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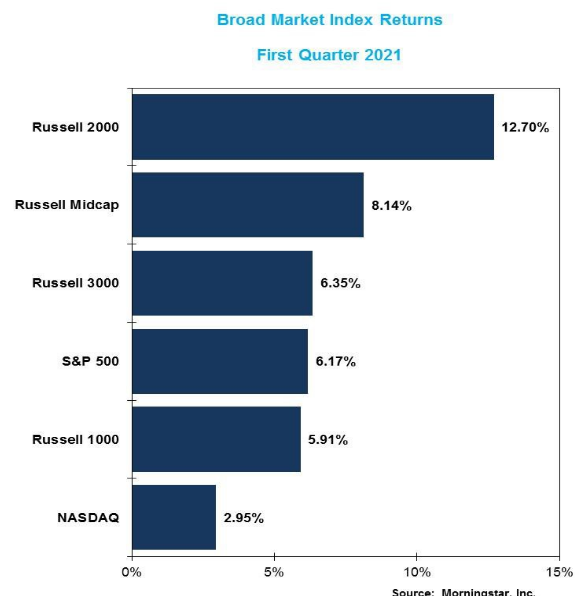
We hope everyone is staying safe as we continue adjusting to the ever changing new normal. Like this time last year, in a short period of time we have seen massive changes in the economy, employment, and the markets. Gratefully this time it has been predominantly positive and encouraging. While there is much detail to dive into this quarter, it is important to note we are getting through this as we have recovered from many difficult times in the past.

The global economy continued to recover in the first quarter of this year, although the rate of improvement was diverse across regions depending on COVID-19 infection trends and monetary policy. There is a continued and increasing optimism about the rate of COVID-19 vaccinations, the tremendous fiscal and monetary stimulus, and the recovering U.S. labor market; however, the spreading of COVID-19 variant strains present a continued risk to economies being fully reopened.

The Economy

The US economy marched higher in the quarter as it continues to rebound from the severe recession brought on by pandemic-related lockdowns. In addition, Congress recently enacted the American Rescue Plan Act, a $1.9 trillion fiscal stimulus package that is expected to keep the recovery's momentum going. Improvements in vaccine rollouts are also anticipated to have a positive effect on global growth in 2021.



Within this context, the Bureau of Economic Analysis released the third estimate of the fourth quarter 2020 real GDP, a seasonally adjusted annualized increase of 4.3%, slightly better than the prior estimate of an increase of 4.1%, but significantly lower than the record-setting 33.4% increase in the prior quarter. The employment situation continues to recover, albeit in inconsistent fashion. The February report showed that employers added 379,000 jobs in the month, and that the unemployment rate fell to 6.2%. The Federal Open Market Committee (FOMC) maintained its supportive monetary policy response to the pandemic, leaving the funds rate target range of 0% to 0.25% unchanged. The central bank also adopted a flexible average inflation target framework, which will allow the committee to keep interest rates near zero even while inflation exceeds its target. The FOMC expects interest rates to remain near zero until sometime in 2023.

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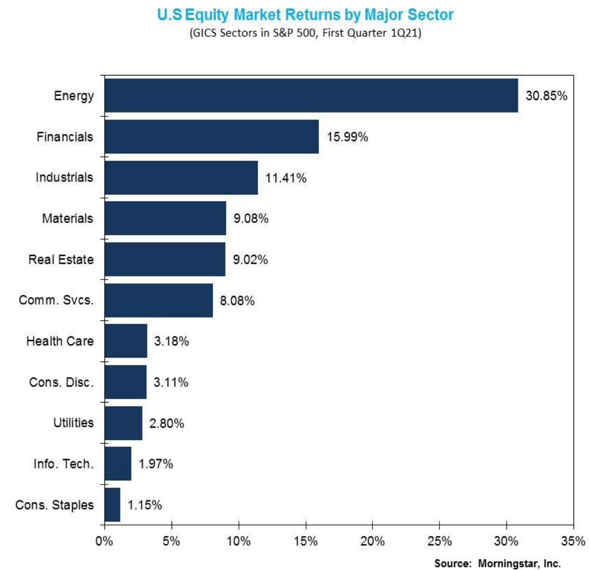
Highlights

