI ACWI ex USA Mid Growth, Small Cap Value – MSCI ACWI ex USA Small Value, Small Cap Core – MSCI ACWI ex USA, Small Cap Growth – MSCI ACWI ex USA Small Growth. Total return for US indices, Net Return for International indices.

[7] 55% for Europe, Japan, EM versus 37% for the US Sources: Hartford Funds, Datastream, Refinitiv, and Schroders. Data from 1/31/01-12/31/20. Notes: cyclical = energy, industrials, materials, financials, real estate, and consumer discretionary.

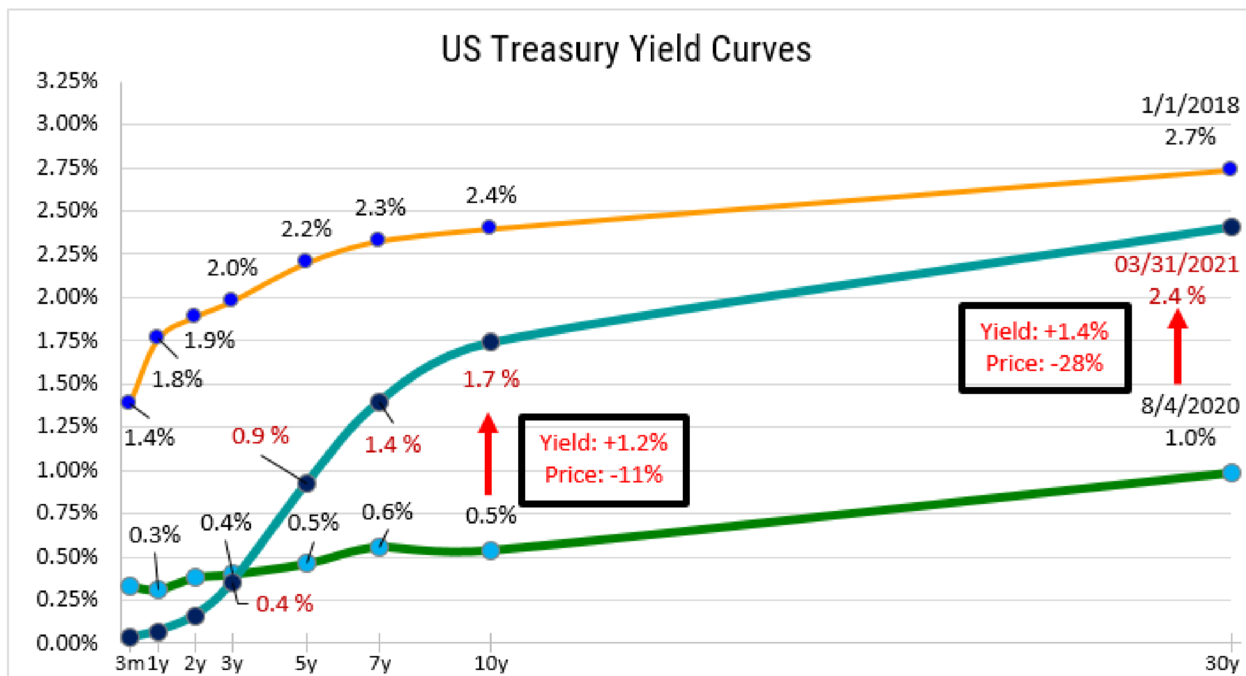
the US market yet to fully recover from their 2020 declines and there are questions about whether parts of these sectors ("dirty" energy and office space) will return to their previous levels at all.

Rising Rates on the Longer End – Good News, Bad News

Low interest rates have allowed governments to borrow the enormous amounts of money needed to blunt the effects of the pandemic. The US has increased its publicly held debt by approximately 28 trillion dollars[8] to a historically high level. This is not necessarily a problem if interest rates on the debt remains as low as they are currently, and the debt is paid down before rates get much higher.

The Fed controls short term rates, but fears of inflation and other market forces affect longer term rates, over which the Fed has less influence. In the illustration of the Treasury yield curve below, the gold line represents the yield curve on 1/1/2018 before COVID. The green line shows the yield curve at its lowest level on 8/4/2020 and the blue line is the current yield curve as of 3/31/2021. As you can see in the black boxes on the chart, the yield on the 10-year Treasury rose 1.2 percentage points to 1.7% causing the price to go down 11% from 8/4/2020 through quarter end. The 30-year Treasury yield rose 1.4 percentage points and its price declined a whopping 28%. Quality bonds were not a good place to invest during this time period. Treasuries and other bond categories have much ground to cover before getting back to normal.

Rising rates are generally good for banks because the difference between the rates that they lend at and at which they borrow increases, thus profitability increases. Higher rates also provide more income for retirees and others who need a source of income and count on regular distributions from their portfolios; however, the path to get to higher rates can be costly.



Source: Federal Reserve Bank of Saint Louis, Waypoint Advisors

The income from high quality bonds was minimal. In fact, the real yield (subtracting inflation) of the 10-year Treasury was negative for much of the first quarter.[9] Market expectations for interest rates can generally be characterized as

[8] Trading Economics, https://tradingeconomics.com/united-states/gdp; US Department of Treasury, https://www.treasurydirect.gov/govt/reports/pd/mspd/2021/opds022021.pdf, Waypoint Advisors.
[9] Source: Federal Reserve of St. Louis – Federal Reserve Economic Data, Series CPILFESL and WGS10YR, Waypoint Advisors.

“lower for longer,” a situation that has been forcing many investors into riskier parts of the bond market or even into high dividend stocks.

Equity Highs and Riskier Bonds

As the economy progresses further, the ability to ride the recovery wave that has buoyed markets to date is expected to fade. Bonds will continue to face the headwinds of rising rates, and it will no longer be good enough to count on the optimism of reopening economies to lift all stocks. The continued stimulus will likely support the high price of equities, but valuations will become more important and the risk of rising interest rates, central bank missteps, further waves of COVID variants, and geopolitical conflicts take on greater importance in deciding where to invest. A nuanced approach to investment selection is more important now.