1Q2021 Market Review and Outlook
The Grand Reopening

After the world was capsized in 2020, Q1 2021 marked a time where a light at the end of the tunnel seemed within reach. Amid vaccination momentum and states reopening, Americans began to feel a sense of normalcy. Economic growth was fueled by surging manufacturing, consumer confidence, and labor market recovery.

Many equity markets indices experienced record highs. Investments tied to the economic recovery soared with investors shifting to the cyclically sensitive sectors and away from the expensive tech heavy investments. Value outperformed growth by the widest margin since 2001, energy stocks posted their best quarterly rally on record and select commodity prices jumped to the highest level in nearly a decade (e.g., copper). Fixed income became the victim of the optimism as interest rates soared along with inflation expectations. Investors were reminded that ultimately the 30+ year bond bull market would come to an end. The 10-year Treasury note posted its worst quarterly performance on record and inflation protected Treasuries outperformed nominal Treasuries by the most since 1Q09.

As we move into 2Q21 and the remainder of 2021, there are many sources of enthusiasm. The economy is on pace to post a record year and consumers are likely to be a driving force of the global recovery. However, with many global equity indices at or near record highs and fixed income's likely rocky year ahead, it is challenging to find value. We will outline our outlook for the economy as we begin to return to a sense of normalcy and where we see value across the different asset classes.

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The Grand Reopening

One year after the worst quarterly decline in GDP in U.S. history, we are seeing a much brighter picture ahead. Not only is real GDP expected to surpass its pre-pandemic peak this quarter, but corporate and household balance sheets are extraordinarily healthy. In addition, the backlogs of orders and slim inventories that were a result of the pandemic-led shutdown are still being worked through and remain at levels that we have not seen in decades.

These forces are colliding with pent up consumer demand as we begin the grand reopening of the U.S. economy. Currently, more than 90% of the states/territories are in some phase of easing and/or lifting restrictions. In addition, the U.S. has vaccinated more than 200 million Americans (with at least one dose) and at the current pace our country may reach herd immunity in the first half of this quarter. This quarter is just the start of a prosperous period of economic growth for the U.S. economy. Below we highlight the driving forces behind our optimistic outlook and outline the risks we are monitoring.

- **Fiscal and monetary support:** The rapid fiscal stimulus in 2020 and the additional stimulus this year is an unprecedented amount of money. To put the more than $5 trillion that has been designated in COVID bills in perspective, the U.S. Government has spent more on COVID relief than it did on World War II, the Vietnam War, World War I, and the Korean War, combined! And that is inflation adjusted. **(Chart 1).** In comparison to other major international countries, the recent $1.9 trillion stimulus package pushed us beyond Japan in terms of how much spending we have put forth as a percent of GDP **(Chart 2).** Fiscal stimulus has only been one tool used to boost the economy. The Federal Reserve balance sheet has exploded to more than $7.7 trillion and continues to grow. The Fed has committed to keeping rates accommodative and the real Fed funds rate is deeply negative. All these efforts combined with the world reopening should support a solid acceleration in growth.

Chart 1

Putting Stimulus in Perspective

Estimates Data is as of March 25, 2021. *Inflation adjusted dollars. Source: Bloomberg Finance LP, Bloomberg.com Politics and Policy, "COVID Relief Bigger than World War II Budget." March 11, 2021. Verdence Capital Advisors.

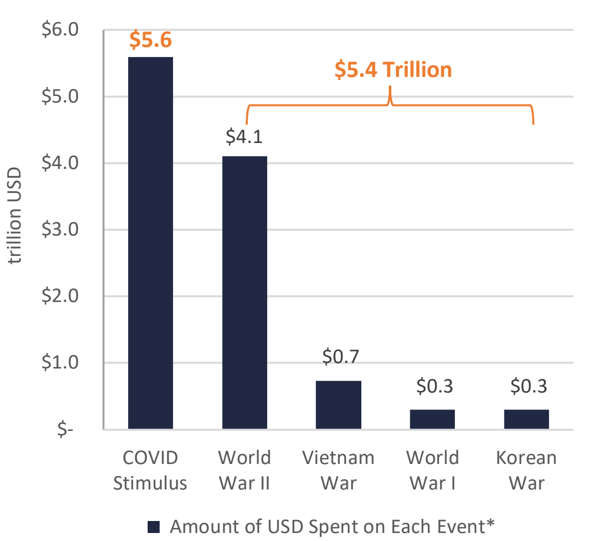
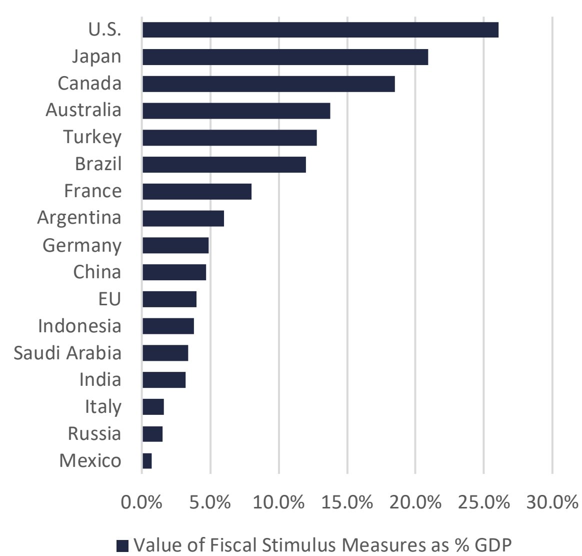


Chart 2

U.S. Leading Global Stimulus Effort

Data is as of March 2021, U.S. spending includes $1.9 trillion stimulus bill and using nominal GDP as of 4Q20. Data Source: Bloomberg Finance LP, Statista, Verdence Capital Advisors.



