Economic Update

A Review of First Quarter 2021

As of the end of the first quarter, according to the CDC, over 150 million vaccine doses had been administered in the U.S. Roughly 16% of the U.S. population is now considered fully vaccinated, as compared to only approximately 2% of the total population worldwide. These U.S. counts should continue to increase substantially over the next month or two, as our rate of distribution has been growing each month. We are now averaging over 3 million shots per day throughout the country.

So finally, after 12 months of on-and-off-again lockdowns, an end to at least the economic misery seems to be in sight. However, it is not clear exactly what that means. Will we go back to the world as it existed pre-pandemic, or have both businesses and consumers made a permanent change to at least some of their behaviors? How much of our economy will immediately snap back like nothing ever happened, and how much of it will never fully recover to where it was before?

U.S. Economy

The Fed, at least, expects a strong recovery for the U.S. economy this year. They just raised their estimate for 2021 GDP growth to 6.5% on the heels of the latest round of stimulus. If true, this would represent the biggest surge since 1984. Goldman Sachs' estimate is even higher. They are predicting 8% GDP growth for 2021 and 3.5% during 2022. The dollar has been strengthening throughout the year in keeping with this renewed optimism about the U.S. economy.

Unfortunately, the cost of this growth is significant. The Congressional Budget Office projects that the U.S. logged a federal budget deficit of $3.1 trillion last year. Adjusting their February projection to include the subsequent stimulus package, JP Morgan estimates that the deficit will increase to $3.4 trillion during 2022.

Surprisingly, despite our mounting debts, inflation readings are still reasonable. In February, the Consumer Price Index for All Urban Consumers rose 0.4% on a seasonally adjusted basis. It has risen only 1.7% total over the last 12 months, which is below the 2% annual figure targeted by the Fed. Markets appear to be expecting inflation to start picking up soon, however, as the spread between nominal treasuries and inflation-protected treasuries implies a 2.3% inflation rate over the next 10 years. This at least partially explains the recent surge in the value of crypto currencies like bitcoin, which has had a spectacular start to the year thus far.

The housing sector has remained relatively strong throughout the pandemic, as buyers and sellers have found ways to navigate restrictions. While historically low mortgage rates have contributed to the recent activity, there have been other significant factors as well. Millennials are now moving into prime home-buying age, and they are often employed in high-wage industries where the ability to work remotely is anticipated to continue even after the pandemic ends. Altogether, homebuilder confidence is strong, even higher than it was pre-pandemic.

The jobs market has been improving, although initial jobless claims continue to hover at around 700,000 per week, which is still high by historical standards. Altogether, the U.S. is still down over 8 million jobs from pre-pandemic levels. On the other hand, a total of 916,000 net jobs were created during March, which is a very strong figure. The unemployment rate has now dropped to 6%. The Fed expects continued jobs growth and is predicting that we reach 4.5% unemployment by the end of the year.

The University of Michigan Consumer Sentiment readings have continued to rise, hitting 84.9 in March. Survey respondents specifically cited jobs growth as one of the major reasons behind their renewed optimism. The positive stimulus news and vaccination news contributed as well. Still, despite recent gains, the figure remains well below the 100.0 level normalized in December 1964.

International Economy

Vaccination is not going as quickly in the rest of the developed world. Canada, for instance, is only at 2% fully vaccinated as compared to the U.S. at 16%. This is not markedly different than many European countries. Germany, the U.K., France and Italy are at 5%, 6%, 4% and 5% respectively. One primary differentiator seems to be whether a country has local vaccine manufacturing capability. Those countries that do not have local production are dependent on the countries that do.

Economic optimism seems to be correlated to vaccination progress. The February Purchasing Managers Index survey reading in the U.S. was 59.5, which signals upcoming economic expansion. By comparison, average Purchasing Managers Index survey results in the Euro Area are lower across the board, averaging 48.8, which indicates continued economic stagnation in the near term.

Not surprisingly, vaccination has been even slower in the emerging world. In China, for instance, less than 1% of people are now fully vaccinated. India isn't much better, at 1%. Combined, these two countries represent approximately 36% of the total world population.

The strengthening dollar that is helping to keep inflation in check in the U.S. is having the opposite effect throughout the world, particularly in many emerging markets. Central banks in Brazil, Russia and Turkey have recently raised rates in order help head off growing inflation in their respective countries. In Turkey, inflation is now 15.6%.

