Q1 2021
Investment Perspectives

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April 2021

- **New President, More Stimulus:** Joe Biden was sworn into office as the 46th President in mid-January, and with de facto control of Congress, Democrats proceeded to pass a $1.9 trillion stimulus package in March. The bill provided more checks to families and extended unemployment aid, in addition to boosting funds for state and local governments. Almost immediately afterward, Democrats shifted their sights to a $3 trillion infrastructure bill.
- **Stocks and Rates Move Higher:** The S&P 500 posted a fourth consecutive quarter of gains and long-term bond yields jumped as investors continued to revise growth and inflation expectations upward. The Fed reiterated its pledge to remain accommodative to encourage hiring and buoy markets, and a wave of fiscal stimulus measures from Washington likely means that new Treasury supply will tick up meaningfully in future quarters.
- **Retail Investors Go Wild:** Pockets of the market experienced extreme volatility during Q1 as retail investors flocked to social media site Reddit for stock tips. Hedge funds focused on short selling were targeted, and a number of heavily-shorted stocks surged during the period. The volatility was so dramatic that some brokerage platforms limited trading, and the episode ultimately caught the attention of Congress who called on the executives involved to testify in front of the House Financial Services Committee.

Market Recap

A fresh round of stimulus and an encouraging trajectory for the COVID vaccination campaign helped push risk assets higher in Q1. Direct payments to US households bolstered consumer finances, and a steadily increasing number of daily jabs has set the stage for a sharp uptick in economic activity during the second half of 2021. The Fed also reiterated its accommodative posture, emphasizing that it would continue to support the economic recovery via low short-term rates and ongoing asset purchases for the foreseeable future.

In equity markets, investors continued to press the rotational bets that had emerged post-election, swapping exposures from the COVID winners—large caps and growth stocks—into the COVID laggards—small caps and value stocks. As evidence of this shift, the more economically sensitive Russell 2000 Index bested the S&P 500 Index by over 6% during the period, and the Russell 3000 Value outperformed its growth counterpart by nearly 11% in Q1.

The US resumed its leadership position amongst global markets as countries around the world have failed to match the scale and scope of its stimulus efforts. Europe and Japan have struggled with uneven economic recoveries, and while most global markets sit at or near all-time highs, non-US gains have generally underwhelmed. Emerging market

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FIXED INCOME

Index	USD Total Return (%) Q1 2021	2020
Barclays 1-10 Yr Muni	-0.3%	4.2%
Barclays US Agg. Bond	-3.4%	7.5%
BofA/ML HY Master II	0.9%	6.2%

EQUITIES

Index	USD Total Return (%) Q1 2021	2020
Russell 3000	6.3%	20.9%
S&P 500	6.2%	18.4%
Russell 2000	12.7%	20.0%
MSCI All Country World	4.6%	16.3%
MSCI EAFE	3.5%	7.8%
MSCI Emerging Mkts	2.3%	18.3%

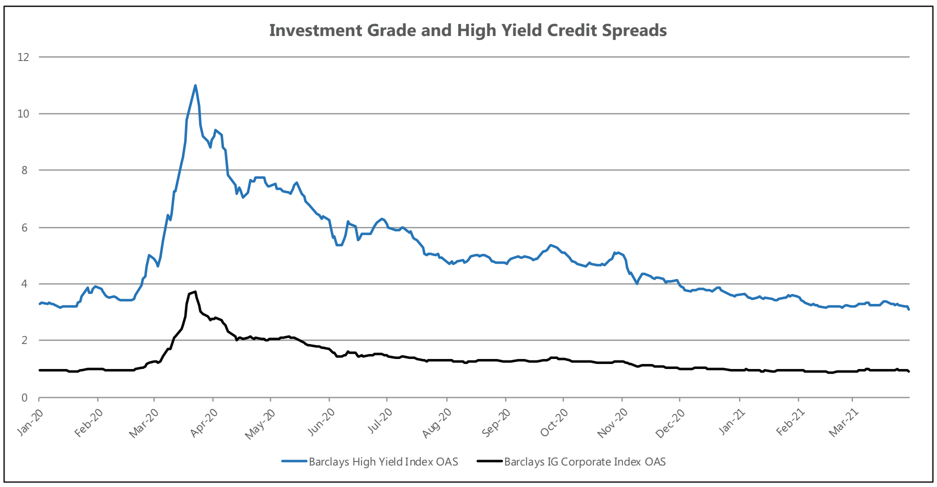
Source: Bloomberg (Data as of 3/31/2021) stocks were the laggards during the quarter as fears of tighter monetary policy aimed at stemming excessive credit growth weighed on Chinese stocks—the largest allocation within the MSCI Emerging Markets Index.