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Past performance is not indicative of future returns

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- **Manufacturing sector still cleaning up pandemic lockdown bottlenecks:** Globally, manufacturing is still working through the orders that were delayed during the pandemic-led shutdown. From a global perspective, manufacturing has risen above its pre-pandemic high. **(Chart 3).** In addition, when looking at the top 10 countries (regarding economic growth), eight out of the top 10 individual manufacturing indices are at or above their pre-pandemic peaks. In the U.S., all indicators point to continued strength in manufacturing with production at a four-year high. The backlog of orders is at the highest level since the dotcom bubble while inventories are at the lowest level since the Great Recession. **(Chart 4).**

Chart 3

Global Manufacturing Surging Beyond Pre-Pandemic Levels

Data is as of March 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors.

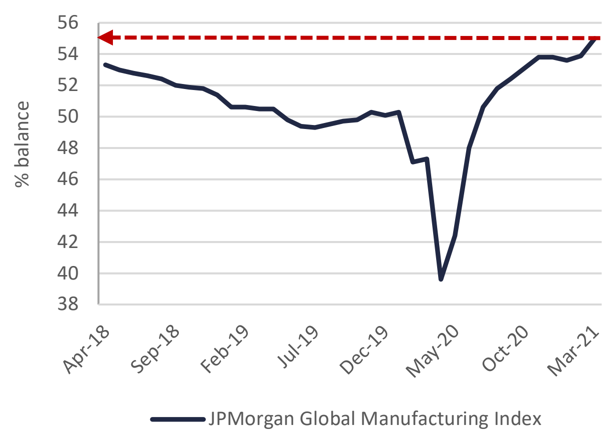
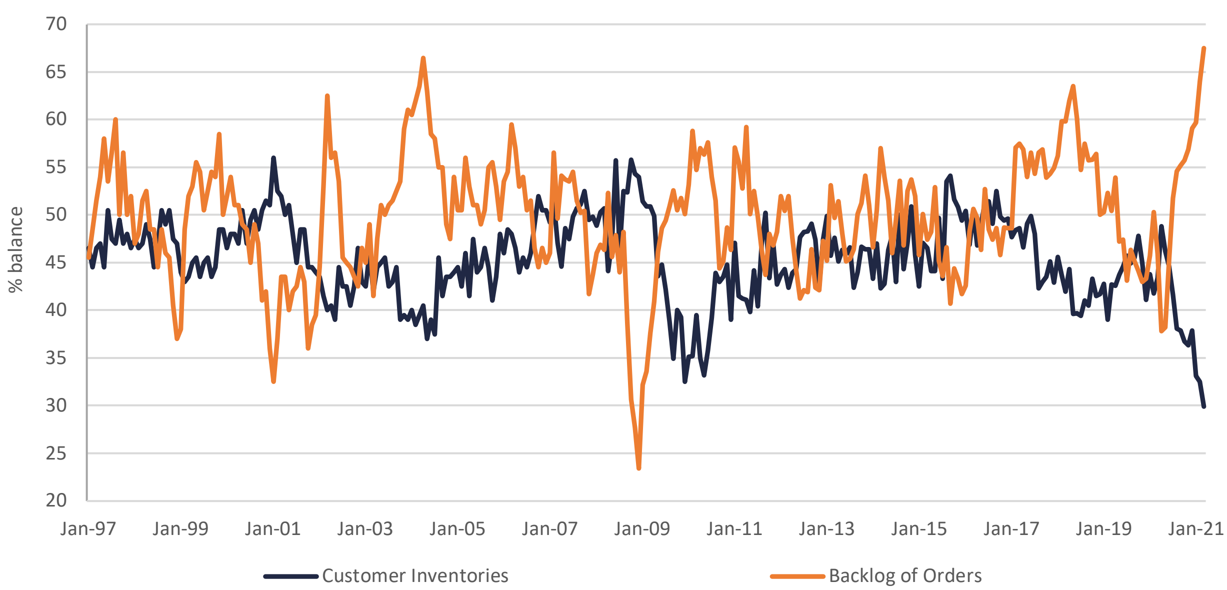


Chart 4

Bottlenecks to Support Manufacturing

Data is as of March 2021. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



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- **Consumer healthy and ready to get out!** We acknowledge that there are still many Americans that are struggling as we have not completely returned to our pre-pandemic way of life. This can be seen by the elevated unemployment rate and changing dynamics in the labor force (e.g., women and minorities having left the workforce). However, the massive fiscal stimulus has helped to bridge the gap until we can fully reopen. Americans have used their stimulus checks to repair balance sheets and stockpile savings. The personal savings rate is over 10% while household debt service ratios are near historic lows. **(Chart 5 – next page).** In the second half of 2021 and into 2022, we expect Americans to spend more on experience and leisure and hospitality as opposed to the stay-at-home spending we experienced over the past year (e.g., furniture, electronics). Americans are already taking to the skies again, searching for travel, driving more, and getting back to restaurants. This is likely to accelerate as we vaccinate more people, and restrictions are lifted.

- **Business confidence is supportive of improving economy and labor market:** Business confidence is important because it can be a good gauge to measure future hiring and capex spending. Confidence has been mixed over the past year, especially for small businesses as we have been battling COVID-related restrictions that were varied across the country. However, there are signs that confidence is improving as we move into the economic reopening with fiscal and monetary policy remaining supportive. **(Chart 6 – next page).** Historically, there tends to be a tight correlation between large and small business optimism. We expect small business optimism to accelerate as the U.S. reopens. The health of small businesses is crucial to our recovery as small businesses employ ~50% of the U.S. private workforce.[1]

> …there are signs that confidence is improving as we move into the economic reopening with fiscal and monetary policy remaining supportive.

