Artemis
FINANCIAL ADVISORS LLC

Market Outlook & Strategy

First Quarter of 2021

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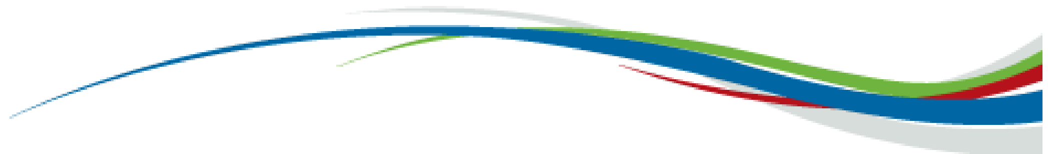

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Executive Summary

- Equity markets moved higher in a bumpy quarter underscored by continuing signs of economic recovery, re-opening activity and increasing vaccine distribution. Commodities (+6.9%), U.S. equities (+6.4%) and global real estate (+6.4%) were market leaders in the first quarter as a rotation toward re-opening activity took hold.

- U.S. equities were boosted by cyclical rotation toward smaller companies (+12.7%) and value/cyclical-oriented companies (+10.8%), which nicely outperformed large-cap growth (+2.1%) after a banner year for growth in 2020.

- Once again, the U.S. market outperformed those in other parts of the world due in large part to outsized fiscal and monetary support. Nevertheless, developed markets outside of the U.S. still had positive returns of +4.0%, and emerging market equities returned +3.1%.

- A major theme in the first quarter was the rise in long-term interest rates. This is largely due to improving expectations for economic growth, but the speed of the movement unnerved markets and negatively impacted bond prices and high-growth company stock prices.

- Bond returns were mostly down for the quarter as bond prices typically move inversely to interest rates. U.S. Treasuries performed the worst (-5.8%) with corporate bonds following (-2.5%). Other segments turned in flat to modestly positive returns.

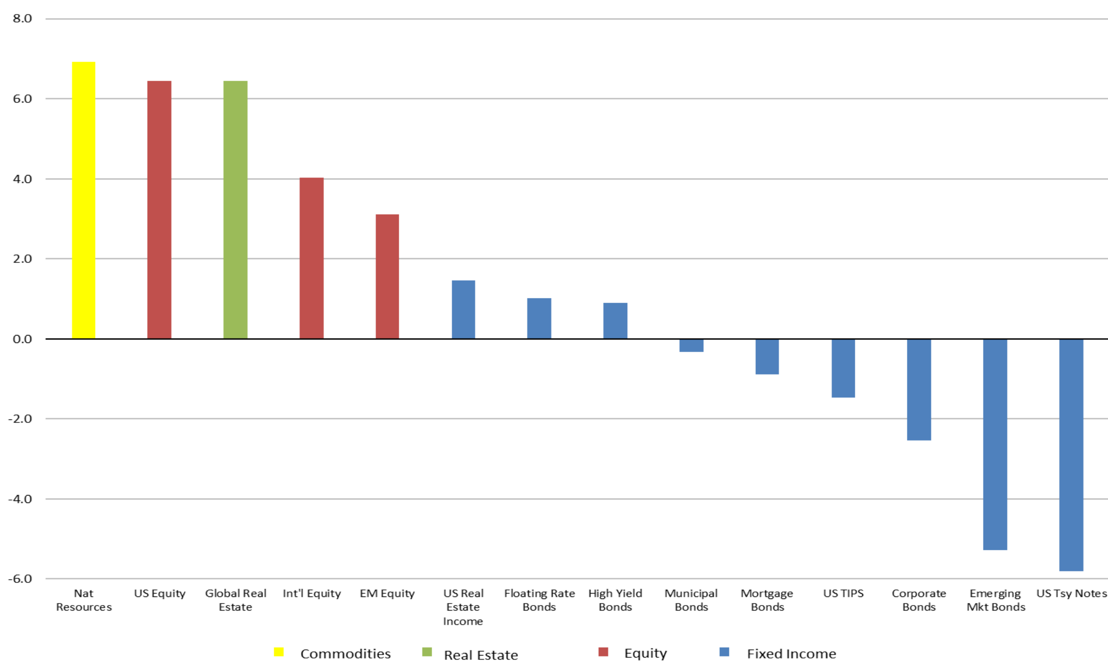
- In this quarter's report, we take a closer look at the relationship between growth stocks and interest rates and why growth stocks are often called "bond proxies". We also discuss the outlook for interest rates and inflation and what it means for near-term portfolio positioning.

- **Artemis strategy.** This quarter we rebalanced client accounts and made a few tactical changes. To capture some of the benefit of economic recovery, we reduced exposure to growth and modestly increased exposure to value, smaller companies and emerging market equities. We also took some chips off the table in a few of the high-flying tech disruptors and, where feasible from a tax perspective, made a swap in the technology disruption lineup. Finally, we added inflation protection to bond portfolios as a hedge against economic growth rising too rapidly and sparking an inflation scare.