Within fixed income, rapidly rising Treasury rates triggered mark-to-market losses across most high-grade bond indices. The benchmark 10-year yield jumped over 0.8% and closed the quarter at 1.7% as investors reassessed their inflation and growth outlooks. The Bloomberg Barclays Aggregate Bond Index experienced its worst quarter in the last 30 years, declining 3.4% on a total return basis. Longer maturity bonds with a greater degree of sensitivity to interest rate changes were especially hard hit. High yield bonds fared better as a result of the increasingly optimistic growth outlook and the ongoing search for yield. The BofA/ML High Yield index managed to advance 0.9% to start 2021 and extended its relative performance gains to over 22% versus the Aggregate Bond Index since the end of Q1 2020.

WHAT A DIFFERENCE A YEAR MAKES

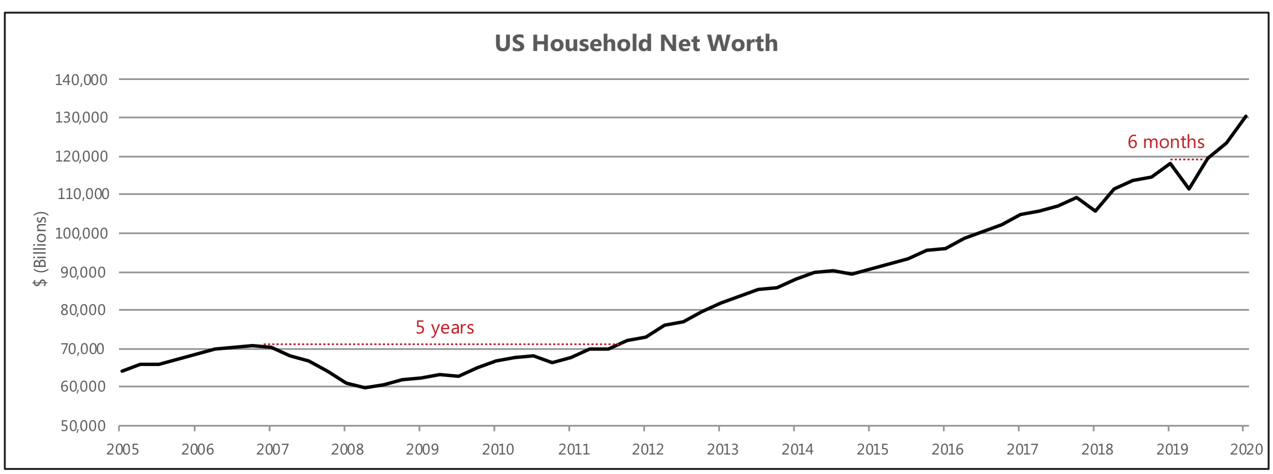
March 23, 2020 marked the low for most major markets during the COVID-induced selloff, and roughly one year later, investors would be hard pressed to find signs of any lingering market stress. The economy may still be in the process of healing—particularly hard-hit segments like travel and leisure—but unprecedented levels of monetary and fiscal stimulus have mended most market wounds.

As an example of this normalization, the chart below shows credit spreads for investment grade (black line) and high yield (blue line) bonds. A credit spread is the additional yield that investors require over a risk-free Treasury in order to compensate them for default risk. Spreads have historically been very sensitive to deteriorating corporate conditions, and as the market began to understand the severity of the COVID crisis in Q1 2020, these measures widened to extreme levels. Investors were commanding an outsized level of compensation in order to accept the risk of lending money to businesses in that environment—even highly-rated ones. Where do these metrics sit now? After extraordinary intervention from the Fed and trillions of fiscal spending, spreads are at or below their pre-pandemic levels even as corporate debt levels have soared. The recovery that only took a little under one year in this recession took three to five years—depending on the index—in the wake of the global financial crisis.



