# MARKET LETTER

## Pacific Portfolio Consulting, LLC

**First Quarter 2021**

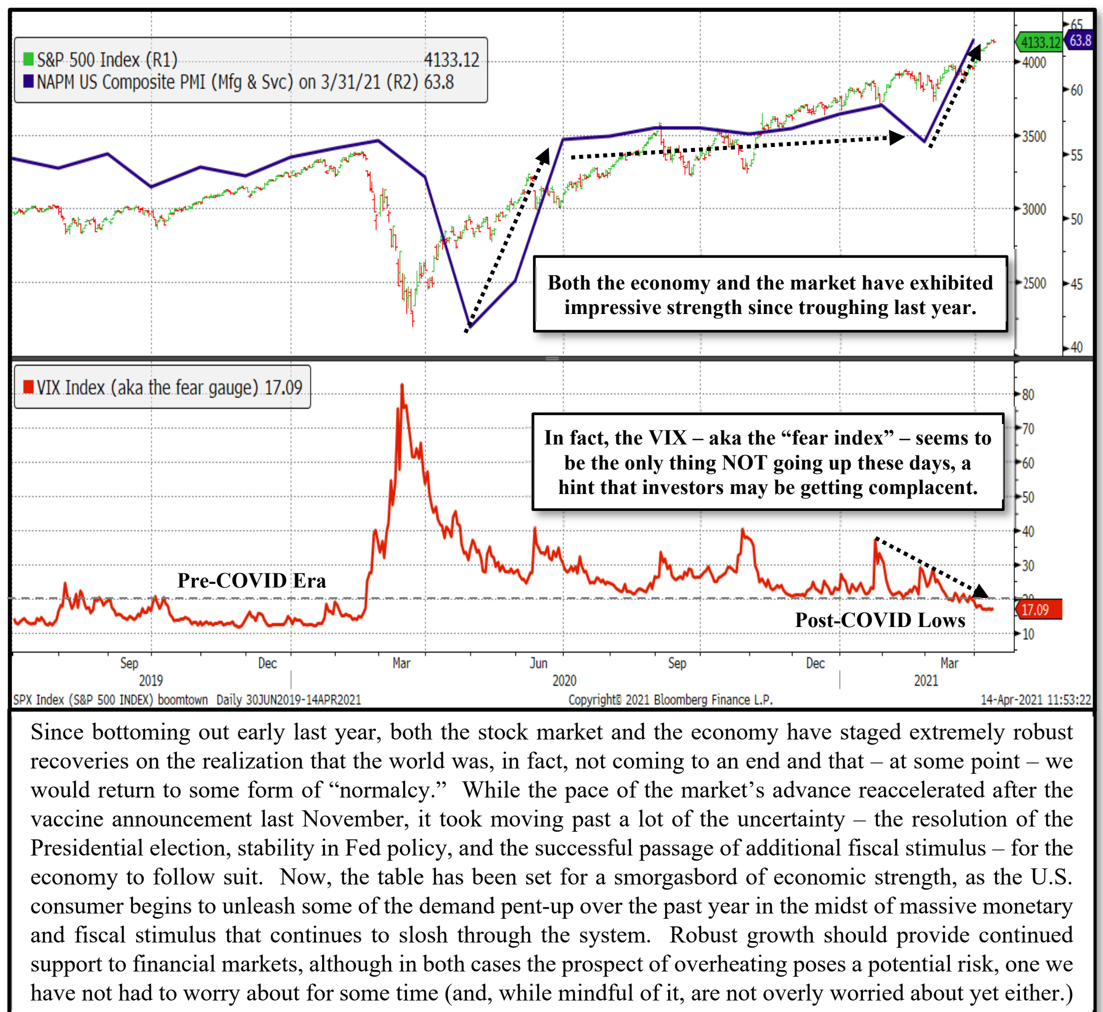
### Welcome to the Boomtown!

Let's be real: it has been a very, very long time since we have had to have this sort of conversation. There's really no other way to put it, though: things are straight up booming right now! The stock market is booming – nothing too terribly shocking there: in fact, if anything, we may all have become just a little bit too accustomed to that recently. The economy is booming, too, though, and *that*, well, that's something that has become much more of a rarity in recent times (read: decades).

As the pace of vaccination in the U.S. proceeds at the brisk pace it has exhibited in recent months, our economy appears poised for a return to "normal" much sooner than many had anticipated and, within the context of continued monetary accommodation and fiscal stimulus, the U.S. – and, to a lesser extent, global – economy finds itself on a trajectory of solidly above-average economic growth for at least the next several quarters.

