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QUARTERLY INVESTMENT PERSPECTIVES: **Q2 2021**

First Quarter Review

It is hard to believe that just one year ago, we experienced the worst quarter for stocks since the Great Depression and the Ten Year U.S. Treasury bond yielded just 0.69% as investors pushed money into cash and other safe havens. An optimistic view was hard to believe in, yet we closed our Quarterly Investment Perspectives at this time last year with this observation - "Regarding volatility, although we are in unprecedented times, it is an ever-present characteristic of the stock market. Each time there is a new bear market, it is easy to feel that this time is different and the end result is going to be far worse than prior experiences. However, in the 25 bear markets that have occurred over the last 100 years, all have recovered, eventually reaching all-time highs."

Though we did not forecast new all-time highs to come so quickly, the first quarter of 2021 saw just that for U.S. stocks, with mid and small cap companies leading the way. Businesses that benefit from an upturn in economic growth, such as industrials, banks, and energy companies, performed particularly well. Promises of additional stimulus and a continuation in easy monetary policy have sparked optimism that the economy will recover quickly from the deep recession experienced last year.

While stocks performed very well during the quarter, bonds experienced one of their worst quarters in forty years, with the Barclays US Aggregate Bond index falling (-3.4%). The Barclays Global Aggregate Bond index declined (-5.3%). The prospect of rising inflation, increasing economic growth, and further debt issuance from central banks around the world caused bond yields to rise and prices to fall as speculators exited bonds for riskier assets.

The jump in risky assets during the first quarter was exhilarating, strange, and concerning all at once. Cryptocurrencies shot up, traders piled into GameStop, and digital assets such as Non-Fungible Tokens (NFTs) experienced their moment in the sun and record setting auction prices. In our outlook for this edition of Quarterly Investment Perspectives, we will take a look at the recent bull market in non-traditional assets, the prospects for economic growth, and what the rest of the year may hold for investors.

Investment Market	Q1 2021
U.S. Large Cap Stocks	6.2%
U.S. Mid Cap Stocks	8.1%
U.S. Small Cap Stocks	12.7%
International Developed Stocks	3.5%
Emerging Market Stocks	2.3%
Barclays US Aggregate Bond	-3.4%
Barclays Global Aggregate Bond	-5.3%

Sources: Eaton Vance, as of 3/31/2021

MARKET REVIEW AND OUTLOOK

A Bull Market in Digital Assets

There have been two common responses to the recent bull market in seemingly every asset under the sun: (1) "This is going to end in tears, isn't it?" or (2) "Why didn't you give me a heads up that [insert asset here] was going to jump 400% in two weeks?" Unfortunately, my formal finance training did not come with a pack of Kleenex nor the ability to predict two week moves in asset prices. Record high prices in the stock market have become mundane in comparison to the trends occurring within other areas of the investment landscape.

To wit, the first quarter saw the spike in meme stocks such as GameStop and AMC spill over into many other areas. Bitcoin's price jumped by 102%, Kanye West's sneaker brand is worth $3.7 billion, and "Beeple," a digital artist, sold his work entitled "Everydays" for $69 million through Christie's Auction House.

The record setting auction quickly pushed the term "Non-Fungible Token", or NFT, into the mainstream media. In short, an NFT is a one-of-a-kind digital asset: that could be a video, a tweet, or computer generated art. The NFT is the claim on the original version of this art, verified and recorded on the blockchain. As new technology like cryptocurrency has proliferated, digital investments like NFTs have become mainstream. While our commentary usually views financial events through the lens of what it means for our portfolios, I think it is just as important to discuss the reasons for the recent rise of meme stocks, cryptocurrencies, and other speculative assets.

Non Traditional Assets Soar	
Bitcoin First Quarter Return	102.8%
Beeple's "Everydays" Auction Value	$69 million
Daily Trading in GameStop	45 million shares
Kanye West's Sneaker Company Valuation	$3.7 billion

Ownership - be it of a business, a home, a car, etc. - has always been lauded in American culture. The American Dream usually referenced owning your own house. It was something to aspire to, that is until you realized it meant you had to spend your Saturday mowing the grass and wondering where all your discretionary income went. Nobody lauds the American dream when they find water in their basement.