Source: Bloomberg (Data as of 3/31/2021)

Another metric that looks even healthier now than it did before COVID is US household net worth levels, per data from the Federal Reserve (chart below). In aggregate, US households



Source: Bloomberg (Data as of 3/31/2021)

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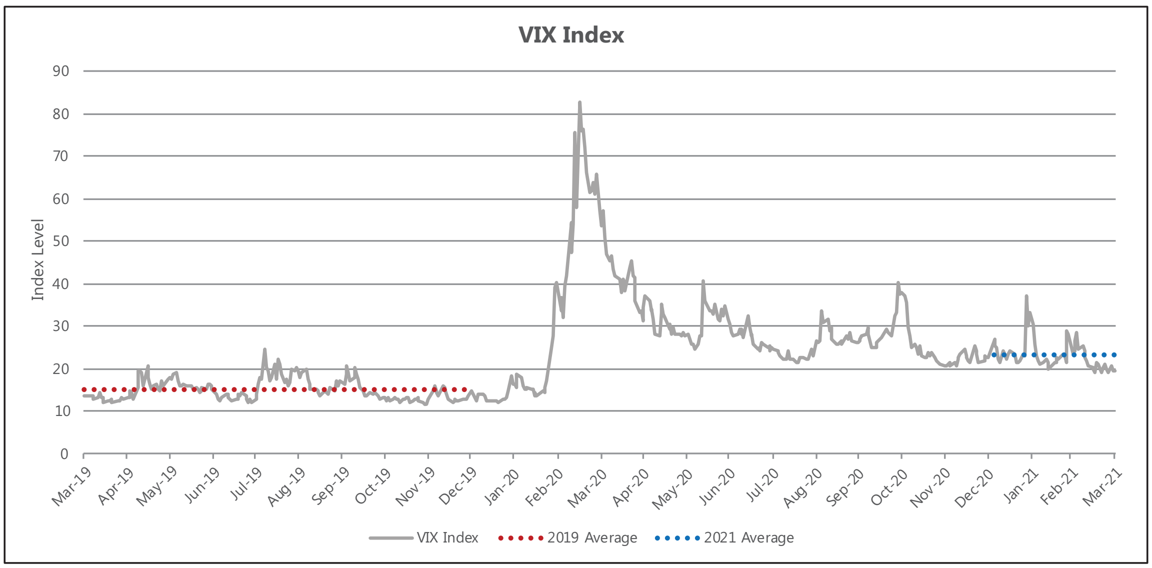
recovered from the COVID dislocation within a six-month period despite unemployment soaring and GDP still running below its pre-COVID high water mark. To be sure, the rapidity of the recovery in financial markets mitigated the decline and accelerated the recovery, but consider that it took five years for households to fully recover from the global financial crisis. The difference this time? Broad fiscal stimulus and direct payments to citizens that supported consumer balance sheets. A related metric, the personal savings rate, skyrocketed alongside household net worth, and both measures underpin economists' expectations that a robust recovery will take hold as the economy fully reopens over the second half of the year, led by a wave of spending from consumers flush with cash.

One of the few market metrics that has not fully reverted to pre-COVID levels is volatility. The chart below shows the CBOE VIX Index—a measure of investors' volatility expectations for the S&P 500 based on options prices—over the past two years. The VIX slowly began the normalization process after hitting extreme levels in Q1 2020. At its peak, the VIX implied that the normal range of daily price moves for the S&P 500 would be roughly plus or minus 5%—almost one year's worth of average S&P 500 returns within one day! While this implied daily range has significantly narrowed to just over plus or minus 1% based on current pricing, 2021's average VIX level is still roughly 50% higher than its 2019 average, suggesting that investors remain on edge about the possibility of another period of heightened volatility.



Source: Bloomberg (Data as of 3/31/2021)

While the toll that COVID exacted on individual's lives and livelihoods cannot by understated, simply looking at market and consumer data for lingering signs of stress might leave you wondering if there will be any lasting damage at all.

SOCIAL MEDIA STOCK PICKERS

Part of the reason that volatility expectations remain stubbornly high despite the healing that has occurred throughout markets is the coordinated efforts of a group of retail investors in Q1. Specifically, a group called "WallStreetBets" on the social media platform Reddit engaged in a collective attempt to generate a "short squeeze" in certain stocks that were heavily shorted. Said differently, the group identified a number of stocks where hedge funds had made large bets on their prices declining, and the Reddit cohort began purchasing shares and/or options to increase prices—ostensibly because they believed the stocks were fundamentally undervalued—thereby causing losses for the short sellers. When the momentum against the hedge funds' short positions became strong enough, they would be forced to capitulate and purchase shares to close their positions. It was a clever maneuver that ultimately sent the prices of stocks like GameStop, AMC Entertainment, and Bed Bath & Beyond soaring higher as the WallStreetBets group was adding hundreds of thousands of members per day.

