



Reiner Financial Group Investment Letter

First Quarter 2021

Market Recap

Global stocks continued to power upward this quarter from their pandemic bear market low on March 23, 2020. The S&P 500 Index gained 6.3%, developed international stocks gained 4.5%, and emerging-market stocks gained 4%. These benchmarks are now up an astonishing 80.6%, 74.8%, and 74.6%, respectively, since the bottom. The S&P 500's one-year trailing return, as of March 23, 2021, was its best since the 1930s. Clearly, it paid not to panic and get out of the markets last spring.

While the “meme” stocks (like GameStop) and the social media–fueled speculation behind them caught investors’ imagination earlier this year, we think the recent “reflation rotation” will be the more enduring equity market trend: For a couple of quarters now, equity investors have been betting on more economically sensitive small caps and value stocks and eschewing large caps and previously highflying growth stocks.

The reflationary winds tore through the bond market as well. The prospect of higher growth and higher inflation caused interest rates to jump. The 10-year Treasury yield more than tripled from the historic low it set last August. Correspondingly, the core bond index fell 3.6%, suffering its worst quarter since 1981. On the flipside, floating-rate loans, which benefit from reflation, gained 1.8%. And most of the flexible, active bond strategies we invest with delivered positive returns this quarter, despite higher rates (and all outperformed core bonds).

Investment Outlook

The primary variables that will determine the direction of the economy and markets remain COVID-19 developments and the fiscal/monetary policy response. These currently imply a base case for a strong economic rebound, particularly in the United States but also globally. This will support the fundamentals underpinning higher-returning asset classes (stocks, credit sectors of the bond market)—as long as interest rates do not move sharply higher.

Substantial progress has been made on the vaccine rollout. Ninety-three million Americans have received at least one dose. At the current vaccination rate, experts estimate the United States could achieve herd immunity by late summer. Daily new cases, hospitalizations, and deaths from COVID-19 have plummeted. We are not out of the woods yet. There is still a risk that we will open up too early or that new infectious variants could prove resistant to the current vaccines. But overall, the light at the end of the pandemic tunnel certainly appears brighter.

Controlling the pandemic will enable us to start getting back to normal lives, boosting economic activity. Growth forecasts had already reflected a rebound. Now they are being revised higher with the massive American

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Rescue Plan Act fiscal stimulus signed into law. The Federal Reserve forecasts the U.S. economy will grow at its fastest pace since 1984. Economic growth should feed into company earnings. The Wall Street consensus expects S&P 500 earnings to grow over 40% in 2021.

Yet the Fed continues to reiterate that it will not preemptively raise interest rates. It intends to wait till it sees inflation above its 2% target for an extended period of time, a new

policy that suggests this economic cycle has plenty of room to run. The Fed has to taper its asset purchases first, which are still going strong at \$120 billion per month, before they even think about raising rates. We take the Fed at its word that it won't be raising rates anytime soon.

So high economic growth, strong earnings growth, but low interest rates? Equity investors couldn't ask for more. A bull market has roared to life. The main threat is our old friend valuation risk. However, shorter term, historically high valuations need not impede it with all the other positives in place. Stocks remain reasonably attractive *relative* to bonds, and we are giving this argument greater credence in our scenario planning.

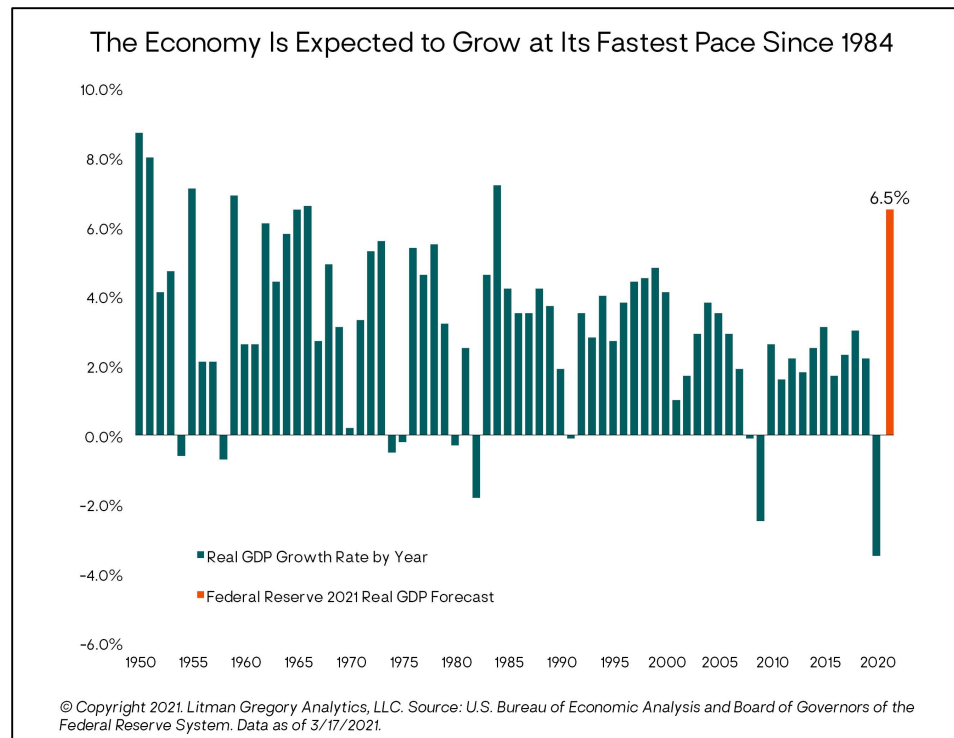
Speaking of bonds, longer-term interest rates have risen in anticipation of a higher-growth, more inflationary environment. That has hurt bond investors this year. Though, we have felt less of an impact as we were significantly underweight to core bonds to protect against just this occurrence. While rates could rise further leading to greater bond price declines, they should stay contained unless inflation spikes up *and* stays higher ...