As our culture has evolved and the "internet of things" has become a dominant force in daily living, the concept of ownership in younger generations has broadened from traditional goals, such as homes, to a significantly wider variety of assets such as currencies (traditional and crypto), art, and digital and real property. Modern technology has made it possible to purchase fractional shares in each of these areas, meaning that ownership is no longer limited to the moneyed elite, but is now available to the mass market through mobile apps such as Robinhood.

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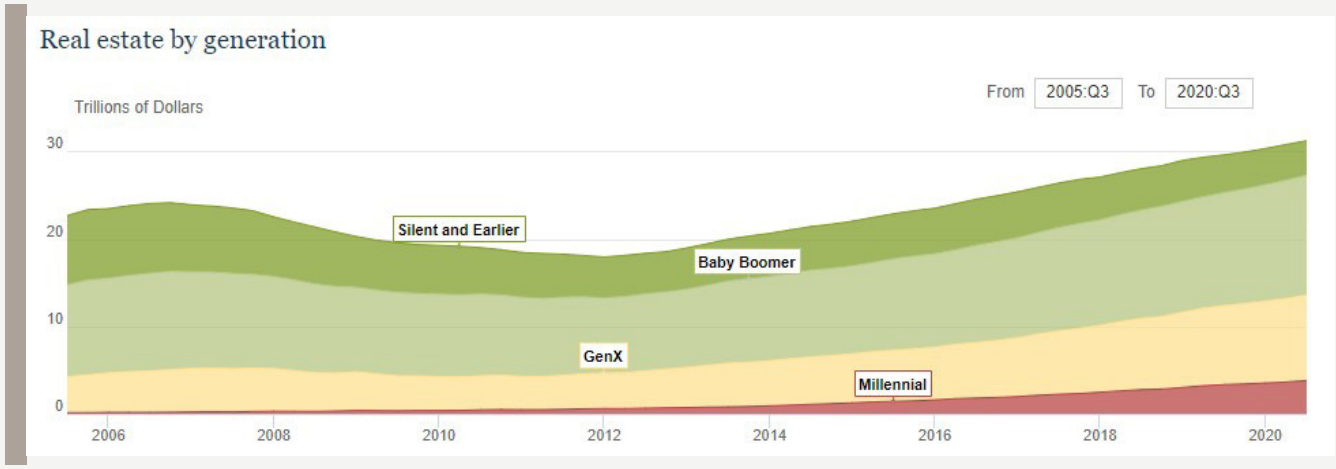
This article by John Luttig captures the shift very well, particularly the following excerpt: "2020 accelerated finance culture: stimulus checks, nothing to spend money on, and lockdown boredom drove people to the stock market. But the driving forces behind the financialization of culture have been accumulating for years. We need to look at interest rates, tech maturity, inequality, and social media to understand the full picture."



"The driving forces behind the financialization of culture have been accumulating for years. We need to look at interest rates, tech maturity, inequality, and social media to understand the full picture" - John Luttig

Millennials have barely scratched the surface of home ownership and with real estate prices skyrocketing due to low rates, it seems clear they are turning to other forms of asset ownership to fill the void. Why bother owning a house, with its leaky basement and multi-decade time horizon, when you could buy into the next Bitcoin from your phone and watch it appreciate over the next week? Ownership culture, and the financial rewards that come with it, has accelerated into the mass market thanks to a mixture of COVID, technology, and inequality.

The conventional wisdom seems to argue that all of this is wrong. It feels strange and reckless as people speculate on one nontraditional asset to the next, informed by social media sites like Reddit and Twitter, rather than the Wall-Street Journal or New York Times. Asset ownership is not always a walk in the park and us salty veterans of stock markets, home repairs, and entrepreneurship know that the financial rewards are accompanied by bouts of volatility, uncertainty, and anxiety.

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However, our takeaway is this: greater access to ownership of assets is a good thing, not something to scoff at. If Bitcoin allows for younger investors to create wealth, transact in new way, and spark innovation, then the entire economic eco-system wins, even if price volatility is extreme.