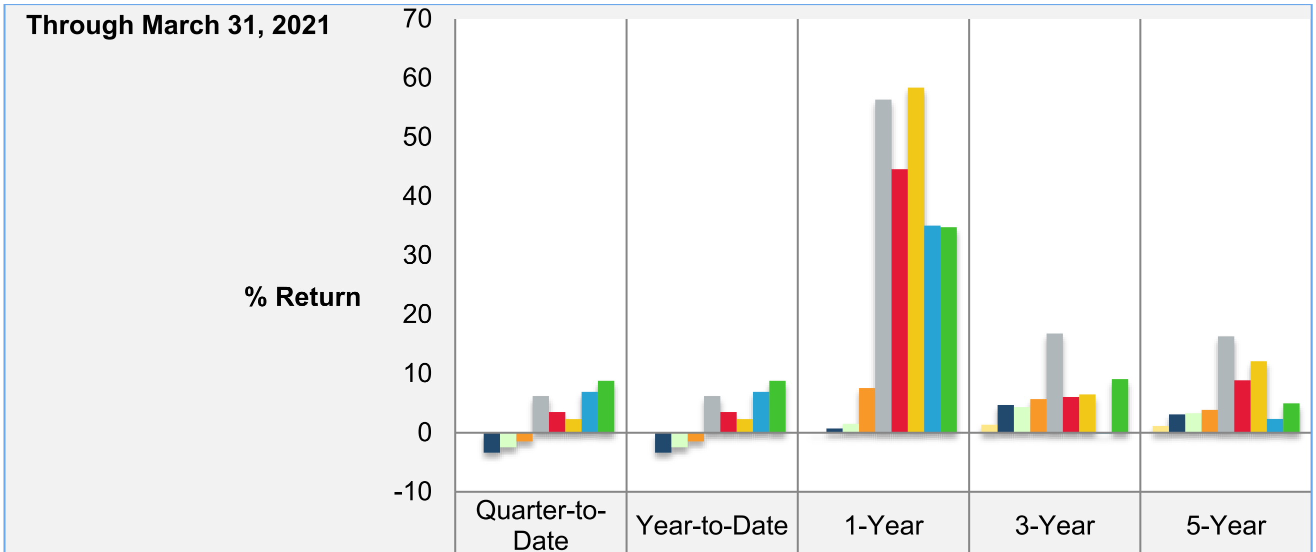
Still, emerging market economies generally have good prospects, as any recovery in the developed world will likely ultimately result in increased imports of both commodities and finished goods from the emerging world. The problem is that the countries that are most likely to benefit from increased developed market demand are not necessarily the same countries that have been struggling with accelerating inflation. Therefore, even though the overall trend is positive, we can expect to continue to see at least some pockets of volatility throughout the world.

Markets

Equity markets have had a good start to the year. Value continued to outperform growth for the second quarter in a row, after lagging for multiple years prior to that. For the market overall, U.S. large-cap equities, as represented by the S&P 500 Index, gained 6.17% during the first quarter of 2021. For comparison, developed international equity markets, as represented by the MSCI EAFE Index, finished the quarter up 3.48%.

Emerging markets underperformed relative to developed ones, but still put up a solid quarter as well. The MSCI Emerging Markets Index finished the quarter up 2.29%. Recent inflation concerns have been good for both real estate and commodities. The Dow Jones UBS Commodity Index and the Wilshire REIT Index have gained 6.92% and 8.81% respectively for the year so far.

Bond indexes were hurt by increasing interest rates. The Barclays U.S. Aggregate Bond Index was down 3.37% for the quarter. The Barclays Global Aggregate Bond Index also lost 2.47% during the period. The Barclays U.S. Inflation-Linked Bond Index, however, was down a little less due to the increased inflation expectations. It finished the quarter down 1.47%.



