rebalance

Spring 2021

Everything's Coming Up Roses

Curtain up! Light the lights!
You got nothing to hit but the heights!
You'll be swell. You'll be great.
I can tell. Just you wait.
That lucky star I talk about is due!
Honey, everything's coming up roses for me and for you!

1959 Broadway musical *Gypsy*, lyrics by *Stephen Sondheim*

The last 12 months have been quite a wild ride, from the onset of the Covid-19 pandemic, economic shutdown, and panic-driven selling to an accelerating recovery and strong global stock market rally. We have written extensively over the last year about how stock markets behave during a crisis period. Now it is time to discuss recoveries.

The seeds of the equity market recovery were sewn during the depth of the crisis period and included aggressive government support to the unemployed and cash injections by global central banks. And now, while we truly are recovering economically, economists and forecasting "experts" continue to cast concern and doubt.

One might ask: "*The news is positive. Isn't that a positive for the stock market? Why are all the talking heads on TV so worried?"*

The Launch

Think about a stock market recovery like getting a rocket from the launching pad at Cape Canaveral in Florida into orbit, with orbit being analogous to a steady-state, self-propelled economy. Like the rocket that requires fuel to power it through the atmosphere and into orbit, our economic recovery requires low interest rates and large amounts of government spending.

By dropping interest rates to nearly zero, Command Central (a.k.a. the Federal Reserve… or "Fed") allowed businesses and individuals to borrow money cheaply. Low interest rates provide all kinds of economic power and spending. Because of the primary methodology stock analysts use to value public companies, as interest rates drop stock prices tend to rise. Mortgage rates go lower, providing stimulus for home buying, and the entire supply chain is stimulated with new home construction. Auto loans are cheaper, which stimulates auto purchases. Businesses can borrow money at lower cost, which means they might add to inventories.

In addition to falling interest rates, the government can supply money to those suffering so that they can resume spending. The U.S. government created rescue packages such as the Payroll Protection Program (PPP) and extended unemployment benefits, injecting more cash into the economy by giving people money to spend. Additionally, the $1.9 trillion American Rescue Plan provided significant government stimulus with potentially more to come via the American Jobs Plan proposed by the current administration. Low interest rates and money provided to those in need gets more cash circulating, which helps power us back toward orbit.

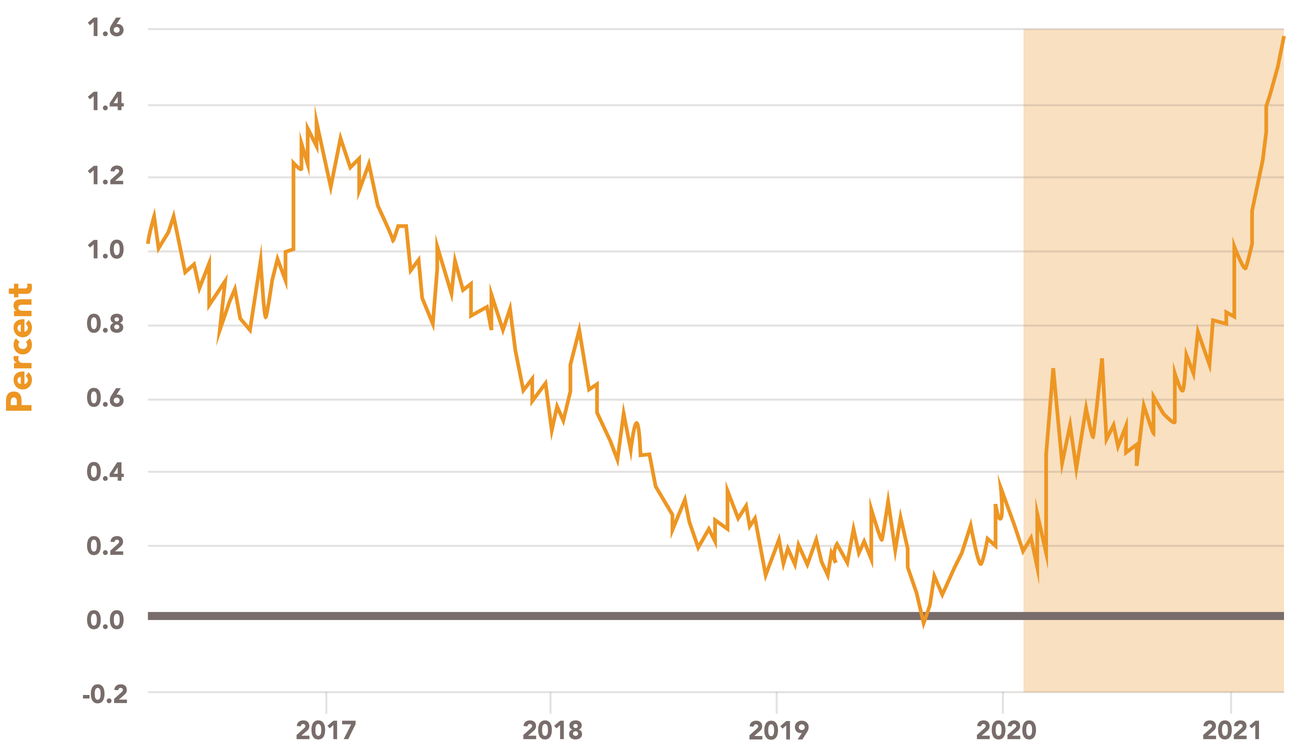
Houston, Do We Have a Problem?

