SUMMIT ASSET MANAGEMENT

"More Money, More Medicine"

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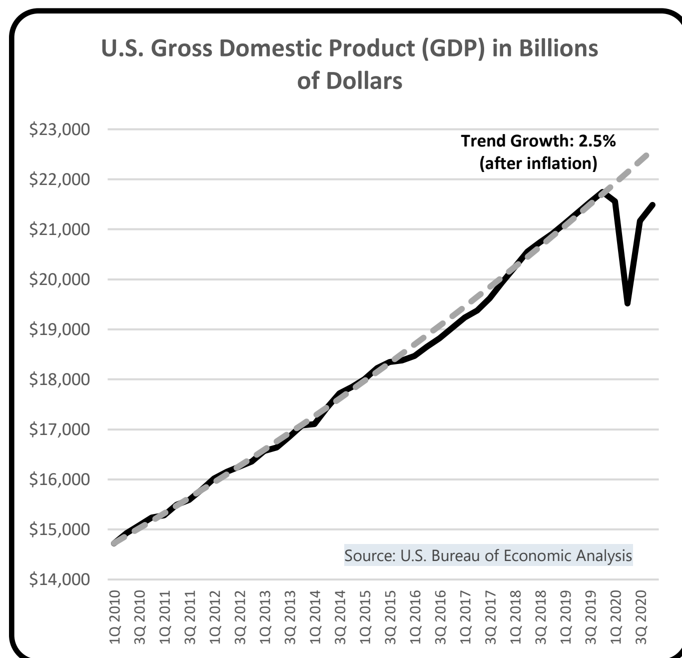
Dear Clients and Friends: April 19, 2021

We are in a very different place today than we were three months ago. We will also be in another very different place three months from now. We are transitioning from weariness and lockdown fatigue to hope to normalcy. The U.S., and the rest of the world, is experiencing two surges: one in vaccines and one in fiscal stimulus. While COVID is still with us, the economy and capital markets are feeling out what a world with the virus largely contained may look like. Expectations are great.

The enthusiasm surrounding economic reopenings helped spur stronger stock markets. Despite another quarter of value-rotation, the growth heavy S&P 500 had a good start to the year, rising 6.2%. Smaller stocks continued their rally, up over 12%. Outside the U.S., returns were slightly more muted with international markets up about 4% and emerging markets up only 2%. However, the stimulus and pick-up in economic activity raised concerns about inflation. This was a major headwind, forcing Treasury yields higher. The Aggregate Bond Index was down about -3.5%.

We think the graph to the right is a terrific depiction of where we have been, where we are now and where we think we are going. The solid line represents the size of the U.S. economy. The graph starts in 2010 with a value of about $15 trillion. Over the last couple of decades, though with some deviation, the economy has tended to grow at about 2.5% annually, after inflation. This trend is represented by the dotted line. Prior to COVID, the economy measured about $21.75 trillion.



As can be seen, we experienced a free fall when the country was largely shut down last summer. The economy shrunk in size by about 10%, or nearly $2.25 trillion. A rapid rebound has occurred as we have started reopening, gaining back about $1.7 trillion. However, a significant gap still remains, both between where we were and where we should have been had COVID not transpired.

How do we get there? More money, More Medicine.

Most economic forecasters believe that not only will the gap be closed in 2021, but we will surpass the trend line. To do so, we will likely experience GDP growth rarely seen in such a developed economy. This growth will be supplied by continued fiscal stimulus and the confidence gained from the ongoing vaccine rollout.

On the vaccine front, the goal is herd immunity. To get there, estimates are that we need about 80% of the population to have protection from the virus. The CDC reports that there have been more than 31 million confirmed cases of COVID in the U.S. They also estimate another 70 million people have been infected, but gone unreported. So, a little more than 30% of the population should have some form of immunity from the virus itself.

As for vaccines, it is now estimated that almost 85 million people are fully vaccinated with an additional 50 million having received one shot. This represents another 25% to 40% of the U.S. population. Combining previously infected people with those receiving vaccinations, we are approaching 60% of people being protected. At the current vaccination rate, we are protecting another 10% of the population each month. Reaching the goal of 80% by the end of the summer is now looking very realistic.

