MARKETS IN FOCUS

FIRST QUARTER 2021 APRIL 15, 2021

GEMMER ASSET MANAGEMENT LLC
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Quarter-In-Review – There was no way the first quarter of 2021 was going to rival the same period last year in terms of global events, but it sure gave it a good go. The year kicked off with something new – the storming of the capital building. The following month, the equity markets were treated to one of the most bizarre short squeezes of all time when someone called 'Roaring Kitty' symbolized the effort to push GameStop into the stratosphere, at least for a few brief days. After that came a mini bond tantrum when yields seemed to increase every day, and then in late March an unheard-of family office suffered one of the biggest margin calls in history and promptly wiped out a multi-billion-dollar fortune in a matter of days.

Market Benchmarks

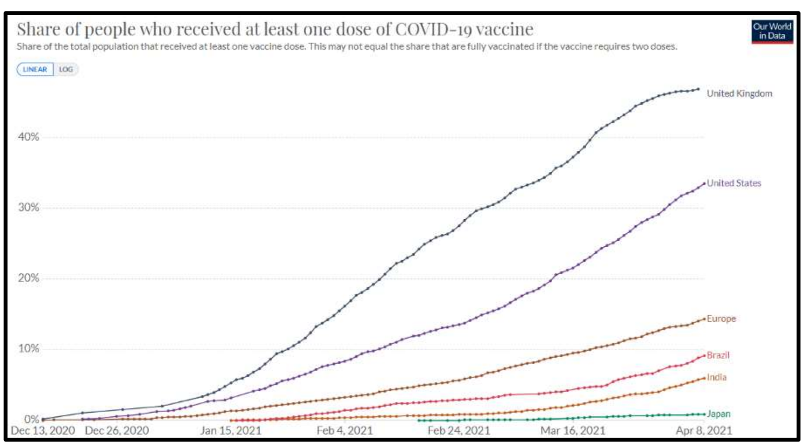
Market Indices	1st Qtr 2021	3-Yr An	5-Yr An
S&P 500 Index	+6.2%	+16.6%	+16.3%
Russell 2000	+12.9%%	+14.8%	+16.4%
Global Equities	+5.4%	+12.2%	+13.6%
Int'l Index (EAFE)	+4.0%	+5.9%	+8.9%
Emerging Mkts	+3.6%	+6.1%	+11.6%
Other Indicators	**3/31/21**		**12/31/20**
Fed Funds Rate	0%-0.25%		0%-0.25%
2-Year Treasury	0.16%		0.12%
10-Year Treasury	1.75%		0.92%
S&P 500 P/E Ratio*	21.9		22.3
Crude Oil	$59.16		$48.45
Core Inflation	1.4%		1.4%

**Forward 12-month operating earnings per S&P*

While the market swings kept everyone on their toes, the virus and economic news was far more encouraging. Most significantly, the rollout of the COVID vaccines ramped up, especially in the U.S. and U.K. President Biden scored a win by passing his first major spending bill, and signs continued to build that the U.S. economy was set to do very well this year. The markets reacted accordingly. As you can see above, all the main equity indexes were solidly in the black for the first quarter, with small-cap stocks leading the way with a +12.9% return. We did see a meaningful rotation in the markets during the quarter away from highly valued growth and momentum names and into traditional value stocks. For example, the large-cap value index was up +10.9% in the first quarter while the growth index was up just +2.2%. The spread in the small-cap universe was even larger. The story behind the rotation is pretty straightforward – investors were buying stocks they think would benefit from the global economy reopening. This boosted sectors such as materials, energy, and particularly financial stocks which should benefit from modestly higher rates and more robust growth.