A rocket launch involves enormous energy, tremendous acceleration and travel through deadly environments. Low interest rates help the rocket lift-off powerfully to make its way through the atmospheric constraints of a damaged economy with a goal of sustained economic flight.

But there are things that can go wrong when powering out of a financial crisis. As the rocket moves towards its goal of achieving a safe orbit, anything that threatens that objective becomes a concern. This quarter, the sudden rise in longer-term interest rates (Chart 1) was a shock, potentially threatening a smooth ride into orbit. A slower, more sustainable rate of change is generally easier for stock markets to digest than a quick pop. Rising interest rates could signal rising inflation. If it becomes a big enough concern, the Fed must consider raising rates to slow down the rocket.

Chart 1: Rise in 10-Year Treasury Yields

10-Year Treasury Constant Maturity
Minus 2-Year Treasury Constant Maturity



Source: Federal Reserve Bank of St. Louis

Inflation

The Fed's "dual mandate" is to keep employment high and inflation low. If there is a surge in inflation beyond what the Fed can tolerate, it will raise interest rates and reduce cash in the economy. Slowing down the engines as we approach orbit is a tricky and delicate task.
Loans become more expensive. Money gets tighter.

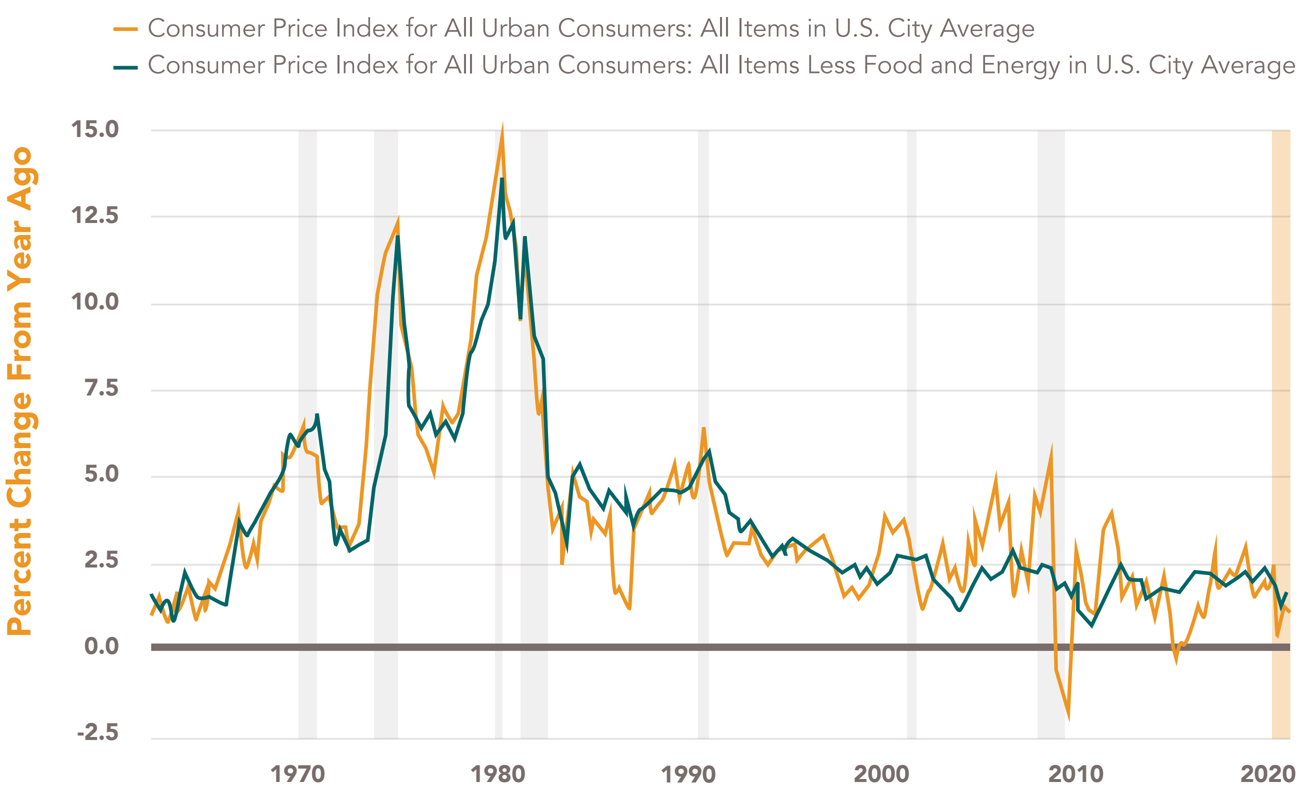
The damaging consequences of inflation are well known. Your expensive steak dinner goes from $40 to $80 over time. Everything starts costing more. If your income doesn't keep up, your lifestyle begins to decline.

Some strategists have expressed concern about the emergence of inflation given the magnitude of stimulus. The American Rescue Plan, and the proposed American Jobs Plan, have only heightened those concerns. The Fed's inflation target is around 2% to 2.5%. The February inflation reading was 1.7%. While there have been inflation concerns since the recovery from the great recession of 2007-2008, the U.S. economy has been running at or below the Fed's desired inflation level since that time.

