QUARTERLY INVESTMENT OUTLOOK

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Academic studies clearly show that major shifts in equity market leadership occur at turning points in the economic cycle. The current cycle should not deviate from this historical pattern. Value managers, small-cap stocks, cyclical stocks, and international stocks should perform best over the next one to two years, while traditional growth stocks and technology should be laggards. In particular, the S&P 500 Index and NASDAQ could trail other market benchmarks for the first time in many years.

Summary and Major Conclusions:

- Both equity prices and government bond yields trended higher in the first quarter as investors dramatically revised upward their expectations for economic growth in 2021 and 2022. The result was a wide divergence in Q1 returns on common stocks versus bonds.
- There also developed a surge in speculative fervor as the quarter unfolded, reflected in a spreading euphoria in a wide range of assets, partially driven by growing fears over rising inflation.
- Risk assets benefited from growing evidence of a looming economic boom, triggered by the passage of President Biden's American Rescue Plan. Investors also became more hopeful regarding a full reopening of the economy, based upon an acceleration in COVID-19 vaccinations and favorable trends in new infections and hospitalizations.
- Far more significant than broad equity market returns were marked shifts in relative performance. Many non-US equity markets outperformed the S&P 500, value stocks outperformed growth stocks, and small-capitalization stocks outperformed large-cap stocks.
- Despite favorable economic prospects, the investment outlook for the next 12 months is challenging because of key long-term economic and policy variables that are highly unpredictable. Adding to the economic and policy challenges are valuation excesses in virtually all asset classes.
- The economic and investment cycles are less synchronized than normal. Equity investors have front-run expected economic trends — bidding up stock prices well in advance of economic developments — to a far greater extent than in previous cycles.
- The equity market has already progressed to a stage that is well ahead of the unfolding business cycle, as investors have pulled forward future returns, borrowing from the future. The clear implication is that future returns from a starting point of overvaluation could be below the long-term average.
- Government bonds have entered an outright bear market, which implies a rising trend in long-term interest rates throughout 2022, at a minimum. This year could be among the worst years in bond market history.
- Rising bond yields are a long-term threat to the equity market. However, the bond market might not derail the bull market in common stocks until real rates begin to impinge on the real economy.

- The key variable with respect to future equity market returns will be the duration of the economic expansion. History is clear that equity bull markets tend to remain in a general uptrend until the onset of the next recession. However, the equity bull market could peak with a longer-than-average lead time to the next recession.

- There are several crucial assumptions in the investment outlook. An outright economic boom should be positive for world equity markets in the short term, but only until the labor market reaches full employment.

- Inflation is a lagging indicator and should remain under control until 2022. There is a high likelihood of a rising trend over the next three years, which would be an extreme negative for stocks, bonds, and the US dollar.

- While the emergence of variants to COVID-19 are worrisome, scientists have proven that they can achieve medical advances that are effective in dealing with regional outbreaks and mutations as they occur, albeit with a time lag.

- Company earnings should grow rapidly over the next two years. Although the equity market is overvalued, stock prices tend to move higher in the short term as long as Wall Street estimates for corporate earnings remain in an uptrend.

- The Federal Reserve will not begin a rate-tightening cycle until later next year, when the economy is approaching full employment. The equity bull market should remain intact until inflationary pressures become more widespread, monetary policy becomes restrictive, and company earnings reach a peak.

- It is possible that the expansion cycle could be shorter than the average cycle of recent decades because of massive government stimulus and the growing risk of an overheating economy. A truncated expansion cycle — and a potential boom/bust cycle — would be a distinct negative for equity returns beyond the next two years.

- Value stocks should continue to outperform growth stocks in an environment of rapid economic and profit growth, rising inflationary expectations, and higher bond yields. Momentum investors will reinforce the shift in market leadership, as they ultimately capitulate and chase the current leaders and sell the laggards.

