It's the End of the World as We Knew It

US stocks continued their upward climb in the first quarter of 2021 with the S&P 500 gaining 6.2% and a whopping 56.5% over the past year through March 31st. Last year's lagging sectors, energy (-33.7% in 2020) and financials (-1.7% in 2020), have become this year's best performing sectors. In Q1 2021, energy was up 30.9% and financials were up 16.0%. More broadly, value stocks as measured by the Russell 1000 value index were up 11.3% for the quarter while growth stocks as measured by the Russell 1000 growth index were up 0.9%. Rising interest rates during the quarter led to a loss of 2.2% for bonds as measured by the Barclays Aggregate bond index.

Asset Class Returns

Asset Class	Benchmark	Q1 January-March 2021	6 Months Q4 2020 - Q1 2021	2020
US Large Cap	S&P 500	6.2	19.1	18.4
US Large Cap Value	Russell 1000 Value	11.3	29.3	2.8
US Large Cap Growth	Russell 1000 Growth	0.9	12.4	38.5
US Small Cap	Russell 2000	12.7	48.1	20.0
International Developed	MSCI EAFE	3.5	20.1	7.8
Emerging Markets	MSCI EM	2.3	22.4	18.3
US Investment Grade	Barclays US Aggregate Bond	-3.4	-2.7	7.5
US Inflation-Indexed	Barclays US TIPS	-1.5	0.1	11.0
US High Yield	BBgBarc US Corp High Yield	0.8	7.4	7.1
EM US$ Debt	JPM EMBI Global	-4.5	1.0	5.3
Absolute Return	HFRX Global Hedge Fund	1.3	6.5	6.8

Source: Morningstar

Governments and central banks have learned a lot since the global financial crisis. In 2009, US leaders chose stimulus while many other developed economies chose austerity to combat the recession. History has shown that big stimulus was most effective.

In today's crisis, the US government has provided an unprecedented $5 trillion in stimulus and the Federal Reserve has held interest rates close to zero. These measures have provided massive stimulus that has helped the stock market rebound and has positioned the US for significant economic growth.

Now, we are on the precipice of the next wave of stimulus - the COVID-19 vaccine itself. While many in the political and medical spheres have stated "the war is not over," investors anticipate a robust economic recovery in the coming months due to economies reopening. This additional stimulus should provide further tailwinds for stock prices.

As we enter the second quarter, let's check in on the themes that we identified at the beginning of the year.

"Work around" solutions adopted by innovative companies across many sectors have turned into process improvements resulting in cost savings and/or greater revenue generation.

Theme Review

THEME 1: INNOVATION ACROSS SECTORS – EMBRACING TECHNOLOGY

As the US vaccination campaign continues to accelerate and life slowly returns to normal, the technological innovations that allowed us all to function beyond expectations will continue to result in new efficiencies and streamlined processes. The traditional approach to the 9-5 work environment may be gone forever, as a hybrid between office and "work from home" models result in greater flexibility and a more mobile workforce. According to a Wall Street Journal article, landlords are currently offering discounts up to 13% below Q1 2020 on rents, while companies are seeking, on average, about 10% less space than a year ago. (Wall Street Journal, "After Covid-19, Office Leases Largely Come With Bargain Rates" April 6, 2021).

"Work around" solutions adopted by innovative companies across many sectors have turned into process improvements resulting in cost savings and/or greater revenue generation. Others who were unable to innovate, unfortunately, have faced significant challenges, and will struggle to catch up.

As a result, we continue to look for companies that embrace industry-specific technological innovations across all sectors of the economy.

While this theme may seem obvious at first glance, as we close the books on the first quarter, many of the 2020 market leaders have experienced curbed enthusiasm in early 2021. The rotation that began in the fourth quarter has continued through Q1, with value stocks leading the way. While this has resulted in lackluster returns for many of our favored technology-oriented innovators, we think making any drastic adjustments based on short-term market movements would be a mistake. Taking the long view, in our opinion, gives our clients the best chance to outperform markets going forward, and leads us to our second theme.

