Aequitas Investment Advisors

Investment Markets Review - First Quarter 2021

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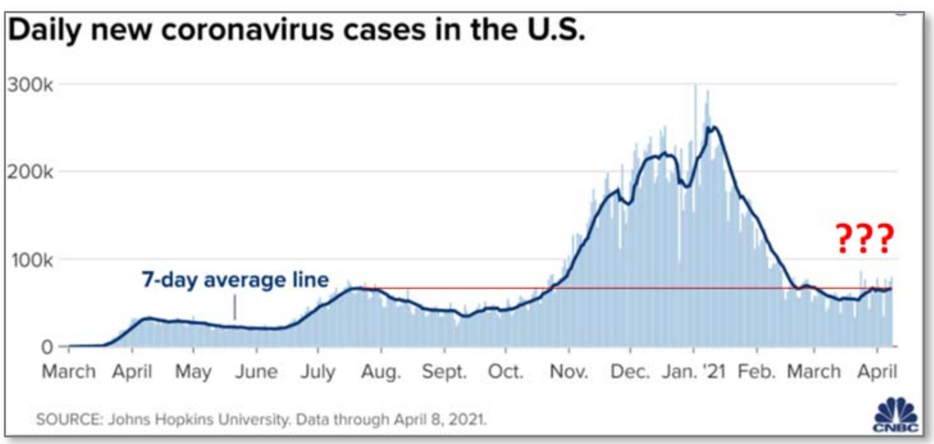
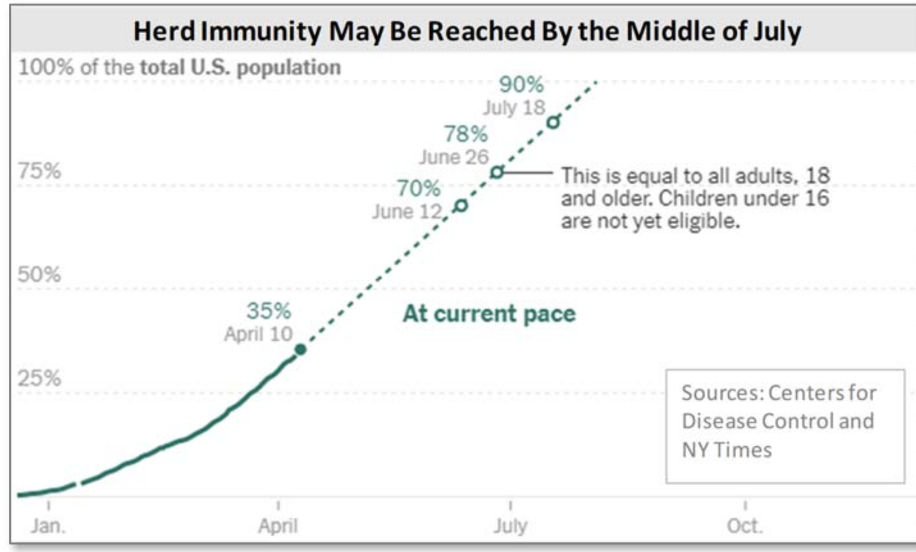
From: Aequitas Investment Advisors

Re: A Ray of Hope

As the Covid-19 vaccine rollout has been ramping up and gaining momentum in the U.S., there is clearly light at the end of this year-long tunnel. With a daily average of more than 3.3 million doses (and climbing), the Centers for Disease Control and Prevention projects that by the middle of July we may reach herd immunity which would be a major achievement in the battle against Covid-19. Combined with new therapeutic drugs and better testing, it is expected that the number of new cases and fatalities will drop precipitously over the summer months. The surge in vaccines coincides with a surge in economic stimulus from the recently enacted $1.9 trillion American Rescue Plan (on top of the Fed's accommodative monetary policies). Assuming all goes well, economists are forecasting that the U.S. economy will grow by close to 7% on a year-over-year basis by end of 2021 – *a figure which would represent the fastest rate of growth in more than thirty-five years!* Before getting too carried away, however, this rosy economic forecast is largely predicated on the assumptions that we can control the virus, including new variants, and can reopen the economy safely; two assumptions which are far from certain given the troubling spike in new cases in Michigan which might be signaling the beginning of a fourth wave of the pandemic. It appears we are in a "beat the clock" situation in our fight against the pandemic. In the words of Dr. Anthony Fauci who spoke earlier this month on NPR's *Morning Edition*, "It's kind of like a race between the potential for a surge