What About Inflation?

Inflation has been at the top of investors' list of concerns lately. Governments all over the world have passed large fiscal stimulus packages in the wake of the pandemic. The United States takes the cake: Congress has spent the equivalent of 25% of GDP on the emergency in a single year and may spend even more with an infrastructure plan on tap. That is a lot of *potential* pent-up spending. Add in an expected economic rebound from the pandemic, and the Fed doing everything it can to stoke a healthy level of inflation, and investors and consumers are understandably worried about maintaining their purchasing power. An inflation spiral would be bad for stocks, bonds, and pocketbooks.

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In the coming months, we will in fact see year-over-year inflation increase, most likely to the 3%-plus range. But this is largely due to prices rebounding from the pandemic lows. However the market reacts to this well-expected data, we want our clients to know that what really matters is meaningful, *sustained inflation*. That could be the catalyst to raise inflation expectations further. And fear of inflation can work like a self-fulfilling prophecy. If consumers think future prices will be higher, they will increase their spending today. Increased near-term demand raises prices for goods and inputs across the economy. Eventually workers will demand higher wages to compensate for higher inflation. Then businesses must raise prices to offset higher labor and input costs and off the wage price spiral goes. It's critically important that the Fed anchors inflation expectations before price trends get out of control.

The jury will still be out even after the next couple of months as to whether this higher inflation will be transitory or the beginning of a longer-term trend. Our leaning at the present time is that it should not be an imminent concern. We'll explain why:

- GDP growth will sharply rebound this year, but we won't be close to full employment for at least a few years. Wage spiral inflation can't really take hold as long as there is slack in the labor market.
- The size of the fiscal stimulus that's been issued is staggering, but it is a one-time injection. The fiscal impulse will turn into a fiscal drag next year.
- Also, not all of it will be spent or spent right away. A meaningful portion will be saved and some will go to paying down debt.
- Finally, offsetting structural disinflationary forces such as demographic trends and technology adoption have not gone away or, in the latter's case, have accelerated during the pandemic.

Still, at the backend of our five-year tactical horizon, a potential broad, long-lasting shift to stimulative fiscal and monetary policies could trigger a return to an inflationary "regime" we haven't seen since the 1970s. If that comes to pass, we could see the negative correlation between stock and bond prices that has been so beneficial to investors switch to a positive correlation, as happened back then. In that world, stocks and bonds move up and down together; bonds don't provide the diversification they normally do, challenging asset allocators.

Closing Thoughts

As the macroeconomic regime evolves, we will tactically, but prudently, adapt and adjust our portfolio exposures based on our assessment of risks and potential return. But today, we believe the most likely scenario over the next year at least is a reflationary one.

This reinforces our strong belief that what has worked so well for decades—simple portfolios consisting of U.S. stocks and bonds—won't work nearly as well over the next five to 10 years. We expect many of the asset markets and market sectors that have been laggards over the past five to 10 years to continue their rebound. Reflation favors non-U.S. stocks and more cyclically sensitive or value equity sectors. Reflation also increases the potential for rising rates and inflation, both negative for core bonds. We are already accounting for this in our portfolio positioning. Our portfolios tilt toward non-U.S. stocks and cyclical/value stocks (looking through to our active managers' positioning). Floating-rate loans have a natural inflation-protection component with their

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resetting coupons. And we have diversified into flexible bond strategies that, with their yield advantage and active management flexibility, should handily outperform core bonds.

We thank you for your continued trust in us and invite you to reach out to your advisor with any questions about the markets or your portfolio.

-Reiner Financial Group (04/09/21)

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