April 19, 2021
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Todd Asset Management

Aiming to Overshoot

Todd Asset Management Q1 2021 US Market Review and Commentary

	1Q 2021	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
S&P 500	6.2%	56.3%	16.8%	16.3%	13.6%	13.9%
Russell 1000 Value	11.2%	56.1%	11.0%	11.7%	9.4%	11.0%

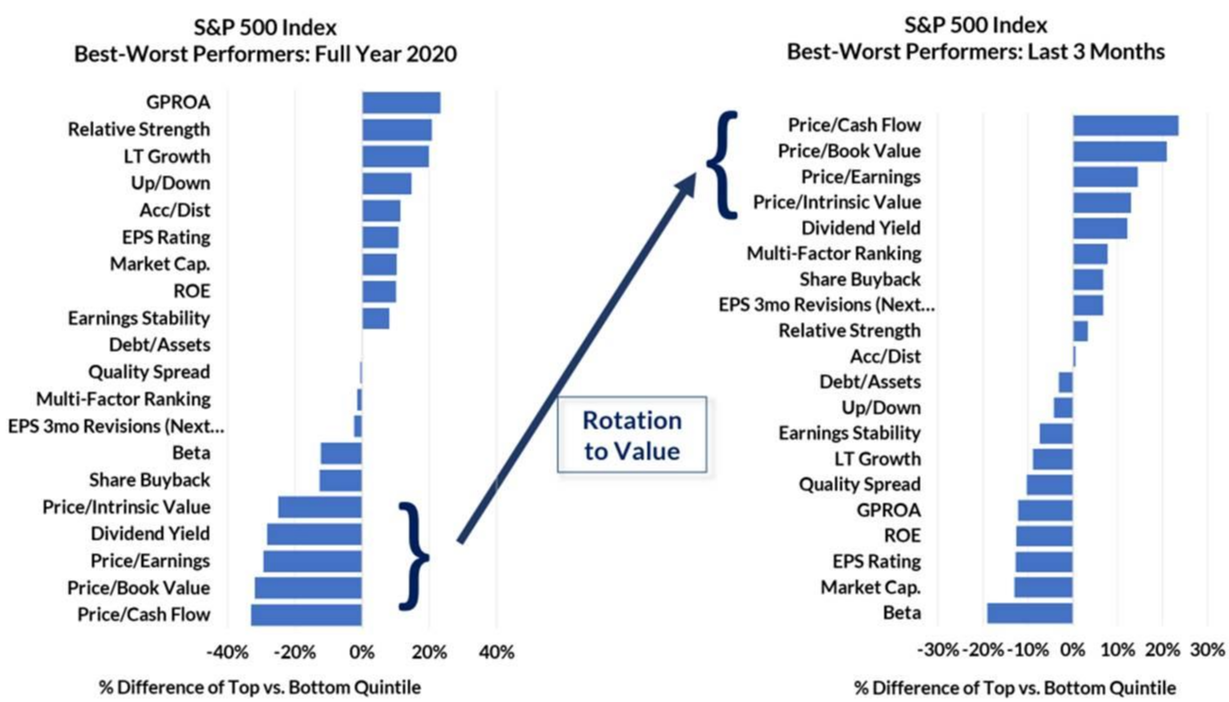
* *Annualized Total Returns.*

Markets acted well during the first quarter on the realization that both the Federal Reserve and the Federal Government are experimenting with the idea of having the economy overshoot the mark during the recovery. The rotation to Value continued as the economic outlook became clearer. As we exit the pandemic recession and enter a new expansion the Fed is willing to keep rates near zero even if inflation exceeds their mandate, while the Government is aggressively pursuing fiscal stimulus to get citizens back to work (and restructure parts of the US economy). This is in stark contrast to the stance both of those organizations took during most of the past 40 years. Let's look a little deeper at each of these and see what implications that has for investors as the year progresses.

- President Biden's first order of business was to set a stimulus plan in place that was on the same order of magnitude as the plan that was introduced at the depths of the Pandemic lockdown. On March 11, the American Rescue Plan Act was signed into law, a $1.9 Trillion fiscal stimulus featuring direct payments to lower- and middle-class households, extends and expands unemployment benefits, and offers aid to state and local governments.
- President Biden's second order of business was addressing Infrastructure needs with the American Jobs Plan, a $2 trillion program designed to update the US infrastructure for highways, airports, ports, the energy grid, broadband access, schools and hospitals over the next 10 years. Funding for this plan is expected to come from increases to corporate taxes.
- The Fed Chairman, Jerome Powell indicated that they intend to keep short term interest rates at or near zero for at least the next couple of years to help employment recover, and believes any inflation from low rates and stimulus will be temporary. Markets are less optimistic than that, and the 10 year bond saw interest rates nearly double during the quarter, from 0.9% to 1.75%, as inflation expectations rose. The Fed wants to see inflation overshoot their 2% long term target for a while.
- Many other things occurred in the quarter. January started with a riot at the capital, followed by the inauguration, a blowout earnings season, and the emergence of the meme (GameStop and the like) stocks. Bitcoin mania, Special Purpose Acquisition Companies (SPACs) and rising inflation expectations were also highlights during the quarter. While interesting, we think many of these market developments are a side effects of the fiscal and monetary measures we noted in the first three bullets.