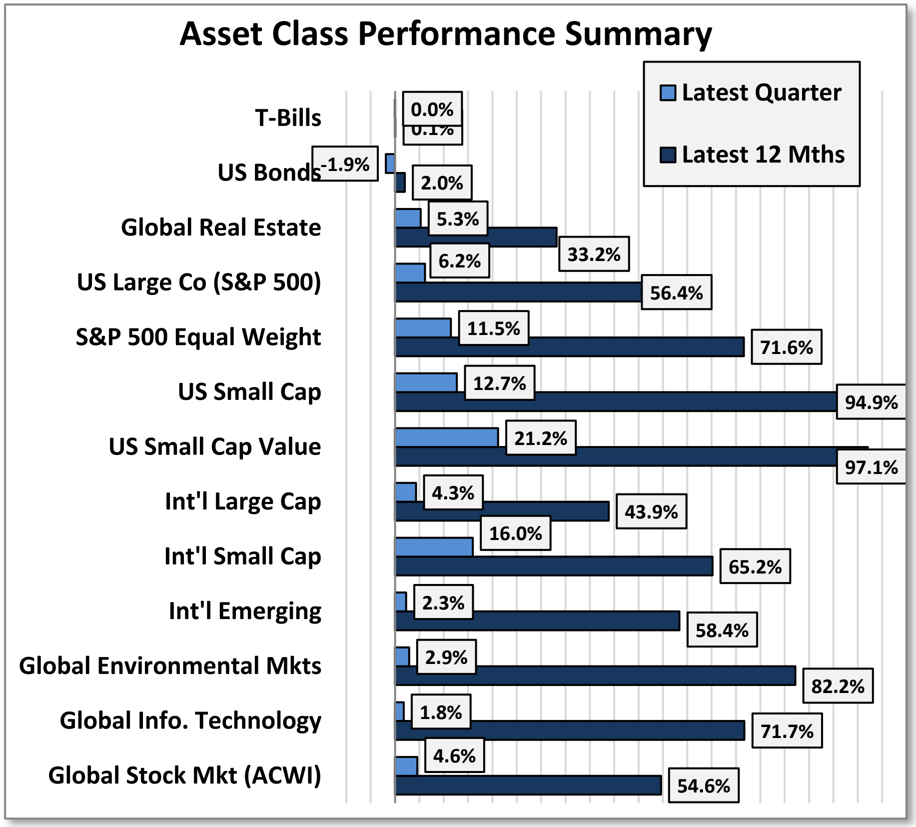




[i.e., fourth wave] and our ability to vaccinate as many people as we possibly can. And hopefully, if you want to make this a metaphorical race, the vaccine is going to win this one." Let's hope he is right!

The Stock Market Already Assumes We Will Win the Race

As we know all too well, the stock market is often driven by the emotions of fear and greed. Today, greed appears to be propelling the stock market higher as investor optimism has been buoyed by favorable vaccine news, a strong rebound in corporate earnings and the introduction of additional government stimulus. Stock prices may have already priced in the assumption that we will win the race against Covid-19 and that our lives might return to some form of normalcy over the summer and into the fall. We have learned through experience, however, that the news can turn negative quite suddenly should, for example, the fourth wave turn out to be worse than expected and businesses are forced to reverse their reopening plans. Greed can quickly turn into fear. Yet, the pieces appear to be in place for a gradual return to normalcy and for the economy to rebound, including: (1) a surge in the availability of vaccines; (2) continued fiscal support (the $1.9 trillion American Rescue Plan); and (3) continued monetary policy support (low interest rates). Letting our guards down and relaxing our precautions too soon could easily turn a cautiously optimistic forecast into another major setback.



Asset Class Performance Review – An Amazing Surge in Stock Prices!

