Market Newsletter

March 31, 2021

EXECUTIVE SUMMARY

- Stocks rose in the first quarter of 2021 propelled by stocks of smaller and low-quality companies.

- The US economy is expected to grow at a record rate in 2021. This has led to fears of higher inflation and interest rates. Interest rates have risen recently but are likely to be kept low by the Federal Reserve.

- Historically, stock prices advance when interest rates increase from a low level because it is usually accompanied by an improving economy, but that relationship reverses at higher levels of interest rates.

- Corporate earnings are expected to grow at the best rate in 10 years.

- Stocks are more expensive than they have been historically. However, there is a wide disparity in the valuation of individual stocks.

- Investing in a concentrated portfolio is not a reliable way to grow wealth as compared to investing in a diversified portfolio because of the high volatility of individual stocks and the uncertainty of predicting ‘mega winners’

Table 1: Market indices

(Returns include dividends)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	6.17%	6.17%	56.35%	16.78%	16.29%
S&P Mid Cap 400	13.47%	13.47%	83.46%	13.40%	13.37%
S&P Small Cap 600	18.24%	18.24%	95.33%	13.71%	15.60%
MSCI Emerging Markets	2.34%	2.34%	58.92%	6.87%	12.48%
MSCI EAFE	3.60%	3.60%	45.15%	6.54%	9.37%
Investment Grade Credit (C0A0)	-4.49%	-4.49%	9.30%	6.19%	4.92%
Non-Investment Grade Credit (H0A0)	0.90%	0.90%	23.31%	6.53%	7.94%
Bloomberg Commodity Index Total Return	-6.92%	-6.92%	35.03%	-0.20%	2.31%
Dollar Index (DXY)	3.67%	3.67%	-5.87%	1.19%	-0.29%
Vanguard Total Bond Market Index (VBMFX)	-3.64%	-3.64%	0.43%	4.52%	2.96%
10 Yr Rate	1.75% 03/31/2021	0.92% 12/31/2020	0.70% 03/31/2020	2.74% 03/31/2018	1.79% 03/31/2016

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg, Yahoo Finance

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 04/08/2021			
	Latest Release	Recent Trend	Notes
Non Farm Employment	916,000	Positive	As the economy reopens hiring has picked up significantly. Restaurants and hotels led the gain in jobs. Unemployment rate fell to a pandemic low of 6%.
Weekly Claims for Unemployment Insurance	744,000	Positive	After falling significantly last year, initial jobless claims have plateaued at a relatively high level reflecting a large number of unemployed people.
ISM Manufacturing Index (over 50 points to growth)	64.7	Positive	The index rose to a 37 year high propelled by new orders indicating a booming economy juiced up by easy monetary and fiscal conditions.
ISM Non Manufacturing Index (Over 50 points to growth)	63.7	Positive	The service sector is seeing vigorous activity as the easing of restrictions is seeing a release of pent up demand. The index is the highest it has been in it's history.

	Latest Release	Recent Trend	Notes
Consumer Prices (Month over month change)	0.4%	Positive	Consumer prices rose driven mainly by energy prices. Ex food and energy, prices were more or less flat in February. Inflation is expected to pick up as the economy re-opens but as of now it is under control.
Producer Prices (Month over month change)	0.5%	Positive	Producer prices were also up, driven by food and energy. Year over year, producer prices were up 2.8%.
Retail Sales (Month over month change)	-3%	Negative	After a very strong January, retail sales fell in February as the effect of the second stimulus check wore out. Consumers are expected to have picked up spending after the third stimulus checks were paid in March. This should lead to a strong number for March.
Consumer Confidence (Conference Board)	109.7	Positive	Consumer confidence shot up to a one year high in March. Consumers assessment of present situation was strong and should lead to higher spending going forward.
Durable Goods Orders (Month over month change)	-1.1%	Positive	Durable good order fell in March for the first time in a year. Core capital goods, which is durable goods excluding aircrafts and defense orders, also fell 0.8%.
Industrial Production (Month over month change)	-2.2%	Positive	Industrial production fell for the first time in 4 months, probably as a result of harsh weather conditions. Not surprisingly, the only sector that showed an increase was utilities.
Capacity Utilization	73.8%	Negative	Capacity utilization is still way below its long term average as the economy is recovering from the affect of the pandemic.
Housing Starts	1.421 Million	Positive	Housing starts fell sharply in February as cold weather froze housing activity. The temporary setback notwithstanding, housing market is strong with low interest rates leading to high demand and low inventories
Home Prices (Case-Shiller 20 city Index- Month over Month)	11.1%	Positive	Home prices rose in all 20 cities in the index. The broader housing market rose at the fastest pace in 15 years.
GDP (Real, Annualized)	4.3%	Positive	After a huge jump in the third quarter, US GDP rose at a healthy clip supported by vaccinations and fiscal stimulus. In 2021, the GDP is expected to grow at the fastest rate in decades.

Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ism.ws, www.nahb.org

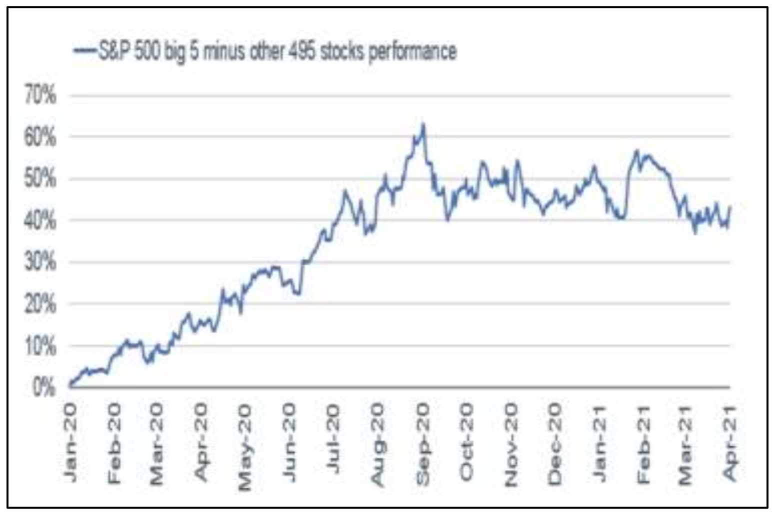
Global stocks rose in the first quarter adding to their positive performance in 2020. Stocks of smaller companies and stocks of lower quality companies rose the most along with expectations for an improving economy. Fears of a spike in inflation as the economy reopens and spending picks up hurt interest rate sensitive bonds (Rising inflation is usually bad for bonds as it lowers the purchasing power of the fixed income that they generate). After declining last year, the dollar strengthened against a basket of currencies, reflecting the faster economic recovery in the US than abroad where vaccination programs have stumbled amidst new waves of covid infections.

The rally in stocks this year has been driven by companies that benefit from the economy reopening, which contrasts with last year, when stocks of companies that benefited from consumers staying at home drove the stock market higher. (Figure 1). In particular, the stocks of the 5 largest companies in the S&P 500, i.e Apple, Microsoft, Amazon, Google and Facebook, all of which benefited from lockdowns, were largely responsible for driving the stock market higher last year. This year, these stocks have trailed the broader markets as seen in Figure 2.

Fig 1: Reopening stocks versus stay-at-home stocks

Source: Goldman Sachs, Charles Schwab

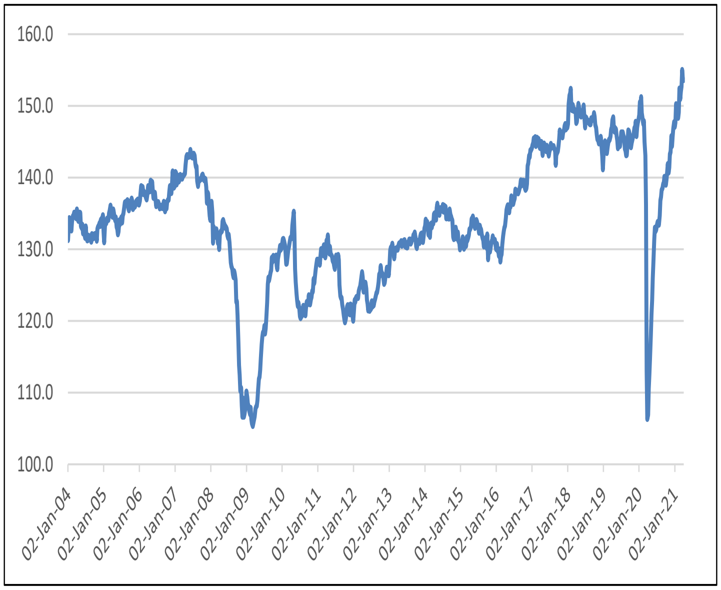
Fig 2: Returns of the largest 5 stocks in the S&P 500 vs the rest