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Chart 5

Healthy Consumer

Data is as of March 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors.

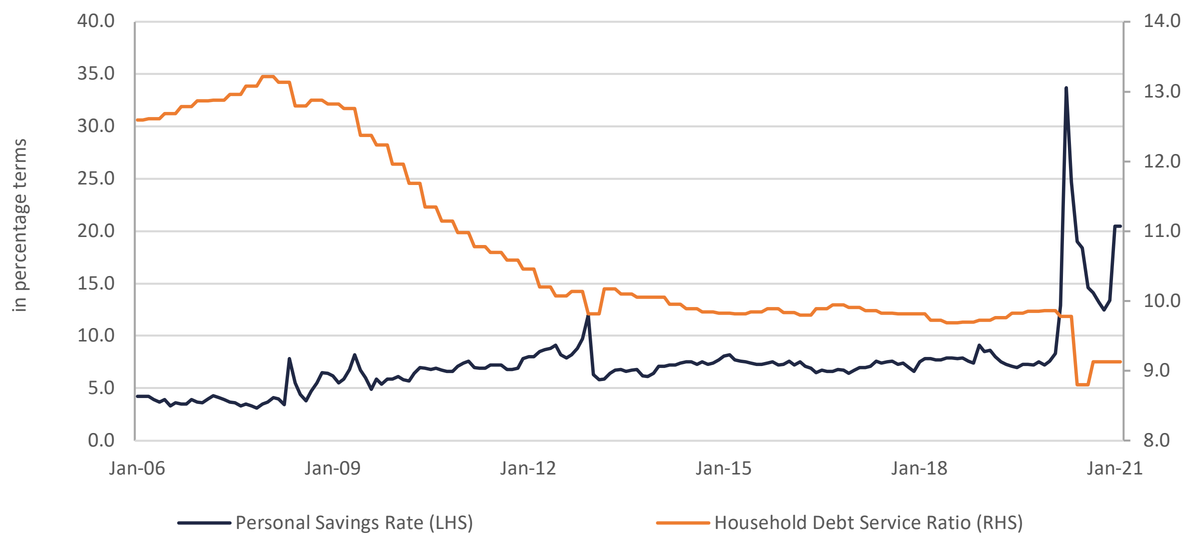
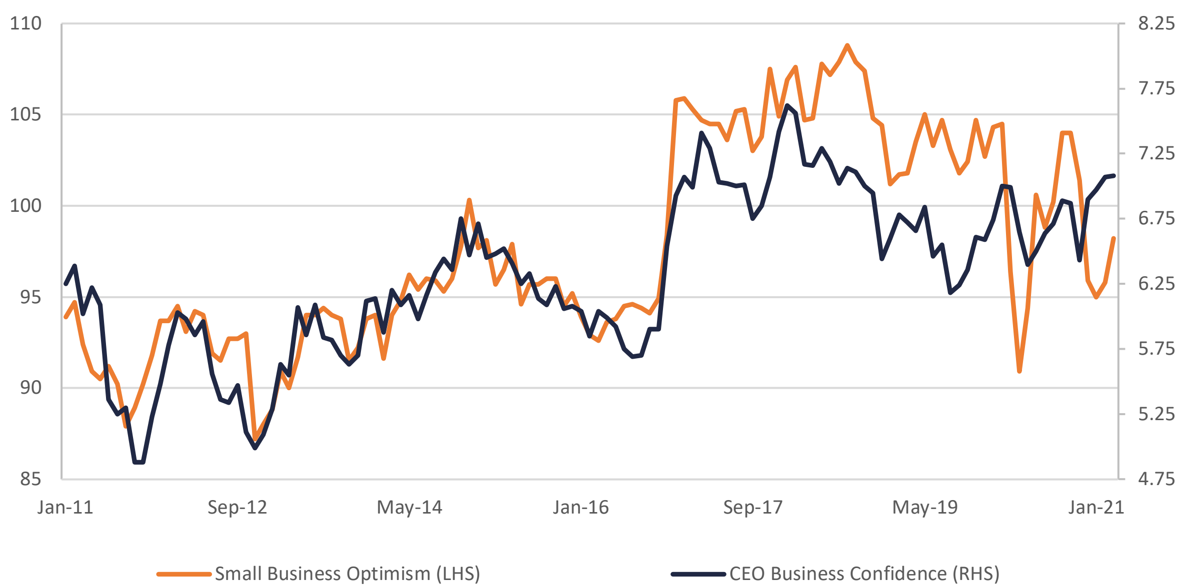


