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QUARTERLY MARKET UPDATE

WEALTH MANAGEMENT by BerganKDV

APRIL 2021

MARKET LANDSCAPE

Name	YTD 2021 Return (%)
Barclays US Aggregate Bond	-3.4
Barclays US Credit	-4.5
S&P 500 TR USD	6.2
Barclays US Corporate High Yield	0.8
MSCI Emerging Markets	2.3
MSCI EAFE	3.5
Russell 2000 TR USD	12.7

Data Source: Morningstar Direct

Economic Strength

The end of the first quarter of 2021 loosely coincides with the one-year mark since the lockdowns and other broad-based coronavirus mitigation strategies went into effect. Obviously much has occurred during this time relating to economic, social, political, and market dynamics.

Currently in terms of economics, aggregate trends in data warrant optimism. As the economy continues to amplify the scope of its regeneration, there is evidence that increased consumer activity is helpful to that effort. High-frequency data (month-over-month) relating to areas in this regard such as box office receipts, hotel occupancy, revenue per available room, rail car traffic, Transportation Safety Administration (TSA) checkpoint data, staffing indexes, etc. all point to early but strong trends towards a normalization of activity.

Correspondingly, the data on Covid is encouraging. Since its peak on January 8th of 2021, new positive daily cases in the US have declined by over 77%. During the same time frame, deaths are down approximately 70% and hospitalizations have decreased over 68%. Vaccines (162 million delivered so far) combined with increased immunity levels in those who have had Covid have made gains in the quest to achieve greater herd immunity. These indicators support the notion that we are solidly on the back half of the case curve. These observations relate to the current predominant strain. If variant strains proliferate to meaningful levels, they will of course dampen the optimism related to recent trends.

Most economic measures anticipate a period of very significant economic growth coming our way. The recently passed $1.9 Trillion stimulus bill (on the back of the $900 Billion stimulus in December) will lead to close to $2 Trillion in spending this year alone, which equates to about 10% of Gross Domestic Product (GDP). Employment growth should continue apace, with projections of seven million jobs to be created this year. This type of massive expansion or recovery of the workforce augmented with productivity-enhancing technology adoption will be a significant contributor to the improvement of corporate financial health.

The aggregate impacts of these combined developments related to government monetary and fiscal stimulus, the reopening of society as the prospect of herd immunity moves near, and the unbridling of pent-up consumer demand point to an economy on pace for GDP growth of about 6%. This scenario would be supportive of strong corporate profits and could enhance the probability for stable capital markets moving forward.

Sector Returns

S&P 500 Sectors	YTD 2021 Return (%)
Information Technology	2.0
Consumer Discretionary	3.1
Communication Services	8.1
Health Care	3.2
S&P 500	6.2
Consumer Staples	1.1
Materials	9.1
Real Estate	9.0
Utilities	2.8
Industrials	11.4
Financials	16.0
Energy	30.9

Data Source: Morningstar Direct

Inflation Expectations

These aforementioned factors aligning to support the economy and markets are positives, certainly in the short term; we do think 2021 should be a good year. However, we do not want to dismiss the potential for longer-term ramifications of the existing substantial, prolonged, and coordinated government stimulus.

The magnitude of spending over the past year is more than considerable. The Covid Relief Bill passed in March had a price

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tag of $1.9 Trillion, with $1.1 Trillion designated for 2021, and $500 Billion targeted for 2022. As we know, the government does not have this money on hand.

The United States Treasury Department, in conjunction with the Federal Reserve (Fed), works to issue debt to deficit finance this spending. This is accomplished as the United States Treasury issues new securities to the public, including foreign governments, sovereign wealth funds, pensions, etc. This is normal operating procedure for the government, though the recent and current amounts are of a magnitude higher than in the past. Last year, federal fiscal deficits totaled more than $3.1 Trillion. It is projected that this figure will expand to $3.4 Trillion for fiscal year 2021.

Concurrently, last year the Fed increased the monetary base, or its holdings of financial assets by approximately $2 Trillion. This is continuing in 2021, as the Fed is purchasing $120 Billion of debt every month.

