WestStar

Wealth Watch

April 2021

"Get Back to Where You Once Belonged"

~ The Beatles

The US economy was doing rather well, growing by 3% in 2018 and 2.2% in 2019. Then the world was hit by the COVID pandemic, and the US saw negative economic growth of -3.5% in 2020. Yet despite the historic downturn of both the economy and the capital markets in early 2020, the ensuing recovery has been swift and substantial amid sustained optimism for a strong recovery. What factors are in play in 2021? What is the potential for rising interest rates and inflation and what effects would ensue?

As we stated in the January edition of the Wealth Watch, 2021 is the year of the vaccine which, in the immortal lyrics of the Beatles, will help us "Get Back to Where We Once Belonged." In that same vein we refer to the Beatles' catalog of songs as the theme throughout this edition.

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Your wealth, well managed.

What You Need Know:

- Stocks performed well in the first quarter while most types of bonds lagged
- WestStar's tactical positioning proved beneficial
- The global economic recovery is well underway across nearly all major countries
- The potential for rising taxes and inflation are areas to watch but may not be problematic in the near term
- There are opportunites to capitalize upon and risks to guard against in all markets while adhering to a long-term strategy

Asset Class Index Performance* First Quarter 2021

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- US Small Cap Stocks 12.70%
- Commodities 6.92%
- US Large Cap Stocks 6.17%
- Real Estate 6.11%
- International Developed Market Stocks 3.48%
- International Emerging Market Stocks 2.29%
- Alternative Investments 2.17%
- High Yield Bonds 0.85%
- Money Market (Cash) 0.05%
- US Investment-Grade Bonds -3.37%
- International Bonds -5.29%

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Market Performance: *"Good Day Sunshine"*

The first quarter of 2021 witnessed a performance bifurcation between stocks and bonds. While all major stock categories were positive, all major bond categories were negative except for High Yield amid the jump in interest rates (by approximately 0.75% on the 10-year Treasury). Stocks were led by Small Cap and Value-Style, up +12.7% and +11.3%, respectively. Most amazing is the performance of Small Cap stocks over the past twelve months—up +95%! While the bond market overall was negative, International Bonds were the weakest in that category, down -5.3%, while High Yield was the best, up +0.9%. Other "non-traditional" categories such as Commodities, Real Estate, and Alternative Investments were positive for the quarter.

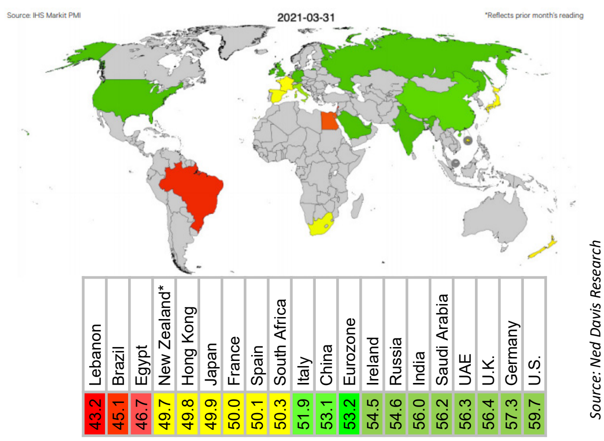
WestStar Tactical Strategy: *"I'll Follow the Sun"*

Our tactical allocation shifts have been more frequent and numerous than is ordinarily the case given the many anomalous events over the past year. Regular readers of the Wealth Watch may recall last April's edition wherein we noted the forming foundation for a rebound and increased stock exposure near the March 2020 market lows. Then in June we emphasized Small Cap and continued to steadily increase our Stock exposure throughout the second half of 2020 while simultaneously reducing our Bond exposure wherein we emphasized High Yield. The most recent modifications made in the first quarter of 2021 were to emphasize Value-Style stocks and increase our inflation-defense strategy via Real Assets. All things considered and given the previous discussion of market performance, our tactical positioning has been rather prescient as we enter the second quarter.

Global Recovery Underway: *"Here, There and Everywhere"*

The momentum of global economic growth increased substantially as we closed out the first quarter of 2021 as the COVID vaccine was more widely distributed and continued monetary and fiscal stimulus spurred activity. Indeed, in March the global composite Purchasing Manager's Index (PMI) jumped to its highest level since 2014, most countries in the world were improving, and the future outlook index rose to its second-best level on record.

The map at right shows that most major countries, with PMI readings above 50, are expanding or improving. While not all are recovering at the same pace, it is anticipated that at this rate all countries will be in expansionary mode by the end of 2021. The US is leading the rest of the world as a result of its massive stimulus measures and the successful administration of vaccines.

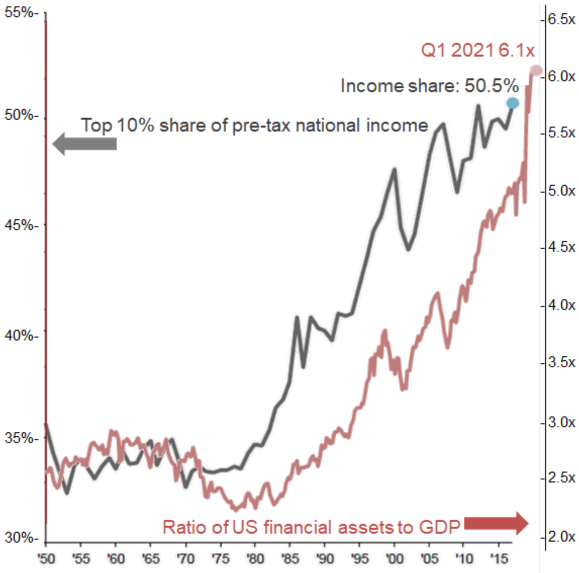


The US has certainly taken the recovery lead. In March, light vehicle sales were the strongest since 2017, manufacturing the most robust in 37 years, and the broadening vaccine rollout indicates the "herd immunity" range will be attained this summer—all this before the full effects of the recent $1.9 trillion COVID relief bill have been fully realized and the pending America Jobs Plan infrastructure spending. At this point the US economy is on track to see GDP growth in the 7% - 8% range in 2021.

