



## Investment Newsletter

First Quarter 2021

The U.S. and international stock markets performed strongly during the quarter, making new all-time highs in the process. In fact, the S&P 500 is now +20% higher than it was at its peak on February 19, 2020 before the onset of the global pandemic. For the quarter, the S&P 500 Index gained +6.05% and the MSCI All-Country World ex-U.S. Index gained +3.49%. Performance was driven by the global rollout of vaccines, the lifting of pandemic restrictions in many U.S. states, continued global economic improvement, and expectations for massive fiscal stimulus from the incoming U.S. Administration.

Fixed income markets were weak for the quarter reflecting rising inflation expectations tied to aggressive fiscal stimulus. The Bloomberg Barclays U.S. Intermediate Government/Credit Index was down -1.86% and the Bloomberg Barclays Municipal Bond 1-5 Year Blend Index was flat. Interest rates rose in all but short maturities, resulting in negative total returns across all taxable sectors and maturities over two years. Yields on longer maturities rose the most, and these returns were hard hit. The 30-year U.S. Treasury bond gave back almost all of the extraordinary gains from last year, posting a total return of -15.84% in the quarter versus +18.72% for all of 2020. Corporate bonds underperformed Treasuries, yet saw continued strong investor demand. Municipal bonds posted positive returns, even in the rising rate environment. Demand for tax-exempt bonds remains very strong, especially given the likelihood of higher income taxes for the wealthy.

Prio fixed income portfolios remain conservatively structured with short average maturities and durations. We expect continued upward pressure on interest rates given the significant fiscal and monetary stimulus in place, coupled with rising inflation expectations, and will be looking to lock in higher yielding securities in this environment.

The three anchors of the U.S. economic recovery have been monetary policy, fiscal policy, and the rollout of vaccines to end the pandemic. With monetary policy firmly in place, the focus has turned to fiscal policy and the vaccine rollout. On fiscal policy, the \$1.9 trillion American Rescue Plan Act was just signed in to law. It includes \$410 billion for stimulus checks, \$360 billion for state & local governments, \$246 billion for unemployment, \$176 billion for education, \$123 billion for COVID-19 and \$105 billion for health care. This is the third stimulus bill approved since the pandemic began - the first was for \$1.7 trillion in March 2020 and the second for \$915 billion in December 2020.

In addition, the new Administration recently proposed The American Jobs Plan, a \$2.3 trillion infrastructure plan for transportation, home- and community-based care for disabled and elderly, manufacturing, buildings, job creation and innovation, utilities and education. If it passes, the U.S. will have spent a total of \$6.82 trillion on fiscal stimulus during the pandemic, or a whopping 32% of 2019 U.S. GDP.

These enormous fiscal stimuli are expected to help drive a furious rebound in both real GDP and corporate earnings growth. U.S. real GDP is estimated to grow +5.8% in 2021 - the fastest since 1984 (+7.2%) - versus -3.5% in 2020. S&P 500 earnings are estimated to grow +25.6% in 2021 - the second fastest since 1996 - versus -13.9% in 2020. Given this stellar growth, the S&P 500's forward P/E ratio is now 22.3x, a +40% premium to its 10-year average of 15.9x, but an -8% discount to its 2000 peak of 24.3x (FactSet).

This extraordinary fiscal policy support has spawned concerns over inflation, rising interest rates, and debt-load sustainability, which have given rise to the popularity of cryptocurrencies.

How will America pay for this unprecedented level of spending? By creating even more debt and raising taxes on the wealthy, who were considered the primary beneficiaries of the pandemic (according to Forbes, the number of billionaires grew +30% since last year and billionaire wealth rose by \$3.9 trillion). U.S. debt is currently \$28.1 trillion and rising, and the debt/GDP ratio is 130% versus 58% in 2000. The federal budget deficit is projected to be -\$2.2 trillion in 2021 (before accounting for The American Jobs Plan bill) versus -\$3.1 trillion in 2020 (CBO).

On taxes, the question is not if they will rise, but when, and by how much? The new Administration just released its Made in America Tax Plan, which proposed raising the corporate tax rate to 28.0% from 21.0%, and increasing the global minimum tax on U.S. multinationals to 21.0% from 10.5%. It estimated its plan would raise \$2.5 trillion in revenue over 15 years and fully pay for its infrastructure plan.

On the individual tax front, the new Administration supports raising the top personal income tax rate back to 39.6% from 37.0% and applying it to personal income above \$400,000 per year (undefined if individual or joint); taxing long-term capital gains at the same rate as wages for households making more than \$1.0 million per year; eliminating the step-up in cost basis on capital gains from inherited assets; and reducing the estate and gift tax exemptions to \$3.5 million and \$1.0 million, respectively, from the current \$11.7 million.

The rollout of vaccines to end the pandemic is the third anchor to sustaining an economic rebound. On that front, 19% of all Americans have been fully vaccinated and 33% have received at least one dose. Of all Americans age 65 and over, 57% have been fully vaccinated and 76% have received at least one dose (CDC). Moreover, the U.S. just announced that all adults would be eligible for vaccination by April 19.

Despite progress on vaccinations, there have been multiple recent setbacks to resolving the pandemic: the existence of five virus mutations in the U.S., including the British variant B.1.1.7, which is more transmissible among young people (who are currently ineligible for vaccination) and has invaded all 50 states; AstraZeneca's vaccine being dogged by blood clot side effects; Brazil has not gotten better and remains the global pandemic epicenter; and new cases of infection have reaccelerated significantly in India and in many European nations, and have begun reaccelerating in the U.S. and Japan. Cases are likely rising again because of three factors: 1) overconfidence tied to higher vaccination levels, 2) relaxing of COVID-19 guidelines by states, and 3) invasion of virus mutations. While there is the possibility of a '4<sup>th</sup> wave' of infections, accelerating vaccinations should prevent that from occurring.

While this is an exciting time for investors with vaccines rolling out globally, interest rates at zero, the government spending incredible amounts of money, a strong U.S. consumer, and the stock market at all-time highs, there are many worrisome signs of froth and excessive speculation, risk-taking and leverage.

Going forward, these are the key unanswered questions for investors:

- a) What will normalized real GDP and corporate earnings growth look like once government stimulus measures have largely been exhausted?
- b) Will the economic recovery become self-sustaining, or will it require a perpetual stream of government stimulus and bailouts?
- c) Will inflation materialize and catalyze higher interest rates?
- d) How much of the new Administration's regulatory, tax and infrastructure programs can actually be enacted, and what will their effects be on the economy?
- e) Is this the beginning of the 'Chinese century' as China continues to advance its long-term focused economic, military and geopolitical agenda?

While it is easy to become preoccupied with stimulus from government monetary and fiscal policy as a driver of stock market performance in the short term, true sustainable wealth creation over the long term is generated by product and technology innovation, and that is where our equity investment strategy remains focused for our clients. As we continue to navigate this challenging market, we think now is a prudent time for clients to review their asset allocation, diversification and tax strategies.

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