Markets in Review

Equity markets moved higher in a bumpy quarter underscored by continuing signs of economic recovery, re-opening activity and increasing vaccine distribution. Commodities (+6.9%), U.S. equities (+6.4%) and global real estate (+6.4%) were market leaders in the first quarter as a rotation toward re-opening activities took hold. See Figure 1.

Figure 1. Asset Class Returns in USD for Q1 2021 (%)



Optimism surrounding the re-opening continued to accelerate in the first quarter with vaccine rates hitting more than 2 million doses daily. In addition, fiscal and monetary stimulus continued apace. During the quarter, Congress passed a $1.9B stimulus bill, and the Biden administration introduced $4B infrastructure spending bill. The Federal Reserve also committed to continue purchasing $120B monthly in U.S. Treasuries. Optimism was further supported by the pickup in employment, with advances in restaurants, hotels, leisure and other ‘back-to-normal’ industries.

These positive developments led to a cyclical rotation toward smaller companies (+12.7%) and value/cyclical-oriented companies (+10.8%), which nicely outperformed large-cap growth (+2.1%) after a banner year in 2020.

Developed markets outside of the U.S. also had positive, but modestly lower returns relative to the U.S. Developed markets increased by +4.0%, and emerging market equities returned +3.1%. The main theme in the sectors was unexpected strength in the U.S. dollar, in part due to rising U.S. interest rates, higher GDP growth and speedier vaccine distribution. Developed international markets struggled with vaccine distribution efforts and additionally, increasing concern regarding Chinese government regulation weighed on emerging equity markets. Two key events related to Chinese government regulatory concerns were the removal of online payments company Ant Group's IPO just prior to its expected launch and a fine of $2.8B levied on online retailer Alibaba for antitrust behavior.

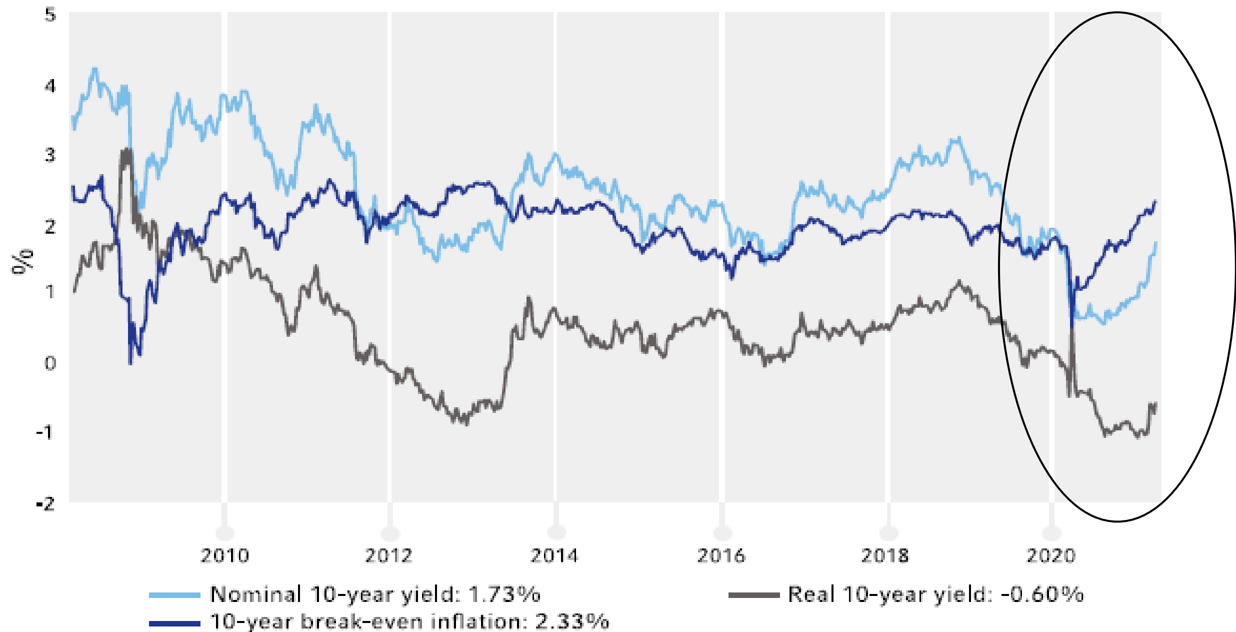
A major theme in the first quarter was the rise in U.S. long-term interest rates, with real interest rates falling further into negative territory. This was largely due to improving expectations for economic growth, but the speed of the movement unnerved markets and negatively impacted bond prices and high-growth company stock prices. The 10-yr U.S. Treasury yield rose from 0.92% on December 31st to a high of 1.75% in March, before settling into a range between 1.6-1.7%. Real interest rates landed at -0.6%. (See Figure 2.)