THEME 2: CYCLICAL RECOVERY – CYCLICAL AND VALUE ARE NOT SYNONYMS

Value stocks have seen the resurgence we expected in 2021 as many sectors within the category are (by definition) more sensitive to the reopening of the economy (i.e. financials, industrials, healthcare, and energy). Value stocks have seen their values increase by 10.9% while the S&P 500 has appreciated only 6.2% in Q1 2021. The Energy sector has been the big winner in 2021, returning 30.9% in the first quarter, and 67.2% over the last six months. However, Big Oil is fighting time as the world migrates to renewable sources of energy. Technology has lagged thus far in 2021, but will, in our opinion, resume a leadership position. The term "cyclical" includes both value and growth-oriented companies and is where we continue to focus as long-term investors.

Sector Returns: Q4 and 2020

Equities	Index	Q1 January-March 2021	6 Months Q4 2020 - Q1 2021	2020
Information Technology	S&P 500 Sec/Information Technology	2.0	14.0	43.9
Real Estate	S&P 500 Sec/Real Estate	9.0	14.4	-2.2
Industrials	S&P 500 Sec/Industrials	11.4	28.9	11.1
Energy	S&P 500 Sec/Energy	30.9	67.2	-33.7
Consumer Discretionary	S&P 500 Sec/Consumer Discretionary	3.1	11.4	33.3
Communication Services	S&P 500 Sec/Communication Services	8.1	23.0	23.6
Consumer Staples	S&P 500 Sec/Consumer Staples	1.1	7.6	10.7
Utilities	S&P 500 Sec/Utilities	2.8	9.5	0.5
Materials	S&P 500 Sec/Materials	9.1	24.9	20.7
Financials	S&P 500 Sec/Financials	16.0	42.9	-1.7
Health Care	S&P 500 Sec/Health Care	3.2	11.5	13.4

Source: Morningstar

High-quality and relentless innovation

We continue to look for high-quality companies that benefit from the cyclical recovery *and* innovate relentlessly. For us that means financial services companies that incorporate digital payments technology, healthcare companies incorporating next generation medical technologies, energy companies that have a diversified transition strategy to renewables, industrial companies that are modernizing processes, and on and on.

Technology is the underpinning that drives successful companies. Coupled with the cyclical recovery, the combination of these two themes drives our equity strategy (*for additional detail, see Portfolio Positioning on page 3*).

THEME 3: FIXED INCOME AND ALTERNATIVE STRATEGIES: DUAL OPTIONS FOR DOWNSIDE PROTECTION

Coming into 2021 interest rates increased as investors began to anticipate the reopening of the economy. The 10-year treasury note saw its yield increase from 0.92% on December 31, 2020 to 1.74% on March 31, 2021. Investors who held the 10-year treasury during the first quarter of 2021 saw a total return loss of -13.74% (Source: FactSet).

As we discussed in the January edition of Market Insights, bonds have historically served two roles in a well-diversified portfolio: a hedge against the stock market's downside and a source of current income. With bond yields at or near historic lows, bonds do not work very well in either capacity. As a result, we continue to believe that for the balance of the year clients will be best served with a lower allocation to bonds and a bias to shorter dated and credit sensitive areas of the bond market. So far, this view has proved correct in 2021.

The reduction in bond exposure and bias toward shorter dated and credit sensitive areas of the bond market does reduce the downside protection bond portfolios have traditionally provided to clients. We are cognizant of this and continue to supplement bonds with exposure to alternative strategies that provide downside protection and a smoother return stream relative to stocks. The coupling of these two asset classes have worked thus far in 2021 with our bond and alternative strategies outperforming their respective benchmarks.

Portfolio Positioning for 2021

As we wrote in our January edition of Market Insights, we entered the year with a relatively bullish view on equities. The fundamental pillars supporting that bullish view (vaccine adoption leading to a robust economic reopening, an extremely accommodative Federal Reserve, and additional fiscal stimulus) are very much still in place today. If anything, the progress of vaccines has been even better than expected and has led to some truly encouraging economic data in recent months. In broad terms, we still certainly prefer Equities over Fixed Income.