*Large Cap: S&P 500 Index; Small Cap: Russell 2000 Index; Int'l Devel: MSCI EAFE Index; Int'l Emerg: MSCI Emerging Markets
Lynch 3-Month US Treasury Index; Real Estate: FTSE EPRA/NAREIT Developed Index; Commodity: Bloomberg Commodity In

Tax Policy: *"Taxman"*

US government deficits and debt were expanding rapidly even prior to the COVID pandemic. Now that total COVID-related stimulus to date exceeds $10 trillion—nearly 50% of GDP in and of itself—it is only natural to anticipate tax hikes in the near future as an attempt to curtail what is already 100% debt-to-GDP. But what effects would higher taxes have on the markets? And wouldn't tax hikes dampen the previously mentioned robust economic growth?

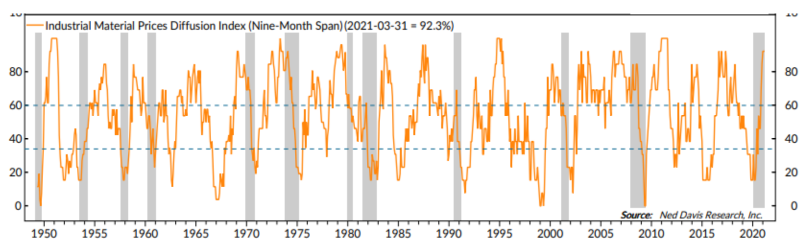


Source: JP Morgan Asset Management

Research shows that the top 10% of earners spend 64% of their after-tax income whereas the bottom 90% of earners spend 99% of their after-tax income. The chart at left illustrates that since 1980 more income has gone to the top 10% (dark gray line) which has had a multi-pronged effect on the economy. Because less of said money is spent and is instead saved (read: invested), aggregate demand has declined, inflation has remained low due to this suppressed demand, and investment in financial assets (savings) has increased (maroon line at left). Furthermore, median household wealth-to-income has not changed in any age group younger than 65 years old over the past 30 years. Should tax increases target the affluent, the effects could be the opposite of what is reflected on the chart at left. In summary, this tax policy could cause financial assets-to-GDP to fall and the values of financial assets (stocks, bonds, etc.) to actually decline despite an increase in consumer demand/spending and the economic growth that comes with it. Furthermore, the return of rising aggregate demand would likely accelerate inflation.

Inflation Rising: *"Can't Buy Me Love"*

Prices are climbing, so what effects would inflation have on growth and investments? The chart at right shows the history of raw industrial material price changes and indicates that at current levels (reading above 60) strong economic growth has historically ensued. It is only when inflation becomes so hot that the Fed begins to tighten that the economy takes a negative hit. The Fed has indicated it is comfortable with inflation running a bit hot for a time and most observers believe it is only transitory. Meanwhile, while rising inflation is generally detrimental to bonds, studies show stocks may continue to climb until the 10-year Treasury yield surpasses 3.5%. Given that at the time of this writing the 10-year yield is around 1.6%, there is still a way to go before we approach that territory.



NDR Calculation based on CRB data prior to May 1990.
Bureau of Labor Statistics PPI and London Metal Exchange Spot Prices after May 1990.
Shading indicates NBER-defined recessions

Economy Performance Full History: 1949-03-31 to 2021-02-28		
Industrial Material Prices Diffusion Index (Nine-Month Span)	% Gain/ Annum	% of Time
Above 60	3.43	44.71
34 – 60	2.46	33.11
Below 34	0.35	22.18
Buy/Hold = 2.40% Gain/Annum		

Remain Focused on Long-Term Strategy: *"The Long and Winding Road"*

We have learned that the global economy is well on the road to recovery and that while investors are concerned about rising taxes and inflation those issues may not be problematic in the near term. Given these factors, our tactical strategy of emphasizing stocks over bonds, small cap over large cap, value over growth, and high yield over investment-grade remains intact for the time being. It is important to note, however, that tactical emphasis does not suggest wholesale abandonment or adoption of any particular asset class. Rather it is defined as making small but meaningful adjustments in asset allocation within the parameters of one's long-term strategy. As such, be cautious of recommendations to "get out of bonds" or "sell all stocks" at any time, as both may have a place in your portfolio regardless of current market trends. Adherence to a well-designed plan is the best path to long-term investment success.

Index; Core Bond: BbgBarclays Aggregate Index; Int'l Bond: BbgBarclays Global Aggregate ex-USD Index; High Yield: BbgBarclays US Corporate High Yield Index; Cash: BofA Merrill
dex; Alternatives: Wilshire Liquid Alternatives Index

The team you can trust.

As true fiduciaries, our focus isn't on selling products to our clients. Instead, we focus on providing personalized service and real financial solutions.

Our team of wealth management professionals has the valuable depth of expertise you need to navigate life's events.

From retirement planning and investment management to trust services and estate settlement, we can help you devise the most effective plan to meet your financial goals.

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