On the one hand, this looks to be very good news for return-seeking assets (although not necessarily the same ones you've become accustomed to cheering for over the past year – more on that later). On the other hand, it's good to remember that the market is a forward-looking, discounting mechanism and, thus, at least some of the good news emerging on the economic front has already been factored into its thinking. Meanwhile, although – as we'll discuss more herein – the set of risks we are now facing is one very different than we have had to worry about over the past year, risks remain. As such, it's important to stick to your long-term game plan even during what is shaping up to be a favorable year, particularly for well-diversified investors.

**Chart 1: Here Comes the Boom**




Since bottoming out early last year, both the stock market and the economy have staged extremely robust recoveries on the realization that the world was, in fact, not coming to an end and that – at some point – we would return to some form of "normalcy." While the pace of the market's advance reaccelerated after the vaccine announcement last November, it took moving past a lot of the uncertainty – the resolution of the Presidential election, stability in Fed policy, and the successful passage of additional fiscal stimulus – for the economy to follow suit. Now, the table has been set for a smorgasbord of economic strength, as the U.S. consumer begins to unleash some of the demand pent-up over the past year in the midst of massive monetary and fiscal stimulus that continues to slosh through the system. Robust growth should provide continued support to financial markets, although in both cases the prospect of overheating poses a potential risk, one we have not had to worry about for some time (and, while mindful of it, are not overly worried about yet either.)

### "I Feel the Urge…the Urge to Surge!!"

Ok, that's not how the line goes, I get it. Still, sometimes you need to be able to take a little bit of poetic license with the title in order to make it fit the situation – and, believe me, this version definitely fits better than the original, for Q1

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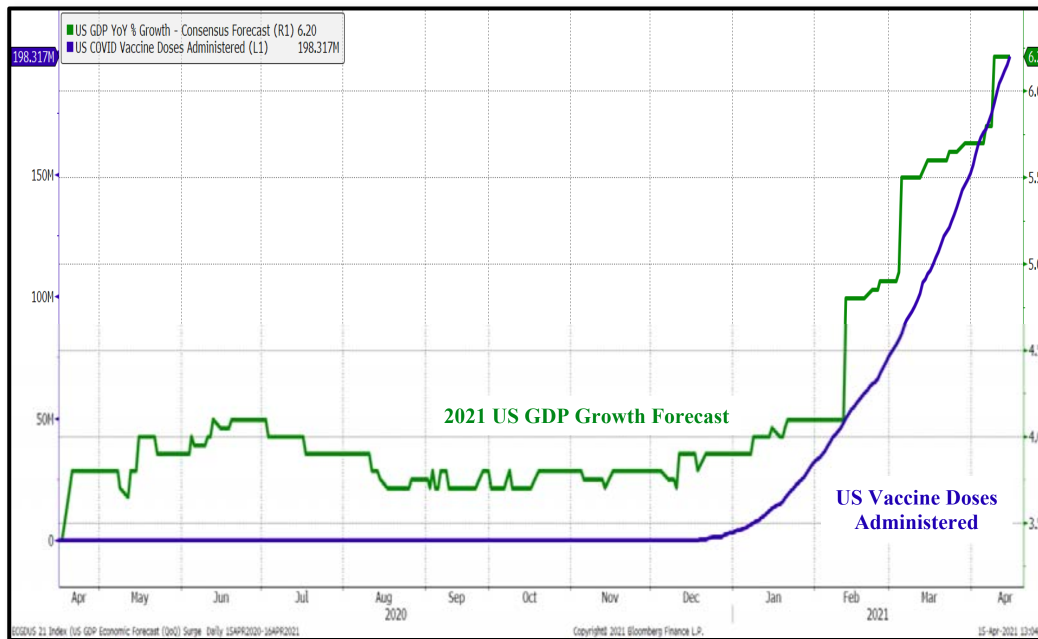
was a quarter of surges pretty much as far as the eye could see. Real-time surveys of economic activity – which had already rebounded dramatically over the quarters following the early-2020 recession – spiked sharply higher during the 1st quarter, the Institute for Supply Management's Manufacturing PMI index reaching its highest level since the early 1980s, while the Services PMI hit an all-time high for its 24-year history. At the same time, forward expectations for U.S. economic growth have also ramped up significantly, with Wall Street's consensus for 2021 rising from roughly +4% GDP growth in January to currently just north of +6% (another level not seen since the early 1980s). While the forecast of our own Investment Committee at the start of the year (just shy of +4.5%) was – at the time – more ambitious than the herd based on our favorable outlook, it has begun to look extremely conservative in the current environment.

