HB RETIREMENT®

FINANCIAL MARKET SNAPSHOT

Q1 Recap: Inflation Concerns Driving Market Returns

APRIL 8, 2021

The first quarter of 2021 saw most market averages move slightly higher while bond market lagged. Year-to-date, total returns were 6.2% for the S&P 500, 8.3% for the DJIA, and 3.0% for the NASDAQ. In contrast, the bond market return during the first quarter was negative, with the Bloomberg Barclays US Aggregate Bond Index (LBUSTRUU) declining 3.4%. After 35 years of declining interest rates, the 10-year U.S. Treasury bond bottomed out at about 0.50% in August. As we entered 2021, the 10-year Treasury yield had risen to 0.91% driven mostly by hopes of a successful Covid vaccine rollout and the economy reopening. However, at the end of March, bond yields had more than tripled off of its August low, closing out the quarter at 1.74%. When bond yields rise, bond prices fall, so 2021 has not started well for fixed income investors.

In late February, inflation appeared to become a primary concern with investors when the January Producer Price Index (PPI) number (+1.3%) unexpectedly came in significantly higher than anticipated, accelerating from 0.3% in December. This surprise report appeared to change the current market narrative.

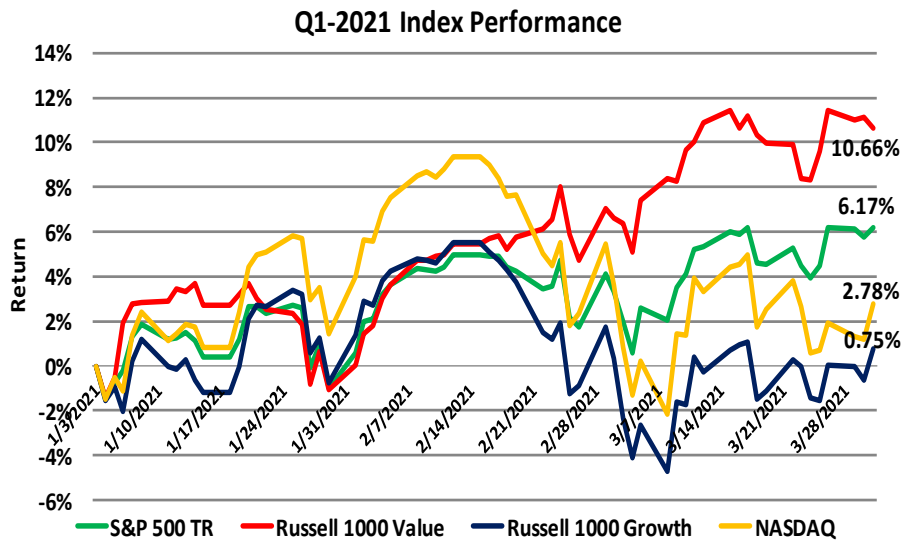
For most of the first quarter, major market indices tended to trade in concert with each other. However, in late February, inflation appeared to become a primary concern with investors when the January Producer Price Index (PPI) number (+1.3%) unexpectedly came in significantly higher than anticipated, accelerating from 0.3% in December. This surprise report appeared to change the current market narrative which goes something like this: Trillions of dollars of government fiscal stimulus will cause the economy to overheat, which in turn, will cause inflation to rise, driving interest rates higher, and inevitably causing stocks to decline due to earnings multiple contraction. More specifically, multiple contraction is expected to have a greater impact on higher growth stocks. Consequently, the market returns for growth and value stocks began to diverge in late February.

Table 1: Notable Returns / Yields / Spreads: Jan. '21 - Mar. '21
Source: Bloomberg
Note: BBG Barc = Bloomberg Barclays; 10Yr Treasury Yield figures as of the end of the month/quarter

	Ticker	Jan '20	Feb '20	Mar '20	Q1-21
S&P 500 Total Return Index	SPXT	-1.0%	2.8%	4.4%	6.2%
Russell 1000 Growth Index	RLG	-0.8%	-0.1%	1.7%	0.7%
Russell 1000 Value Index	RLV	-1.1%	5.8%	5.7%	10.7%
MSCI EAFE Index	MXEA	-1.1%	2.1%	1.8%	2.8%
MSCI Emerging Markets Index	MXEF	3.0%	0.7%	-1.7%	1.9%
BBG Barc. US Agg Bond Index	LBUSTRUU	-0.7%	-1.4%	-1.2%	-3.4%
10-Year Treasury Yield	USGG10YR	1.065%	1.404%	1.740%	1.740%

HB Retirement - We specialize in the investment design assistance and function of corporate retirement plans and wealth management for individuals. We provide insight and specialized support to assist you in managing your fiduciary obligations, and assist your employees with retirement planning.