For the past 10 years, central banks worldwide have been working overtime implementing policies designed to keep rates low and provide support to the economy. They have also begged central governments to pursue fiscal stimulus, though Governments spent much of that time pursuing austerity/regulation instead of growth oriented policies. That started to change with the last US administration as they implemented supply side tax policies and deregulation, and economic growth was better than for the eight years following the Financial Crisis. With the Pandemic, this seems to be getting into high gear recently with fiscal response amounting to approximately 25% of US GDP being injected into the economy over a relatively short time frame. Most of last year's plans were relief oriented. The new administrations plans are designed to give a real kick start to growth by offering direct aid to many of the people negatively impacted by the Pandemic, and investing in our infrastructure. For the next two years, we expect economic growth is going to be robust as the vaccines allow a reopening to satisfy pent up demand, while monetary and fiscal policies are being aimed to overshoot during the early part of this recovery. That's something we have not seen in a long time (perhaps ever?), and thus far the stock market is liking it. We think the second half of the Bull Market we have been in since 2009 is starting to unfold, and if history is a guide the second half is usually better than the first.

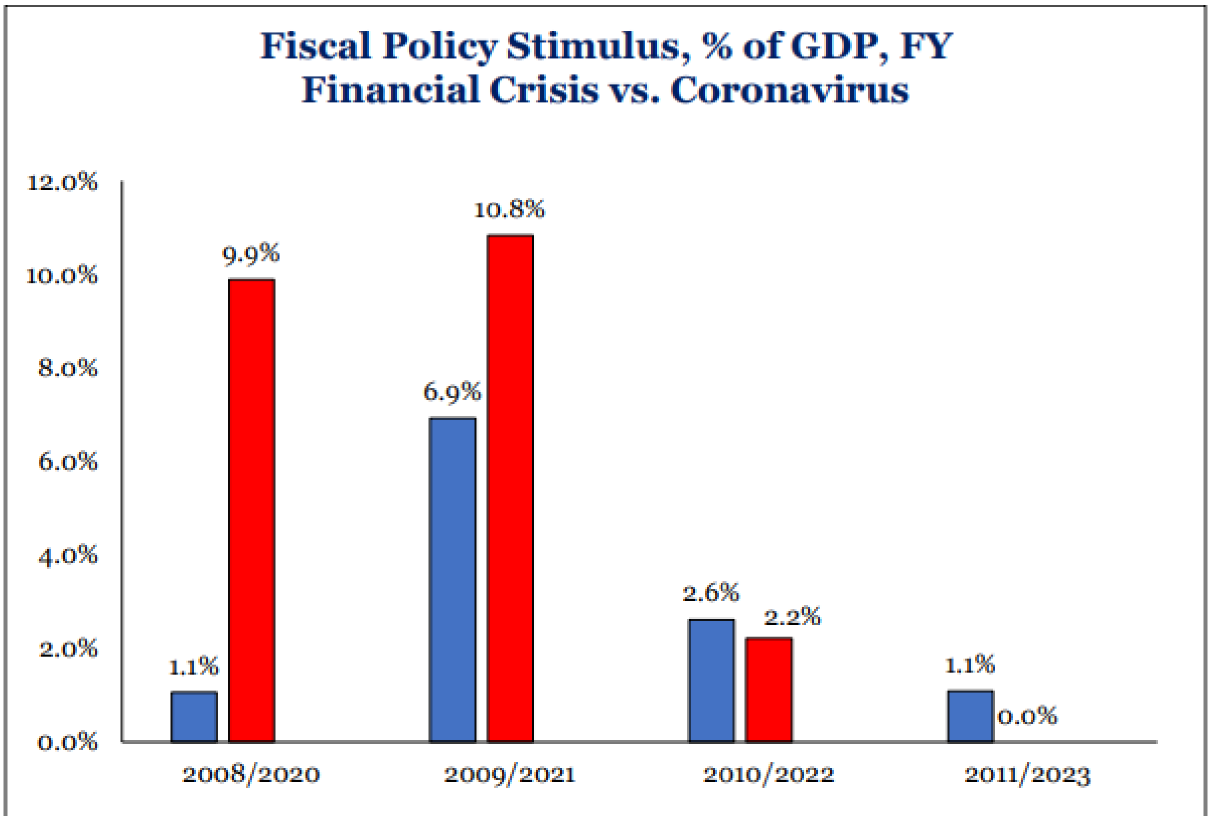
<u>Factors</u>



Source: Bloomberg, William O'Neill + Co. and Todd Asset Management

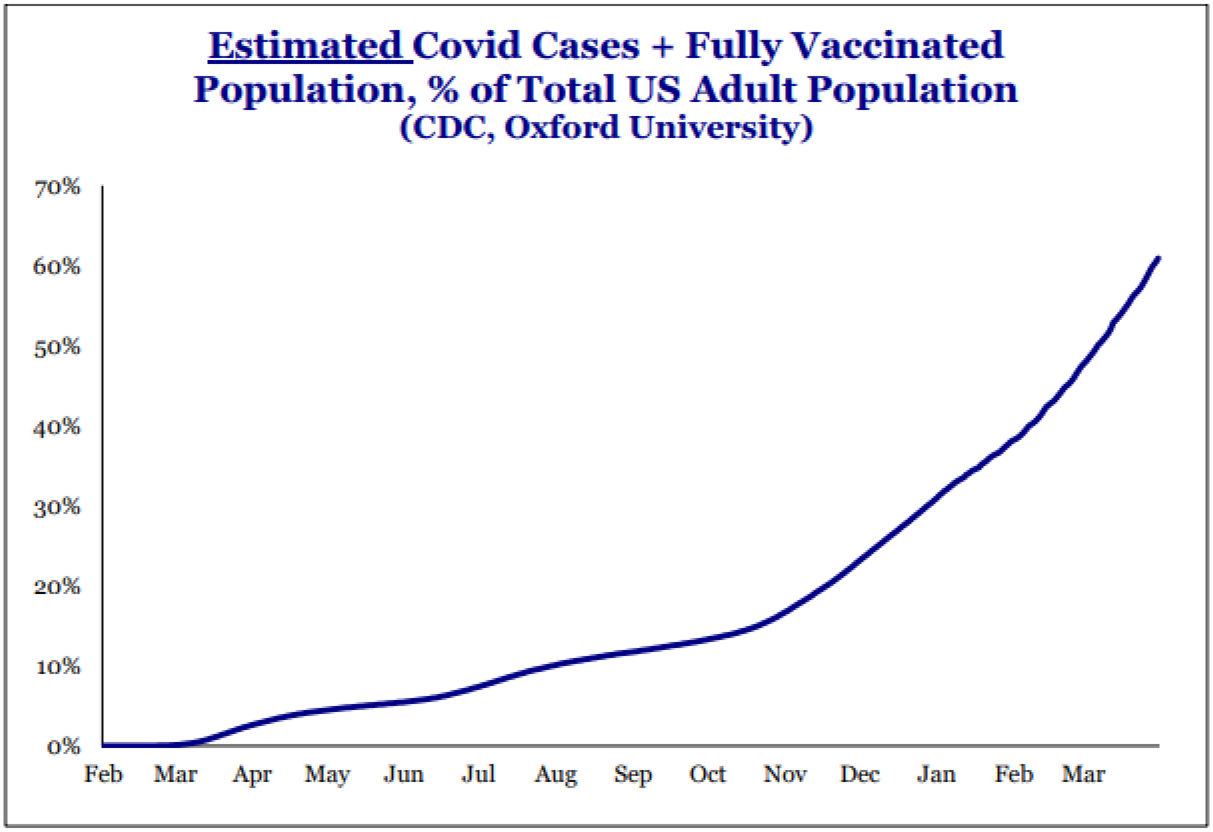
Our customary Factor charts are presented above illustrating which factors helped performance or hindered it for the past 3 months and trailing year. Both of these charts have shifted substantially over the past few quarters, as investors have moved back to rewarding traditional valuation factors and are shifting away from the growth darlings of the last few years. The best four factors over the prior quarter and year were all valuation metrics. The worst were the larger capitalization steady growth indicators. We are at the beginning of an economic expansion, so recession fears should not hit for years to come. As investors seek to benefit from recovery induced earnings improvement, the rotation to value should continue. We believe this represents a significant rotation in the market that should last for quite some time.