- US dollar depreciation is inflationary and supportive of the domestic manufacturing and capital goods industry. It is also a catalyst for a shift in global equity market leadership from the US to non-US equity markets, and from growth to value.

INVESTMENT REVIEW

Financial markets responded to an upturn in economic confidence as the quarter unfolded. Both equity prices and government bond yields trended higher in the first quarter in response to upward revisions to GDP growth, causing stock and bond prices to go in opposite directions. The S&P 500 registered a total return of 6.2% in the quarter, while the return on investment-grade bonds was a negative 3.5%. Long-term Treasury bonds suffered a negative total return of 14%, while investment-grade corporate bonds declined by 4.6%. The total return on high-yield corporate bonds was 1%.

Inflationary Psychology: Evidence of a growing speculative fervor proliferated as the quarter unfolded, reflected in a wide range of assets and partially driven by rising concerns over inflation. Market prices of crude oil, gasoline, copper, lumber, land, aluminum, houses, used cars, and Bitcoin all soared in the quarter. The price of Bitcoin surged from less than $6,000 one year ago to a peak of $61,000 in mid-March.

- **Irrational Exuberance:** Collectibles also soared in price, including artwork and baseball cards. A Tom Brady rookie trading card sold for a staggering $3.1 million last month; a Mickey Mantle rookie card sold for $5.2 million. *These trends are a manifestation of a speculative frenzy resulting from excess central bank liquidity worldwide, along with a steady rise in inflationary expectations*.

IPOs and SPACs: According to the market for inflation-indexed bonds, long-term expectations for inflation rose to 2.65%, up from 1.9% in December and only 1.5% last summer, and the highest level since 2011. Another indicator of investor exuberance was the record $175 billion in initial public offerings (IPOs) raised by more than 600 companies globally — a nearly ***fivefold*** increase over Q1 2020 — including a surge in novel SPAC (Special Purpose Acquisition Company) deals.

The sharp increase in economic confidence was attributable to a variety of factors:

- Despite a sharp weather-induced slowdown in February, the US economy gathered momentum during the first quarter. Household income, retail sales, automobile production, building permits, factory orders, and business investment strengthened in March.

- Following a very difficult January, public health conditions improved dramatically as the quarter unfolded. Although absolute levels remain unacceptably high, infections and hospitalizations declined significantly in the quarter.

- Prospects for manufacturing, distribution, and vaccination of the population also improved during the quarter. The Biden administration announced that there would be an ample supply of vaccines to inoculate 300 million Americans by the end of May.

- Market optimism regarding economic growth was also boosted by developments on the fiscal policy front. In addition to the $900 billion COVID relief package signed into law late last year, Congress passed a $1.9 trillion stimulus bill that will provide funding for a wide range of economic, social, and healthcare initiatives.

Relative Equity Performance: More significant than headline equity market returns were the marked shifts in relative performance within global equity markets. *Shifts in market leadership were profound: Many non-US markets outperformed the S&P 500, the value stock index outperformed the growth stock index, and small-capitalization stocks outperformed large-cap stocks*. The Dow Jones Industrial Average (+8.3%) easily outperformed both the S&P 500 and the tech-heavy NASDAQ (+3%). The small-cap Russell 2000 was the performance leader in the quarter with a total return of 12.8%.

Growth and Value: The shift in leadership from growth to value was especially notable. As measured by Russell Investments, the 12% total return on value stocks significantly outdistanced the 1.2% return in the growth index. Over the past six months, value stocks (+31%) outperformed growth stocks (+14%) by an exceptionally wide margin. However, growth stocks retained their lead over value stocks, 64% to 58%, over the past 12 months.

INVESTMENT OUTLOOK

The investment outlook for the next 12 months is challenging because of major economic and policy developments that have the potential to cause massive shifts in market sentiment. *Adding to the economic and policy challenges are valuation excesses in virtually all asset classes*. The result is likely to be a prolonged period of heightened market volatility in many asset classes. Stocks should continue to outperform bonds over the next year, although temporary interim reversals are likely in each.