GDP

In the latest data available, the Bureau of Economic Analysis released the third estimate of the fourth quarter 2020 real GDP, a seasonally adjusted annualized increase of 4.3%, slightly better than the prior estimate of an increase of 4.1%, but of course far lower than the record 33.4% increase in the third quarter as the economy rebounded from pandemic lows. Strength was most prominent in investment segments such as equipment, inventories and residential, as well as exports. Government spending in areas other than defense and imports were offsets. Corporate profits declined by 1.4% (not annualized) during the quarter after having jumped more than 27% in the prior period. From an economic perspective, 2020 was one of the most difficult years in US history, with the economy contracting by -2.4%. With the economy beginning to increasingly open up, prospects for 2021 look more promising.



HOUSING

The housing segment cooled somewhat in the latest quarter, retreating from cycle highs achieved last October. Home financing costs rose as mortgage rates crept higher. Existing-home sales for February (the latest monthly data available) declined to an annualized rate of 6.2 million units, 6.6% lower than the results from January, but up about 9.1% from year-ago levels. The inventory of existing homes was approximately two months of supply, lower than levels of the prior year. Existing-home prices in February increased 16.2% from February 2020. In the new-home segment, the NAHB Housing Market Index, a measure of homebuilding activity, ended the quarter at 82, off from its cycle high of 90 in November. The housing market remains in good shape despite higher mortgage rates and increasing materials costs.

EMPLOYMENT

The February employment report (the latest data available) showed a jobs situation that continued to improve as the pandemic has diminished. Employers added 379,000 jobs during the month, materially higher than the consensus expectations of a gain of 177,000. The leisure/hospitality industry experienced the strongest gains, indicative of the economy continuing to open up. The outlook for employment is bright with the onset of warmer weather and more widespread distribution of vaccines. The unemployment rate in February declined to 6.2%, and the labor force participation rate inched down to 61.4%.

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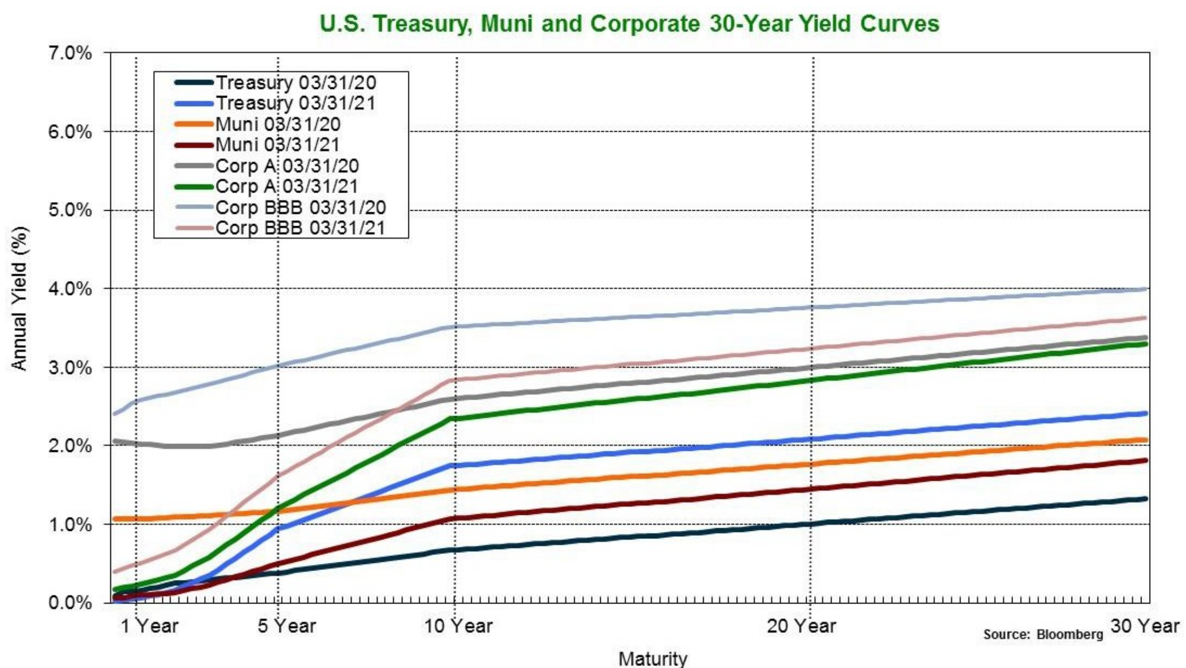
FED POLICY