Measuring inflation has become much more complicated over the last 30 years as U.S. manufacturing shifted to offshore locations due to globalization with less expensive labor costs. In addition, the U.S. has become more of a service-driven economy than a manufacturing-driven economy. General price inflation as measured by the consumer price Index (CPI) has been muted for years (see Graph 2 below). However, these indexes do not contain all asset types, and some of the inflating items are missing. For example, for housing prices the CPI uses rent, not the price of homes.

The return of classic inflation is very difficult to predict, but protecting yourself against inflation means quite simply owning inflating assets. Our firm endeavors to protect **Rebalance** clients by adding asset classes that inflate to various degrees (with inflation) into most portfolios.

Chart 2: Historical Consumer Price Inflation (CPI)



Source: U.S. Bureau of Labor Statistics

Keep your seatbelt fastened

Recoveries, like downturns, are transitional periods often featuring comparisons of reality to expectations. The ride up can be as bumpy as the ride down in a correction. The current upturn in fundamentals is fueled in part by very low interest rates, a system flooded with liquidity (cash), and government spending. A sustained recovery still requires this fuel and news, good or bad, that threatens a continuation of these supportive measures also threatens stock markets.

Please enjoy the ride on the recovery rocket, the reopening, and a more normal 2021. But remember to keep your seatbelt fastened as there may be more turbulence ahead.

World Markets Review

First Quarter 2021

Q1 2021	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
	Stocks				Bonds	
	6.35%	4.04%	2.29%	6.22%	-3.37%	-1.90%

Since Jan 2001	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Avg. Quarterly Return	2.4%	1.6%	3.0%	2.5%	1.2%	1.1%
Best Quarter	22.0% Q2 2009	25.9% Q2 2009	34.7% Q2 2009	32.3% Q3 2009	4.6% Q3 2001	4.6% Q4 2008
Worst Quarter	-22.8% Q4 2008	-23.3% Q4 2008	-27.6% Q4 2008	-36.1% Q4 2008	-3.4% Q4 2016	-2.7% Q2 2015

Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index [net div.]), US Bond Market (Bloomberg Barclays US Aggregate Bond Index), and Global Bond Market ex US (Bloomberg Barclays Global Aggregate ex-USD Bond Index [hedged to USD]).