Critical Issues for Investors: In general, the manner in which the investment cycle unfolds in coming years will be predicated upon the unfolding of the traditional business cycle. *More specifically, the ultimate **duration** of the expansion is the most significant issue facing financial markets over the next two years*. The most pertinent factors in this regard include the pace of economic growth; the trend in inflation and long-term interest rates; and the thrust of monetary policy.

- **Economic Growth:** It might seem counterintuitive to conclude that cumulative investment returns over the next three years will be inversely related to the speed of the economic recovery. An outright economic boom would prove to be unsustainable by pulling forward full employment, causing inflationary pressures to increase and monetary conditions to tighten sooner than otherwise.

- **Vaccines and Variants:** Prospects for a sustained improvement in public health conditions are predicated upon a *race between vaccinations and mutations and variants to COVID-19*. There are risks in the short term to both of these variables that are unpredictable. Actual trends could either facilitate the transition to an economic boom or postpone a full reopening of the economy.

- **Rising Inflation:** The path of inflation in 2022 and 2023 is the most significant long-term variable in the investment outlook. A rapid rise in inflation would trigger economic instability and a more aggressive monetary tightening cycle, exerting upward pressure on borrowing costs. A rising trend in wage and price inflation is also a negative for company profit margins in the long run.

- **Rising Bond Yields:** Although it seems clear that the long-term trend in bond yields is upward, the speed and timing of this rising trend is crucial. A faster and disorderly rise in bond yields would be a negative for both the fixed-income and equity markets. I expect market yields to rise in distinct waves over the next two years.

- **Overheating Economy:** Common stocks perform poorly in an overheating economy because of the rising risk of monetary restraint. In principle, the Federal Reserve has no choice but to respond to a sharp rise in inflation with a draconian tightening of monetary policy.

- **Bond Yields and Valuation:** The primary risk associated with higher inflation is a rising trend in long-term interest rates. There is a strong correlation between bond yields and equity valuations: A sustained rise in bond yields would set in motion a progressive decline in equity price-to-earnings (P/E) ratios.

- **Fiscal Policy:** The federal government has already enacted legislation to increase cumulative spending by more than $5 trillion, the equivalent of 25% of GDP. Fiscal initiatives already in place increase the risk of an overheating economy; an additional large-scale spending package later in the year involving infrastructure and green energy investments would greatly increase the odds of a dreaded boom/bust cycle.

- **Tax Increases:** Investors should be prepared for tax increases later this year, mainly on corporations and wealthy individuals. However, it appears likely that these will not be of sufficient size and scope to ***significantly*** slow the pace of the economic expansion.

Duration of the Expansion: *Pulling it all together, the key independent variable with respect to future equity market returns will be the ultimate duration of the economic expansion*. History is clear that the equity market tends to remain in a general uptrend until the next recession is imminent. *History also shows that stock returns are maximized during long expansion cycles*. The ten-year expansion cycles of the 1990s and the 2010s were accompanied by cumulative stock returns of 400%. Conversely, equity market returns were only 100% during the much shorter business cycles of the early 1970s and early 2000s.

- **Factors to Monitor:** It is too early in the current economic recovery to gauge the potential longevity of the expansion. *The key signals for investors to monitor include the path of inflation, the shape of the yield curve, and the thrust of Federal Reserve policy*. Future fiscal policy initiatives will also affect the duration of the expansion.

KEY INVESTMENT THEMES

Definitive conclusions regarding these critical variables will not be apparent until 2022 and beyond. However, financial markets are anticipatory and possess an uncanny ability to discount fundamental trends in advance. Therefore, forward-looking financial markets compel investors to make prudent judgments regarding future economic trends. What follows are the major conclusions in my outlook for world financial markets over the next one to two years.

- An outright economic boom should be positive for world equity markets in the short term until labor markets reach full employment. Inflation is a lagging indicator and should remain under control until 2022.