Interesting Charts We Saw this Quarter



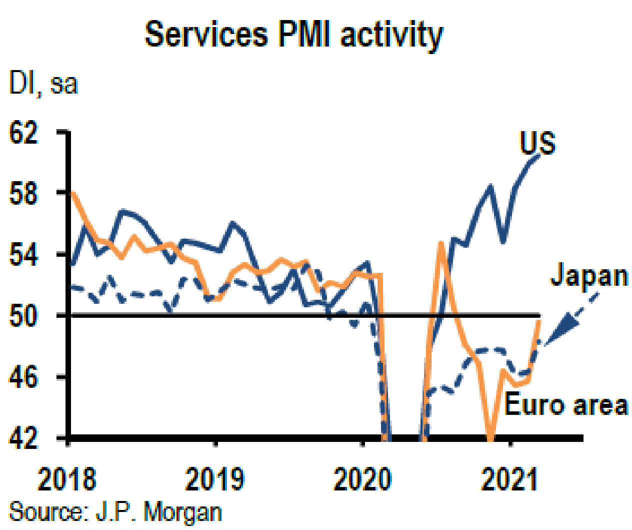
Source: Strategas

The pandemic has led to more significant fiscal spending than the Global Financial Crisis. As you can see from the chart above, the US is spending over 20% of GDP over last year and this year to counter the Coronavirus, compared to roughly 8% of GDP during the Global Financial crisis. Stimulus spending is probably going to increase as the current administration plans on introducing even more infrastructure plans during 2021. According to IMF studies, stimulus spending promotes better employment, investment and GDP growth for years to come.



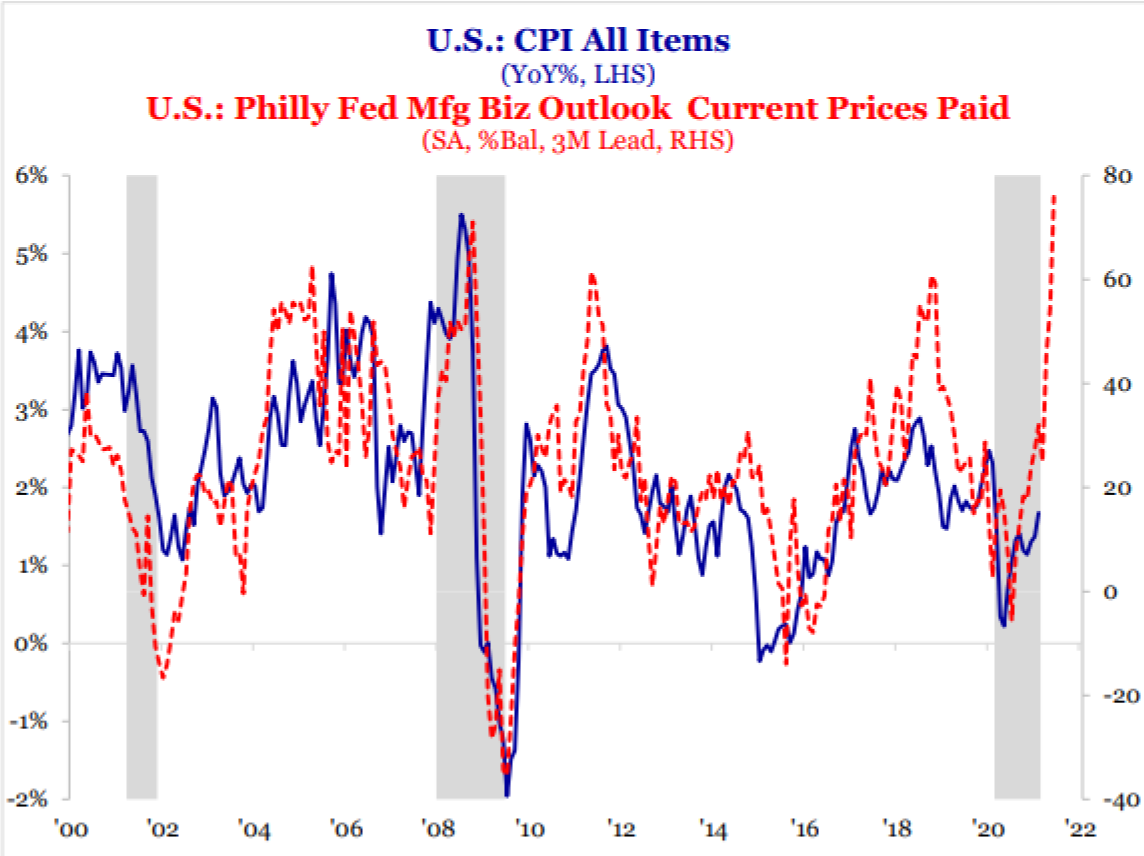
Source: Strategas

Estimates vary, but many experts agree that "herd immunity" occurs when between 65% and 75% of a population has been infected or vaccinated with a disease. Herd immunity happens when enough of a population has protection against an infection that it stops being able to spread - and even people who don't themselves have immunity are indirectly protected. If that is the hurdle, the US should reach that hurdle over the next couple of months and allow for further re-opening.