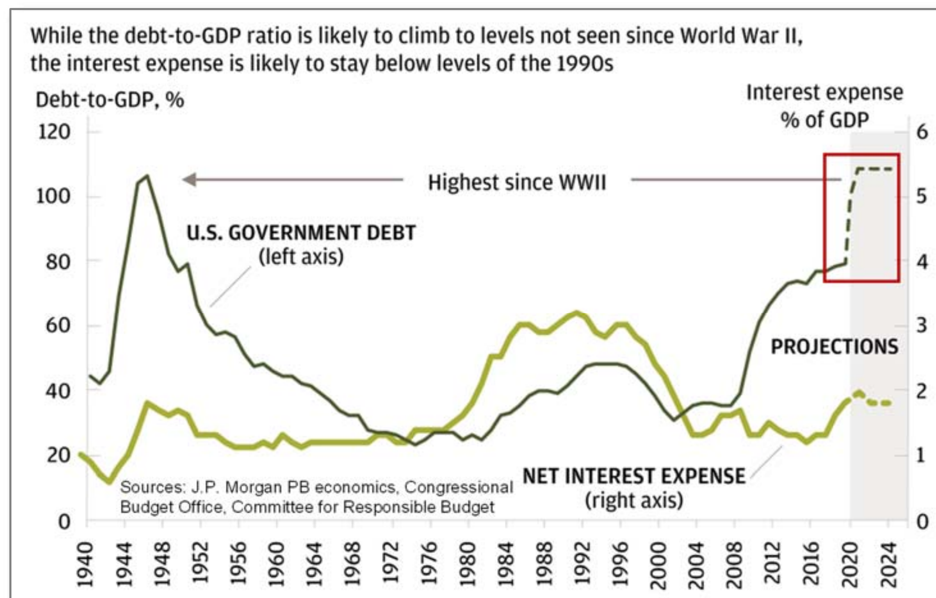
As businesses have been gradually reopening, many of the stocks which were hit the hardest during the downturn one year ago have made a remarkable comeback – *even cruise line stocks have more than doubled in value since the lows of the equity markets in March of last year*. Small Cap stocks were among the biggest losers a year ago, but for the trailing twelve months, they have surged by close to 95% with Small Cap Value stocks up by more than 97%. This is evidence of what some are referring to as the "reopening trade" which has propelled stocks in beaten down industries sharply higher as investors anticipate the economy will continue to rebound.

In viewing performance over the trailing twelve months, all of the asset classes invested in equities performed extraordinarily well with the Global Stock Market (MSCI ACWI) climbing by close to 55%. The aforementioned US Small Cap (+94.9%) and Small Value stocks (+97.1%) led the pack, but the other asset classes within equities delivered gains of between 33.2% (Global Real Estate) and 82% (Global Environmental Markets). U.S. Bonds gained 2%, despite their recent weakness, while U.S. Treasury Bills eked out a paltry return of 0.1%.

For the latest quarter, the best performance came from U.S. Small Cap Value stocks (+21.2%), International Small Cap stocks (+16.0%), U.S. Small Caps (+12.7%) and the S&P 500 Equal Weighted Index (+11.5%). The Equal Weighted Index is a better measure of the breadth of the stock market rather than the Market Cap Weighted S&P 500 Index. Speaking of the S&P 500 Index, it gained 6.2% for the quarter followed by Global Real Estate (+5.3%). Int'l Large Caps and Emerging Markets stocks gained 4.3% and 2.3% respectively. Of note, Global Information Technology Index, which had been the clear winner in 2020, ended up in last place among the stock asset classes for the quarter with a gain of 1.8% (the top four holdings of this index are Apple, Microsoft, Taiwan Semiconductor and Samsung). The Global Stock Market gained a healthy three month return of 4.6%. U.S. T-Bills provided no return (just safety), but the impact of rising interest rates on longer-term bonds can be clearly seen with U.S. Bonds losing 1.9%.