Chart 6

Business Confidence Improving

Data is as of March 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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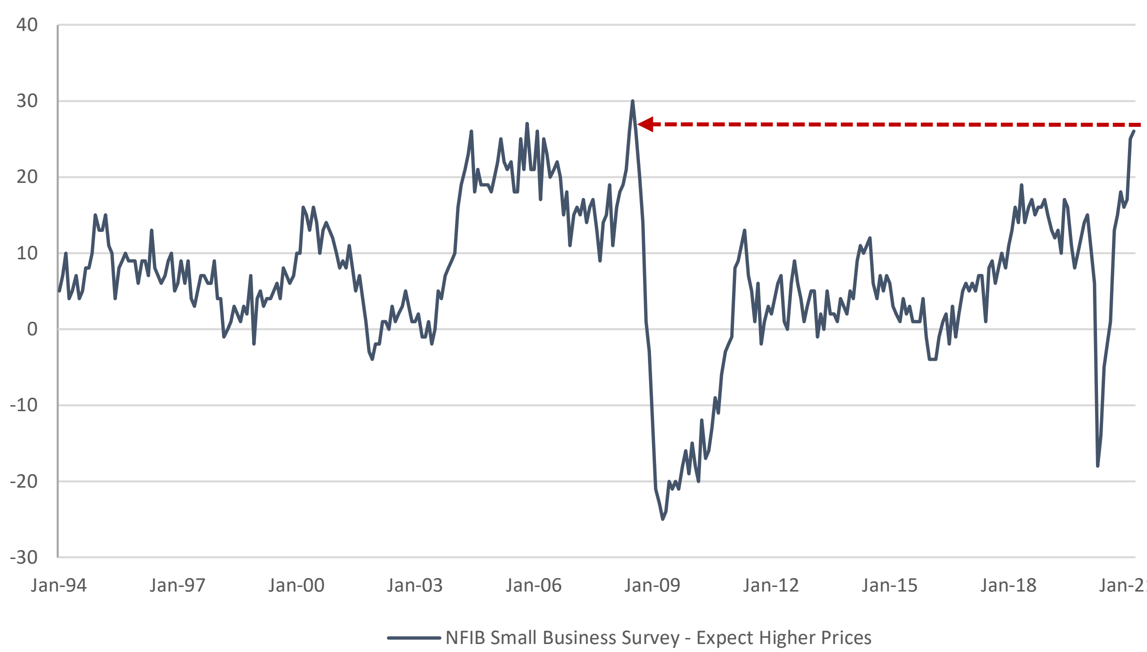
There are multiple sources of optimism about the economy over the next 12 months and beyond. Never have we witnessed the amount of stimulus that we have seen over the past year. There are few things that could derail the positive effects of accommodative monetary policy, fiscal stimulus, and a return to normalization. However, we would be complacent to not consider potential risks. The following are a few risks we are monitoring.

- **Inflation: Not a question of if, a question of when?** The COVID-related Government stimulus has catapulted the money supply to a record high. Before COVID, Americans remember the massive stimulus in the aftermath of the Great Recession. However, the increase in the money supply in 2008 was a small blip on the radar compared to what has happened over the past year. An influx of money and COVID related backlogs of materials have led to large increases in important input costs for companies. We have seen this concern in several surveys from the manufacturing sector and small businesses as the expectations for higher prices are near record and/or multi decade highs. **(Chart 7).** In addition, market expectations for future inflation have increased to the highest level since 2013. We will closely monitor inflationary pressures because companies have one of two options, either absorb the price increase or pass it onto the consumer. Therefore, either inflation increases, or profits get squeezed. Both can be a risk to the economy and the equity market.

Chart 7

Businesses Expecting Higher Prices

Data is as of March 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors



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- **Rising interest rates:** If interest rates are rising for the right reasons (e.g., better economic growth) as opposed to the wrong reasons (e.g., policy error, inflation scares) it should not threaten economic growth. In fact, we believe that rates rising off the emergency levels seen during the pandemic are a sign of things improving. In addition, rising real rates are good for our saving population. In contrast for those that are highly leveraged, rising interest rates may make the cost of funding debt more expensive. For example, the massive debt taken on by the Federal Government to fight COVID may be more difficult to fund once interest rates rise. **(Chart 8).**

- **Labor market recovery:** We believe that once the economy reopens to its pre-pandemic levels, the labor market will quickly improve. However, the damage done to the labor market by the pandemic has been complex and unique. There are more than four million Americans still categorized as long term unemployed. The pandemic has also had a disproportionate effect on low income paying jobs, women, and minorities. We are confident this will be repaired over the next 12 months. However, if this is slow to recover or individuals are incentivized to not return to the labor force (e.g., prolonged unemployment benefits) this may threaten our optimistic outlook.

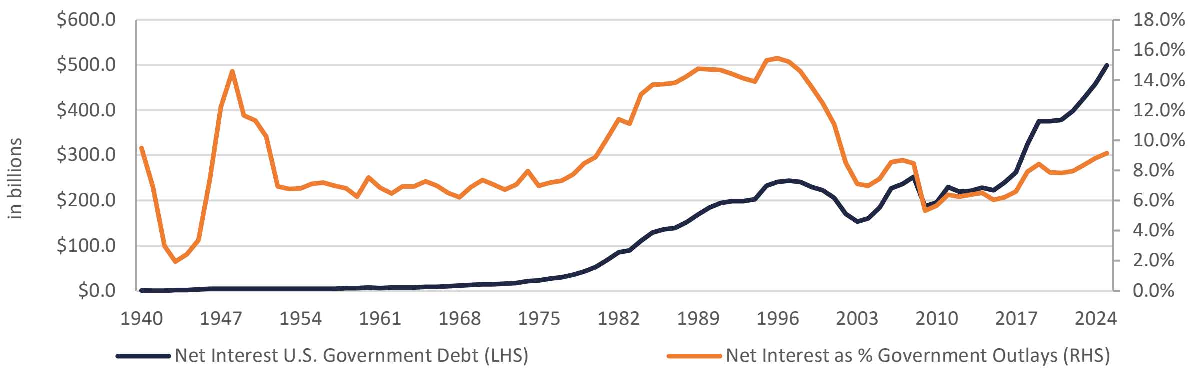
- **Policy error:** The Biden Administration has unveiled additional stimulus packages and been clear that they want to use higher taxes to fund their ambitious plans. At this time, it is too early to speculate what may or may not get through even with a full democratic Congress. However, it would be irresponsible to not monitor the risk of policy error if tax hikes are too aggressive at a time when the economy is trying to expand.

