Fundamentum
2021 Q1 Commentary

For the 1st Quarter of 2021, equity returns were again positive with markets reaching new highs. However, there were significant performance differences in market capitalizations and style while fixed income returns were more difficult. As noted in the following table, cyclical (value & smaller capitalization) stocks which are sensitive to U.S. economic growth continued to outperform. Negative bond returns for the quarter broke a string of 10 consecutive, quarterly positive results. In fact, this was the worst quarterly performance for the Barclay US AGG Bond Index since 1981[1].

Q1 Total Returns by Asset Class[2]

Index	Return
Russell 2000 Index	+12.69%
Russell 3000 Value Index	+11.88%
Dow Jones Industrials Index	+8.29%
S&P 500 Index	+6.17%
MSCI EAFE Index	+3.61%
MSCI EM Index	+2.21%
Russell 3000 Growth Index	+1.19%
Barclay US AGG Bond Index	-3.37%

The continuing, strong rebound in economic growth in the U.S. was the key factor that drove asset performance this quarter. Supporting this growth were three pillars – massive Fiscal stimulus, significant Monetary accommodation, and rapid Vaccine development and distribution. These pillars led to a reopening of the U.S. economy, rapidly improving employment outlook and high corporate/consumer cash levels.

Earnings growth continues to be impressive. For Q1 2021, estimated earnings growth for the S&P 500 increased from15.8% on December 31, 2020 to 23.3% by the end of the quarter. Seven sectors recorded improving results led by Energy, Financials, and Materials. The estimated (year-over-year) revenue growth rate for Q1 2021 is 6.3%, which is above the 5-year average revenue growth rate of 3.5%[3].

Within equities, there was a change in leadership as value stocks jumped to the lead while richly valued growth stocks faded. For the quarter, Energy and Financial stocks outperformed and Technology stocks underperformed. Looking at market capitalization, smaller companies that are tied more directly to the U.S. economy were the best performers.

The U.S. economy should continue to recover and grow with the passage of the third stimulus package - The American Rescue Plan of 2021. This $1.9 trillion package is rapidly being deployed and is equal to approximately 8% of the U.S. Gross Domestic Product. This brings the total price tag of U.S. fiscal stimulus to the pandemic to over $5.5 trillion pushing the federal debt to 102.3% of GDP according to the Congressional Budget Office (CBO)[4].

Although lagging the U.S. economy, other countries are improving and should benefit from the U.S. stimulus and expected growth. According to the Organization for Economic Co-operation and Development's (OECD) macroeconomic model, the U.S. stimulus is likely to boost growth in Japan, Europe, and China by 0.5 percentage points over the next 12 months and lift global GDP growth by just over 1 percentage point[5].

The strong economic news had more of a dampening impact across the fixed income spectrum. Investors shifted from worrying about not enough growth to now being anxious that growth will be too fast. Expectations for inflation began to emerge leading to a jump in bond yields and negative bond price action. Given stimulus payments, accumulated savings, pent-up demand, and job growth, demand pull inflation is beginning to appear. On the supply side, cutbacks in just-in-time inventories, weather disruptions, and the closure of the Suez Canal further strained supply chains pushing up prices and inflation expectations.

Rising interest rates could be an issue for the equity markets especially with its current high valuations and favorable position relative to low bond yields. However, if the reason for higher yields is projected economic growth, equity markets can perform quite well. Concern would develop if the Federal Reserve became "Hawkish" and less accommodative - tightening monetary policy. The Federal Reserve has clearly stated that rates will remain low for an extended period to ensure the economic recovery is sustained and employment is fully recovered.

Reflecting the Fundamentum Investment Committee's outlook, two significant actions were taken during the 1st Quarter of 2021 within the Tactical Models. In January, with the "reopening" trade continuing to gain strength and U.S. Large-cap stocks expensive and overextended, Fundamentum tactical portfolios were repositioned to reduce their U.S. Large-cap exposure and corresponding increase positions in Mid-to-Small cap areas and Emerging markets. The Investment Committee believed the valuations of these investment styles were more reasonable and they had greater exposure to economic growth. In February, we adjusted the bond portfolios of the Fundamentum Tactical Models to reflect stronger economic growth and the increasing risk of inflation and rising interest rates. Prior to this trade, the Tactical Models' bond duration was equivalent to the duration of the benchmark. Post trade, the Tactical Models' duration was reduced to approximately 80% of the benchmark's bond duration.

As we stated in our 4th Quarter 2020 outlook, we continue to strongly believe long-term expectations for equity and fixed income returns will be below historical norms as the Fiscal stimulus fades, Monetary policy becomes less accommodative, and we are left with higher valuation levels, rising interest rates, and increasing taxes. Therefore, we continue to encourage advisors to build diversified portfolios with lower capital market returns into their client's long-term financial plans.

Fundamentum Investment Committee:

John Nichol, CFA® - Chief Investment Officer
Trevor Forbes - Investment Committee
Robert Armagno - Investment Committee

Sources:

1 Smith & Howard Wealth Management, Market Recap - First Quarter 2021
2 Comerica Wealth Management, April 5th, 2021
3 FactSet - Earnings Insight, March 26th, 2021
4 First Business Bank Review - First Quarter 2021
5 Russell Investments - Global Market Outlook 2021

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