The longer-term implications of an episode like this are difficult to determine. Was this simply a flash in the pan type of event that resulted from smaller investors having stimulus money that could be used for speculative ventures? Or, is there a structural shift occurring in the market thanks to zero-fee trading and social media platforms that can be used to rapidly mobilize investors? Perhaps it is a combination of the two, with no-commission, "gamified" brokerage apps helping to

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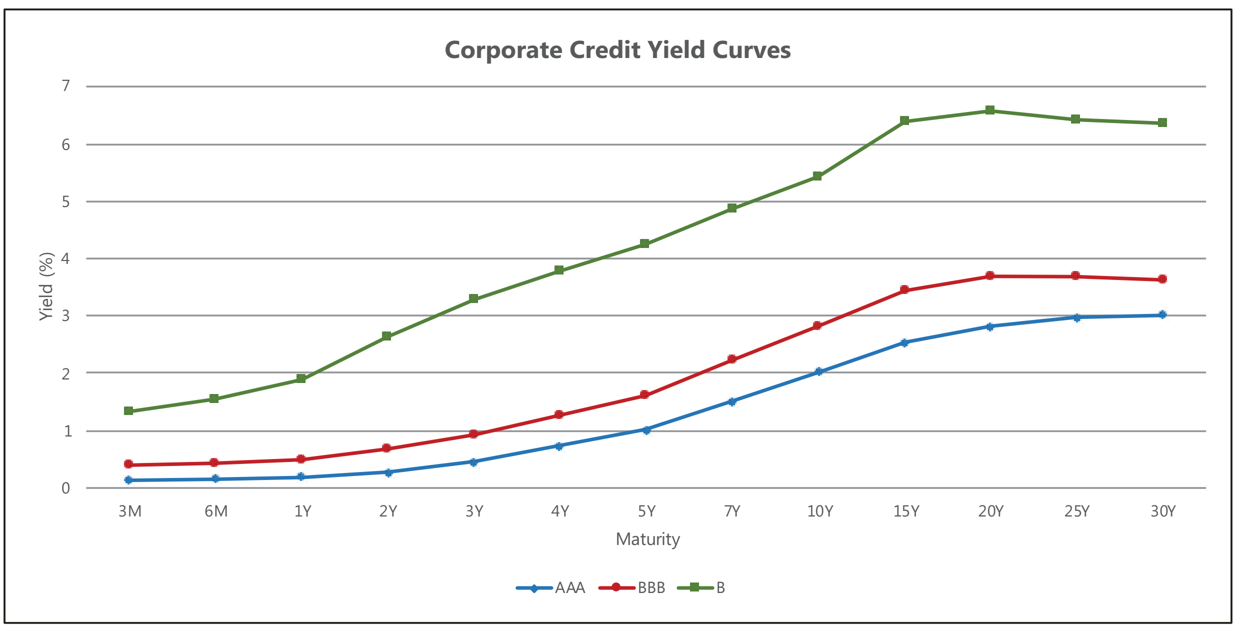
democratize investing at the same time that throngs of unemployed or underemployed citizens received direct payments and wanted to find a more compelling investment vehicle than a bank account yielding 0%. It was reasonable to believe that all of the stimulus being injected into markets and the economy would have unforeseen externalities—both good and bad—and this may have represented a perfect storm scenario.

RATES UP, PRICES DOWN

Investors relying on bonds to generate income in their portfolios should celebrate higher risk-free yields, but the process of getting to higher yields can be painful as it unfolds. As discussed in the market recap section, the 10-year Treasury yield jumped roughly 80 basis points during Q1—its biggest single quarter increase since 2016 and the fifth largest increase in the last 30 years. Unfortunately for existing holders, as bond yields rise, bond prices fall. To illustrate the concept with a simple example, consider an investor who purchased a 10-year bond with a 1% yield for $100 last year. That investor could not sell the same bond for $100 today if newly-issued 10-year bonds are being issued with 2% yields; the price would need to be adjusted downward so the effective yield is consistent with current market levels.