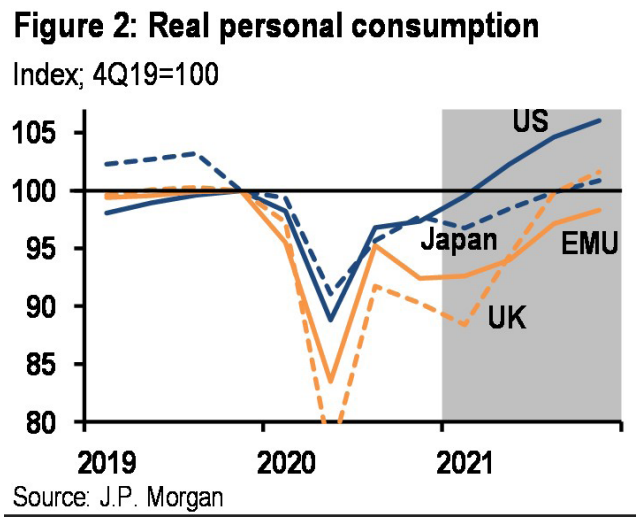
There will be people left holding the bag when pricing in some of these assets falls off a cliff, just as there was in the late 90's. Yet the technology and developments that came from the money rush in the 90's have lasted for decades after, even if companies like Pets.com flamed out. Today's analogy could be electric vehicles and battery suppliers. Many of these companies may never achieve profitability but the absolute scale of investment into the space should help get widespread electric vehicle usage and infrastructure above stall speed. Ultimately, the money flowing into this and other new technologies will have long-term benefits in the economy for years to come.

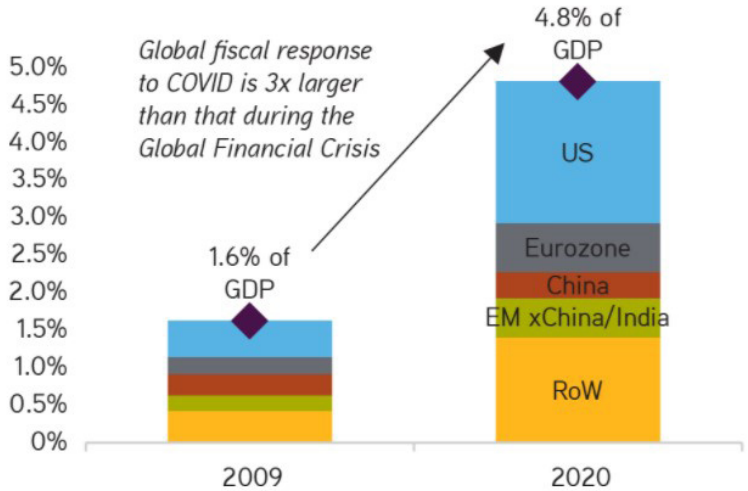
Are We in a Goldilocks Economy?

The transition from widespread shutdowns last April, to 7% GDP growth this quarter illustrates just how quickly the U.S. has recaptured the economic losses from last year. According to a recent note from JP Morgan, recent data "continues to impress and support our view that the global economy is entering a phase of boomy growth and accelerating inflation." The suppression of interest rates, combined with multiple waves of stimulus packages rolled out by global governments has sparked a ferocious rebound in the economy, bridging the gap for things to open back up now that COVID cases are significantly lower and widespread vaccine availability can keep the virus suppressed.

As we assess how economic growth will progress from its current level, we believe the most important item to watch is central bank and government intervention in the markets. The economic rebound after the global financial crisis took 10 years to develop, and only experienced modest growth, because there was so little fiscal stimulus and central banks repeatedly signaled their desire for tighter financial conditions. Today's environment is much different, with three times the amount of fiscal stimulus as 2009, and central banks promising low rates for the foreseeable future

Consumption has rebounded rapidly in the U.S., as fiscal stimulus has been 3 times larger than that during the financial crisis.