**Chart 2: U.S. Economy "Going Mach 2 With Its Hair on Fire"**




It's really not a coincidence that the two lines in the graph above have been moving together: it's very clear – and, in our opinion, quite appropriate – that expectations for growth in the U.S. economy are now directly tied to the pace of vaccination and, thereby, how soon we can all go back out and start making up for lost time with the willy-nilly (once again, apologies for using industry jargon) consumption of goods and services. The U.S. vaccination process continues to make great strides – in fact, doing considerably better than much of the rest of the world – and as we get closer to reaching herd immunity, bringing us closer to a full-fledged reopening of the economy, the prospect of a literal surge in business and consumer activity inches closer to fruition (Try googling the term "revenge travel" to see my point!)

So, what is driving this surge in economic activity anyway? Well, very much in keeping with this section's theme, it is, in fact, the surges that are taking place in other areas. Like the COVID vaccination process, for example, where – assuming 2 doses per person – we have gone from vaccinating roughly 1 million Americans per week at the start of the year to a pace as I write this of roughly 10 million per week. Or how about the surge in fiscal stimulus? We had already gotten a good dose (no pun intended, seriously!) of that last year and our message has been pretty consistent since that time: expect a lot more. While it may have taken longer than many would have liked, thus far in 2021 we have seen passage of a roughly $2 trillion stimulus package, much of which was deliberately targeted at segments of the population and economy where the propensity to spend is greater (to increase the likelihood that such funds will be recycled into the economy instead of being put into savings). Already, we have a cumulative U.S. fiscal response to the COVID pandemic in excess of $5 trillion, roughly one-quarter of total U.S. GDP and three times the total stimulus delivered following the Great Recession – and that's before we even pass the massive long-term infrastructure package currently kicking around Capitol Hill! Meanwhile, the doubled-barreled boost provided by this powerful combination of vaccine and stimulus has, quite naturally, begun to produce a surge in consumer confidence and expectations, which – after having plummeted as the COVID pandemic took hold – previously had remained rather stubbornly depressed under the near-constant drear and dread of a year of social distancing and working from home.

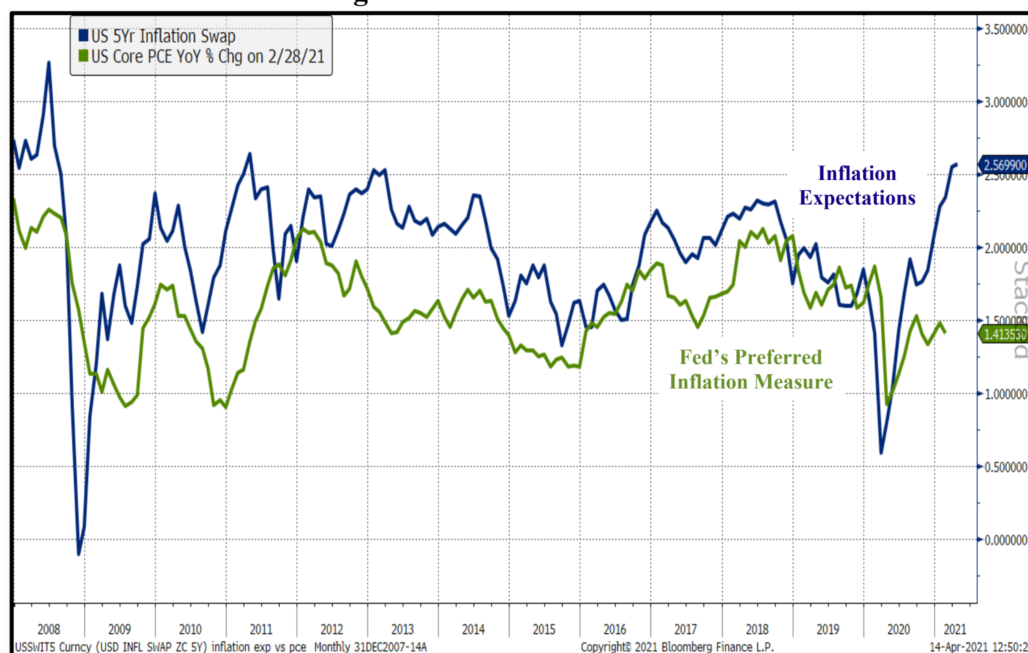
Make no mistake: we like making bold calls and we enjoy prognosticating as much as the next finance geek, but there is really no limb for us to go out on here: the U.S. economy is set to go gangbusters (a highly technical term some of you may have already encountered in these pages in the past, although conditions generally only give me the chance to use it once a decade or so). As such, the stage clearly has been set for the production of a play very different than that which has been running during most of the pandemic; it is also, however, a stark change in scenery relative to the pre-COVID economic expansion as well. Since the end of the recent recession, the economy has been experiencing a very natural snap-back, albeit one still limited by some pretty onerous contact restrictions, effectively operating with one hand tied behind its back. Now, we are getting to the point where the economic engine is just about ready to begin

"firing on all cylinders". To push my luck with this latest analogy just a little bit further, think of the ongoing fiscal stimulus as Nitrous and, to make things fun, let's cast the Federal Reserve as the local sheriff, who has deliberately pointed his radar gun in the other direction. In other words, the economy is going to be running hot and no one – least of all the Fed – is going to even try to stop it.