The conundrum for allocators is that long-term rates may continue to rise as investors command higher compensation for inflation risks and the Treasury issues massive amounts of debt to fund the budget deficit, creating a supply-demand imbalance. The simple solution would be to own bonds that exhibit less price sensitivity relative to changes in interest rates, but yields on high-quality, short-term bonds with those characteristics remain mired near 0%. Against that backdrop, investors are increasingly forced out the risk spectrum and into lower-rated issues in order to generate a modicum of yield without exposing themselves to outsized interest rate risks. If executed thoughtfully, this can be a winning strategy, but the concern is that investors begin substituting credit risk—which can be equally impactful on prices if markets fear rising odds of defaults—for interest rate risk. The chart below illustrates this concept by showing yields on corporate bonds by maturity (horizontal axis) and by credit quality (color). Moving from the highest-rated segment (blue line) to the lowest rated segment (green line) will increase yield, but investors must be aware of the commensurate increase in risk.



Source: Bloomberg (Data as of 3/31/2021)

WHERE DO WE GO FROM HERE?

With US stock markets sitting at or near all-time highs, investors are rightfully asking how much higher risk assets can go before there is a day of reckoning. One way to gauge the relative attractiveness of current prices is to tap into the collective wisdom of Wall Street analysts and look at their average 1-year price target for the S&P 500—a broad measure of US large and mid-cap stocks—relative to its current price. As you can see in red at the top of the chart on the following page the S&P 500 currently sits roughly 10% below the consensus 12-month price target.

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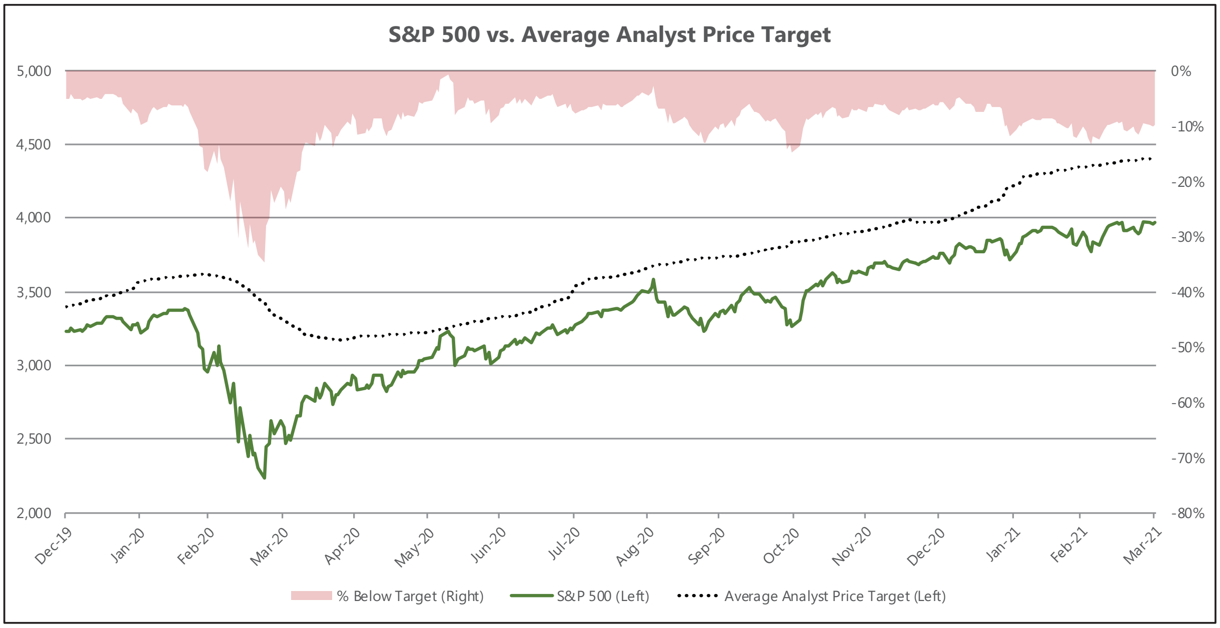

Source: Bloomberg (Data as of 3/31/2021)

Analyst estimates are far from infallible, but they may provide a useful barometer for how much market upside is on offer over the coming months. Current levels are a far cry from the 30% discount at the worst of the COVID selloff, but it still implies an attractive amount of upside from current prices. Conversely, as the market levels nearly reached the analyst targets in May and August 2020, the S&P 500 swiftly pulled back. The direction and rate of change for the consensus targets continues to offer a vote of confidence for the trajectory of markets over the next 12 months, and if the analysts are correct, the answer to "Where do we go from here?" might be "higher" after all. ●