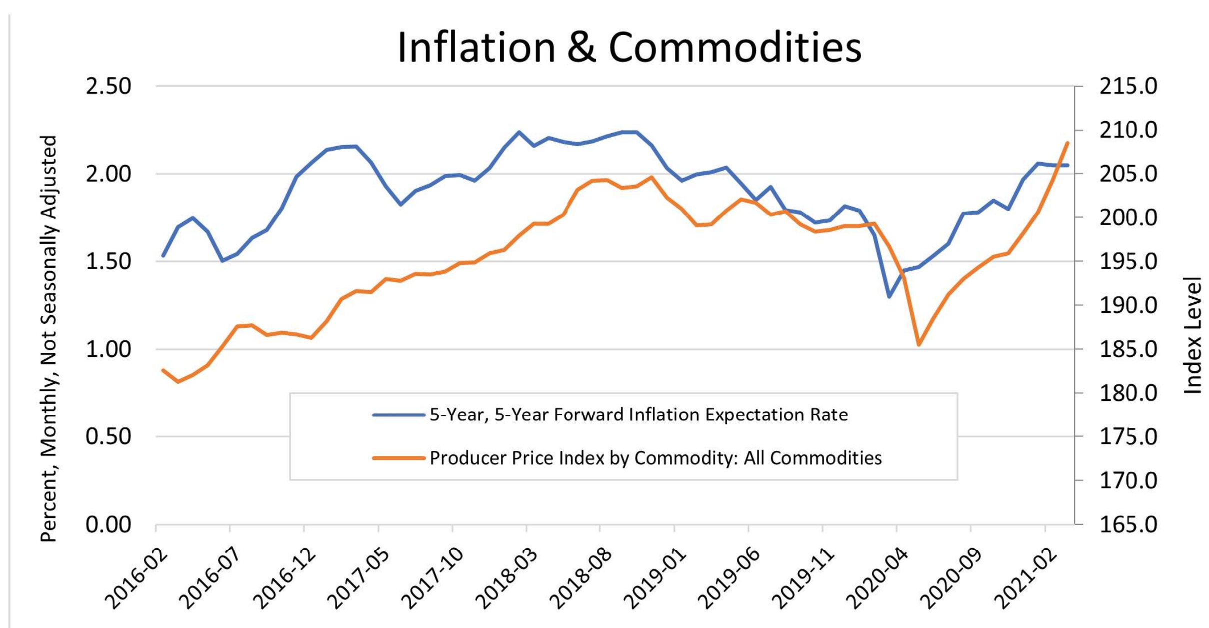
This deficit financing dynamic of issuing additional debt to generate money available for government spending tends to place upward pressure on interest rates, as it is difficult to sustain natural demand for the large amount of debt being issued. The net effect has been an increase in the money supply (using the M2 measure, which is a measure of the money supply that includes cash, checking deposits, and easily convertible near money) of near 25% in the last year.

The increased monetary base, coupled with pent-up demand as the economy reopens, supply chain imbalances resultant for the economic shutdown, and elevated unemployment all combine to raise the specter of high and persistent inflation moving forward. While we expect inflationary pressures to indeed build, we would anticipate levels to remain within benign historical norms over the next few years, likely in the 2.5% to 4% range using the Consumer Price Index (CPI). While there is no short-term risk that the Fed will tighten its monetary stance to combat inflation, it is something that will have to be considered as a longer-term issue that could impact markets.

Value Emerging

A primary investment theme over the past decade, which reached a crescendo during the pandemic last year, has been the outperformance of growth stocks over value stocks. A common issue or point of debate throughout history is which is the better factor by which to invest capital; do companies which possess higher revenue growth potential enjoy greater return prospects, or are companies with established markets and the ability to reliably distribute dividends a better investment? There really has been no clear consensus as they have regularly and evenly traded leadership.

Inflation



Source: Federal Reserve Bank of St. Louis via Y Charts

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Historically, growth companies are typically more expensive than value companies and can do quite well when other options for revenue growth and return prospects are subdued. This has certainly been the case through 2020. It seems as if this is changing, though, along with circumstances surrounding broad-based economic fundamentals.