## Hold the Line

This is, quite frankly, an unusual spot in which to find ourselves and yet the Fed has made one thing – and one thing only – abundantly clear and that is that it is not worried about inflation. Mind you, the Fed did NOT say it doesn't expect higher inflation, just that it is not worried about it. In fact, we have little doubt (as in none) that we are poised for higher inflation near-term: the base effect alone of lapping the extraordinarily weak inflation readings notched in the depths of the recession last year make a pop in the year-over-year comparison all but inevitable in the months to come. That, however, is the very definition of "transitory." Nonetheless, once you begin to factor in the economic "juice" we discussed earlier, it is not terribly difficult to build a case for inflation moving to "historically high" levels (which is still not saying very much) on a more sustained basis as the expansion continues to heat up. At this time, however, we are looking for more of an inflation "scare" than a "problem" and certainly do not foresee any kind of "runaway inflation" scenario, whereby an extended period of well above-trend inflation would cause the market's inflation expectations to become unanchored from their long-standing level (not surprisingly, right around the "magical" 2% level) and begin to fuel a vicious cycle.

**Chart 3: Is the Fed Putting Out Fires…With Gasoline?!**



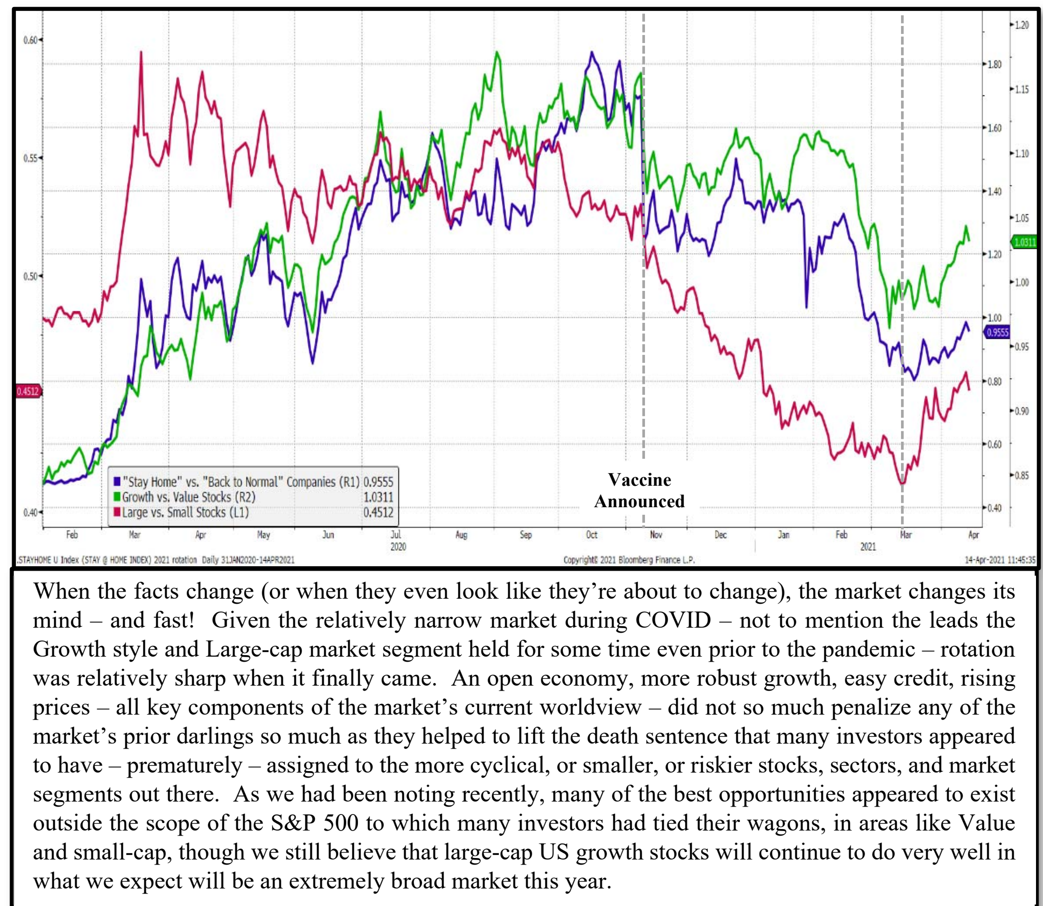

Speaking of surges, we would have been remiss had we failed to mention the recent surge in inflation expectations, if not in inflation itself. A backdrop of stimulus-enhanced economic growth and a Fed pledging to sit on its hands went a good way towards spooking the bond market this past quarter, sending inflation expectations sharply higher (something the Fed would no doubt take as a "win"). Longer-term interest rates rose substantially as well this period, essentially a bond market bet that the Fed will have to tap the brakes sooner than it expects. There's an old Wall Street expression that "The bond market is always right"; there's another, though, that says "Don't fight the Fed". Just like Thunderdome, two truisms will enter the arena, only one will leave. For now, our money is on the Fed.

Thus, we believe the Fed will, indeed, look to hold the line on policy and not only tolerate but, in fact, actually welcome higher inflation, as – at long last – it finally begins to implement formally the long-anticipated policy shift to targeting 2% inflation "on average" rather than treating it as a line in the sand. This will also allow Fed policymakers to lean harder on the unemployment rate, not only to put millions back to work but – if their plan is successful – also to create some wage inflation along the way in an effort to share more broadly the benefits of the current economic prosperity. Within the context of an economy that, as we have often noted, has rarely so much as touched the 2% inflation level in the past dozen years, they look to have considerable runway before their feet come anywhere near the proverbial fire, leading to our expectation that – while it will no doubt at least try to bring up the topic of tapering its quantitative easing program as we move post-reopening – the Fed is unlikely to attempt to move its policy interest rate off the zero-bound anytime before late next year at the very earliest.

## Blink and You Might…Wait, Never Mind…

Yes, I'm afraid it's true – at least in the strictest sense: a good portion – certainly the "easy money" – of the "reopening trade" is already behind us. Well, what did you expect? As we mentioned in the intro, the market is a forward-looking