	Quarter-to-Date	Year-to-Date	1-Year	3-Year	5-Year
T-Bills	0.01	0.01	0.10	1.36	1.13
Barclays US Agg Bond Index	-3.37	-3.37	0.71	4.65	3.10
Barclays Global Agg Bond Index	-2.47	-2.47	1.50	4.32	3.29
Barclays US Infl Linked Bond Index	-1.47	-1.47	7.54	5.68	3.86
S&P 500 Index	6.17	6.17	56.35	16.78	16.29
MSCI EAFE Index	3.48	3.48	44.57	6.02	8.85
MSCI Emerging Markets Index	2.29	2.29	58.39	6.48	12.07
DJ UBS Commodity Index	6.92	6.92	35.04	-0.20	2.31
Wilshire REIT Index	8.81	8.81	34.74	9.04	4.96

Outlook

There is much reason for optimism about the economy over the near term. The vaccination rollout over the last three months has gone better than expected - in the U.S., at least. Per President Biden, we have now secured more than enough shots to inoculate every U.S. resident who wants it. We are now in the position to help other countries as well. It is in our best interest to do so since, ultimately, the health of our economy depends on the health of the global economy. It also depends on the necessity of stamping out Covid-19 throughout the world before too many newer, deadlier variants evolve.

Putting aside the long-term implications of the debt that we continue to take on, the recent stimulus package should also provide at least a short-term boost, as most of the aid will likely wind up directly in the hands of people who will spend it in short order.

On the other hand, market valuations are not cheap at these levels. So, while we are somewhat optimistic due to the current economic tailwinds, we still recommend some caution. A diversified portfolio containing a reasonable amount of equity exposure is always recommended for any investor with a long enough time horizon.

Barclays US Aggregate Bond Index: The Aggregate Bond Index is a broad-based benchmark that measures the investment grade, dollar-denominated, fixed-rate taxable-bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS. The Aggregate rolls up into other Barclays Capital flagship indices such as the multi-currency Global Aggregate Index and the Universal Index, which includes high-yield and emerging markets debt. The Aggregate Index was created in 1986, with index history backfilled to Jan. 1, 1976.

Barclays Global Aggregate Bond Index: The Global Aggregate Index provides a broad-based measure of the global investment grade fixed-rate debt markets. The Global Aggregate Index contains three major components: the Aggregate (USD 300mn), the Pan-European Aggregate (EUR 300mn) and the Asian-Pacific Aggregate Index (JPY 35bn). In addition to securities from these three benchmarks (94.0% of the overall Global Aggregate market value as of Dec. 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar (USD 300mn), Euro-Yen (JPY 25bn), Canadian (USD 300mn equivalent) and Investment Grade 144A (USD 300mn) index-eligible securities not already in the three regional aggregate indices. The Global Aggregate Index family includes a wide range of standard and customized sub-indices by liquidity constraint, sector, quality and maturity. A component of the Multiverse Index, the Global Aggregate Index was created in 1999, with index history backfilled to Jan. 1, 1990.

Barclays Global Inflation-Linked Index: The Global Inflation-Linked Index (Series-L) includes securities that offer the potential for protection against inflation as their cash flows are linked to an underlying inflation index. All securities included in the index have to be issued by an investment-grade-rated sovereign in its local currency. The list of eligible currencies is the same set of currencies eligible for inclusion in the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) represents a stand-alone multi-currency index exposed to the real yield curve for each relevant currency. As such, the index does not contribute to the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) was created on Oct. 31, 1997.

S&P 500® Index: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. It measures the movement of the largest issues. Standard & Poor's chooses the member companies for the 500 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. The returns presented for the S&P 500 are total returns, including the reinvestment of dividends each month.

MSCI EAFE Index: The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed-market equity performance, excluding the U.S. and Canada. As of April 2002, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index: The MSCI EMF (Emerging Markets Free) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of April 2002, the MSCI EMF Index consisted of the following 26 emerging-market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

DJ UBS Commodity Index: Dow Jones-UBS Commodity Index℠ and Dow Jones-UBS Commodity Index Total Return℠ the DJ-UBSCI℠ family includes both the DJ-UBSCI℠, which is calculated on an excess-return basis, and the DJ-UBSCITR℠, a total return index based on the DJ-UBSCI℠. The former reflects the return of underlying commodity futures price movements only, while the latter reflects the return on fully collateralized positions in the underlying commodity futures.

Wilshire US REIT Index: Introduced in 1991, the Wilshire REIT index is intended as a broad measure of the performance of publicly traded real estate equity securities. The index is market-capitalization weighted of publicly traded real estate securities, such as Real Estate Investment Trusts (REIT), Real Estate Operating Companies (REOC) and partnerships. The index is composed of companies whose charters are the equity ownership and operation of commercial real estate.

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