Economic & Investment Perspectives

Figure 1: 3/31/2021 Returns (Source: ACIMA)
Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	Q1	1YR	Current vs. 52-wk High	Current vs. 52-wk Low
US Aggregate Fixed Income	AGG	-1.1%	-3.4%	0.7%	-4.9%	0.6%
U.S. Treasury Bonds	GOVT	-1.4%	-3.6%	-4.6%	-7.5%	0.5%
Investment Grade Corp Bonds	LQD	-1.5%	-5.5%	8.1%	-6.7%	7.8%
Muni Bonds	MUB	0.6%	-0.7%	4.9%	-1.6%	6.8%
High Yield	HYG	1.2%	0.6%	18.9%	-0.7%	18.9%
Non-US Fixed Income	BNDX	0.0%	-2.3%	2.7%	-2.8%	2.1%
Emerging Markets Bond	EMB	-0.7%	-5.5%	17.2%	-6.2%	16.1%
Global Equity						
ACWI Global Equity	ACWI	2.9%	4.9%	54.5%	-1.8%	60.5%
United States	VTI	3.6%	6.5%	62.9%	-1.2%	69.7%
International Developed	EFA	2.5%	4.0%	45.3%	-1.7%	50.0%
Emerging Markets	EEM	-0.7%	3.2%	58.8%	-8.5%	63.5%
Global Equity by Region						
United States	VTI	3.6%	6.5%	62.9%	-1.2%	69.7%
Europe	IEUR	3.3%	5.2%	49.1%	-1.0%	54.2%
Asia ex-Japan	AAXJ	-2.1%	3.4%	57.0%	-9.5%	62.4%
China	MCHI	-6.2%	0.9%	44.3%	-16.2%	48.0%
Japan	EWJ	0.4%	1.4%	40.4%	-5.2%	47.8%
Latin America	ILF	4.1%	-5.9%	54.5%	-10.6%	64.0%
US Equity						
US S&P 500	IVV	4.6%	6.3%	56.5%	-0.5%	62.6%
NASDAQ 100 QQQ	QQQ	1.7%	1.8%	68.4%	-5.6%	76.5%
US Large Growth	IWF	1.8%	0.9%	62.5%	-4.9%	70.1%
US Large Value	IWD	6.0%	11.3%	56.0%	-1.4%	61.9%
US Eqwt S&P 500	RSP	6.0%	11.6%	70.7%	-0.9%	79.3%
US Mid Cap	IJH	4.7%	13.6%	83.5%	-2.9%	97.5%
US Small Cap	VTWO	1.4%	12.8%	95.6%	-5.9%	115.6%

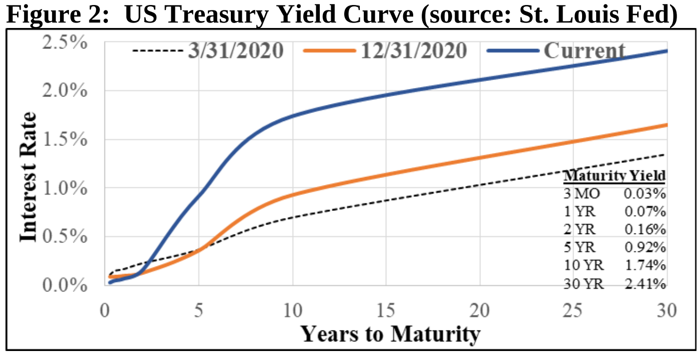
Interest rates rose further in March, continuing the trends of negative bond returns and disparate but largely positive returns for stocks. Equity markets closed the month and quarter just below all-time highs despite rising yields, inflation fears and volatility, buoyed by vaccines, stimulus and accommodative central bank policy. Performance highlights for the month and quarter (Q1) are below; we review the stunning one-year returns on page 2.

- Global equity (ACWI): +2.9% this month (+4.9% Q1).
- US Equity: US stocks (VTI) rose 3.6% in March (+6.5% Q1); the S&P 500 (IVV) gained 4.6% (+6.3% Q1). Small caps (VTWO) rose 1.4% for the month, under-performing large stocks, but out-performed significantly in Q1 (+12.8%). Comparing growth (high earnings growth and valuations) and value (lower growth and valuations, higher dividends) returns highlights changing market leadership: Value (IWD) trounced growth (IWF) in March (+6.0% vs. 1.8%) and Q1 (+11.3% vs. +0.9%) but trails over the past year (+56.0% vs, +62.5%).
- Non-US Equity: Emerging markets (EEM) fell 0.7% in March (+3.2% Q1); Chinese equities (MCHI) fell 6.2% (+0.9% Q1). Developed markets (EFA) were +2.5% in March (+4.0% Q1), led higher by European equities despite rising virus concerns.
- Bonds: US bonds (AGG) fell 1.1% this month (-3.4% Q1) as interest rates spiked. Treasuries (GOVT) and corporate bonds (LQD) logged weak returns. EM debt (EMB) lost 0.7% for the month (-5.5% Q1), but US high yield gained 0.1% (+0.8% Q1).