Value emerges ahead in short-term

Taking a closer look at our equity positioning, we came into 2021 retaining our slight bias to "growth" sectors over the "traditional value" sectors. That positioning has not worked to our favor so far in 2021, as value outperformed growth by 10.4% in the first quarter. The important questions are: "Why did this happen"? and "Are we changing our positioning now as a result"?

So, how did value outperform growth by such a margin in the 1st quarter? Much of the reason is simply a function of where we are in the economic cycle. Traditional value sectors usually lead the way initially as we first dig our way out of a recession. These "value" sectors are highly sensitive to the health of the overall economy and this initial economic surge (either expected or real) benefits them greatly in the short term.

Secondly, the rapid rise in longer term interest rates we observed in the first quarter typically hurts growth companies much more than value companies. The 10-year treasury yield has risen from 0.92% to begin the year up to 1.74% to close out the quarter on 3/31/21. While some value sectors (like financials) actually benefit from rising rates, growth companies (and particularly technology) are usually punished by such moves. Growth companies are all about looking to the future, and if their future cash flows and earnings are hurt by higher rates, that's the negative.

It is important to pause and remember that some rise in rates is absolutely normal and an important part of a growing economy. Also, while 1.74% is higher than where we started the year, it is still a historically low interest rate. We want to keep an eye on these rising interest rates, but it's the speed of the move that needs to be scrutinized, not the absolute level.

Maintain bias for growth long-term

So, have these moves in the first quarter been enough for us to reconsider our slight preference for growth over value? The short answer is: Not Yet. We continue to maintain our slight bias for growth (see Theme 2 above). While we always have our eye on the day-to-day gyrations of the markets, we are long term investors. We still believe that growth and innovation will be rewarded in the long term. Companies in traditional "growth" industries like technology, communication services, and health care should continue to innovate and produce above trend earnings growth, backed by the secular trends brought to the fore by the pandemic. In addition, these companies typically have stronger balance sheets than their "value" counterparts, which helps provide stability during a recovery which could still have a hiccup or two ahead.

However, we believe balance is important and to that end we have added funds to both financials and real estate (both of which are traditional "value" sectors) in many client portfolios during the 1st quarter. We have also been rebalancing some client portfolios that have extreme overweights to growth and tech stocks.

Prefer US vs International

We continue to prefer US-based stocks over their international counterparts. While global diversification is important, and we believe in investing across the world–we maintain a pro-US bias. The speed of the economic rebound has been faster in the US than in the rest of the world (with the exception of China), and particularly Europe, where new strains of COVID have led to renewed lock downs. In addition, the US came into the pandemic in better economic standing than Europe. The US is home to many of the top growth companies in the world, so this position is also tied in with the better performance we are expecting for growth stocks (over value) in the long term.

Still bearish on fixed income

We came into 2021 bearish on fixed income and remain so now. We expect continued gradual interest rate increases to weigh on returns of government bonds. We still see fixed income as an important diversifier, and a way to offset equity volatility. However, we are currently underweight relative to our long-term targets, favoring shorter portfolio duration and lower credit quality in an actively managed portfolio, given the likely trend of rising rates.

Diversifying with liquid alternatives

We continue to overweight liquid alternatives for their ability to provide diversified return streams that are uncorrelated to traditional equity and bonds. There are various types of liquid alternatives in our client portfolios and they serve different purposes. Some are used for their low correlation to stock markets and as risk mitigation for the overall portfolio. Others give us access to different or non-traditional areas of the fixed income market. In any event, we see these liquid alternatives as crucial in today's environment as diversifiers (especially considering our outlook for fixed income).

Bullish, but expect the unexpected

Overall, we expect the unexpected in 2021 as the global economy reacts to both continued vaccination efforts and stimulative governmental measures focused on guiding the economy back to normal. We remain very bullish over a longer time frame, as we tactically manage through potential fits and starts in the near term.

As always, please don't hesitate to reach out to your contacts at Webster Private Bank if you have any questions. It is a pleasure to serve you during these difficult times and we appreciate the trust you have placed in us.