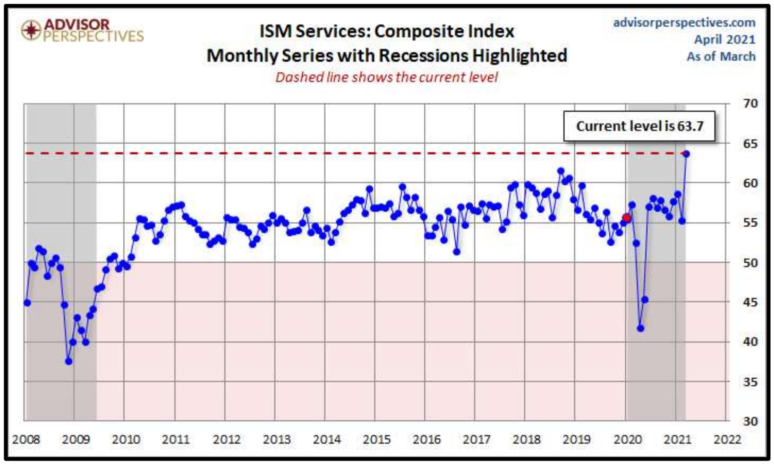
As for interest rates, longer-term yields moved significantly higher. The yield on the 10-year almost doubled to close at 1.75%. As you would expect, this led to losses in most fixed income sectors. Intermediate-term Treasury bonds were down -5.7% in the first three months of the year while long-term bonds were down -13.9%. This was the worst quarter for Treasury bonds in many years. However, there were pockets of resiliency. Lower quality corporate bonds were up +0.6% and our three holdings in the bond space held up well. BlackRock Total Return is a traditional intermediate bond position and was down just -2.8%. Both PIMCO Income and Schwab Short-Term held up even better, down just -0.3% and -0.6% respectively.

The Race to Vaccinate the World – Depending on where you sit in the world, you have a very different view of the current COVID situation. In the U.S. we are making rapid progress towards providing a vaccine to everyone who wants one by late April or early May. Already certain counties in the country are providing vaccines to anyone who requests one that day. As you can see below, roughly a third of the U.S. population has had at least one shot. Of course, this also means two-thirds have not had a single dose so there is a window of risk, especially as the new variants start to take hold. But the good news is that it appears the current vaccine options provide protection against these new variants, particularly b117 that is gaining ground around the world.



Outside the U.S. the picture is far more mixed. The U.K. has inoculated roughly 50% of the population and is quickly on the path towards herd immunity. Continental

Europe is another story. France has reintroduced lockdown measures to combat rising case loads, as have Poland, Hungary, and large parts of Italy. Brazil is seeing some of the highest rates of both new cases and deaths since the crisis started last March. Conversely, the data out of China indicates basically no new cases over the last few weeks, at least per the official statistics.



After the last year we can all be forgiven for thinking there is another shoe to drop. Maybe a new variant will prove impervious to the current vaccine options? Could Europe struggle with b117 all year, forcing their economy to remain dormant? Sadly, the disparities between the developed and developing world are going to be with us for some time. But for now, the outlook appears constructive. The most likely scenario appears to be one where we continue to ramp up the vaccination effort worldwide week-by-week and month-by-month, and while booster shots may be required this fall or winter, the current vaccines will buy us time to move the global economy back to whatever normal is going to be. This is a vast improvement from where we stood just twelve months ago.

Economic Snapback – Just as the vaccination effort is a mixed picture worldwide, it is a similar story for the global economy. To take two extremes, European GDP contracted -0.7% at an annual rate in the fourth quarter of 2020 as lockdowns and a subdued policy response weighed on activity. Conversely, falling infection rates combined with, shall we say, an 'exuberant' fiscal policy, meant the U.S. grew +4.3% over the same period. We are probably looking at more of the same in 2021, as least as far as the U.S. is concerned. Recent economic data is setting some impressive records. For example:

- The ISM Manufacturing index hit its highest level since 1983 in March.
- The ISM Services index hit its highest level ever in March (chart above).
- Employers added 916,000 new jobs in March.
- Home prices were up over +11% nationwide through the end of January, the fastest pace of appreciation in fifteen years.
- Home inventory levels are at record lows, with only two months-worth of supply on the market (chart at the bottom of the page)