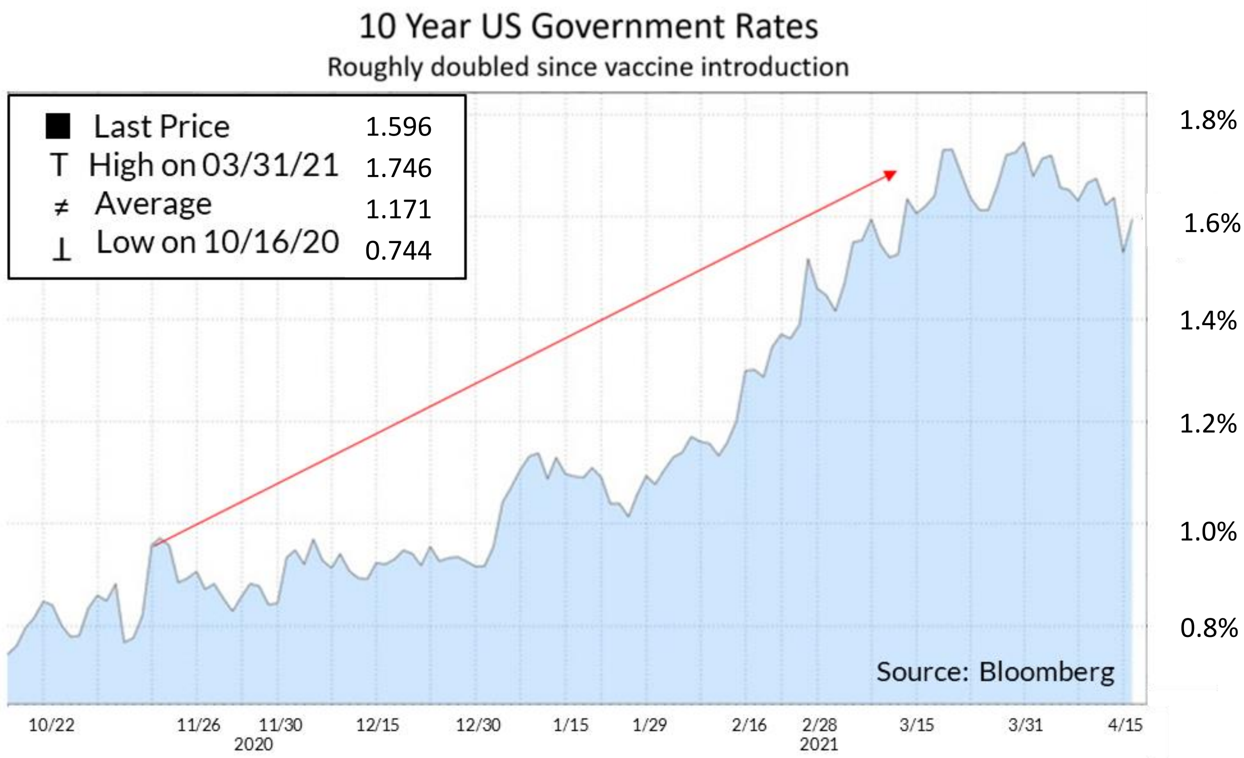
Services are already experiencing a recovery in the US, as the chart to the left shows. Japan and the Euro area are lagging our recovery, though we believe they will catch up in the second half of the year.