The Inflation Outlook

Inflation has become an increasingly popular topic in recent months as policymakers and investors assess the implications of unprecedented fiscal and monetary stimulus alongside ongoing supply chain bottlenecks resulting from COVID-related disruptions. It remains to be seen whether a bona fide inflationary environment will take hold, but what is nearly certain is that the next few months will see substantially higher inflation readings as a result of "base effects", or the idea that anomalous readings from prior periods can distort year-over-year or month-to-month measures. In this case, the economic shutdowns that occurred around this time last year pushed inflation metrics markedly lower due to curtailed consumer and business spending. Even though goods and services prices are not currently showing signs of a dramatic spike higher, the year-over-year comparisons will make headline inflation readings appear to be very high.

The difficult task for monetary authorities and investors alike will be disentangling the signal from the noise when reviewing inflation data over the coming months. For its part, the Fed has repeatedly stated that it believes that the likely uptick in inflation will be transitory. Moreover, the Fed's inflation target of 2% on average suggests that it would actually welcome an extended period of higher inflation after failing to hit its target for most of the 2010s.

Investors have taken a somewhat more cautious view toward inflation. The chart on the following page shows the 5-year and 10-year inflation breakeven levels implied by pricing within the Treasury market. These levels represent the market's best guess at what the average inflation level will be over the next 5 and 10-year period. As you can see, inflation expectations are approaching their highest levels since the early part of the 2010s. This may be driven by some combination of decreased probabilities of disinflation and increased probabilities of upside risks to inflation, but in either event, markets seem to be more concerned about a prolonged period of inflation than the Fed.

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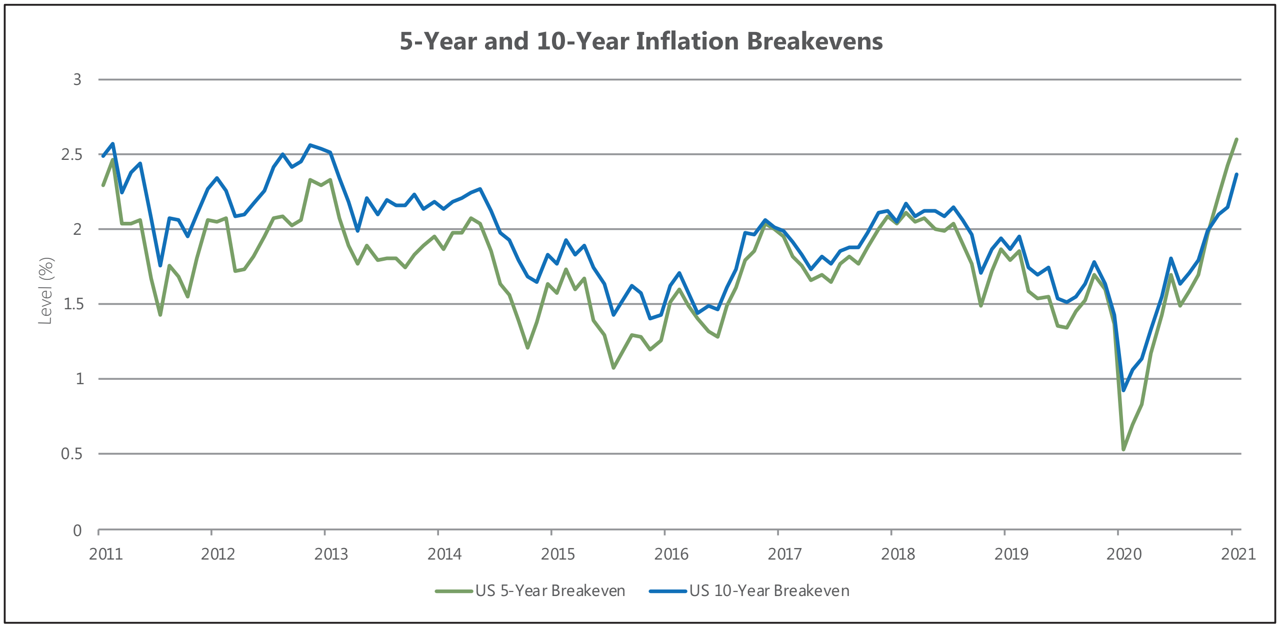