Interest rates have wide-ranging effects, from debt service to bond prices and stock valuation mechanics, so significant short-term changes, either up or down, are often hastily and fitfully digested by various segments of financial markets. (See the next section for more on this dynamic.)

As for alternatives, global real estate (+6.4%) and commodities (+6.9%) were beneficiaries of the improved outlook for economic growth, as well as the prospective U.S. infrastructure spending bill, known as the American Jobs Act, which would serve as a tailwind for both sectors by pumping another $2 trillion into the economy.

Bond returns were mostly down for the quarter as bond prices typically move inversely to interest rates. U.S. Treasuries performed the worst (-5.8%), followed by corporate bonds (-2.5%). Muni bonds (-0.3%) as well as those tied to real estate (+1.5%) held up better, in part due to optimism about increased infrastructure spending. Treasury inflation protected securities (TIPS) also held up reasonably well (-0.2%).

Figure 2. U.S. 10-year Treasury Yields Since the Great Recession



Why are Growth Stocks Sensitive to Interest Rates?

As noted above, one of the quarter's main themes was the notable rise in long-term U.S. interest rates and decline in bond prices. At the same time, the share prices of many of last year's high-flying growth stocks sold off, including those in our technology disrupter lineup. Why would technology stocks act like long-maturity bonds?

To understand why, consider that when you are buying a high-growth stock, you are in many cases buying a stock of a company that is currently unprofitable but expected to grow strongly into the far-off future. When interest rates are low, investors don't discount those future profits by much. (Remember, a dollar in hand today is worth more than a dollar in the future because the one you have today can be invested and earn a return. To reflect this, we "discount" tomorrow's dollars compared to having those dollars today.) When interest rates are low, investors are more indifferent to when those future profits will be realized. But when interest rates (and therefore discount rates, which are interest rates plus a premium for the risk you are taking) are high or increasing, those future profits are worth

less. A recent article in the *Wall Street Journal* provides a good example, and I quote it here.[1]

"Consider the valuation of a [high-growth] company that is expected to increase its earnings by 20% a year for the next 25 years. Say it now earns $1 a share, and investors are putting a discount rate of 6% on its future earnings. A standard discounted cash-flow analysis would place a value of about $182 on those future earnings. Now imagine that the yield on the 10-year Treasury note goes up by two percentage points and the discount rate on future earnings is bumped up to 8% as a result. The value of those earnings drops to about $129."

As the value of earnings decline, other opportunities less sensitive to the discount rate will become more attractive on a relative basis and start attracting more capital as a result.

Of course, this whole discussion raises the question as to what the trajectory of interest rates might be over the next 1-2 years. And this depends in part on whether inflationary pressures are going to increase. Many argue that it is going to be tough to get inflation above 2% on a sustained basis. They point to the fact that we haven't been able to achieve this goal even when we were at full employment just before the pandemic. Why then would we see a spike in inflation when there are still 8 million people out of work?

The Federal Reserve is the nation's primary inflation-fighting entity. It's Board of Governors has said recently that we may see some transitory inflation (e.g., one-time price adjustments in response to pent-up demand for hotels, airline flights, etc.). However, the Fed recently changed its "reaction function," which drives how it adjusts interest rates to reduce the risk of too much inflation, and the rates we are seeing will not force the Fed to stop purchasing bonds.

Thus, subdued inflation will let the Federal Reserve delay any rate hikes and, as such, real bond yields are likely to remain very low. Indeed, 10-year Treasury yields have fallen in the last month (see Figure 3), in part because the Federal Reserve has started to convince investors that it won't bump up interest rates to ward off inflation. And, not surprisingly, the tapering of bond yields starting in mid-March reversed the recent pattern of cheap and cyclical stocks outperforming growth. See Figure 4.

But there is a lot of uncertainty to such a view, and if the economic data are extremely strong over the next several months, and investors want more inflation risk premium, then

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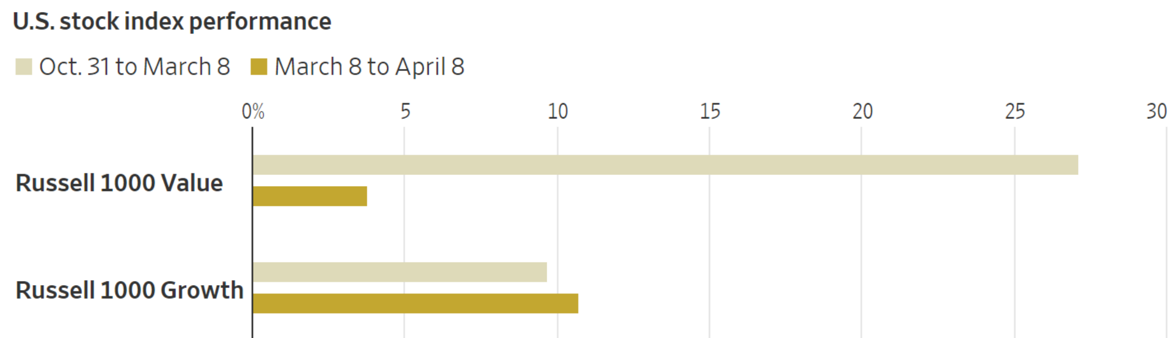
[1] Lahart, Justin. "The Stock Market Reshuffle Has Room to Run." Wall Street Journal, March 23, 2021