**Chart 4: Investors Change Up Their Kool-Aid**




When the facts change (or when they even look like they're about to change), the market changes its mind – and fast! Given the relatively narrow market during COVID – not to mention the leads the Growth style and Large-cap market segment held for some time even prior to the pandemic – rotation was relatively sharp when it finally came. An open economy, more robust growth, easy credit, rising prices – all key components of the market's current worldview – did not so much penalize any of the market's prior darlings so much as they helped to lift the death sentence that many investors appeared to have – prematurely – assigned to the more cyclical, or smaller, or riskier stocks, sectors, and market segments out there. As we had been noting recently, many of the best opportunities appeared to exist outside the scope of the S&P 500 to which many investors had tied their wagons, in areas like Value and small-cap, though we still believe that large-cap US growth stocks will continue to do very well in what we expect will be an extremely broad market this year.

mechanism and it did not take much for it to extrapolate on the current vaccination trajectory and figure out that the clouds would soon be parting over beaten down sectors like travel, leisure, and retail at the same time that the champions of the "work-for-home" regime hit a major air pocket. The market flipped its paradigm virtually overnight and Zoom was suddenly down nearly 50% – despite still trading at more than triple its pre-COVID levels – and stocks like American Airlines and Carnival Cruise Lines had more than doubled (in spite of which they have yet to even regain their pre-pandemic levels.)

As you would expect, the forces that drove such dramatic reversals also impacted the broader global capital market – pretty much every corner of it, in fact – even if the effects were not quite as dramatic (although some certainly came close).

Broadly speaking, stocks have done extremely well in these conditions. That's not all that surprising, since stocks are generally viewed as reasonably good insulators against the effects of inflation, not to mention the fact that stronger economic growth is expected to drive further strength in corporate earnings. Oh, and, of course, the other thing stocks had going for them this period: the fact that they're not bonds. Although tensions in the bond market had begun to subside as the 2$^{nd}$ quarter began, U.S. interest rates actually closed out Q1 at their highest level since the onset of the pandemic, notching their fastest quarterly increase since – say it with me – the early 1980s. We've been over this a number of times in the past but, to give you a refresher, interest rates and bond prices move in opposite directions; as a result, when bond market investors sent intermediate- and long-term interest rates higher, betting that inflation would force the Fed to raise its policy rate sooner rather than later, a majority of bond market segments were dragged into the red this period. The broad investment grade benchmark, the Bloomberg Barclays Intermediate U.S. Government/Credit index, was down -1.9% over the first three months of the year, while its somewhat longer duration – and, thus, more interest rate-sensitive – sibling, the Bloomberg Barclays U.S. Aggregate Bond index, was down -3.4%. Only those sectors with greater credit-sensitivity – things like leveraged loans and high yield corporate and municipal bonds, which tend to be more sensitive to economic growth prospects – managed to eke out gains this quarter.

