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# FIRST QUARTER 2021 ECONOMIC AND FINANCIAL MARKETS REVIEW

2021 began with a continuation of the 2020 stock market rally due to expectations for improving economic and corporate earnings growth this year. This growth is anticipated due to ongoing monetary stimulus provided by the Federal Reserve Board and fiscal stimulus/relief provided by Congress. Economic growth is also expected due to an increasing number of Covid-19 vaccinations, the re-opening of businesses, and increased demand for goods and services. Finally, investor sentiment rose during the first quarter this year as traders and investors became emboldened to take additional risk, confident that stocks would continue to appreciate. As a result of these positive trends, the S&P 500 Index finished the first quarter up 5.77%, while the Dow Jones Industrial Average gained 7.76%. The Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index declined 1.86% during the first quarter.

When the pandemic began last year, the Federal Reserve Board lowered short-term interest rates to near zero and started a program of printing money to purchase bonds in the bond market. Purchasing bonds increases bond prices, which drives interest rates down since there is an inverse relationship between bond prices and interest rates. This strategy helps the economy because it lowers the interest rates that companies and governments pay when borrowing money. It also reduces the interest rates that consumers pay when borrowing to finance purchases such as homes and cars. This low-interest rate policy also helped the stock market to appreciate because investors shifted money from bonds into stocks to attempt to earn a better rate of return than low-yielding bonds.

While the Fed was printing money to purchase bonds, Congress provided additional fiscal stimulus by approving another pandemic economic relief package of approximately $1.9 trillion. This bill includes, among other things, direct payments to certain consumers, an extension of unemployment insurance supplements for qualified workers, an expansion of the child tax credit, money to re-open schools, grants and loan programs for small businesses, and funding for state and local governments. This stimulus gave investors confidence that the economy would pick up steam during the second half of this year.

As the stock market gained momentum in the first quarter, investor sentiment increased, with traders and short-term investors becoming comfortable taking on more risk. This risk-taking could be seen in the amount of money investors were borrowing to buy stocks, the amount and size of options trading by retail investors, and the considerable rise in speculative assets like cryptocurrencies and electric vehicle stocks. Perhaps the best example of investors' willingness to accept risk was when traders bought stocks such as GameStop mostly because they read on social media that others were buying the same stock.

Despite recent stock market gains, some warning signs appeared during the first quarter that may complicate the most optimistic forecasts. For example, despite the Fed's attempts to keep interest rates low, long-term interest rates in the bond market have risen lately due to concerns regarding future inflation. If the Fed continues to print money and the U.S. government continues to borrow large amounts of money to spend on stimulus measures, the result could be an increase in inflation and long-term interest rates. Rising interest rates could lead to a headwind for the economy and stocks because it will raise borrowing costs.

Regarding investor sentiment, it is initially positive for stocks when investors are optimistic because they are willing to assume more risk. However, at some point, over-optimism becomes negative for stock prices. The reason is that the over-optimism leaves the market overvalued, and most market participants become fully invested. The stock market then becomes vulnerable to a sell-off because there is less money supply available to buy stocks. Some market technicians believe a "bubble" is occurring in certain parts of the stock market. There is also a considerable amount of risk-taking in cryptocurrencies, such as Bitcoin, and other asset classes like commodities. The higher the asset prices go and become disconnected from the real economy, the larger the next market decline could be.

Our outlook on the stock market is currently neutral as the positive re-opening of the economy will continue to be offset by higher interest rates and overconfidence among investors. We continue to prefer large companies that pay dividends, although we are glad to see a recent broadening out of stock gains to mid-size and small-size company stocks. Last year the "stay at home" growth stocks far outperformed value-oriented stocks. This year, as the economy reopens, value stocks are competing with the performance of growth stocks. We still like gold as an inflation hedge, and we are steering clear of long-term bonds, which will likely continue to lose value as interest rates rise.

As always, we will continue to monitor ongoing economic and financial market conditions. In the meantime, please contact us if you have any questions regarding your investment portfolio or the financial markets in general.

** Index returns were obtained from the Wall St. Journal and Bloomberg Barclays on April 1, 2021.*