U.S. INFLATION SCARE BREWING



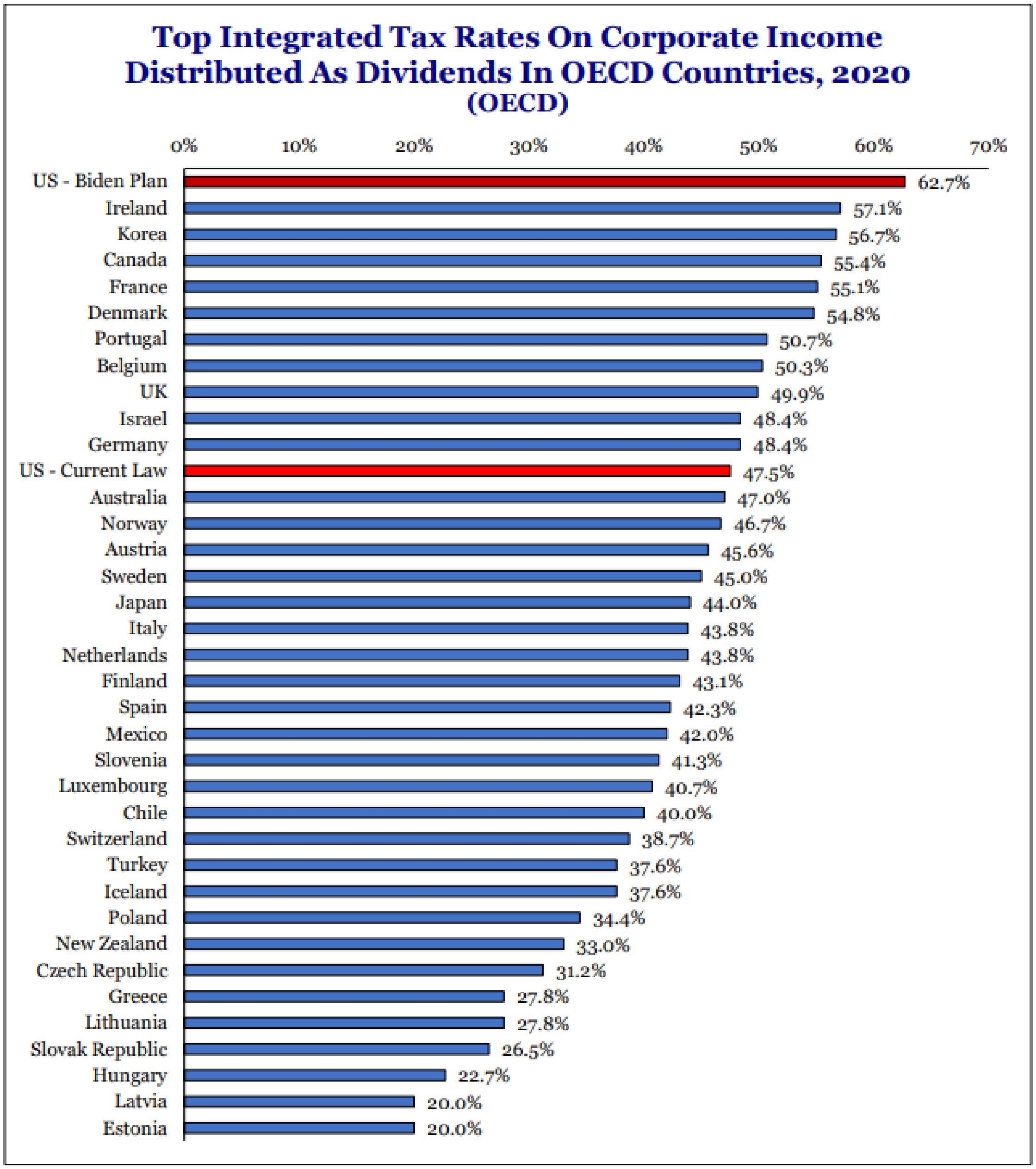
Source: Strategas

The chart above illustrates the relationship between the Consumer Price Index (blue line) and a current prices paid index for manufacturers (red line) shortages are occurring currently that have this prices paid index spiking, which most investors think could work their way into an inflation scare. The bond market may already be concerned as the recent doubling in our 10 year rate is partially because of this. The Fed has already addressed inflation concerns and suggests they will not consider changing rates until inflation rates are actually well above their long term target of 2%. They view any increase of inflation over the near term as temporary.