The FOMC made no change to the federal funds rate target range of 0% to 0.25%, but it is now implementing a new flexible average inflation targeting framework. With this new approach the committee will allow inflation to run higher than its equilibrium target of 2% before implementing rate increases. Indeed, the Summary of Economic Projections indicated that inflation is likely to be higher than the target over the next few years, but the expected path of the fed funds rate remains little changed. The committee's "dot plot" – the forecast of the fed funds rate – shows a median projection of rates remaining near zero through 2023. The FOMC believes the economy remains quite far from its objectives, and despite stronger economic growth this year, the fed funds rate is likely to remain at current levels for the foreseeable future.

Interest Rates

Fixed income securities' prices on balance were lower (and yields higher) in the quarter as the global economy continued to heat up, and inflation expectations rose. Even though the FOMC and other central banks throughout the world maintained an aggressive monetary policy stance, trillions of dollars of fiscal stimulus passed by Congress have heightened the specter of inflation. Yields also reacted to the increasing availability of vaccines and their likely impact on accelerating economic growth. As has been the case in recent quarters, volatility in the fixed income market was relatively constrained, as prices declined in a generally orderly fashion. Yields climbed steadily throughout the quarter. As mentioned above, the FOMC made no change to its policy stance, and reiterated that it sees rates remaining near zero perhaps through 2023. As such, the FOMC is expected to maintain the target federal funds rate range at between 0% to 0.25% for the foreseeable future.



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The shape of the Treasury yield curve steepened significantly during the first quarter, with yields on the shortest-term maturities remaining little changed, while yields in the intermediate- and long-term segments of the curve rose fairly substantially. Analysts believe the steepening is an indication of improvement in investor expectations for the economy. Yields declined by about 0.03% on short-term maturities, while rising more than 0.80% on intermediate- and long-term securities. By the end of the quarter, the yield on the benchmark 10-year US Treasury note was higher, ending at 1.74%, compared to 0.92% on December 31.

The lack of volatility was a result of the countervailing forces of the FOMC communicating that it would keep short-term rates extremely low for the time being, and the higher inflation expectations fueled by an accelerating economy. Inflation expectations were also materially higher, with the Fed's gauge of five-year forward inflation expectations exceeding the level of 1.96% on December 31.

Total returns on fixed income securities were lower, with negative returns in almost every segment of the market. The Bloomberg Barclays Treasury 5-7 Yr. Index declined by -3.6% for the quarter. The Bloomberg Barclays US Credit Corporate 5-10 Yr. Index dropped -3.9% during the three months. High yield securities, which often follow the performance of equities, gained ground, posting a return of +0.9%. Municipals posted moderately lower results in the quarter, as the Bloomberg Barclays Municipal Bond Index edged lower by -0.4% during the quarter. Prices of non-US fixed income securities were sharply lower in the quarter, as the Bloomberg Barclays Global Aggregate ex-US Index gave up -5.3%. Emerging markets bonds posted sharp losses, with the JPM EMBI Global Index lower by -4.7%.

Equity Markets

Stocks posted a fourth consecutive quarter of strong gains following the sell-off in 2020's first quarter. Many broad indexes have now rallied by 50%-90% since bottoming in March 2020. Analysts have pointed to continued economic improvement resulting from diminishing adverse consequences of the pandemic, as well as the potential effects of the $1.9 trillion in fiscal stimulus recently passed by Congress. More widespread distribution of vaccines is also a contributor to heightened optimism, as lockdowns can be removed and more segments of the economy can begin to safely come back online. Returns on broad equity market indices was choppy throughout the quarter, but the trend was higher. When the quarter ended, the S&P 500 Index had advanced +6.2%, and has gained +56.4% over the past 12 months.