Taking a more detailed look at the equity market, meanwhile, relatively broad-based strength was evident for most of the quarter, though there were some meaningful crosscurrents to be seen below the surface. The broad market – for which we are using the S&P 500 index of large, U.S. companies as a proxy – gained roughly +6% for the quarter – a very respectable showing, but not necessarily anything to write home about; if, however, we take even a very slightly longer-term view and consider the trailing twelve-month period, we can see that – coming on the heels of several very impressive quarters following the bear market trough last year – the market gained a very impressive +56% over the past year, one of its very best showings in the past sixty years.

For the past quarter, though, the S&P just wasn't where the action was; reflecting investors' renewed willingness to embrace cyclicality and risk, small-cap U.S. stocks delivered double the return of the S&P; value stocks, nearly double. So, if you double your pleasure and combine the two factors together, you get small-cap value stocks returning over

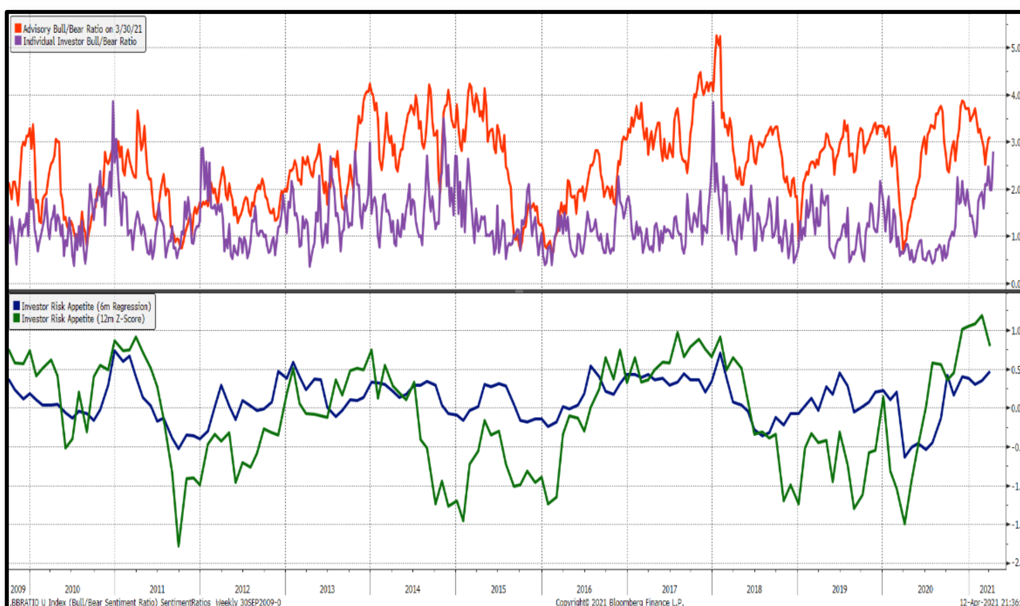
21% in Q1 alone; while these waters may have been muddied somewhat by the retail investor “tea party” that hatched from a Reddit chatroom in late January – a matter we wish we could have been able to skip over, but which has gotten too much attention and, quite frankly, simply refused to go away quietly – it was very clear, nonetheless, that a massive rotation in style, market capitalization, and economic sector was underway.

Similar forces were working their way through non-U.S. equity markets as well, particularly the resurgence in value stocks, driving the MSCI EAFE Value index to outperform its Growth counterpart by a wide +8% margin for the quarter. The tailwind for foreign small-cap stocks, meanwhile, was distinctly less pronounced than in the U.S. this quarter. Similarly, emerging market stocks eked out a fairly modest gain in Q1, underperforming our expectations considerably in the short-run, as the Chinese market – which makes up nearly 40% of the MSCI EM index – felt the weight of the Chinese government’s crackdown on its domestic internet companies. Meanwhile, from the perspective of a U.S. investor – which we, of course, are – returns on foreign stocks in general were considerably less attractive than those earned on U.S. stocks in large part due to the sharp rise in the U.S. Dollar during the quarter, a by-product of the rising differential between U.S. interest rates and those of other major economies (although almost all of this gain has now been given back over the first couple of weeks of April, as interest rates have receded).