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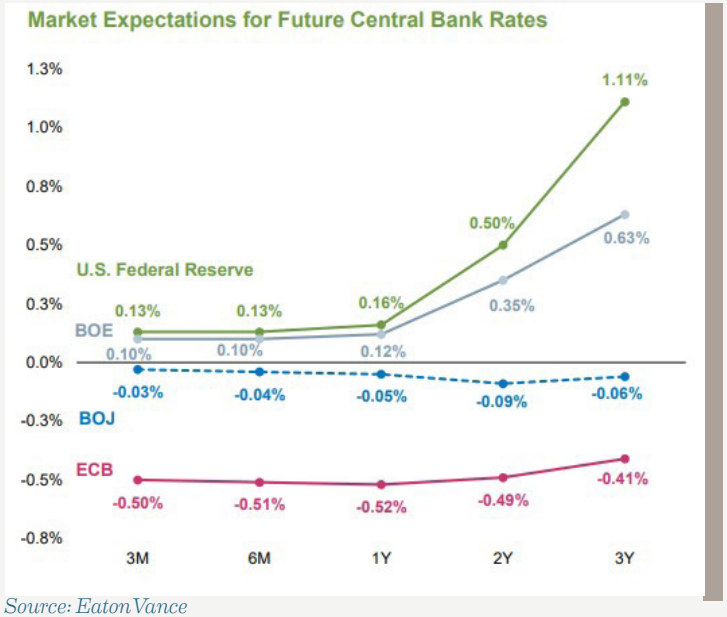
Jerome Powell, the chairman of the Federal Reserve, stated in his most recent press conference that he wants to see "substantial economic progress" before tapering its stimulus plans. The Federal Reserve tends to signal policy changes at a glacial pace, and Powell saying it will take some time to slow down their stimulus programs, let alone raise interest rates, tells us a lot. Current expectations are for one rate hike in two years and two more rate hikes to 1.11% in three years. In other words, low rates, easy lending conditions, and a favorable borrowing environment are here to stay for the next couple years.

With respect to fiscal stimulus, we have seen two significant packages passed and the Biden administration is now proposing a $2.2 trillion infrastructure spending package. The government is in "spend now" mode so the question shifts to when will they raise taxes and will it stall the economic momentum we are currently experiencing.



Source: Eaton Vance

Given the dynamics of the Senate, a 50/50 split between Republicans and Democrats means that any significant overhaul of the tax code will require a 60 vote majority or a bill passing through reconciliation, which limits the extent of what can be done. This slimmest of Democratic advantages means that moderate swing voters, like Joe Manchin of West Virginia, hold the keys to any changes in tax policy. Manchin has already indicated that he is opposed to raising corporate taxes to 28% and would prefer a smaller increase to 25%, which is still below the 35% level they were at before the Trump administration.

The political dynamic looks a lot like a "goldilocks" scenario where the combination of low interest rates, a continuation of stimulus spending, and modest tax hikes creates a favorable "not too hot, not too cold" environment for the economy and financial markets. While we are concerned about market valuations and speculative sentiment, we believe the current environment of easy monetary policy and pent-up demand should make any market corrections temporary in nature.

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Closing Thoughts

As we embark upon the second quarter, we are encouraged by improving trends in how the virus is being managed and what this portends for our society. Most importantly, the degree of worst-case outcomes, such as hospitalization and death, have been significantly curtailed to start the year. We are eager to see a return to normalcy across our country and look forward to meeting in person as circumstances allow.

The economy and markets have experienced significant upheaval over the last year but are on strong footing in 2021 thanks to coordinated efforts by the Federal Reserve and federal government to provide a significant degree of stimulus. A major mistake after the financial crisis was pumping the brakes too soon on restorative measures. Based on the language and actions from current officials, they have learned their lesson from that time period and are eager to keep the wheels in motion after our most recent crisis.

We are mindful of the degree of speculation that is percolating in stocks and non-traditional assets. It would not be surprising if there was a correction in the coming months, which could be a result of inflation continuing to ramp or a concern that the Federal Reserve might start hiking policy sooner than anticipated. However, we are of the mindset that the Fed is willing to let inflation run a bit hot and the markets to continue pushing higher in the interest of keeping economic growth humming. Combining the Fed's easy stance on policy with our view that near-term tax changes will not be overly burdensome, we believe these two factors should help support growth in the intermediate term.

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All data as of 3/31/21 via Eaton Vance, KKR, JP Morgan, MarketWatch, and Barrons.