ICR® 1st Quarter Newsletter – April 2021

Markets continued to rally in the first quarter as investors celebrated another round of fiscal stimulus and the economy's continued recovery. The S&P 500 rose 5.8%, foreign developed stocks were up 2.8%, and emerging markets increased 2%. Some of the lagging sectors from last year were the best-performing in the first three months of 2021. Energy lost 34% in 2020, but led the way with a 31% gain in the first quarter of this year. Financials also performed well, posting a 16% return during the quarter.

Investors cheered another round of fiscal stimulus that saw $1.9 trillion get pumped into the economy. $410 billion of that package went out as direct stimulus payments to citizens, some of which seemed to find its way to the stock market. Indeed, the first quarter was marked by pockets of rampant speculation. The number of new brokerage accounts skyrocketed as the "retail" investor engaged in the market in a substantial way. Some of that is healthy engagement, though the recent trend in chasing "meme" stocks is concerning as it feels inevitable that the story will end badly for a lot of people (though not all).

One of the bigger stories in the first quarter was the sharp rise in interest rates. The ten-year Treasury bond yield rose from 0.92% to 1.75% in just three months, causing bond prices to plunge. This was especially painful at the long end of the curve where treasuries suffered their worst quarter since 1980. The surge in interest rates gave the stock market pause as trading was choppy near the end of January and throughout February, before recovering nicely in March. Growth stocks are seen as being more negatively affected by higher interest rates. Indeed, the NASDAQ lost 10% over a three-week period before recovering sharply.

The rise in rates is largely attributed to expectations for better economic growth and the possibility of that growth – along with the huge fiscal stimulus – leading to higher inflation. So, will all the money that has been injected into our economy lead to inflation? Most economists seem to agree that we will see at least some increased inflation in the coming months, but some of the explanation for that is that we will be measuring it versus the deflation that took place during last year's economic shutdown. That is, reported inflation numbers will almost certainly increase relative to a low base.

Aside from statistical blips, though, will we see the type of inflation that can create economic disturbance and market anxiety? The answer to that is far less clear, but we have already seen supply chain disruptions combined with increased demand cause inflation in certain pockets of the economy. Lumber prices, for example, have more than tripled in the past year, originally surging because of supply issues combined with Americans rushing to Lowe's and Home Depot to remodel their homes that they were suddenly spending a lot more time looking at. Then, with interest rates so low, new housing starts shot up, recently hitting a 15-year high in March. And new homes, as you can imagine, require substantial lumber. So, excess money in consumers' pockets plus increased demand has combined with supply shortages to cause exactly what economics textbooks would predict – inflation.

Lumber is just one extreme example that supports the notion of increased inflation. Leisure, travel, hospitality, and other sectors most negatively affected by COVID also faced deflationary pressures. Consumers shifted their preferences last year in response to the changes caused by the pandemic and it's quite possible – perhaps even likely – that their preferences will shift back in the other direction as we move past the pandemic (hopefully). Rather than cause widespread inflation, that would simply change where the pockets of inflation are found.

While much hand-wringing is taking place over all the money that has been pumped into the system, it is important to remember that Americans are saving money at record-high rates (13.6% in February). That means that a lot of the stimulus money is either sitting in bank accounts or being invested in the markets. Unless and until the savings rate drops substantially, the excess money in the system will be hard-pressed to cause meaningful inflation. Of course, we should never discount Americans' appetite for consumption and it is quite possible their pent-up demand from the past year will result in a summer of unprecedented spending.

If that scenario plays out and increased inflation proves more enduring, what effect would that have on the markets? First, the Federal Reserve would be put in a very difficult position. Would they raise rates to combat inflation at the risk of stopping the economic recovery short of its full potential? Or would they keep their foot on the gas and hope that inflation naturally comes back down to a more acceptable level?

The former scenario would likely be met with dismay from investors. Higher rates mean a larger discount for future corporate earnings, which equates to a lower current valuation. Corporations and investors have fallen in love with low rates that allow them to borrow money for next to nothing and a shift in that policy would likely cause a readjustment of market expectations. While this would probably be short-term in nature and not terribly painful over the long run, the volatility during the readjustment process could be unsettling.

If the Fed keeps its commitment to low rates for the foreseeable future, we could see inflation rise well above their 2% target for an extended period. Historically, during periods of rising inflation, the stock market has tended to underperform relative to periods of tame inflation. And with yields as low as they are, investors would also likely sell their bonds if inflation was outpacing their yield. While this scenario probably isn't the most likely, it is concerning as it leaves almost nowhere to hide.

We don't see out-of-control inflation as an imminent threat, but it has joined the list of potential risks in the coming months. If it becomes a problem, it could be painful in the short run, but we believe we've crafted portfolios that may bend but should not break in the face of inflation or other potential risks to financial markets.

As always, let us know if you have any questions or want to make adjustments to your portfolio. We are grateful for the opportunity to serve you, and we want to help you achieve your financial goals.

Sincerely,

James A. Heine

James L. Cobb

Market Report (as of 3/31/21)

Index	2021 YTD (%)	3-Year Annualized (%)	5-Year Annualized (%)
S&P 500	5.8	14.6	14.0
Dow Jones Industrial Average	7.8	11.0	13.3
U.S. Aggregate Bond Index	-3.4	4.7	3.1
MSCI EAFE (Foreign Index)	2.8	3.3	6.0

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