Performance of each of the eleven primary economic sectors was positive during the quarter, with the more cyclical sectors posting higher returns as the economy accelerated. Energy, Financials and Industrials were the strongest performers on a relative basis, generating returns of +30.9%, +16.0%, and +11.4%, respectively. The Consumer Staples, Information Technology and Utilities sectors were the poorest relative performers, posting returns of +1.2%, +2.0%, and +2.8%, respectively.

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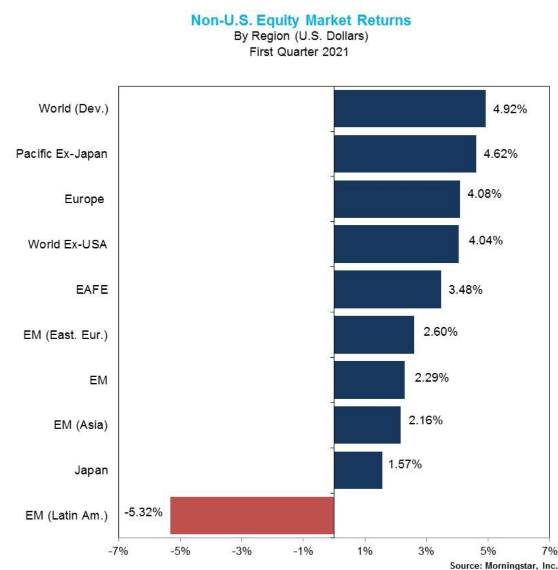
The Russell 1000 Index of large capitalization stocks generated a +5.9% total return. Within the large cap segment, value stocks far outperformed growth stocks. Small cap stocks, as represented by the Russell 2000 Index, outperformed large caps, and finished the quarter with a total return of +12.7%. Small cap value outperformed small cap growth. The NASDAQ Composite, dominated by information technology stocks, finished the quarter with a gain of +3.0%. The Dow Jones Industrial Average of 30 large industrial companies advanced by +8.3%.

Real Estate Investment Trusts (REITs) were higher during the quarter, with the DJ US Select REIT Index up +10.0%. Commodities also posted robust gains, with the Bloomberg Commodity Index adding +6.9% for the quarter.

International stocks also generated material gains during the quarter, and generally performed in line with US equities. The MSCI World Ex USA Index, which measures performance of world markets outside of the US, rose by 4.04%. The MSCI EAFE Index of developed markets stocks advanced by +3.5%. Regional performance was mixed for the quarter. The Pacific ex- Japan region was the strongest performer on a relative basis, with a return of +4.6%. Latin America was the poorest relative performer, declining - 5.3%. Emerging markets performance was modestly positive, as the MSCI Emerging Markets Index was higher by +2.3%.



Looking Forward

The global economy continues to recover from the severe but brief recession brought on by the pandemic. While growth rebounded in the third quarter of 2020, it has been inconsistent since then. However, many economists are very optimistic on the prospects for the economy in 2021, primarily as a result of the improvement in vaccine rollout and distribution, and the enormous amount of fiscal and monetary stimulus that is now in the system. The consensus among economists is that the efficacy of the vaccine rollout is crucially important to the trajectory of the recovery. Even though the number of cases of the virus have declined throughout the world, economists are worried that new variants of the virus or hiccups in the vaccine rollout process could deliver a setback to the recovery. Congress' recent passage of the American Rescue Plan Act worth $1.9 trillion is expected to provide a helpful boost to enable a more sustainable demand-driven revival over the coming years. Analysts expect global job growth to lag somewhat behind the general economic rebound as many industries such as manufacturing and retail are still trailing well behind their pre-pandemic levels. In addition, vaccinations will have a significant impact on how quickly mobility, and by extension employment, will return to normal. Geopolitical risks will also be elevated in a post-pandemic environment, as US-China relations will continue to be prominent as the US strives to move away from supply chain reliance on China.

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