Yet Another Surge (to Be Concerned About Later)

At this moment, our nation's priority is to win the race against the pandemic, bring our economy back to full employment and restore the livelihoods of those who have been hit hardest by the pandemic through no fault of their own. This



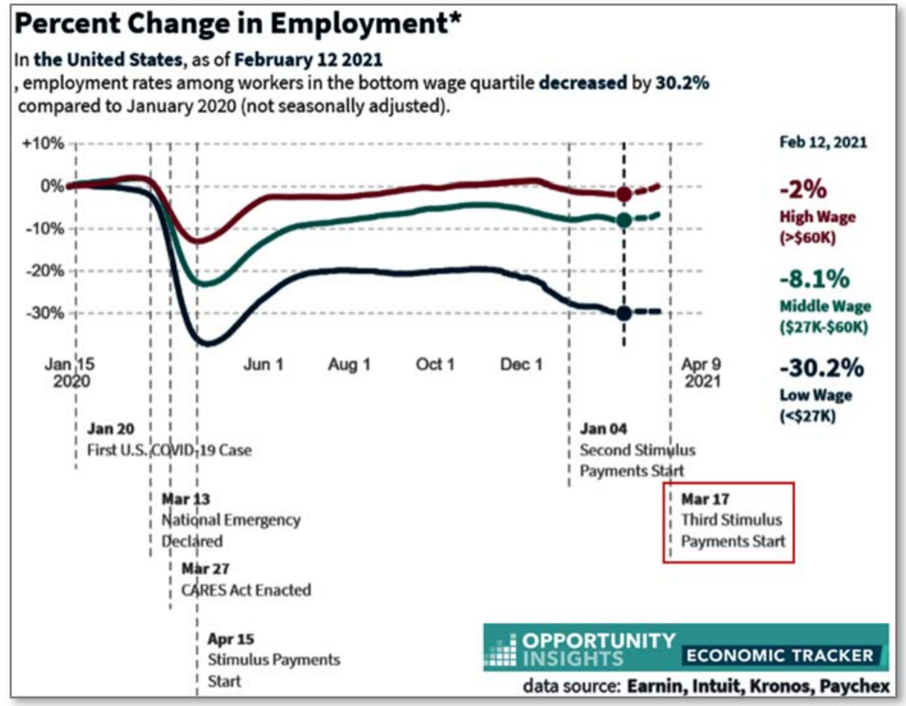
effort will continue to be very costly for our government and, ultimately, for taxpayers. Our national debt will soon reach the highest level on record as a percentage of our GDP (slightly over 100%); and higher than the total debt amassed during WWII. Perhaps one saving grace is that the cost to service the debt, i.e., the net interest expense, should for now only be slightly higher than the historic norm thanks to low interest rates. As long as rates remain relatively low, and assuming the U.S. Treasury continues to lock in low rates by issuing longer-term securities, our net interest expense could remain low as a percentage of GDP for quite a while. However, running up government debt is not a free lunch and will ultimately have to be reckoned with. Some of the risks posed by high levels of government debt include:

- If the net interest expense becomes too high, it may force the government to reduce spending in more vital areas, and/or raise taxes to service the debt.
- The need to finance high levels of debt may crowd out more productive uses of those dollars and further dampen economic growth. Japan is a case study of a country caught in a vicious cycle of high government debt and persistently slow economic growth (Japan's Debt-to-GDP exceeds 240%, or more than twice that of ours). It is interesting to note that despite all of their debt, Japan's inflation rate has been near zero over the past ten years (their economic growth has been barely positive as well).

The risks of running up the government debt load could have a profound impact upon our country's long term economic vitality. At this moment, however, government spending is critical to help us get through the pandemic and restore the economy.

What About Inflationary Risks?

Should the economy rebound later this year as strongly as many economists anticipate, there is speculation that we may experience an inflationary spike. The Federal Reserve's two mandates are to achieve maximum employment and to maintain stable prices, i.e., keeping inflation under control. At present, the Fed's priority is to implement policies designed to foster economic growth and, thereby, help lower the unemployment rate. The rate of unemployment remains unacceptably high at around 6% *on average* across all wage earners, but particularly high (and devastating) among lower wage earners (refer to the chart to the top right). According to a recent interview with Barron's Magazine, the president of the Federal Reserve Bank of San Francisco, Mary Daly, reiterated the Fed's immediate goal of keeping rates low until we achieve full employment (an unemployment rate of roughly 3%). The Fed's long-term inflation target is



2% and we are now at 1.7% overall (the food CPI, however, is 3.6%). The Fed does not appear to be concerned about excessive inflationary pressures in the long-run, and they would accept inflation above their 2% target in the short-term as the economy heats up as long as they achieve their goal of full employment. According to Daly, "We always have the tools to pull inflation down if it gets too high. I see a temporary rise in inflation; it comes back down. I'm much more worried about regaining full employment and lifting inflation up to our 2% average inflation target".