Interest Rates and the Economy

Interest rates rose markedly during the first quarter, continuing the rise off of historically low yields a year ago. Figure 2 graphs the US yield curve, which plots yields (Y-axis) for various maturities (X-axis) of US Treasuries. Short-term yields remain near zero and will likely be anchored there for years according to the Federal Reserve (Fed). Long-term interest rates have moved steadily higher but remain low relative to historical levels. The benchmark US 10-year bond yield climbed to 1.74% from 1.44% last month (versus 0.93% at year-end and 0.70% one year ago).

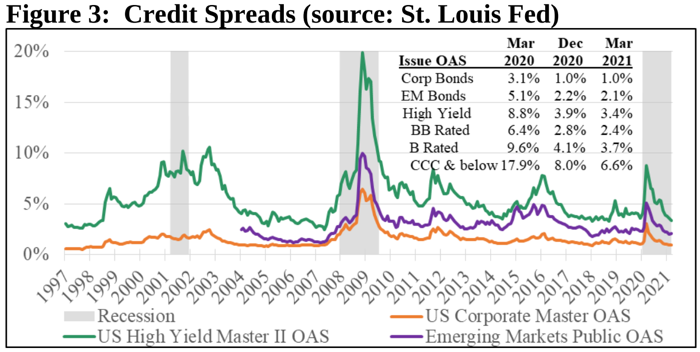
Figure 2: US Treasury Yield Curve (source: St. Louis Fed)



For bonds other than US Treasuries, we track the option-adjusted spread (OAS) between various bond yields relative to comparable US Treasuries. Low or narrowing spreads signal optimism as investors are willing to accept lower returns on risky assets. Credit spreads spiked on pandemic fears last March but have tightened steadily since and are now at or below pre-pandemic levels.

- Investment grade corporate bonds yield 1.0% over Treasuries, unchanged this quarter but down from 3.1% a year ago.
- Emerging market bonds carry an average yield premium of +2.1% versus +2.2% at year-end and +5.1% one year ago.
- High yield (non-investment grade) spreads narrowed to +3.4% in Q1 and are significantly below year-ago spreads of +8.8%. The riskiest bonds (rated CCC & below) yield +6.6% over Treasuries, well below panic levels of +17.9% last March.

Figure 3: Credit Spreads (source: St. Louis Fed)

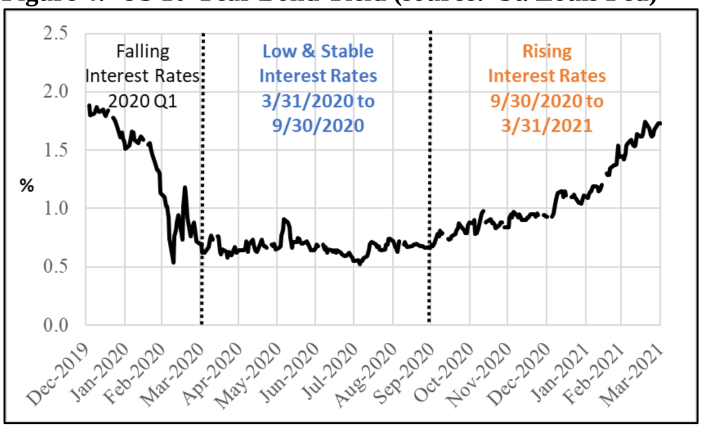


Extraordinary One-Year Returns

One year ago, the world was in full-blown panic mode in the early stages of the pandemic. Little did we know that despite health and economic fears, global stock markets had already bottomed, thanks to unprecedented monetary intervention by the Fed and global central banks (interest rate cuts, bond buying, money printing) and massive government spending. The resulting recovery in stocks and other risk assets has been stunning. In this section, we take a moment to recognize the incredible returns of the past year and bisect them in the context of interest rate regimes.

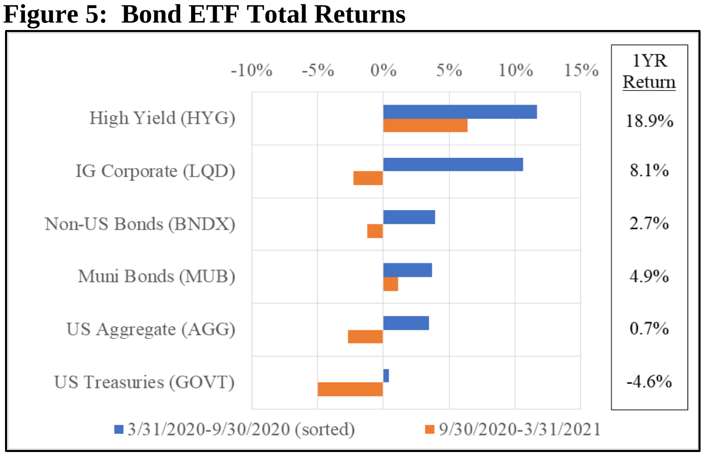
By the end of March 2020, the US 10-year bond yield (Figure 4) had fallen precipitously as investors fled to the safety of US Treasuries (driving bond prices up and yields down). Yields stabilized for about six months and then began to rise back toward pre-pandemic levels as the economy began to recover.