Source: Charles Schwab, Bloomberg

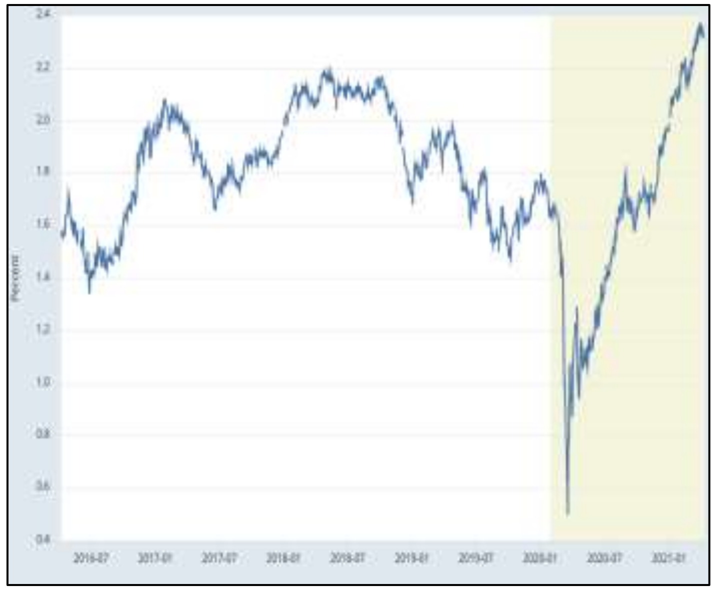
The US economy is recovering strongly as seen in Table 2 above. Forward looking indicators, such as the ECRI Weekly Leading Index, have risen signaling robust growth as seen in Figure 3. In the US, vaccination programs have advanced and as of this writing a little over 20% of the population has been fully vaccinated. Social distancing restrictions are being eased across the country and some optimistic scenarios project a semblance of normalcy as early as July. After contracting by over 30% annualized rate in the second quarter of 2020, the US GDP (Gross Domestic Product, a measure of the Economy) grew by over 30% and 4% in the third and fourth quarter of 2020. In 2021, the US GDP is expected to grow by over 6.2% as per forecasts by the Federal Reserve (Fed), which revised it up from an earlier forecast of 4.2% made in December. That is the highest growth rate in several decades and has set off alarms of inflation expectations. The breakeven inflation rate, which is the expected inflation rate based on bond prices, has spiked recently, as seen in Figure 4. Rising inflation and interest rates (Which usually follow inflation higher) are usually expected to hurt stock prices. However, historically the relationship has not been that straightforward. As seen in Figure 5, stock prices advance when interest rates increase from a low level because it is usually accompanied by an improving economy, but that relationship reverses at higher levels of interest rates. Figure 5 also illustrates that the level at which the relationship reverses has fallen in recent times. The Fed itself does not seem too concerned about the spike in inflation being long lasting and has said it will keep interest rates low for several years.