ECONOMY BOTTOM LINE: The actions of the Federal Government and Federal Reserve are joining forces with the grand reopening of the U.S. economy and we expect an ongoing acceleration in economic growth. Businesses and individuals were healthy going into the pandemic and have improved balance sheets further. Manufacturing is strong and likely to accelerate as backlogs of orders and slim inventories need to be worked through. This sets up for a positive outlook for the economy.

Chart 8

Rising Interest Rates to Impact Federal Deficit

Data is as of Trump's 2021 fiscal year budget dated February 2020. Source: Office of White House and Budget Management, whitehouse.gov, Verdence Capital Advisors.



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Fixed income: Getting a Glimpse of True Interest Rate Risk

In 1Q21 bond investors experienced what interest rate risk truly feels like. After a multi decade rally in bonds, the Bloomberg Barclays U.S. Aggregate Index posted its third worst quarterly decline on record and Treasury holders experienced the worst quarterly decline since 3Q80. The rapid acceleration of the vaccine distribution and states reopening justified interest rates moving off the emergency levels seen during the depths of the pandemic. All data suggests the rise in interest rates is not behind us. Nominal GDP is rebounding and expected to post some of the best quarterly numbers seen since the 1980s. If history is a guide, the 10-year yield should move higher from current levels to price in the better economic growth outlook. **(Chart 9).** In addition, with fundamentals deteriorating for the U.S. Government budget (due to COVID spending), we would be cautious about fixed income investment at these levels.

We do not believe in abandoning fixed income for portfolio diversification benefits, but we would be defensive, especially since many bond investments are yielding less than five-year inflationary expectations. **(Table 1).** Instead, we would recommend the following for our fixed income allocation.

Table 1

Fixed Income Yielding Less Than Inflation Expectations

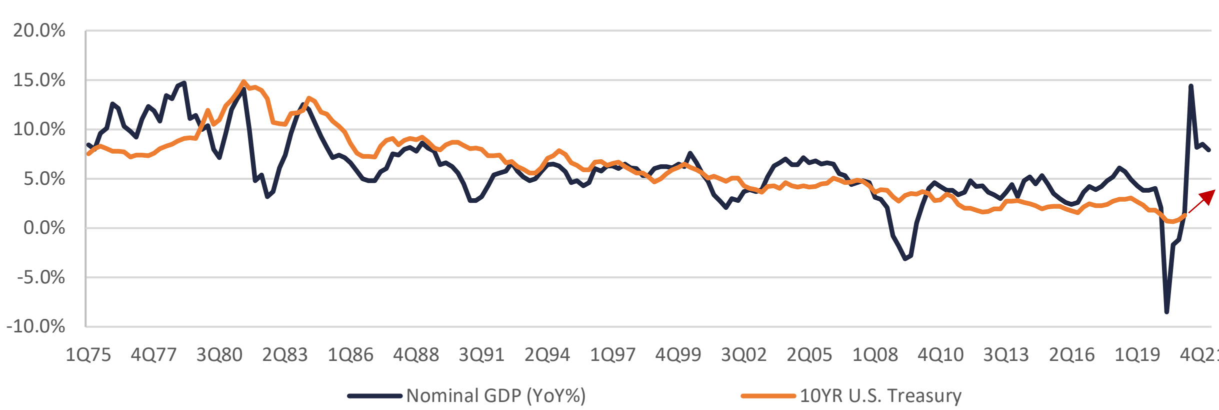
Data is as of April 16, 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors.

Fixed Income Sector	Yield to Worst - 5 Year Inflation Expectations
US Corporate High Yield	1.37%
EM USD Aggregate	1.28%
U.S. IG Corporate	-0.45%
10YR U.S. Treasury	-1.04%
U.S. Aggregate	-1.11%
U.S. Gov/Credit	-1.17%
Municipal Bonds	-1.61%
U.S. Treasury Index	-1.68%
TIPS (1-10 YR)	-1.81%
U.S. Floating Rate Notes	-2.21%
2YR U.S. Treasury	-2.46%

Chart 9

Economic Growth Suggests Higher Interest Rates

Data is as of April 10, 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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- **Short duration is the key to mitigating losses in a rising rate environment:** While the Fed remains committed to keeping the rise in interest rates orderly, the reality is that over the next 18-24 months interest rates across a variety of maturities are likely to rise. Therefore, we believe it is prudent for investors to be defensive with their bond exposure and focus primarily on short duration fixed income. The first quarter was a difficult time for fixed income investors in long term bonds. The quarterly return difference between a 10-year U.S. Treasury and a 2-year U.S. Treasury was the widest on record **(Chart 10).**