### We’re On The Road to ~~Nowhere~~ NORMAL!

Look, I loved the ‘80s but I’ll admit that I wasn’t all that focused on the economy or the market at the time. Certainly, there were good times – and, of course, I’m referring mostly to the economy and markets here – but let’s not overlook the fact that the decade also had its fair share of hair on it at times. So, as the comparisons between our current economic resurgence and the conditions that prevailed in the early 1980’s continue to pile up, we would be foolish not to at least consider the lessons learned during that period as we are assessing – and we always are – the potential risks and opportunities currently on the horizon.

**Chart 5: FOMO is a Real…Oh, Wait – We Can’t Say That**




Sentiment isn’t exactly on fire, but it certainly has been heating up, with investors not only talking the bullish talk, but backing those words up with their portfolio positioning. Many investors seem to be exorcising their “fear of missing out” by reaching for more than even a robust equity market advance can offer them. This has continued to produce pockets of excess, leading certain of the more speculative assets to extraordinary gains within a very short period of time (as you consider buying Bitcoin, though, note that – and we provide this merely as a cautionary example – those SPACs we warned about last quarter have dropped about 24% in the past month). None of this invalidates the favorable backdrop for return-seeking assets, but it does speak to the potential for cooling off periods, either for the market as a whole or, at the very least, for those specific sectors or securities that get ahead of themselves along the way. We believe it also speaks to the benefit of retaining diversified exposure to the entire range of styles and asset classes – which recently helped ensure representation to all of the areas benefitting the most from last quarter’s rotation – to eliminate the risk of having put all of a portfolio’s eggs in one basket (no matter how nice a basket it may appear to be).

Thus, while we view the current rising strength of the U.S. (and, eventually, global) economy in a very favorable light, we will, nonetheless, need to remain mindful of signs that it may be beginning to overheat. This is not something we believe investors need be overly worried about in the short run, and certainly not to the degree to which the bond market has been wringing its hands lately. As the expansion continues to gain steam, however, and is initially left unchecked by a Fed policy hellbent on stoking some inflation, the possibility of an economic “melt-up” is something we will need to leave on the table moving forward.

Meanwhile, when we consider the lag with which monetary policy typically has an impact (interest rate increases have been estimated to

have a delay of up to 18 months before their effects are felt on the economy), there is inevitably the possibility that when the Fed likes what it sees on the employment front enough to finally make its move, it may end up being later to the party than it realizes. This could ultimately require the Fed to move more aggressively than it would have liked, leading to a greater risk of it accidentally choking off economic growth and pushing us into another recession; again, something to keep in mind going forward, but we are obviously nowhere near that point yet.

In the meantime, the backdrop for equity markets continues to look quite favorable on a number of fronts. We would use this space as a final reminder – for this month's missive, anyway – that the market mechanism discounts future good news into current prices and to point out that the second derivative – the pace at which things are getting better – must at some point taper off (for example, the recent pace of fiscal stimulus can't go on forever, let alone keep increasing); this means that the market will eventually need to be content with plain old "good" rather than "getting better." With that being said, however, for the time being things are still getting better: corporate earnings growth remains impressive, with expectations for further gains as the economy continues to pick up steam. This will be critical to gradually alleviating what are – particularly in certain areas – somewhat lofty valuations, though it will probably take the next couple of years of growth to do so. Meanwhile, the breadth of the market has also been getting quite a bit better, thanks in no small part to the recent rotation, which has expanded the scope of the market's advance, both in terms of economic sectors and individual stocks, to its broadest reach since 2009, taking the pressure off the narrow handful of companies that were previously supporting the full weight of the bull market. This should continue to provide greater benefits to diversified investors holding positions across a broad spectrum of styles, regions, and market capitalizations, all of which we expect to continue to do well in the environment we envision going forward.

This expanded breadth has already begun to pay dividends, helping the market to ride out with only minor flinching a quarter that saw both interest rates and the U.S. Dollar soar, not to mention the failure and liquidation of a major hedge fund. In fact, pretty no matter what got thrown at investors this past quarter, stocks went up, as did fund flows into equity-related vehicles. There is little room to dispute that investors' fascination with financial assets of all sorts has been on the rise, both in some healthy and unhealthy ways. This will continue to bear monitoring, if nothing else speaking to the greater possibility of a correction or, at the very least, a period of consolidation.

