# Review & Outlook

## First Quarter 2021

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### Review and Outlook

The first quarter of 2021 was interesting to be sure, with riots in Washington DC, dangerously cold weather in Texas, and COVID vaccinations increasing from almost zero to nearly three million a day. Nevertheless, the S&P 500 index extended its liquidity-fueled run, increasing 6% since the start of the year. The market is up on expectations about a continued economic recovery, and the amount of money that has been added to the economy with the various stimulus bills.

As we have seen in the past, the Federal Reserve raising interest rates can put great pressure on market valuations and stock prices. And while the Fed has kept short-term rates near zero percent, the yield on 10-year Treasuries has moved up sharply. The current yield remains low by historical standards, but the rapid increase in yields was troubling to some investors, so the stock market fluctuated late in the quarter. Growth stocks, or stocks whose current valuation hinges on high growth of future earnings, were hit particularly hard.

The labor market is also strengthening, but more slowly than GDP, and in a very uneven fashion. Much more than GDP, the labor market reveals the inequities across different groups. High wage earners saw only a small, and temporary drop, in employment. On the other hand, low wage workers saw a 31% drop in employment last April, and employment is still 10% below where it was in January 2020. That means there are still 10 million people looking for work. The heavy impact on jobs in leisure, hospitality, food service, and home healthcare jobs means women and communities of color, who dominate the workforce in those industry sectors, have been hit the hardest.

**Index Performance Data**
**Total Return as of 3/31/2021**

| Indices[1] | Q1 2021 | Trailing 12 Months |
|---|---|---|
| CRSP U.S. Total Stock Market Index | 6.4% | 62.8% |
| MSCI Global ex-U.S. Total Stock Market Index | 4.7% | 55.3% |
| Bloomberg Barclays U.S. Aggregate Bond Index | -3.4% | 0.7% |

Last fall, we embraced a view of growth in the stock market. We adjusted our clients' portfolios in the middle of the first quarter of 2021 to have a little less emphasis on growth-oriented stocks (due to concerns about rising interest rates) and a little more emphasis on value-oriented stocks (which have lower price-to-earnings multiples). This change reflects our view that the economy should do well, and that the underlying fundamentals of investments will become increasingly important this year. Our long-standing focus on high quality, short-term bonds means we are appropriately positioned in fixed income, since the value of short-term bonds changes much less than the value of long-term bonds when yields increase.

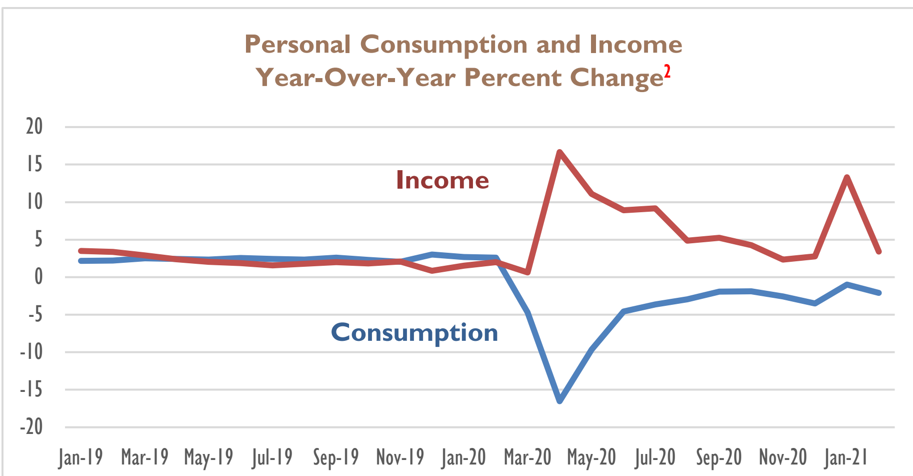
The amount of money the government and Federal Reserve are pushing into the economy has many people worried about inflation, and the financial markets reacted accordingly in the first quarter of 2021. Some amount of inflation is already visible, but economists and policy makers counter by saying that the price increases are temporary, driven by supply chain disruptions and other short-term anomalies. They say that they will start to worry about inflation only when wages are noticeably going up.

Looking ahead, we anticipate strong economic growth into the fall and continuing in 2022, assuming there is not another resurgence of the virus. The National Association of Business Economists is calling for 4.8% growth in GDP in 2021, and 3% growth in 2022. GDP growth at that level should boost corporate earnings and provide support for stocks. The labor market should regain pre-pandemic levels in 2022, though some sectors will be slower to recover. Business travel, for example, just isn't going to be the same.

We've seen a large increase in income with the stimulus bills. At the same time, consumption has been down, leaving money for savings or investing. This flow of new money into the stock market pushed prices up in 2020 without much regard to the underlying fundamentals. We expect that to change in 2021, with investors caring more about the actual performance of the companies they put their money into.

We also expect inflation to remain an issue through at least the first half of 2021. The Fed has stated that it will be very patient with inflation, allowing it to remain above its target of 2% for some time. The Fed has said it wants to see an economy that pulls up wages for those at the lower end of the earning spectrum, noting that many of those people are not counted in headline unemployment figures.

People who have stepped away from work to focus on remote learning for their children or to care for an ailing parent may not be counted as unemployed. If those people are not actively looking for work, they are not considered to be part of the labor force. As such, the Fed is also looking at labor force participation rates and employment-to-population ratios (which suggest a weaker labor market than what the unemployment rates suggest) while deciding what to do.




It looks like economic growth will accelerate through the summer, as the government stimulus kicks in and COVID infection rates drop with more vaccine roll-outs. Volatility in the stock markets will remain as investors try to work out when, and with what magnitude, the Fed will start to raise interest rates.

## In Focus

We also think concerns about higher taxes will add to market volatility. And we highlight here the possibility of changes to the cost basis step-up allowance. A step up in cost basis is a readjustment of the value of an appreciated asset for tax purposes upon inheritance. You may already be leveraging this rule in your own estate planning, or consider it a topic of interest since a change to the current rules could affect the financial markets.

When an asset is passed to a beneficiary, its value has typically increased since the time when the original owner acquired it. Upon the death of the original owner, the asset receives a step-up in cost basis to reduce the capital gains tax burden on the beneficiary. In the case of stock that has appreciated hundreds of percent, the savings in capital gains tax can be enormous. For example, if you have $5 million in Microsoft stock that was purchased at a very low price, all the proceeds would be considered capital gains when the stock is sold. This means your tax bill could be over $1 million. If the cost basis is stepped up to the current market value of the stock, your tax bill disappears. The realized capital gains for the sale would not be $5 million, but $0.

The Biden administration is reported to be looking for ways to reduce or eliminate this tax rule. This may be of particular consequence to folks holding onto legacy stock positions or real estate that has risen in value since it was first purchased. It appears that the step-up tax break remains in place for now, surviving the most recently proposed infrastructure bill, where the focus is on raising corporate, rather than individual, tax rates. Nevertheless, future spending bills could include modifications to the step-up provision, so it is an issue that we are watching and that investors should keep on their radars.

1. Index price and performance data is provided by Black Diamond Wealth Platform, an SS&C Advent product.
2. Data for chart from https://fred.stlouisfed.org/