Fig 3: ECRI Weekly Leading Index



Source: ECRI, Sarsi

Fig 4: Breakeven inflation: Expected inflation priced in bonds



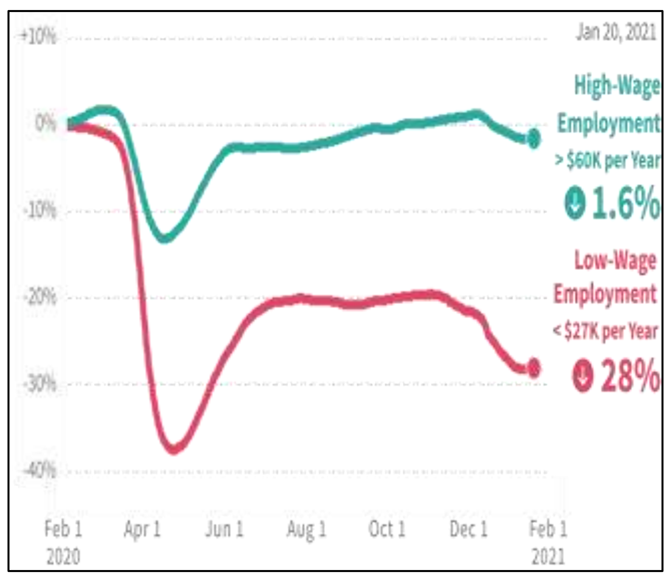
Source: The Federal Reserve Bank of St. Louis

One side effect of the pandemic is the uneven employment rate between high earners and low earners as seen in Figure 6. The employment rate for those earning over $60,000 per year has bounced back to almost pre pandemic level, while those earning less than $27,000 are struggling with significant unemployment. One of the reasons for this is that low wage employment is concentrated in industries such as restaurants, leisure and hospitality which have been most affected by lockdowns and social distancing.

Fig 5: The relationship between rising rates and stock prices

Source: JP Morgan

Fig 6: Employment for high earners vs low earners



Source: Opportunity Insights

In line with a recovering economy, US corporate earnings are expected to increase by a record 24.5% in the first quarter, as per Factset. If realized, it would be the best quarterly growth rate in 10 years. Analysts have been raising their estimate of earnings growth rate over time and that usually augurs well for the actual realized earnings growth.

The 12-month forward price earnings ratio (A measure of how expensive or cheap stocks are) for the S&P 500 is about 22, which is higher than its historical valuation. However, there is a wide disparity in the valuation of the individual components of the index, with the median spread between the price earnings ratio of the cheapest and the most expensive stock currently at 18 as compared to a 25-year average of 11.

Investing in a concentrated portfolio

With stocks at all-time highs and several stocks having risen significantly, there is a feeling among investors that investing in a concentrated portfolio with a handful of stocks is the way to grow wealth. The argument to support this thesis is usually based on hypothetical scenarios of how much money one could have made by investing in stocks such as Amazon, Tesla or any one of the 'high flying' stocks before they became successful companies. These arguments usually seem obvious after the fact. However, it is difficult if not impossible to buy and hold these stocks with large sums of money that make up a significant portion of one's net worth.

The stocks of almost all successful companies have gone through gut-wrenching drawdowns. Amazon fell over 94% in the early 2000s, Facebook fell over 50% right after its IPO in 2012, Tesla fell over 60% last year and Netflix fell by over 75% in 2011. During these drawdowns, there is some adverse news followed by negative narratives about the company, making it difficult for investors to stay invested especially when large sums are involved.

In addition, looking only at companies after they have become successful in making investment decisions ignores the fact that historically only a small percentage of companies have produced outsized returns as compared to a diversified portfolio of stocks. Research by JP Morgan using the Russell 3000 stock index over the last 40 years shows that only 10% of the stocks in the index can be classified as 'mega winners' i.e they produced returns more than 500% over the index returns (Figure 7). 44% of the companies experienced a 'catastrophic stock price loss' i.e a loss of over 70%, and 42% of the stocks experienced absolute negative returns during that time. 66% of the stocks in the index performed worse than the overall index.

Fig 7: Stocks in the Russell 3000: 1980-2020

Sector	% of stocks experiencing negative absolute returns 1980-2020	% of stocks experiencing negative excess returns vs Russell 3000 1980-2020	% of stocks defined as "Megawinners" 1980-2020
All Sectors	**42%**	**66%**	**10%**
Communication Services	52%	70%	10%
Consumer Discretionary	47%	68%	11%
Consumer Staples	35%	61%	17%
Energy	63%	84%	5%
Financials	33%	63%	10%
Health Care	43%	62%	15%
Industrials	40%	68%	13%
Information Technology	54%	73%	10%
Materials	39%	69%	11%
Utilities	16%	85%	4%

Source: JP Morgan

The above observations support investing in a diversified portfolio especially when investing a significant portion of one's net worth in a reliable manner.