The American (to the) Rescue Plan

As clearly displayed in the Percent Change in Employment Chart (above), the employment rate for low wage earners is still about 30% lower than before the pandemic. The $1.9 trillion American Rescue Plan was largely designed to provide relief to those individuals and their families in the middle and lower wage levels. This Act followed the CARES Act enacted in March of 2020 ($2.2 trillion; 25% of which went to large corporations) and the Consolidated Appropriations Act enacted in December of 2020 ($900 billion). Seeing that this new plan would cost the average taxpayer about $13,000 (in debt), we thought a review of some of the most important components of the Act would be worthwhile:

- Individual stimulus checks: $1,400 per person and $1,400 per dependents. Phased out for individuals earning more than $80K and joint filers earning more than $160K.
- Unemployment benefits: extends benefits by $300 per week through September 6, 2021.
- Earned Income Tax Credit: extends eligibility to more people, including adults aged 19-24 who are not full-time students.
- Child Tax Credit: Expands the credit significantly for children of low-income parents. (This should lift millions of children out of poverty.)
- Nutrition Assistance, especially for women and children, and for families to replace free or reduced-priced meals previously provided by their children's schools.
- Housing Aid: sends funds to state and local governments to aid low-income households with rent and utility bill assistance.
- Education and Childcare: aid to help elementary and secondary school students return to the classroom, in addition, aid to childcare providers for lower income families.
- Funding for Vaccine Distribution and Testing Services.
- Health Care Subsidies: extends subsidies for those purchasing health insurance through the Affordable Care Act.
- Small Business Relief: especially for restaurants and providers of food and drink through the Restaurant Revitalization Fund.

The American Rescue Plan is designed to build a bridge to the other side of the pandemic and assist those in the greatest need while we are getting there.

Statement from Madam Secretary

We are fortuntate to have Janet Yellen at the helm of the U.S. Treasury at this critical time given her understanding of how the economy functions and her substantial experience, including being chair of the Federal Reserve (2014 to 2018) and chair of the White House Council of Economic Advisors (1997 to 1999). She understands the hardship being felt by those suffering the most during the pandemic, especially the unemployed, their families and children. Her words below were written last month at the time of the passage of the $1.9 trillion American Rescue Plan:

> "From the time the pandemic began up until this very week, the economic data has contained deep pockets of pain. Roughly 18 million people are still receiving unemployment insurance, and nearly one million of the families relying on it say their children don't have enough to eat.

Upon taking office, I worried that many of these families would be haunted by the covid economy long after the health emergency was over. We know that when the foundations of someone's life collapse – when they lose a small business, or the roof over their head, or the ability to eat dinner every night – it can scar them permanently; their ability to earn is forever lowered. I worried this would happen on a mass scale, but now I am confident that it won't.

With the passage of the American Rescue Plan, I believe Americans will emerge from the pandemic with the foundations of their lives intact. And that is an enormous economic and moral achievement for America.

Indeed, we are now charting a very different course out of this crisis compared to the one a decade ago [i.e., the Financial Crisis of 2008-09]. Rather than a long, slow recovery, I expect we could reach full employment by as soon as next year.

Our Treasury team will be doing everything we can to accelerate the recovery. We are ready to get to work implementing the measures in the Rescue Plan, including economic impact payments, expanded child tax credits, help for struggling renters and homeowners, and support for state, local and tribal governments.

Of course, there will still be tough months ahead, but eventually, this law will help clear away the immediate crisis in front of our eyes, and let us start building a better post-covid future."

Closing Words

Spring is the season for renewal and hope, and with some light appearing at the end of the pandemic tunnel, there is much to be hopeful for. All of us at Aequitas hope that you and your loved ones are well and that this springtime brings you joy. Perhaps in the not too distant future, we will be able to meet with you again in person!