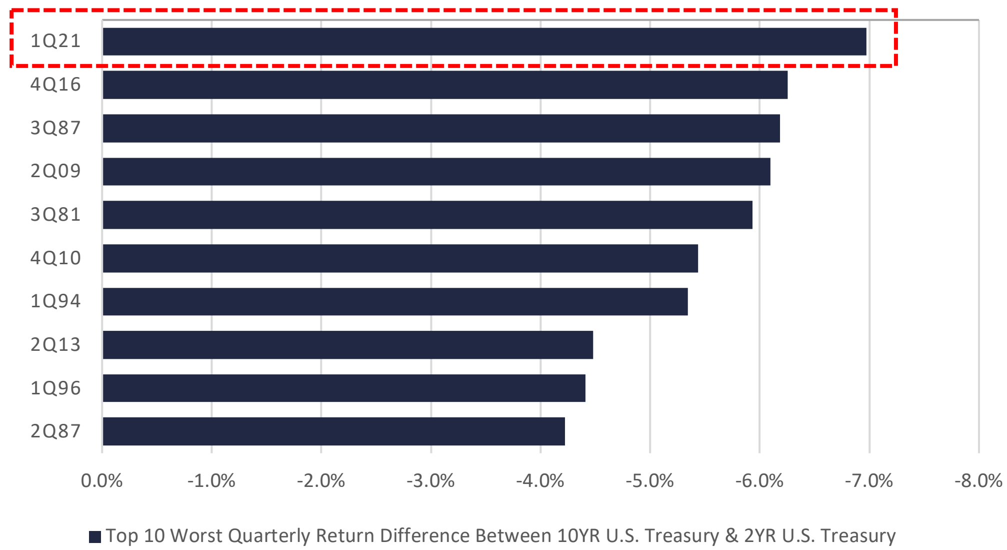
- **Do not reach for yield; risk/reward minimal:** While higher yielding fixed income carries a lower duration given its high coupon, we would exercise caution. The extra yield investors gain to buy high yielding debt compared to a Treasury bond is at the lowest level seen since before the Great Recession. While credit fundamentals are improving, the yield on high yield debt is likely taking that into account.

FIXED INCOME BOTTOM LINE: An improving economic outlook, rising inflationary pressures, a rotation out of bonds and massive budget deficit will overshadow support from the central bank. We recommend short duration fixed income as a portfolio diversifier and caution investors not to expect returns seen in recent years. In our view, bonds will offer little to no price appreciation over their coupon.

Chart 10

Long Term Bond Investors Experience Record Losses

Data is as of 1Q21. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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Global Equities: Room for Valuation Gap to Narrow

Global equities rose for the fourth consecutive quarter in 1Q21, but it was not necessarily a smooth ride. Select sectors/regions encountered a correction in 1Q21 (a drop of 10% or more) as rising interest rates hampered areas with inflated valuations (e.g., U.S. tech). Given the aggressive fiscal and monetary policies around the world and grand reopening of the economy we continue to favor equities over bonds. Equities should benefit from a solid earnings recovery, healthy balance sheets and relative attractiveness over other investments (e.g., bonds).

> …the rally off the bear market lows from last March has been impressive, and the speed at which equities recovered their losses has been astounding.

However, the rally off the bear market lows from last March has been impressive, and the speed at which equities recovered their losses has been astounding. After a record rally like we have seen over the past year, it is not unjustified to be skeptical about how much further equities can rise. Especially with valuations looking stretched across a variety of equity styles. Therefore, selectivity and patience are important. We believe there are several areas of the global equity market that still have room to see the valuation/performance gap narrow and produce attractive long term return potential for investors. In this environment it is also important to accept that there is nothing wrong with a healthy cash position. Volatility is expected and having liquidity to take advantage of opportunities to reposition within equity allocations is imperative. Below we highlight our recommendations across the global equity market as we navigate through a recovery in the global economy and consider the extraordinary monetary and fiscal stimulus.

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- **International developed equities attractive:** We continue to favor developed international equities over U.S. equities. International equities have more attractive valuations and have lagged the U.S. rally since the end of the last recession (i.e., The Great Recession). **(Chart 11).** In addition, international equities have underperformed in recent months because of the additional lockdowns in specific European countries and disappointing vaccine rollout. However, while these countries may be combatting domestic challenges with the pandemic, they stand to benefit more as global economic trade accelerates. Germany, Spain, France, United Kingdom, and Italy are just a few international developed countries that see a larger portion of their GDP comprised of exports. The U.S. has the least amount. As a result, in Europe the sector breakdown of their equity market leans more cyclical than the U.S. and cyclicals should continue to outperform as economic growth accelerates. **(Table 2).**

Chart 11

International Equities Have Lagged the U.S. for More Than a Decade

Data is as of March 31, 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors.

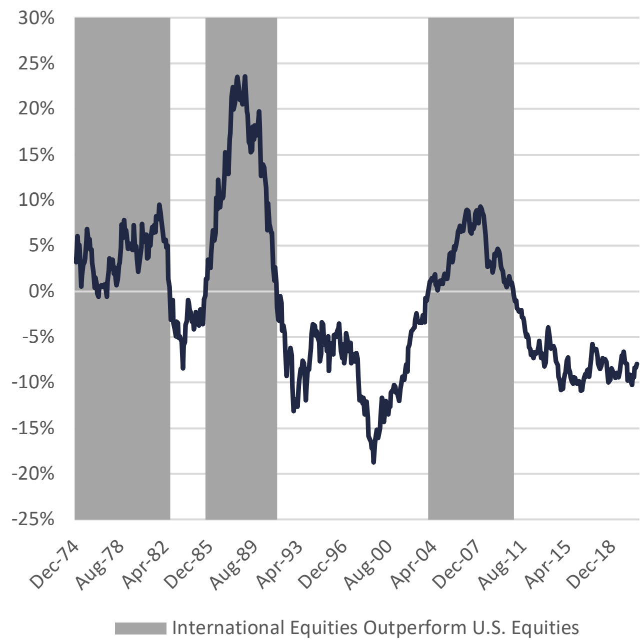

Table 2

European Equities Stand to Benefit from Cyclical Recovery

Data is as of April 6, 2021. Source: Strategas Research Partners, Verdence Capital Advisors.