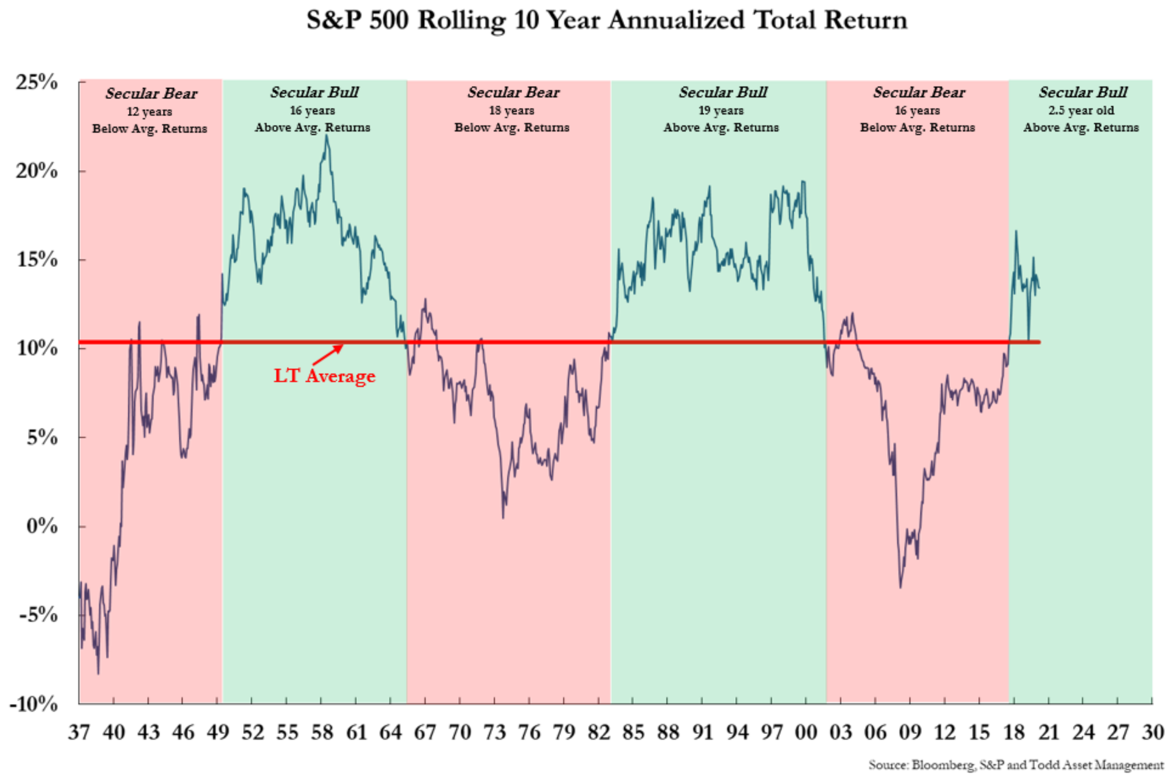
Introduction of a vaccine has led investors to expect a resurgence of economic growth, and interest rates are moving up confirming that positive outlook. Recent economic data supports this, and expectations for US economic growth have been steadily rising. Current estimates are for full year GDP growth to be over 8% (nominal), a rate of growth we have not seen in years. Rates likely have more to rise as this growth is realized, something that could inflict losses on bond holders. This is supportive for equities right now.