Source: Bloomberg (Data as of 3/31/2021)

With respect to the practical implications of inflation on portfolios, we would suggest thinking about portfolio positioning in terms of explicit and implicit bets. The explicit calls are generally more straightforward, but identifying your implicit biases requires second and third derivative thinking. For instance, an allocation to highly valued technology stocks could represent an implicit call on low inflation. Why? Higher inflation is generally accompanied by higher interest rates. Higher interest rates generally mean a higher cost of capital and higher discount rates when calculating the present value of a company's future cash flows. For companies that are not expected to have significant revenues and/or earnings until years in the future (e.g., pre-revenue biotech companies, tech businesses with high cash burn rates, etc.), these interconnected factors can negatively impact their current valuation.

Within fixed income, investors concerned about inflation can look at TIPS, or inflation-protected Treasuries, as an outright bet on higher readings. For TIPS investors, the principal value of their bonds will adjust based on changes to the Consumer Price Index (CPI), insulating investors from declining purchasing power. Perhaps more importantly, investors should understand the duration profile of their overall fixed income portfolio to gauge their sensitivity to inflation. Duration is a shorthand way to measure approximately how much price gain or loss would occur based on a change in interest rates. As an example, if inflation is rising and bond yields rise 1% in response, a fixed income portfolio with a duration of 5 years could expect to experience a price decline of 5% (1% interest rate change x 5 years duration). That makes a shorter duration profile an implicit bet on higher inflation.

For equity investors, the oft-cited explicit way to play rising inflation is to boost allocations to companies with direct commodity exposure. Commodities have historically been a good hedge against higher inflation, and energy and materials producers typically benefit from their operating leverage (i.e., high fixed cost structure) during periods of rising prices. The implicit bets range from financial stocks that benefit from inflation translating into higher long-term rates, thereby improving profit margins on loans to high-valuation growth stocks that can be hurt by rising inflation for the aforementioned reasons. A simple heuristic would be to say that rising inflation favors value stocks versus growth stocks, and vice versa for disinflationary conditions—exemplified by the results that we generally saw in the 2010s.

Whether COVID has truly ushered in an inflationary regime change can only be judged with the fullness of time, but with markets forecasting higher levels of inflation over the coming years, investors would be well served to understand their portfolio exposures vis-à-vis inflation and its knock-on effects. ●

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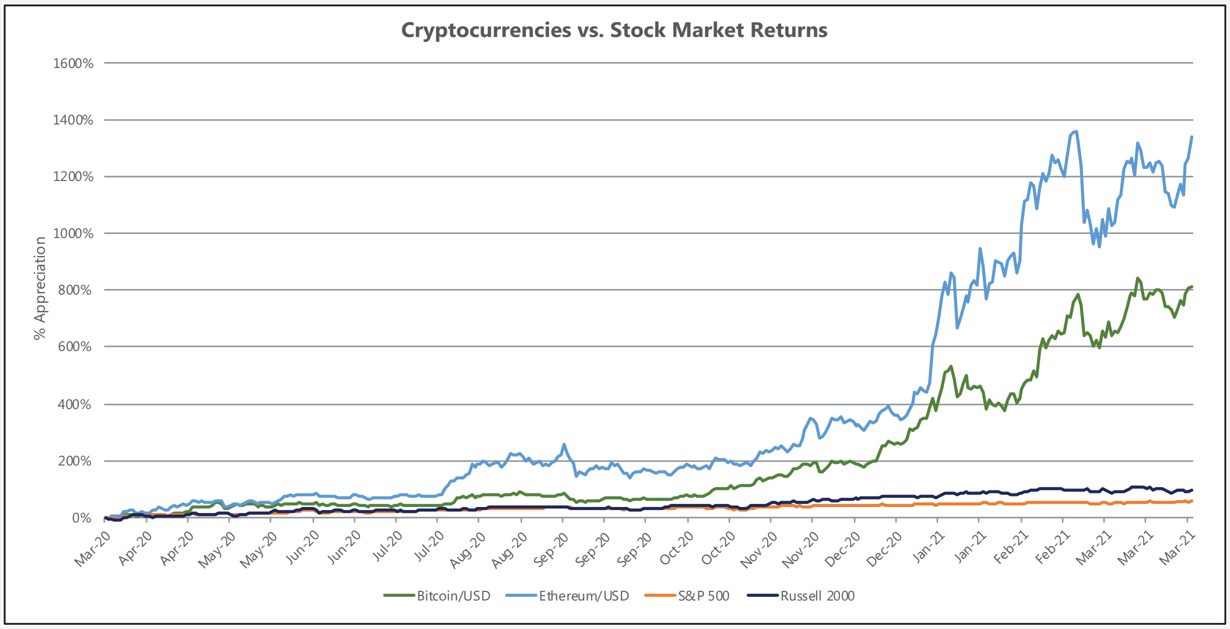
Chart of the Quarter