Sector	S&P Europe Weighting	S&P U.S. Weighting	Europe Weighting Compared to U.S. Weighting
Industrials	15.3%	8.7%	6.6%
Cons. Staples	12.4%	6.1%	6.3%
Materials	8.3%	2.7%	5.6%
Financials	16.5%	11.2%	5.3%
Utilities	4.6%	2.6%	2.0%
Energy	4.5%	2.7%	1.8%
Healthcare	13.3%	12.7%	0.6%
Cons. Discretionary	11.9%	12.6%	**-0.7%**
Real Estate	1.3%	2.4%	**-1.1%**
Communications	3.7%	11.2%	**-7.5%**
Tech	8.2%	27.1%	**-18.9%**

- **Slight overweight to EM equities:** Like our international developed counterparts, we believe emerging market economies stand to benefit from a global resurgence in economic growth in 2H21 and beyond. These economies tend to be more export dependent so they should benefit from increased global demand. In many major emerging economies, we have seen the flexible and accommodative monetary and fiscal policy showing up in leading indicators.

  China and India have seen a substantial rise in their economic leading indicators and are expected to see some of the best economic growth in 2021. **(Chart 12).**

- **Room for rotation to run in the U.S.:** Over the past two quarters we have seen value stocks in the U.S. outperform growth stocks by the most since the dotcom bubble burst in 2001. Value has been gaining momentum as interest rates rise and the economic cycle is beginning to shift from the recovery phase into the expansion phase. In this environment where growth is expected to accelerate at a speed not seen since at least the 1950's **(Chart 13 – next page),** cyclical and value-oriented stocks should outperform. This includes sectors such as financials, industrials, and materials. In addition, history suggests that small and midcap stocks outperform large cap stocks in the two years after a recession ends **(Chart 14 – next page)** as the economy moves into the expansion phase.

EQUITIES BOTTOM LINE: After a record rally like we have seen over the past year, it is not unjustified to be skeptical about how much further equities can rise. Especially with valuations looking stretched across a variety of equity styles. There are several areas of the global equity market that still have room to see the valuation/performance gap narrow and produce attractive long term return potential for investors. In this environment it is also important to accept that there is nothing wrong with a healthy cash position.

Chart 12

Emerging Market Fundamentals Better than Developed Markets

Data is as of March 31, 2021. Estimates for growth are as of April 2021. Source: Bloomberg Finance LP, IMF, Verdence Capital Advisors.

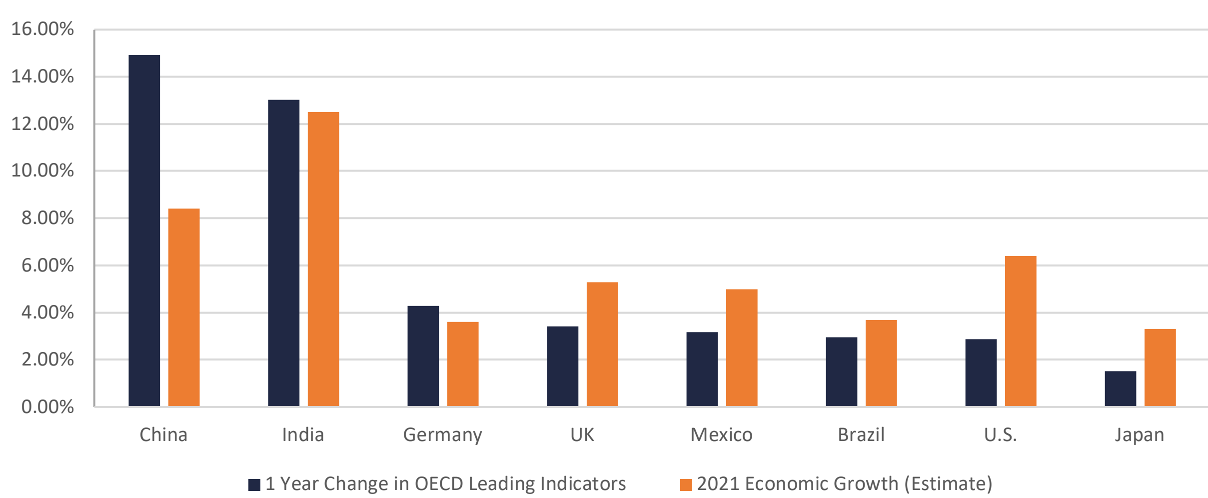

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Chart 13

Economic Growth Expected to be the Best in Decades

Estimates are as of April 16, 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors.