the Federal Reserve may have to start tapering its purchases and raise rates to slow the momentum. Bottom line: We are going to be watching this dynamic very closely and, as a result, hold a more balanced portfolio between growth and value.

Figure 3. Recent Trajectory of U.S. Treasury Yields in 2021

Source: Financial Times

Figure 4. Growth Beating Value Once Again



Artemis Portfolio Strategy

This quarter we rebalanced client accounts and made a few tactical changes. We reduced exposure to growth and modestly increased exposure to value, smaller companies and emerging markets. The rationale for this was two-fold. An economic recovery supports the prospects of companies that stand to disproportionately benefit from increased consumer spending and pent-up demand. Additionally, rising interest rates increase profits of bank stocks, the largest sector in the value index, as they benefit from the increased spread between short- and long-term interest rates and declining loan defaults. In contrast, and as explained in the previous section, high-growth companies are often hurt by rising rates because it makes the future earnings less valuable. That said, we think that long-term rates in the U.S. are close to peaking for now, thus we remain neutral between large-cap growth and large-cap value.

In addition to this rotation, we took some chips off the table in a few of the high-flying tech disruptors and made a swap in the technology disruption lineup to a new fund that emphasizes investments more broadly in ‘industrial innovation’: energy storage, electric vehicles, sensor technology, in addition to robotics and AI.

Finally, we added a smattering of inflation protection to bond portfolios as a hedge against the potential for economic growth to rise too rapidly and spark inflation. We do believe inflation is on the rise, but the degree to which it continues its trajectory is unclear at the moment.

Most importantly, our intention in the next few quarters is to be prudent in our overall equity exposure as the rally extends. We plan to continue to rebalance and keep targets in line rather than letting them run.

Market Index Descriptions (for Figure 1)

Equities:

The **Dow Jones U.S. Total Stock Market** is a market cap-weighted index providing broad-based coverage of the U.S. stock market. Considered a total market index, it represents the top 95% of the U.S. stock market.

The **MSCI EAFE + Canada (net)** is a market cap-weighted equity index that is designed to measure the equity market performance of developed markets, excluding the U.S.

The **FTSE Emerging Markets All Capitalization China A Inclusion (net)** is a market cap-weighted index representing the performance of large-, mid- and small-capitalization stocks in emerging markets.

Fixed Income:

The **Bank of America Merrill Lynch U.S. Treasuries 7-10 Year** measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years.

The **Bank of America Merrill Lynch U.S. GNMA Mortgage Backed Securities Index** is a market cap-weighted index, including generic-coupon Ginnie Mae mortgages, with at least of $150 million principal amounts outstanding.

The **Barclays Capital 1-15 Year Municipal Bond** measures the performance of tax-exempt investment grade debt of U.S. municipalities having at least one year and less than 15 years remaining term to maturity.

The **Bank of America Merrill Lynch U.S. Corporate 5-7 Year** measures the performance of U.S. dollar denominated investment grade rated corporate debt having at least five years and less than seven years remaining term to maturity.

The **J.P. Morgan Emerging Market Bond Global Core** is a broad, diverse U.S. dollar-denominated emerging markets debt benchmark that tracks the total return of actively traded debt instruments in emerging market countries.

The **Bloomberg Barclays U.S. Treasury U.S. TIPS** measures all publicly issued, U.S. Treasury inflation-protected securities that have at least one year remaining to maturity.

The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks the prices of futures contracts on physical commodities on the commodity markets.

The **Fidelity Real Estate Income Composite** is a benchmark that combines the total returns of the Merrill Lynch Real Estate Corporate Bond Index (40%), Morgan Stanley REIT Preferred Index (40%), and the FTSE NAREIT All REIT Index (20%).

The **S&P Global REIT Index** measures the performance of equity REITs and real estate operating companies (REOCs) traded globally.

The **Bank of America Merrill Lynch U.S. High Yield Master II** tracks the performance of U.S. dollar denominated below investment grade-rated corporate debt publicly issued in the U.S. domestic market with a maturity of at least one year remaining.

The **S&P/LSTA U.S. Leveraged Loan 100** reflects the performance of the largest facilities in the leveraged loan market.