US WILL HAVE THE HIGHEST INTEGRATED CORPORATE TAX RATE IN THE OECD UNDER THE BIDEN PLAN

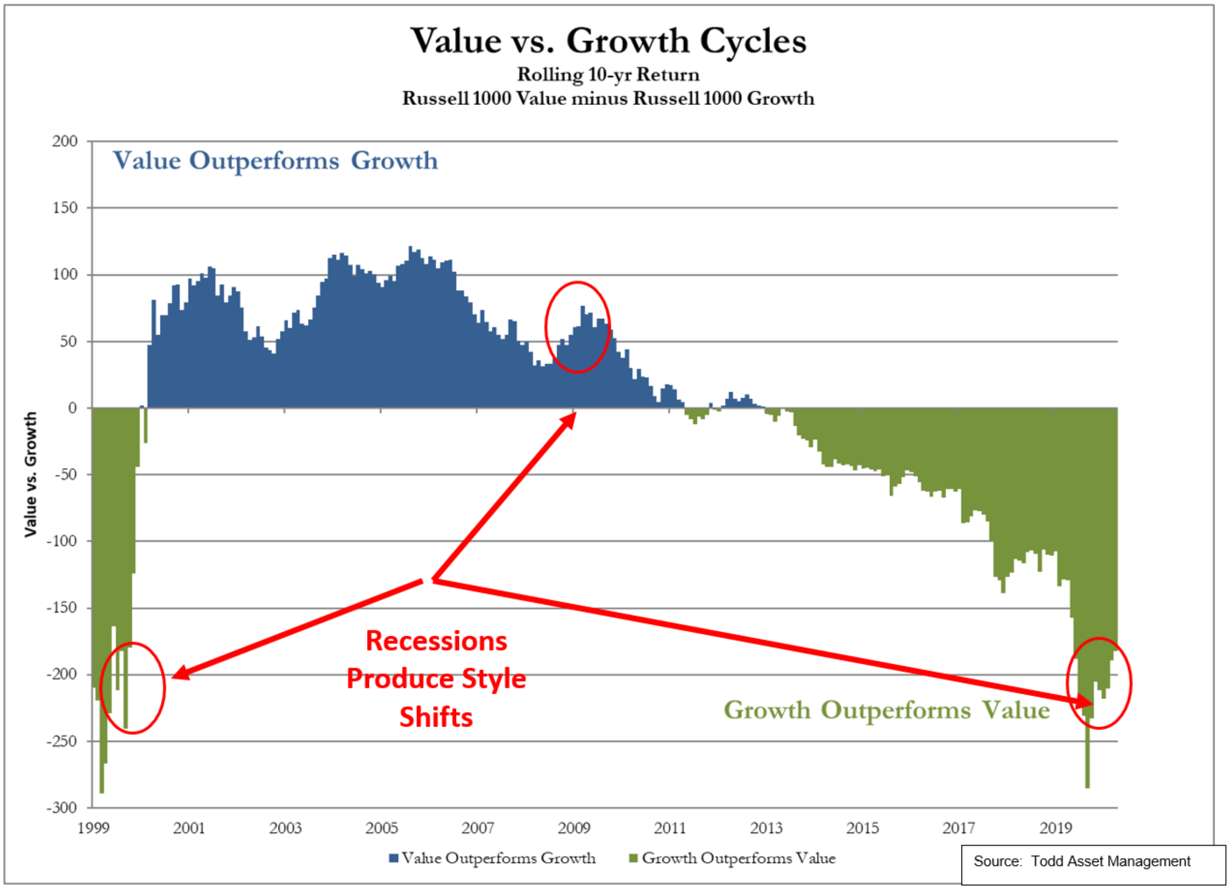


Source: Strategas

One potential concern for the anticipated recovery could be the higher rates that President Biden has told corporations to expect over the next couple of year. The proposed taxes, if enacted, would leave the US with the highest integrated tax rate on corporation's foreign earnings among our peers.



The chart above shows the rolling 10 year returns for the S&P 500 over time, segregating them into secular bull and secular bears. Based on this measure, the US has only just entered this secular bull 3 years ago, and the average of the last two bull markets was about 18 years on this measure. We believe the US market still has room to move over the coming decade.



The last chart we will leave you with shows the cycles that occur in Value versus Growth. The chart above illustrates the rolling 10 year returns for the styles, with the blue bars indicating value outperformance and the green lines showing growth outperformance. We've also highlighted the starts of recessions with some arrows and circles. Our conclusion is that recessions, like style shifts, are rare. Following recessions, leadership tends to change, and that change tends to last about ten years. ***Given that we just finished a recession, we believe the recent shift to favor value investing should be durable and long lasting.***

<u>Summary</u>

Unprecedented levels of government spending are being complemented by record low rates and resulting in an economic boom for 2021. Following the recession, we are at the beginning of a new economic cycle that should last for years, and result in value stocks leading markets for some time to come. Markets do not go up in a straight line though, and that is what it feels like they have done since last year. We believe we are entering the second half of a secular bull market that started in 2013, but would not be surprised to see the market trade sideways for a few months as it digests the impacts of higher taxes and higher rates on the outlook. We expect a resumption of the uptrend later on this year as investors become comfortable with the idea of this expansion lasting as long as prior ones.

The shift to favor value stocks should be durable, as fears of recession over the past 5 years are what has driven the insatiable grab for growth stocks at any price. Our sense is that a broader group of stocks should participate in the second half of the bull market. We believe many of the more economically sensitive sectors should be the beneficiaries of this trend. Energy, Financial, Industrial and Material stocks have been the leadership during the first quarter. We think they are likely to be mentioned much more frequently over the next five years as the economic expansion plays out.

As always, if you need any additional information, please feel free to contact any of us.

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04/19/21
S&P 500 – 4,155 (Intraday)
Russell 1000 Value – 1,536 (Intraday)

Refer to the following page for more information on the commentary presented. This is pertinent to this letter and should not be reproduced or duplicated without this disclosure.

TODD
Asset Management

<u>Disclosure</u>

The indexes used in this letter are unmanaged, and not available for direct investment. They do not include the reinvestment of dividends, nor do they reflect management fees or transaction costs.

S&P 500 Index is a widely recognized index of market activity based on the aggregate performance of a selected portfolio of publicly traded common stocks. The performance data was supplied by Standard & Poor's. It is included to indicate the effect of general market conditions.

Russell 1000 Value Index is a widely recognized index of market activity based on the aggregate performance of common stocks from the Russell 1000 Index, with lower price-to-book ratios and lower forecasted growth values. The performance data was supplied by Frank Russell Trust Company.