MIDWEST CAPITAL
ADVISORS™

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To Our Clients and Friends:

We are pleased to bring you our report for the first quarter of 2021.

The last 14 months have been nothing short of extraordinary. Equity markets reached new highs in February 2020, only to drop precipitously in March, then claw their way back to new highs (for the S&P 500 anyway) just a few days ago. Some specifics: On March 23, 2020, the S&P 500 Index fell 2.9% to 2,337. That turned out to be the bottom[1], despite the fact that the coronavirus pandemic worsened in the ensuing months and the economy sank deeper into recession. From the mid-February 2020 high to the March 23 bottom, the Index dropped 34%, wiping out nearly three years' worth of gains. By August, the market had recovered all of its losses. On Friday April 9, the S&P 500 hit another record high, it's 20th for 2021[2]! While investor confidence regarding the economy and progress in the pandemic war had some impact, most of the market gains can be attributed to massive amounts of support from the Federal Reserve and Congress[3]. More on the price of this support later.

For the quarter[4] the S&P 500 Index gained 6.17%; and the MSCI World ex-USA (gross dividends) added 4.17%. Bonds (particularly U.S. Treasuries) had a miserable quarter[5], The Bloomberg Barclays U.S. Aggregate Bond Index shed -3.37% for the quarter, giving back in one quarter almost half the 7.5% it gained in 2020[6]. In stark contrast to the broad equity market, for the one-year period starting with the March 23, 2020 bottom in the equity markets, the Index is up only 0.71%, far below its average 10-year return of 3.36%[7].

Let's touch on some of the things that are going to affect the equity and fixed income markets going forward.

Last month, President Biden signed into law a $1.9 trillion pandemic relief/economic stimulus package. The new law provides up to $1,400 to many Americans. It also extended a $300 weekly jobless-aid supplement and expand the child tax credit for one year. It also will distribute money to schools, state and local governments, and fund vaccination efforts along with offering support to multi-employer pensions and increasing subsidies for people who purchase health plans under the Affordable Care Act.

On Friday April 2 the Bureau of Labor Statistics released its March employment data. Payrolls increased a staggering 916,000 for the month, easily

[1] In the 12-month period starting with the March 23, 2020 low, the S&P 500 returned a heady 67% (ex-dividends).

[2] Source: Wall Street Journal online edition April 9, 2021.

[3] Uncertainty is normally the equity markets' biggest fear and the coronavirus gave us about as much of that as anyone has ever experienced. When it became clear that Congress and the Federal Reserve were prepared to do pretty much whatever it took to save the economy, most of the uncertainty went away, giving equity investors the confidence they needed to return to the equity markets.

[4] Unless otherwise indicated, all returns information is from Dimensional Fund Advisors.

[5] The Bloomberg Barclays U.S. Markets Govt All Bonds Total Return Index had its worst quarter since 1980.

[6] For the one-year period ending March 31, 2021, the Index is up only 0.71%.

[7] Source: Vanguard.

beating the consensus estimate of 660,000. Most of the increases came in leisure and hospitality (up 280,000), construction (up 110,000), and education and health services (up 101,000). Meanwhile, manufacturing jobs increased 53,000, while government jobs rose 136,000 (almost all in education services)[8].

Both the manufacturing and services sectors are booming. The ISM Manufacturing PMI jumped to 64.7 in March of 2021 from 60.8 in February, well above market forecasts of 61.3. It is the highest reading since December of 1983[9]. The ISM Non-Manufacturing index rose to 63.7 in March, easily beating the consensus expected 59.0. The 8.4 point jump in the headline index represents the second largest monthly rise in series history, behind just June of 2020 when the index was emerging from the shelter-in-place orders that decimated activity. March's reading of 63.7 is the single best reading since recording began back in 1997.

With the economy doing well (and projected to continue to do well[10]), employment increasing and growing optimism in the fight against COVID, it is not hard to see why the equity markets are doing well. But why are bonds down so much this year? It is pretty simple: Higher yields[11]. These can be primarily attributed to inflation fears and the already huge (and increasing) federal deficit.

This rise in rates has led some to be concerned about stock market valuations. As the rate on "risk-free" investments (i.e., U.S. treasuries) investments rises, the return on "risk" assets (i.e., stocks and similar asset classes) start to look more unattractive relative to less risky investments. While first quarter earnings are expected to be a robust 24.5% year over year[12], we must remember that earnings for the first quarter of 2020 were far more muted as the economy started to feel the impact of the pandemic, which makes the headline somewhat less significant.