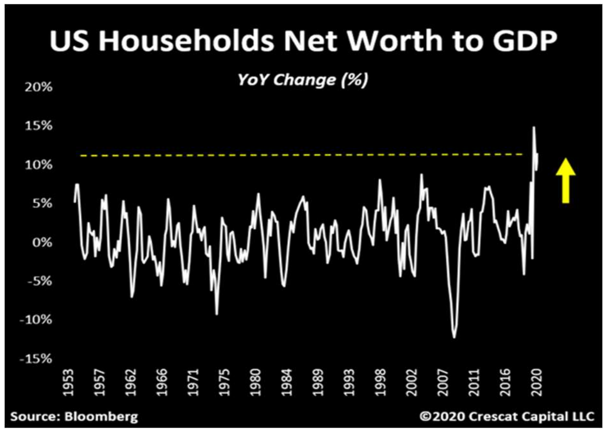
There are two factors at play. First, we shouldn't be surprised at a snapback after last year's turmoil. People are returning to work after many months, businesses are restocking inventories, travel is picking up, and people are eating out once more. This is to be expected after a short, sharp recession like we saw last year. We should also expect to see something similar in Europe and other parts of the world that are slowly vaccinating their populations, only with a lag. However, we must not forget how much money was thrown at the problem the last few months, and now this cash is finding its way back into the global economy.

Unprecedented Stimulus for Unprecedented Times – It's easy to lose track of the various disaster relief/stimulus programs rolled out since the COVID crisis started. The $2tn CARES Act, the Payroll Protection Plan, expanded unemployment benefits, a $900bn deal in President Trump's last full month in office, etc. It all adds up. And on March 11th of this year President Biden signed the $1.9tn American Rescue Plan Act of 2021. If you add it all together the U.S. has now spent right around 25% of GDP on the various programs between March 2020 and now. By way of comparison, we spent less than 5% of GDP to combat the financial crisis of 2008 and 2009!!

Other than being large, the other notable feature of all the plans is that they directly target lower income individuals and families. A recent study estimates that those at the lowest income level have seen their earnings boosted by close to 30%, and in some cases more. In general, consumers are sitting on over $2tn of excess savings, some of which will clearly be spent in the months to come. Another way to show the tailwind consumers will supply to the U.S. economy going forward is to look at household net-worth (chart at the top of the next page). Despite the challenges of the last few months this statistic has grown at the fastest rate in living memory. Income transfers, market gains, and most importantly, appreciating homes, all play a part. This sets the stage for a solid period of growth both this year and next.

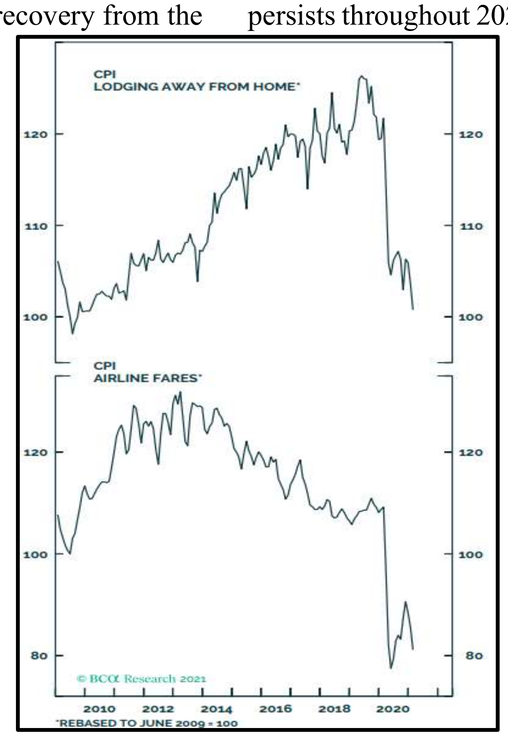
Is it Finally Time for Infrastructure? It's become something of a running joke in the financial community that every Presidential initiative since at least George W. Bush contains an infrastructure plan that goes nowhere.

