

Investment Review & Outlook

April 2021

Review

The first quarter 2021 is the kick-off of the “return to normal.” Rising supply of vaccines along with massive increases in both fiscal and monetary stimulus are beginning to have a positive impact on the global economy. Pent-up demand and stimulus checks, coupled with a relatively high savings rate will be unleashed as more people return to work and school.

	FY 2021	FY 2022	1Q:21	2Q21	3Q21	4Q21
United States	6.3	4.0	5.0	9.5	8.3	3.0
Canada	6.2	4.1	5.0	4.0	7.5	5.5
Japan	4.2	2.4	-1.0	6.0	5.0	3.0
China	9.5	5.6	6.0	5.0	5.5	5.7
Euro Area	5.1	5.0	-1.0	6.0	14.0	5.5
United Kingdom	7.3	6.3	-9.4	22.1	19.3	6.7

Source: JP Morgan, Global Data Watch, April 1, 2021

The anticipated rebound is a bit uneven in the first quarter numbers but is expected to even out as the full year progresses.

The Federal Reserve believes the impact on the rate of inflation will be transitory as opposed to sustained. Inflation is not yet a material concern but markets are beginning to anticipate it could be a problem going forward.

Inflation Expectations



We anticipate a huge rebound in S&P 500 earnings in coming quarters, which we expect will get us back to the prior peak (4Q:19) around mid-summer 2021. Earnings growth will reflect the rebound in economic growth, but at the same time the equity market Price/ Earnings ratio will likely shrink from a recent high near 40 times earnings to a more reasonable 24 times earnings by year-end 2022 as a function of rising longer-term interest rates.

Global Markets

All sectors of the S&P 500 had positive results in the first quarter 2021. Cyclical shares in the form of energy and financials offered the best results. Technology shares, in a significant reversal, lagged the broad market along with the interest rate sensitive utilities sector.

While short-term interest rates were little changed, the 10-year Treasury yield increased from 0.92% to 1.74% at quarter-end, pushing longer term bond prices lower. The steepening yield curve has boosted the relative performance of the US Dollar versus the Euro, lifting the Dollar from 0.818 at the beginning of the year to 0.852 at quarter-end.

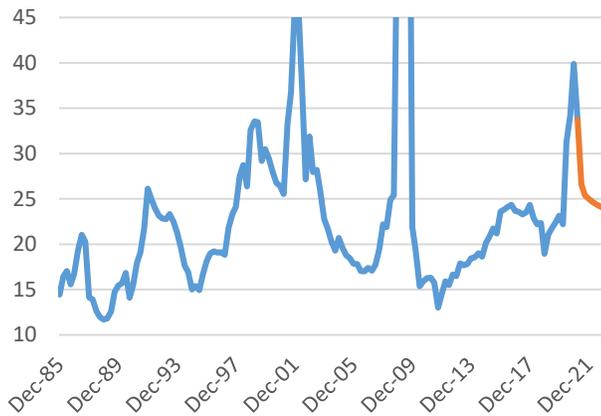
Equity Market Performance To 31-Mar-2021, in US Dollars

	1st Quarter 2021	12 Months 3/31/2021
MSCI World Index	4.9%	54.0%
EMU	4.7%	54.2%
France	4.4%	50.0%
Germany	4.2%	59.3%
Switzerland	-2.0%	23.7%
United Kingdom	6.2%	33.5%
Japan	1.6%	39.7%
Pacific, ex Japan	4.6%	54.0%
EAFE	3.5	44.6%
USA	5.4%	58.6%
Emerging Markets	4.0%	68.8%

Source: Morgan Stanley Capital International,
Total return, dividends less withholding tax reinvested

Outlook

S&P 500 Price / Earnings



We use a regression analysis that plots historic data, forward interest rates and S&P earnings data to try to estimate where the market P/E might be headed. Over the past year, the data was too messy to be useful. But as we normalize, we think we have a reasonable road map going forward.

Standard & Poor's 500				
	Annual Earnings	%Change Y-o-Y	Price/ Earnings	Year-end Price
Dec-13	100.20	15.8%	18.5	1848.36
Dec-14	102.31	2.1%	20.1	2058.90
Dec-15	86.53	-15.4%	23.6	2043.94
Dec-16	94.55	9.3%	23.7	2238.83
Dec-17	109.88	16.2%	24.3	2673.61
Dec-18	132.39	20.5%	18.9	2506.85
Dec-19	139.47	5.3%	23.2	3230.78
Dec-20	94.14	-32.5%	39.9	3756.07
Dec-21e	158.34	68.2%	25.0	3950
Dec-22e	183.03	15.6%	23.9	4380

Source: Standardandpoors.com March 31, 2021, SlateStone Wealth

The market is already discounting a lot of very positive news. The first test begins next week as the first quarter earnings season commences. First quarter earnings are expected to be up modestly compared to the first quarter 2020, but the full weight of the pandemic was not seen until subsequent quarters. What we really care about is any discussion regarding the second quarter 2021 and beyond.

While we can not predict the timing of a market correction with any degree of precision, we expect one to arrive in the not too distant future. Markets anticipate the future, and when everything is perfect it is time for caution. We would anticipate the traditional 10% correction sometime over the next six months. Note that we would expect the market to be little changed from current levels following a correction and the subsequent rebound.

One source of potential instability comes from the bond market. The bond market is already showing signs of concern in the outlook for inflation and the impact on longer term bond yields. The multi-decade decline in bond yields is over.

10 Year Treasury Yield



While the Fed has committed to allowing the economy to “run hot” for a period. What happens if inflation becomes a concern? Five year forward average inflation expectations are already pushing against the 2.5% level.

We remain positive in our outlook for the health care sector, as a function of modest Price / Earnings ratios, accelerating research and development expenditures, and ageing demographics on a global scale. Although a democratic sweep of Congress increases the political threat, it is offset to some degree by the power of the “big pharma” lobby. We are interested in exploring inflation hedging shares over the longer term and some incremental financial share exposure in the context of a market correction.

On the fixed-income side, our conservative approach to bond investments in the context of credit quality remains in place. The yield curve has begun to “steepen” from very low levels, a process we suspect will continue for an extended period. We do not expect to make any “real” money in bonds but will endeavor not to lose any.

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