Investment Review and Outlook – Spring 2021

The U.S. Economy and Massive Government Spending:

The business expansion is moving into high gear with upbeat economic reports showing acceleration in job creation, lower jobless filings, surging retail spending and a very strong turnaround in both industrial output and homebuilding. The latter sectors experienced a severe winter weather setback in many regions but March was the highest level of U.S. manufacturing activity in 37 years. A well-regarded price index (Case-Shiller) tracking single family homes in seven of the largest national markets, showed the largest increase since 2006 with a 12% year-over-year gain through February.

Supporting this rapid growth is the accelerating reopening of the economy in many areas of the country and the administration of COVID-19 vaccines. More than 25% of adults have now been fully vaccinated and 40% have received one shot. In addition, the recently passed $1.9 trillion government stimulus legislation is contributing to increased consumer spending and overall business activity.

On March 31st, the administration also proposed a massive, wide-ranging $2 trillion infrastructure plan over eight years. The plan calls for spending beyond traditional infrastructure projects such as repairing bridges, highways, and roads, modernizing our airports. The plan includes funds for expanding broadband access, upgrading the U.S. electric grid and improving drinking water infrastructure. In addition, significant funds, nearly 30% of the overall proposal, would be provided to care for elderly and disabled Americans along with research and development and job training.

Paying for the proposed program will involve making unpopular, decisions. A significant hike in the corporate tax rate from 21% to 28% is suggested. The rate was lowered from 35% in 2017. Also, Bloomberg reported this past week that the new top capital gains rate would increase from 20% to 39.6% on income over $1million for investments in stocks and real estate. Additionally, there would be higher income taxes for individuals in the upper tax rate tier. Business groups are aligned against the plan, arguing that the tax hikes would counteract the stimulus sought by the proposed bill. The task will be to get this massive proposal through a divided Congress. Senate Minority Leader Mitch McConnell said that he is not likely to support the proposal because of the massive tax increases.

There are likely to be consequences from the significant levels of government stimulus spending put in place over the past several months: the monetary packages going direct to consumers and small business, along with what the impact would be from the proposed infrastructure legislation. Already, the economic progress that we have seen, especially recently, is being accompanied by rising inflation. Reports on producer goods, consumer prices and labor are currently showing emerging cost pressures. Recent surveys in the homebuilding and manufacturing sectors also suggest the same.

Meanwhile, Q1 2021 earnings reporting season is showing very strong results on both the revenue and profit front. It is likely that corporate results will continue to be very good in the coming weeks and for the balance of 2021, as the economy continues to accelerate.

According to reports from the Federal Reserve, personal consumption expenditure growth is estimated to approach 10% annually while GDP is now tracking an 8% increase, much faster than earlier forecast. Also supporting continued economic expansion are statements from the Federal Reserve suggesting that interest rates are likely to remain at their present level for some time.

3620 Happy Valley Road, Suite 203, Lafayette, California 94549 | Main Line 800.930.7913 | Facsimile 925.283.7916

While the foregoing is very positive, it should be expected that there will be some setbacks along the way as the economy continues its rapid recovery. Building inflationary pressures may eventually result in elevated interest rates that have a negative impact on growth. And, while reopening efforts are accelerating, COVID-19 cases are increasing in some regions of the country. That is troubling. There is also no assurance that the administration's infrastructure proposal will receive approval, given the makeup of Congress. An uncertain outcome, during the negotiating process, could raise the level of volatility in the securities markets.

The Stock Market:

In our last client letter on January 31, 2021, we stated the following:

"The strength in the stock market so far in 2021 suggests that investors are now focusing on the potential for stronger economic growth with increased fiscal support, especially with the wide array of ambitious goals being established by the Biden administration on spending initiatives, including investment in our country's infrastructure."

The foregoing continues to be the case as investor sentiment remains quite positive. During the opening weeks of Q2 2021, the focus is on improving economic readings and better-than-expected first-quarter corporate earnings reports that are providing a positive backdrop for the stock market. A large question, however, is how much of this good news is already factored into the stock market and is fanning high investor expectations. As a result, equities are trading at historically elevated levels. While recent market trends may well continue, the high valuations and relatively low dividend yields could make the stock market vulnerable to unwelcome news.

Of note, in recent weeks reports have revealed an uptick in inflationary forces within the U.S. economy, as mentioned earlier. However, at least for now, concerns about higher inflation, interest rates and bond yields are being set aside by the market and the focus is on identifying companies that will be beneficiaries of the expanding U.S. economy.

Investment Strategy:

Sector rotation has been the theme in the stock market for a while as investors increasingly move from high-profile growth companies into more economically sensitive companies with close ties to the business cycle. Basic industrials, energy, financials and materials companies are examples.

Starting in late 2020, we added several cyclical companies to our investment universe that will benefit from the improving economy and the significant government spending we are seeing. Also, attractive are companies positively impacted by a higher level of consumer spending, supported by massive federal stimulus programs and higher disposable income as workers return to the labor force.

As the economy recovers and expands, we apply a disciplined approach with valuation parameters for new portfolio investments, especially now at the present level of security valuations.

G. Frederick Schroeder, CFA
President and Chief Investment Officer

April 30, 2021