In any historical context, the one-year trailing returns of 56% for the S&P 500 and 95% for the Russell 2000 are extraordinary—and even more so against the backdrop of a global pandemic that decimated certain segments of the economy. But, what if we told you that there were two assets with a combined market capitalization of over $1 trillion that dwarfed the returns of those stock indices over the same period?

The Q1 Chart of the Quarter (below) shows the returns of the two largest cryptocurrencies, Bitcoin and Ethereum, relative to the S&P 500 and Russell 2000 over the past 12 months. As you can see, the stock market gains hardly register on the chart relative to the exceptional advances for Bitcoin and Ethereum, up more than eightfold and thirteenfold, respectively.



Source: Bloomberg (Data as of 3/31/2021)

To be sure, cryptocurrencies are highly speculative assets that still lack a well-defined regulatory structure and present myriad risks at this stage of their lifecycle. Numerous pundits have labeled it a bubble, and the legendary investor Warren Buffet went so far as to call it "rat poison squared". Even accessing the asset class in a turnkey manner has posed its own challenges for investors. Setting aside the debate of whether cryptocurrencies are viable long-term investments, perhaps there are lessons that investors can take from their meteoric advance in recent years. Among them:

- **Fiat currency debasement.** Currencies issued by governments are also known as "fiat money" and include the likes of the US dollar, euro, yen, etc. Central banks around the world have continued to fight economic stagnation and disinflationary trends by expanding the monetary base (i.e., printing money) since the global financial crisis. While this has not resulted in broad inflationary pressures to date, one can observe that prices of financial assets—like stocks—and collectibles with supply constraints—like fine art or vintage cars—have soared in value over the past decade. It stands to reason that at least some portion of Bitcoin's price rise can be traced to its fixed supply (there will only be 21 million Bitcoins created) in relation to the rapidly expanding supply of fiat currencies and concomitant concerns about long-term central bank irresponsibility. In general terms, when liquidity is abundant and supply is seemingly unlimited, perhaps investors would be wise to seek assets with scarcity value.

- **Network effects.** A common criticism of cryptocurrencies is that they have no intrinsic value—there are no cash flows nor are there any assets backing the value of the digital coins. For some investors, that may be disqualifying. But, perhaps the value of digital assets is best viewed in terms of their adoption rates and the scale of the networks that are being created. Like social media companies or mobile payment platforms, growth can be self-reinforcing and exponential; as more people join an ecosystem, the network expands and becomes more robust. The longer digital assets like Bitcoin and Ethereum exist without major technology or security issues, the more likely that their

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user bases will grow and signal broader validation. There also becomes a prisoner's dilemma of sorts for businesses and institutions; in the event that these digital assets are actually here to stay, can you risk being the last one to adopt or invest in the new technology and fall behind competitors? The broader lesson here may be to look for investments with network effect-like characteristics, where adoption begets more adoption at an increasing pace.

- **Innovation.** Digital assets are emblematic of the types of innovative technologies that are being developed to disrupt and displace legacy systems and protocols. Specific to cryptocurrencies, the underlying "blockchain" technology that provides the infrastructure for these digital assets has numerous use cases with the potential to impact broad swathes of the global economy. More generally, whether it is blockchain or other technological platforms, markets will continue to look for the next big idea and funnel capital towards the most compelling initiatives. Not all will succeed, but having an allocation to the types of innovative products/companies that can relegate entrenched players to "melting ice cube" status may help investors hedge their portfolios against the potential pain caused by creative destruction.

As regulatory authorities grapple with an entirely new set of issues and central banks contend with an increasingly digital future, it is impossible to say with certainty how the digital asset landscape will evolve. So, whether or not specific investments like Bitcoin and Ethereum are suitable for your portfolio, investors would be wise to consider some of the core characteristics that have underpinned their rapid advance in recent years.

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