As a result, despite recent pressures on the bond market, we continue to believe we will find opportunities to be grateful to be holding a sleeve of such assets in diversified portfolios with anything less than a cast-iron stomach for volatility. We take further comfort from accessing much of this exposure via the talented active fixed income managers we employ, given the massive inefficiency that exists within the bond market, where only half of the bonds in existence are in any fixed income index whatsoever. For the other times, however, we see much potential for our Alternatives allocation to carry its weight this year, as these – very deliberately – target lower volatility than stocks but are able to avoid the interest rate risk inherent in bonds (not to mention as commodities continue to react favorably to any further inflation fears).

While our Investment Committee implemented early this year modest tilts in favor of areas like small-cap and value stocks that have worked well thus far, providing a slight bias towards those areas of the market the Committee viewed as most likely to benefit from the conditions we forecast for this year – these were made within the context of our continued advocacy for use of a disciplined and patient approach to the long-term, strategic investment process. As always, we look forward to communicating with you further regarding our views and outlook and, of course, I invite you to reach out to your advisor or me to address any questions or concerns you may have.

-Jim Ayres, CIO

## 1ST QUARTER 2021 CAPITAL MARKET PERFORMANCE

| *Index (as of 3/31/2021)*[1] | 1 Qtr | 1 Year | 3 Year | 5 Year | 10 Years |
|---|---|---|---|---|---|
| FTSE 3-month T-Bills | 0.02% | 0.21% | 1.45% | 1.15% | 0.60% |
| Bloomberg Barclays Gov't/Credit Int. | -1.86% | 2.01% | 4.36% | 2.75% | 2.88% |
| ICE BofAML US High Yield | 0.81% | 23.15% | 6.51% | 7.90% | 6.30% |
| Bloomberg Barclays Multiverse | -4.34% | 5.46% | 2.85% | 2.88% | 2.39% |
| S&P 500 | 6.17% | 56.35% | 16.78% | 16.29% | 13.91% |
| Russell 1000 Value | 11.26% | 56.09% | 10.96% | 11.74% | 10.99% |
| Russell 1000 Growth | 0.94% | 62.74% | 22.80% | 21.05% | 16.63% |
| Russell Mid Cap | 8.14% | 73.64% | 14.73% | 14.67% | 12.47% |
| Russell 2000 | 12.70% | 94.85% | 14.76% | 16.35% | 11.68% |
| Russell 2000 Value | 21.17% | 97.05% | 11.57% | 13.56% | 10.06% |
| Russell 2000 Growth | 4.88% | 90.20% | 17.16% | 18.61% | 13.02% |
| MSCI EAFE | 3.60% | 45.15% | 6.54% | 9.37% | 6.02% |
| MSCI EAFE Small Cap | 4.59% | 62.54% | 6.72% | 10.91% | 8.39% |
| MSCI Emerging Markets | 2.34% | 58.92% | 6.87% | 12.48% | 4.02% |
| MSCI Frontier Markets | 0.85% | 39.61% | -1.12% | 6.93% | 4.29% |
| Wilshire US REIT | 8.81% | 34.74% | 9.04% | 4.96% | 8.48% |
| DJ Global Select RESI | 6.57% | 35.66% | 5.21% | 3.60% | 6.57% |
| Bloomberg Commodity Index | 6.92% | 35.04% | -0.20% | 2.31% | -6.28% |
| Credit Suisse Liquid Alts | 5.04% | 25.73% | 7.47% | 6.08% | 4.01% |
| 60-40 Balanced EQ/FI – US Only | 2.93% | 32.39% | 12.11% | 10.99% | 9.62% |
| 60-40 Balanced EQ/FI – Global | 2.04% | 31.80% | 9.69% | 9.54% | 7.20% |

[1] The Bloomberg Barclays U.S. Government Credit Intermediate and Multiverse indices are registered service marks of Bloomberg Finance LP. Barclays is a service mark of Barclays Bank Plc, used under license; the ICE BofAML US High Yield index is a registered service mark of Intercontinental Exchange; BofAML is a service mark of BofA Merrill Lynch, used under license; the S&P 500 Index is a registered trademark of the McGraw-Hill Companies, Inc.; the Russell 1000, Russell 1000 Value, Russell 1000 Growth, Russell Mid Cap, Russell 2000, Russell 2000 Value, and Russell 2000 Growth indices are registered trademarks of the Frank Russell Company; the MSCI EAFE and MSCI Emerging Markets indices are registered trademarks of MSCI or its subsidiaries; the Wilshire REIT index is a registered trademark of Wilshire Associates Incorporated; the DJ global Select RESI index is a registered trademark of Dow Jones Trademark Holdings LLC; the Bloomberg Commodity Index is a service mark of Bloomberg Finance L.P.; the Credit Suisse Liquid Alternative index is a trademark of Credit Suisse Group AG.