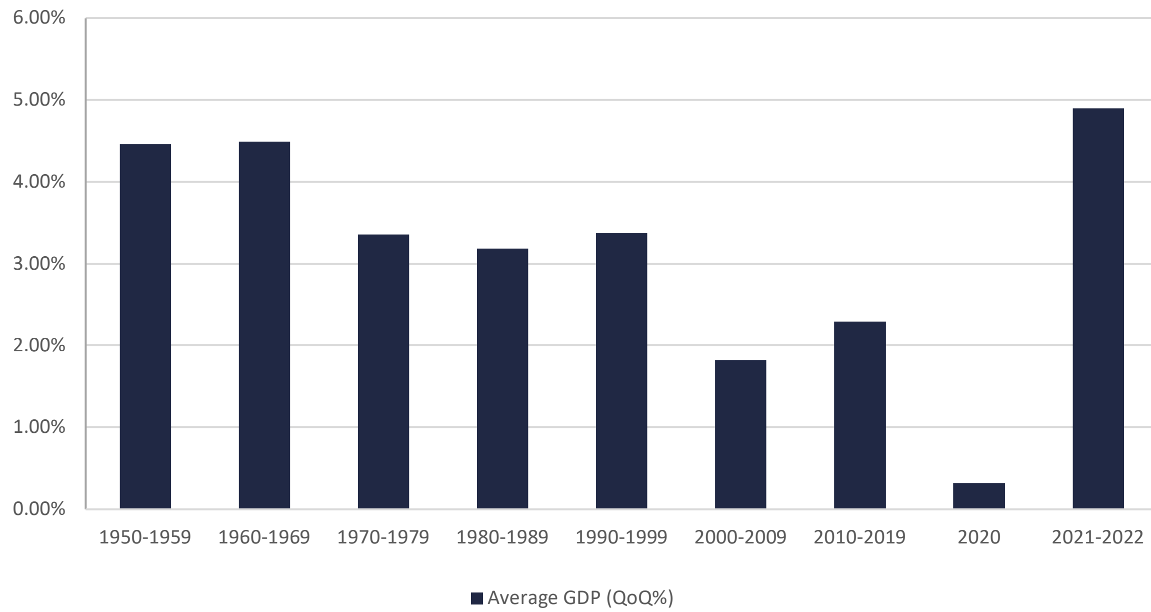
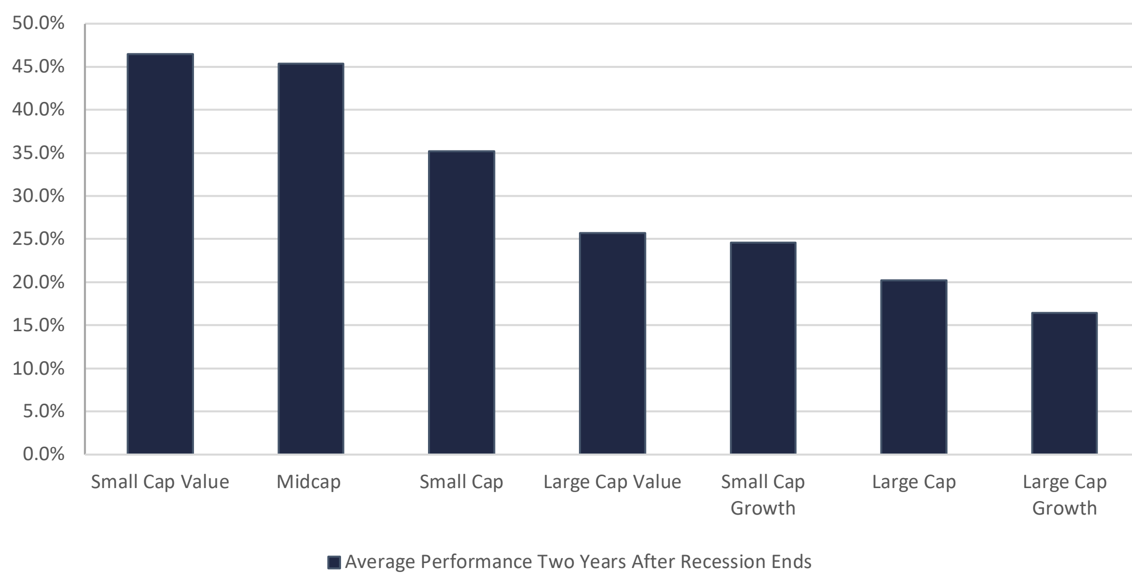


Chart 14

History Gives Us Guidance Where to Invest in the U.S.

Data reflects last five recessions from 1980 to 2009. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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Alternatives: No Need to Chase Public Market Risk

As we navigate through the economic cycle, experience stretched valuations in the public market and we witness misguided mass speculation in other areas of the market (e.g., SPACs, Cryptocurrency, MEME frenzy) it is important to consider alternative investments. We are in a period where we are watching equity markets make regular record highs, Governments are racking up records amount of debt, Central Bank intervention has resulted in massive amounts of negative yielding debt and inflation is a true market risk.

Therefore, the traditional benefits one may receive from a simple 60/40 portfolio of stocks and bonds may not offer the same diversification or returns as has been experienced historically. It is also likely to produce much more volatility than an investor is accustomed to. In contrast, investing in the private market removes the daily volatility, has historically offered low correlations, appears to offer attractive risk adjusted returns and may be a better way to hedge against the inflation that will arise (one day) due to the pandemic related spending.

ALTERNATIVES BOTTOM LINE: As we navigate through the economic cycle, experience stretched valuations in the public market and witness mass speculation in areas of the market (e.g., SPACs, Cryptocurrency, MEME frenzy) it is important to consider alternative investments in portfolios. Investing in the private market removes the daily volatility, offers low correlations, attractive risk adjusted returns and may be a better way to hedge against the inflation that will likely arise due to the pandemic related spending.

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Summary: Verdence View

We believe we are at an inflection point where we are putting the pandemic behind us and embracing a return to normalcy. From an economic perspective there are many forces that are fueling the optimism about the economic outlook and we are already seeing the pent-up demand that we believe will drive economic growth. This is also fueling euphoria in risk assets. While we favor an overweight in global equities (in both the public and private market), with valuations at current levels, we are not adverse to holding excess cash in investment accounts. Having flexibility and liquidity offers investors the chance to take advantage of volatility that is likely to arise as we move into the economic expansion phase. We also acknowledge that in an environment of massive liquidity like we are experiencing at this point in the economic cycle, speculative investments will emerge, and investors may be intrigued. Especially if they fall victim to the fear of missing out. We remind investors that due diligence and discipline are crucial at this inflection point. It can be dangerous to chase momentum especially if underlying fundamentals do not support it. We will continue to monitor market developments and adjust our asset allocation if it is deemed necessary.

As always, if you have any questions about our perspective, please do not hesitate to reach out to your advisor.

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1.) Small Business Administration, smallbiztrends.com

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