Remember the term ‘shovel ready’ as it related to infrastructure plans that could start immediately? That basically went nowhere. And here we are again. President Biden is proposing a $2.25 trillion, eight-year infrastructure push. The main elements include spending on transportation, electric vehicle support, green housing, broadband buildout, and much more. The new plan has the somewhat unique characteristic of being revenue neutral, at least in theory. Biden is proposing paying for the new plan through an increase in the corporate tax rate to 28% from 21% (Trump cut it to 21% from 35% in 2017), penalizing corporate offshoring, and instituting a 15% minimum tax on all corporations.



As you would expect, the battle lines drew up quickly. But what appears to be different this time relative to other infrastructure plans is that the Democrats may be able to use the reconciliation process again this year. This means they will be able to pass the bill on a simple party vote. And given that public opinion is in favor of both more infrastructure spending and higher corporate taxes, the odds appear good they will go this route. For the economy and the markets, the story is likely to stay the same. The fiscal tailwind for the U.S. economy is going to be strong for the foreseeable future. Yes, corporate taxes may go up, but it isn’t like this money will be saved. It will be used to fund spending somewhere else. Unlike the post-financial crisis period, today’s debate couldn’t be any further away from fiscal austerity.

The Fed and Transitory Inflation – The recovery from the COVID crisis has rested on three legs of a stool. The first was science and vaccine development. The second was increased fiscal spending to buy time until the vaccines were available. And the third was monetary policy – ultra-low interest rates, rapid money supply growth, and asset purchases to shore up the financial system. Neither the vaccine rollout nor the fiscal deluge looks like it will reverse course in the next twelve months. Monetary policy, on the other hand, could. It all comes down to inflation. As we asked in last quarter’s letter, is inflation in today’s world inevitable? Or more importantly, is inflation about to take off to the point that the Federal Reserve and other central banks around the world feel compelled to take the punch bowl away and reign in liquidity?



We must first state up front that economists struggle with inflation and what causes it. Do you remember the old Milton Friedman quip that ‘inflation is always and everywhere a monetary phenomenon…’? Print too much money and inflation goes up, at least that was the contention. In today’s world this doesn’t seem to work. Central banks have consistently failed to hit their inflation targets since 2009 despite their best efforts.

Over the short-term inflation is almost certainly going to pick up. As you can see from the chart below, prices for both hotels and flights plummeted over the last year. However, as people start traveling again it’s not unreasonable that these prices will move back to their old levels. While this will boost the inflation measures, is it really inflation? Not really, in that it is simply reversing a prior decline. Fed Chairman Powell has talked a lot of late about transitory inflation, and this is what he means. They are unlikely to react to short-term spikes in inflation.

But how do you distinguish between short-term spikes and more permanent price pressures? That really is the $64tn question that no one yet knows the answer for. The Fed clearly wants to see full employment, which many define as unemployment under 4%. Just recently Powell said he wanted to see a series of months where job growth exceeded 1MM. We are sticking with the theme we communicated last quarter. We think we are moving along the continuum from deflation to reflation. The reflation theme probably persists throughout 2021 and the first half of 2022 before we transition to worrying about inflation. Our best guess is inflation runs hot for a while (say 2.5% to 3.0%), but to the extent this means more wage growth, particularly at the lower end, it could be a net positive.

The bottom line is we do not think global central banks will reverse course anytime soon. Maybe they are fighting the deflationary war of the last thirty years and setting the stage for an inflation problem later this decade, but it is too soon to make that call. For the time being the liquidity backdrop should remain favorable for the markets over the coming months.

Implications for the Equity Markets – Over the last few months both the stock and the bond markets have moved a long way towards pricing in the recovery scenario we've detailed above. Stock prices have rallied across the board and bond investors have increased their inflation expectations and are, therefore, demanding higher yields. The critical question for investors is twofold: 1) have expectations run too far ahead of reality, and 2) is something fundamental about to change that will upset the apple cart?