Figure 4: US 10-Year Bond Yield (source: St. Louis Fed)



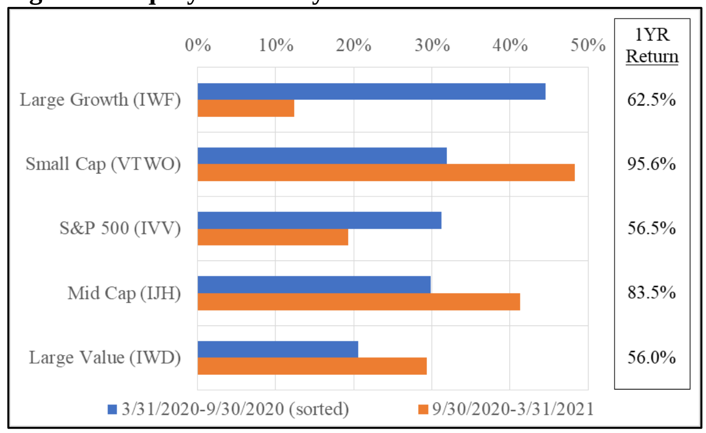
As one would expect, fixed income investments (bonds) behaved differently in the sub-periods (Figure 5). Returns were positive amid low and stable interest rates (3/31/2020 to 9/30/2020, blue bars below, sorted high-to-low) but turned negative as rates rose (9/30/2020 to 3/31/2021, orange bars). High yield rose throughout the past year as credit spreads narrowed from panic levels.

Figure 5: Bond ETF Total Returns



Equity returns in the past 12 months have been nothing short of astounding. Global stocks were up over 50%, and US small cap stocks have nearly doubled! Returns were impressive across the board throughout the period, but stocks and ETFs exhibited differing style (growth, value) and size (large, mid and small cap) leadership during the two interest rate regimes (Figure 6). During the initial phase of the recovery (3/31/2020 to 9/30/2020, blue bars below, sorted high-to-low), large growth-oriented stocks and ETFs generated the best returns, powered by low interest rates and tech and e-commerce stocks, which continued to grow earnings during the shutdown. As the economy began to truly recover and interest rates began to rise (9/30/2020 to 3/31/2021, orange bars), equity leadership shifted to the more economically-sensitive stocks and ETFs (small cap, mid cap, value stocks).

Figure 6: Equity Size & Style ETF Total Returns



We can see this changing leadership at the economic sector level (Figure 7). During the initial recovery (3/31/2020 to 9/30/2020 column, sorted high-to-low), the growth-oriented leadership is confirmed by the stellar returns of the consumer, technology and communications sectors. As the recovery broadened and rates began to rise, leadership shifted away from these sectors toward economically-sensitive areas (energy, industrials, materials) and financials (where net interest margins improve with a steepening yield curve). The basic materials sector was strong throughout, likely due to exposure to commodities as the US dollar weakened.

Figure 7: Sector ETF Total Returns

Economic Sector	ETF	1YR	3/31/20-9/30/20	9/30/20-3/31/21
Cons Discretionary	XLY	72.7%	50.5%	14.7%
Technology	XLK	66.8%	45.9%	14.3%
Basic Materials	XLB	78.4%	42.7%	25.0%
Communications	XLC	67.0%	34.8%	23.8%
Industrials	XLI	69.4%	31.5%	28.8%
Health Care	XLV	33.9%	20.1%	11.5%
Cons Staples	XLP	28.9%	19.3%	8.0%
Financials	XLF	67.1%	17.0%	42.9%
Real Estate	XLRE	32.1%	15.3%	14.5%
Utilities	XLU	19.4%	9.0%	9.6%
Energy	XLE	78.0%	6.1%	67.8%

Bottom Line

The recovery of financial markets over the past year has been breathtaking, and rising interest rates have been a focal point for investors and markets, especially as yields have risen at an increasing pace in 2021. Given the massive increase in the money supply (money printing), inflation concerns are genuine, but, thus far, the rise in yields appears to be consistent with economic recovery. The global economy appears to be in recovery mode, backstopped by governments and global central banks ("whatever it takes"). Economically-sensitive assets (emerging market stocks and bonds, US small/mid-cap and value, commodities) remain attractive given the improving health and economic outlook.

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