The **Rebalance** Investment Committee works with two broad asset classes as the basic building blocks of our client portfolios: Growth and Income. During the first quarter of 2021 these asset classes performed as follows:

Growth Asset Classes

Large U.S. Stocks. Large-cap U.S. stocks performed well in Q1 2021 based on continued good news about the U.S. reopening, low interest rates, government stimulus and optimism about future earnings. Cyclical stocks continued to do well based on the view that 2021 would be a strong recovery year leveraging some pent-up demand and related spending from 2020.

Small Cap Stocks. Small company stocks did particularly well in Q1. Smaller companies were particularly hard hit in the pandemic related downturn, and are now seen as strong beneficiaries of a reopening economy. There was some positive influence from the "meme stock" phenomenon which saw smaller companies such as GameStop rally strong in the quarter.

International Developed Stocks. Foreign developed markets rose in early 2021 based on similar expectations for recovery as in the domestic economy. Dollar strength likely subtracted some returns.

Emerging Market Stocks. EM stocks benefited from China's economic rebound and continued strength in both commodities, semiconductors and consumer strength which fuel many major emerging market businesses.

Real Estate. U.S. real estate investment trusts (REITs) showed some strength in Q1 as well. Real estate investors are looking forward to positive trends in 2021 and 2022 as re-opening impacts retail businesses, and as people return to their physical offices, restaurants and malls.

Income Asset Classes

U.S. Government Bonds and TIPS. Longer-term interest rates rebounded strongly in Q1 based on the favorable economic outlook and the massive amounts of fiscal and monetary stimulus. There is some fear of resurging inflation although near-term readings are still benign. This growth-driven rise in interest rates negatively impacted prices of government-issued fixed income including U.S. Treasury bonds and Treasury Inflation Protected Securities (TIPS). Remember that bond prices fall when interest rates rise.

U.S. Corporate Bonds. U.S. investment-grade (higher-quality) corporate bonds prices also fell along with rising interest rates.

High Yield Corporate Bonds. U.S. high-yield bonds produced a positive return during the quarter based on superior yields relative to high-grade corporate and government bonds, as well as some tailwind from improving views of equities.

Emerging Market Bonds. Emerging market sovereign debt very often is issued in U.S. dollars and prices of these bonds weaken when the dollar strengthens (as it did in Q1 of 2021) vs. the local currency of the issuing country. This happens because the debt payments in dollars are effectively increased when the local currency weakens.

Preferred Stocks. As a “hybrid” security that is part fixed income and part equity, preferred stocks are influenced by forces influencing both stock and bond markets. In the first quarter of 2021, preferred stocks were influenced by the general negative movement of bond prices and positive move in equities in the first quarter. As with high-yield corporate bonds, preferred stocks rose slightly in Q1.

The Rebalance Investment Committee

The **Rebalance** Investment Committee meets several times a year to review our client portfolio options, asset class selections, and overall economic factors. The Committee's goal is to curate client portfolios that generate the most investment return for the least amount of risk.

The Rebalance Investment Committee meeting in New York, April 2019 (left to right: Scott Puritz, Charley Ellis, Jay Vivian, Burt Malkiel, and Mitch Tuchman)

Rebalance and its clients are fortunate to have such respected and savvy financial experts guiding key investment decisions.

Professor Malkiel is an emeritus Princeton University economics professor, a former board member of The Vanguard Group, and the author of the investment classic *A Random Walk Down Wall Street.*

Dr. Ellis was for three decades the managing partner of Greenwich Associates, the leading strategic advisor and consultant to large institutional investors around the world. He was Chairman of the Investment Committee of the famed Yale Endowment, and he has served on the governing boards of The Vanguard Group, Yale, Harvard, NYU Stern, Exeter, the Whitehead Institute, and the Robert Wood Johnson Foundation.

Jay Vivian is the former Managing Director of the IBM Retirement Funds, responsible for over $100 billion in IBM investment funds for more than 400,000 employees worldwide.

We thank them for their input and wisdom.
Very truly yours,

Your **Rebalance** Team