As interest rates have risen, and may well continue to, the attractiveness of yielding assets such as fixed income and dividend-paying stocks has climbed in tandem. The opportunity set for decent returns expands as this occurs, diminishing the attractiveness of a significant pillar of support for growth stocks. Further, as the economic recovery broadens, the massive outperformance of certain industries and sectors positively affected by quarantine (mainly technology and communication services such as video conferencing, streaming, online retail, etc.) seems to have peaked. This makes sense as the legacy economy is starting to gain traction, causing a rotation from the Covid economy to a more balanced condition.

We witnessed over the past year an acceleration in the adoption of certain technologies which lowered costs and improved productivity. This pulling forward of multi-year future demand and implementation schedule of these tools into the past year was never going to be sustainable, however.

Strength in the value space is reinforced by stronger earnings growth expectations in value compared to growth for this year and next. This is consistent with the theory (results in Sector Returns Table also supports this) that areas such as manufacturing, industrials, materials, infrastructure, etc. which make tangible products have a better ability to pass on inflationary costs to consumers as interest rates rise than do traditional technology and growth sectors. This combined with normal profit-taking and reversion to the mean dynamics seems to support the value style for the foreseeable future.

Cryptocurrencies

One of the biggest topics in the investing world as of late is Bitcoin and the wider cryptocurrency universe. Institutional and individual investors are all postulating about the space. What is it? Is it a good investment? Should I own it? How do I own it? And so on.

To quickly review, Bitcoin is a cryptocurrency that was invented back in 2009 and was the first successful attempt to create a digital, decentralized, peer-to-peer exchange of value. It is a programmable, highly fungible token that can be spent like electronic cash or saved like digital gold, distributed around the world through a set-in-stone money printing schedule to a subset of users who compete to secure the network with

Outperformance of Value

Data Source: : Y-Charts

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energy, and in return, get freshly minted Bitcoin.

Twelve years later, with a market cap of $1 trillion, its success as an experiment in the concept of digital and decentralized finance has spurred the development of other projects and applications within the cryptocurrency space, launching an entire industry centered on blockchain technology.

While the technology is interesting and progressing, the main conversations revolving around cryptocurrency focus primarily on its nature and opportunities as an investment. While Bitcoin receives the most attention, it is fair to apply a summary of the investing characteristics to the entire crypto space.

Cryptocurrencies are incredibly volatile. Price swings within the cryptocurrency markets are many times the magnitude of the stock market, where 20-30% price movements over a period of just a day or two can occur with regularity.

These price gyrations take place within bull and bear market cycles, which heretofore have occurred (understanding that the historical data range is very limited, given the newness of the assets) in a similar pattern in terms of scale and duration. The long-term trend has been positive for Bitcoin, though there have been massive variances in price during its ascent.

Adding to the volatility of the space is the lack of regulation. There have been numerous examples of projects launched possessing no fundamental use case or prospects that investors have flocked to, ultimately ending in failure.

Another defining characteristic of cryptocurrency relates to access. Because all assets are stored on the blockchain itself (or an exchange connected to the chain), there is somewhat of a technological barrier which investors need to navigate to buy and store the assets.

The tradeoff for personal custodial control of your assets and the ability to send them quickly, anywhere, at any time is the risk of loss. The custodial process is not as straightforward and comfortable as the traditional security universe.

Obviously, the cryptocurrency industry is still in its infancy. As with anything new, it possesses much potential, though it is layered with many risks and unknowns. We believe that there is little doubt the blockchain technology and the digitalization of finance will continue to evolve and disrupt existing legacy industries in the years and decades to come.

However, from an investment perspective, we do not believe that the default inclusion of the assets into an investment portfolio as a standard allocation makes sense this time, as its volatility and nascency cannot be relied upon in a traditional wealth management context.

Additionally, the products and infrastructure required for Registered Investment Advisors (RIA's) to access the asset class do not yet exist (other than Greyscale, which acts like a closed-end fund). As the space develops and Institutional interest and infrastructure builds and evolves, though, this could change.

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