From the money side, in the U.S., the amount of extraordinary fiscal and monetary stimulus has been unprecedented. In March 2020, the Federal Reserve lowered the Fed Funds Rate to 0% and embarked on a massive new program of buying bonds and other assets to stabilize markets. Congress, in December, then passed the CARES Act, followed by a $900 billion COVID relief bill. This March, they passed the $1.9 trillion American Rescue Plan. Now, the Biden administration hopes to pass an additional $2 trillion infrastructure bill. Cumulatively, these bills amount to over $7 trillion in extraordinary spending or almost 30% of GDP. By comparison, the fiscal response to the Financial Crisis amounted to less than 5% of GDP.

There is a wave of money making its way through the U.S. economy. Most of this money will flow into increased spending and economic activity both at home and abroad. Both the American Rescue Plan and proposed infrastructure bills target lower- and middle-income families more directly than previous relief packages. Statistics show that benefits received by these groups make their way into the economy much more quickly and efficiently than money given to higher-income citizens. In other words, the former spend it, and the latter save it.

Early last year, we speculated that at the end of this pandemic, we expected massive economic activity. The "animal spirits" would be released from weary Americans who had been cooped up for too long, had lots of cash in their pockets from both stimulus and forced reduced spending, and had seen much of their credit card debt magically cured. That time appears to be now. This activity will fill the economy gap mentioned earlier. Projections are for first quarter annualized GDP growth to come in around 4%, followed by 10% in the second quarter and 8% for both the third and fourth quarters. Unemployment should respond accordingly by hitting 4.2% by the end of the year.

Outside the U.S., the amount of stimulus has also been significant, boosting prospects for recoveries, especially in Europe. China appears further ahead in its recovery already but should continue to benefit as the rest of the world returns to normal.

Outlook

One reasonable concern is that all this money will lead to runaway inflation and significantly higher interest rates. Based on those fears, we experienced a bout of volatility during the first quarter, especially in the bond market. The yield on the 10-year Treasury rose from 0.9% to 1.6% creating headwinds and negative returns for most bonds.

A bond's yield is made of up of three components: a risk-based factor, a time factor, and an inflation factor. A bond's price reacts inversely to that yield. If yields go up, the bond's price goes down and vice-versa. In this case, expectations for higher inflation are causing investors to demand a higher payment from that component of the yield. The result was volatility and prices trending down.

In the near-term, we would expect inflationary pressures to build in some parts of the economy, especially in areas where supplies are constrained, and capacity is limited. Many of the inflation numbers we will see in the coming months will be "year-over-year" comparisons with the coronavirus crisis last Spring when prices collapsed. This "base effect" will likely push reported numbers into the 3-4% range. The Fed believes that these pressures will be temporary and will subside as the supply of goods and services rises to meet demand and the stimulus tapers off. We agree but will be watching.

While potential returns look lackluster, bonds still offer a good safe harbor from storms and are necessary for diversification. Our bond portfolios are generally focused on higher quality, shorter maturity holdings that are less sensitive to moves in interest rates and changes in inflation expectations. We also look for and employ other niche fixed income opportunities that are ordinarily less impacted by these factors.

Staying diversified remains important. Last year's headlines were often grabbed by companies focused on the "stay at home" trend or innovative new ideas or products. However, for the second consecutive quarter, equity gains were more widespread. The recent rotation from large-cap growth to more cyclical and value strategies continued. As the pandemic eases, investors have started to favor more economically sensitive sectors like industrials, energy and financial companies.

Many of the trendiest stocks saw their momentum stall during the quarter and are now down for the year. In fact, the 25 stocks in the S&P 500 with the lowest returns last year are all positive to start 2021, with a median return of +32%. On the flip side, the best performing stocks from last year now have a median return of -3%. We view this broadening of performance as a healthy dynamic, strengthening the bull market.

Going forward, we continue to see opportunities for stock markets to grind higher, although with continued volatility. The picture for bonds is less attractive. We view the economic expansion accelerating along with job growth as those areas slow to recover start to do so. Consumers are in relatively healthy financial shape and, with COVID restrictions being lifted, will be able to begin to spend more aggressively. These actions will translate into business earnings growth, supporting stock prices. However, this outlook for growth is a consensus opinion and likely partially reflected in valuations of current stock prices. A vaccine distribution setback or new COVID variants taking hold could present new challenges. We remain cautiously optimistic and look forward to better times ahead.

Thank you again for your continued confidence and trust as we work through these extraordinary times. We welcome your comments, questions, and referrals. Please don't hesitate to contact us and stay safe and well.

Summit Asset Management LLC