- While the emergence of variants to COVID-19 are worrisome, scientists have proven that they can produce medical advances that are effective in dealing with outbreaks as they occur, albeit with a time lag.

- Company earnings should grow rapidly over the next two years. *Although the equity market is overvalued, stock prices tend to move higher in the short term as long as estimates for corporate earnings remain in an uptrend*. Nonetheless, an overvalued equity market implies that stock prices will rise more slowly relative to the pace of company earnings.

- *The economic and investment cycles are less synchronized than normal*. The equity market has already progressed to a stage that is well ahead of the business cycle, as *investors have pulled forward future returns*. The implication is that cumulative future returns could be lower than might be expected consistent with the current very early stage of the economic expansion.

- The Federal Reserve will not begin a rate-tightening cycle until later next year, when the economy is approaching full employment. The equity bull market should continue until inflationary pressures become worrisome, monetary policy becomes restrictive, and company earnings reach a peak.

- The Treasury yield curve should continue to steepen until the Fed begins to raise short-term interest rates. In principle, a steepening yield curve is a manifestation of investor expectations for strong economic growth and rising inflation.

- Government bonds have entered an outright bear market, which implies a rising trend in long-term interest rates throughout 2022 at a minimum. Rising bond yields might not derail the equity bull market until real rates begin to impinge on spending.

- The catalysts for an end to the equity bull market during 2022 include much higher interest rates and inflation, a marked slowdown in profit growth, and the onset of a new rate-tightening cycle.

- Value stocks should continue to outperform growth stocks in an environment of rapid economic and profit growth, rising inflationary expectations, and higher bond yields.

- US dollar depreciation is inflationary and supportive of the domestic manufacturing, materials, and capital goods industries. It is also a catalyst for a shift in global equity leadership from US to non-US equity markets.

- On a preliminary basis, it appears likely that the expansion cycle could be shorter than the average cycle of recent decades because of unprecedented government stimulus and the growing risk of an overheating economy. A truncated expansion cycle would be a distinct negative for long-term equity returns.

Equity Market Leadership: *Academic studies clearly show that major shifts in equity market leadership occur at turning points in the economic cycle*. The current cycle should not deviate from this historical pattern. Value managers, small-cap stocks, cyclical stocks, and international stocks should perform best over the next one-to-two years, while traditional growth stocks and technology should be laggards. *In particular, the S&P 500 Index and NASDAQ could trail other market benchmarks for the first time in many years*.

Commercial Real Estate: *Along with the fixed-income market, the asset class most vulnerable to future price declines is commercial real estate (CRE)*. The pandemic has significantly altered behavioral patterns pertaining to travel, shopping, living, and working and commuting, to the detriment of office buildings, retail stores, hotels, and apartments in large urban centers.

- **Delinquencies:** Property prices have collapsed in many regions, and delinquencies on commercial real estate are mounting. Nearly $150 billion of CRE debt is currently in serious distress. In addition, 20% of hotel mortgages are delinquent, whereas more than 12% of mortgages on retail properties are delinquent. I expect lackluster returns in the commercial property market in future years.

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Bloomberg Barclays High-Yield Corporate Bond Index: measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

Dow Jones Industrial Average: is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States.

NASDAQ: is an American stock exchange at One Liberty Plaza in New York City. It is ranked second on the list of stock exchanges by market capitalization of shares traded, behind the New York Stock.

Russell 2000 Index: is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

Russell 3000 Growth Index: is a market capitalization-weighted index based on the Russell 3000 index. The Russell 3000 Growth Index includes companies that display signs of above-average growth. The index is used to provide a gauge of the performance of growth stocks in the United States.

Russell 3000 Value Index: : is a market-capitalization weighted equity index maintained by the Russell Investment Group and based on the Russell 3000 Index, which measures how U.S. stocks in the equity value segment perform by including only value stocks.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

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