Higher Rates Are Usually Bullish For Stocks

S&P 500 Index Returns Under A Higher 10-Year Yield

Rising Rates Start Date	Rising Rates End Date	Duration (Months)	Change in 10-Year Treasury Yield	S&P 500 Gain/Loss
12/26/1962	8/29/1966	44.7	1.7%	18.3%
3/16/1967	12/29/1969	34.0	3.6%	1.3%
3/23/1971	9/16/1975	54.6	3.2%	-18.1%
12/30/1976	9/30/1981	57.8	9.0%	8.7%
5/4/1983	5/30/1984	13.1	3.9%	-7.9%
8/29/1986	10/16/1987	13.8	3.3%	11.8%
10/15/1993	11/7/1994	12.9	2.9%	-1.4%
1/19/1996	7/8/1996	5.7	1.5%	6.7%
10/5/1998	1/21/2000	15.8	2.6%	45.8%
6/13/2003	6/28/2006	37.0	2.1%	26.0%
12/30/2008	4/5/2010	15.4	1.9%	33.3%
7/24/2012	12/31/2013	17.5	1.6%	38.1%
7/8/2016	10/5/2018	27.3	1.9%	35.5%
3/9/2020	2/25/2021	11.8	1.0%	39.4%
	Average	25.8	2.9%	17.0%
	Median	16.6	2.4%	15.0%
	% Positive		100.0%	78.6%

Source: LPL Research, FactSet 03/03/21

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

On the first question, at least as it relates to stocks, we would contend that we have yet to see how powerful the earnings recovery is going to be so it is hard to say expectations are ahead of reality. Corporate earnings were down over -22% in 2020, and the first quarter of 2021 will be the first quarter of growth since the COVID crisis started. Expectations are certainly high for this year (+41% year-over-year growth), but who is to say they are too high? It is going to take at least a few quarters before we have a feel for what a reasonable run rate is. Bears will contend that stocks are priced for perfection at over 20X forward earnings, but we have seen this movie before. After every recession over the last few decades stocks start the cycle expensive but earnings ultimately catch-up. The time to worry is when stocks are expensive late in the expansionary cycle. We are not there yet.

As for the second question, some questions are hard to answer. For example, what if China invades Taiwan or a new COVID variant shows up that is resistant to today's vaccines? Few people have any great insight into these issues. A more market related game changer concerns interest rates – aren't rising rates a threat for stocks? Sometimes, yes, but usually not. As you can see from the table above, during prior periods when the 10-year yield has increased meaningfully stock prices have performed reasonably well. This makes intuitive sense – yields are going up because the economy is expected to do well. A stronger economy means better earnings prospects which usually means stable to higher stock prices, all things being equal. Typically, where this scenario doesn't work is when yields are going up because of an inflation problem and a hawkish central bank. We aren't there today. Higher yields are still reflective of better economic prospects down the road, not 'out-of-control' inflation. That could be a story for later this decade, but not now. We continue to think stocks outperform bonds over the next few months, albeit with much more volatility.

Looking Ahead – The last year has been tumultuous for everyone. Financial concerns pale in comparison to people's worries about health and well-being, and we hope everyone's family is well. It is encouraging that vaccine rollout is progressing as quickly as it is, and we hope lives can get back to normal this year as the economy slowly reopens. We are certainly in a race to vaccinate enough people before the new COVID variants gain ground, but there are reasons for hope that the coming year will be one of recovery.

As for the market outlook, we continue to think that the three legs of the stool that supported the markets over the last twelve months remain firmly in place. Vaccines, fiscal spending, and monetary policy should all be pulling in the same direction for the rest of this year. We worry about the inflation outlook longer-term, but we do not think it poses a problem in 2021 or even 2022. And while rising interest rates will likely continue to be a headwind for bond investors, stocks should benefit from the improving growth outlook and easy liquidity environment.

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