Equity valuations are above their historic averages. The S&P 500 Index is trading at just over 22 times projected earnings, while its five-year average is 18.14[13]. Earnings growth in the year ahead should lead to some compression in these ratios. That being said, there is no denying that equity valuations are high, particularly when one considers we are only in the beginning stages of an economic expansion[14].

There are other potential market risks of an economy that has returned to "normal" and employment that has returned to what the Fed considers "full". First, inflation, to some degree or another, is finally likely to reappear after a long absence. When it does, the Fed is going to have to consider easing its current "accommodative" monetary policy because inflation is at (or on track to be at) the levels that the Fed aims for in order to keep the economy running at the appropriate level of heat[15]. Many have criticized the Fed for continuing its easy money policy while the economy soars[16]. This has not fazed Fed Chair Jerome Powell, who only yesterday said the Fed is in no hurry to raise rates,

[8] All statistics are from the Bureau of Labor Statistics.

[9] Source: Institute for Supply Management.

[10] At its March meeting, the Fed upgraded its real (after inflation) GDP projections for the fourth quarter of 2021 from 4.2% to 6.5% year-over-year, a better than 50% increase; this was no doubt heavily influenced by the passage of President Biden's infrastructure package.

[11] It is a basic principle that as interest rates rise, bond prices fall.

[12] Source: FactSet.

[13] Ibid

[14] According to the April 10, 2021 Wall Street Journal online version, financial assets have never been so expensive at the start of a recovery as they are now.

[15] Since 2012, the Federal Open Market Committee of the Federal Reserve, as part of its "dual mandate" regarding inflation and employment levels, has targeted a two percent inflation rate. In August 2020, that framework changed somewhat with the Fed announcing its "Average Inflation Targeting" policy, by which they will aim to achieve inflation of above 2% for some time to make up for years of undershooting this target.

[16] See, e.g., CNBC's April 5, 2021 Market Insider.

even if inflation hits the Fed's two percent target[17]. Bond investors are assuming a Fed funds rate hike in December, 2022, while the Fed's consensus is that there will be no rate hike through 2023, a full year later[18].

A second risk is taxes, which at some point are going to be raised to pay for the deficit[19]. Those taxes having the greatest potential impact on the equity markets are, of course, those on corporations. Higher taxes will, all else being equal, reduce earnings, which puts pressure not only on equity valuations, but also on things like dividend payouts.

To one degree or another the markets at some point have wrestled with the challenges that are before us now. Outcomes may be similar this time around or could be quite different – no one knows. Rather than speculate on what is going to happen we recommend that investors stay focused on two keys to long-term investment success.

First, have (and stick to) a well-designed and implemented financial and investment plan. Investors need to focus on the few things that are controllable, such as having a plan that is designed with their needs in mind to harness market returns as well as keep them from overreacting to short-term market volatility to the point of abandoning it.

Second, don't try and time the market. That kind of strategy is rarely successful because one has to be right on when to exit the market *and* also when to re-enter the market. It is a time-worn phrase but time *in* the market is more important than timing the market. To illustrate, the annualized return of the S&P 500 Index from 2000-2019 was 6.1%. However, if one missed the top 10 up days that return drops to only 2.4% and if one missed the top 20 up days that return drops to a paltry 0.1%.[20] It's an easy point to make but one that is worth a periodic reminder.

As is our usual practice this time of year, we have just completed a comprehensive review and analysis of our basic equity and fixed income allocations to determine the nature and extent of changes we believe are warranted in light of our market outlook for 2021.

Finally, we are pleased and excited to announce that Sarah Hunt has joined the MCA team as an associate financial planner. In this role Sarah will perform a variety of client service functions and also support the rest of the team. Welcome, Sarah!

[17] This is due not only to the "average inflation targeting" concept but because the Fed wants to see sustained two percent inflation before it raises rates. Source: Scott Pelley interview of Chairman Powell on "60 Minutes", April 11, 2021. For what it is worth, the Chairman's outlook on the economy and employment was decidedly positive.

[18] Source: CNBC's April 5, 2021 Market Insider.

[19] The Biden administration fully expects and supports this. The only other way to ease the deficit is to cut government spending which, in our view, seems extremely unlikely in the foreseeable future.

[20] Source: Charles Schwab and Co., Inc.

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