As a result, the Russell 1000 Value Index (RLV) finished the first quarter up 10.7% while the Russell 10000 Growth Index (RLG) struggled to move into positive territory, and end of the quarter up just 0.75%.



Source: Bloomberg

Overall, investors and economists are split on the inflation outlook, with some predicting a wave of rising prices driven by stronger demand and pandemic stimulus, while others say the forces that have contained price pressures for years – from technology to demographics – are still in place.

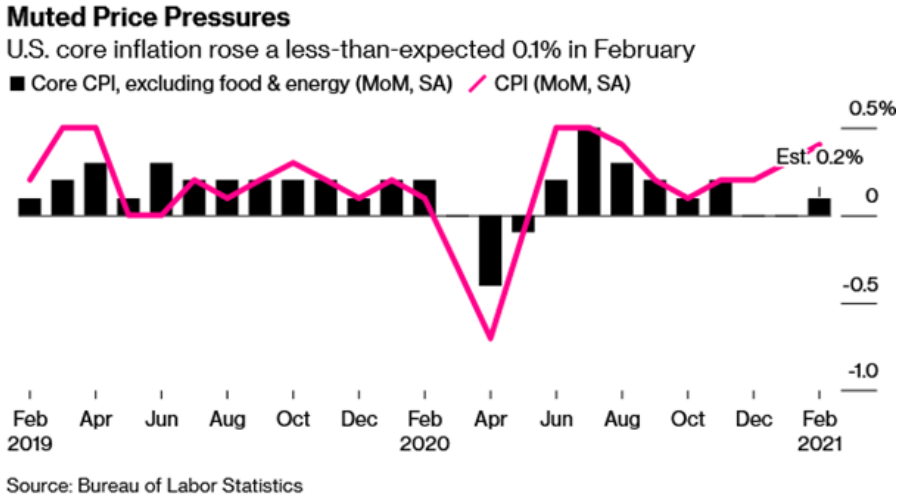
What is More Recent Data Telling Us About Inflation Trends?

Other than the January PPI report, most data suggests that inflation remains fairly subdued. However, the debate persists and will likely be a concern with many investors through the second quarter, and perhaps well into the third.

Other than the January PPI report, most data suggests that inflation remains fairly subdued. However, the debate persists and will likely be a concern with many investors through the second quarter, and perhaps well into the third. This will likely be, in part, due to the optics related to the easier comps last year, when the CPI declined 0.3% in March, 0.7% in April and 0.1% in May. Consequently, part of the anticipated spike in the Q2 inflation rate will be the result of price decreases early in the pandemic flowing through to the annual calculation. At present, the consensus CPI estimate calls for the Q1-21 to be 1.8% before accelerating to 2.9% in Q2 and then beginning decelerating in the back half of the year, exiting 2021 closer to 2.0%.

Core CPI Isn't Seeing Signs of Inflation!

On March 10th, the Labor Department reported that February's Consumer Price Index (CPI) increased 0.4% after rising 0.3% in January. In the 12 months through February, the CPI gained 1.7%, the largest rise since February 2020, after climbing 1.4% in the 12 months through January. When energy and food are excluded, the core CPI roses just 0.1% in February, or an annual pace of 1.3%.



Generally speaking, higher PPI numbers are believed to be a forward indicator of future Consumer Price Index (CPI) growth. However, some economists have noted that slack in the labor market could make it difficult for businesses to pass on higher costs to consumers, providing a potential offset to inflation at the consumer level.

On March 12th, the Labor Department reported that the Producer Price Index for final demand rose just 0.5% in February, with the costs of energy being the primary driver of growth. Generally speaking, higher PPI numbers are believed to be a forward indicator of future Consumer Price Index (CPI) growth. However, some economists have noted that slack in the labor market could make it difficult for businesses to pass on higher costs to consumers, providing a potential offset to inflation at the consumer level.

We note that the Labor Department is expected to release March PPI data on April 9th and March CPI data on April 13th. At present, the consensus March estimate calls for the PPI to increase 0.5%, with core PPI increasing 0.2%.

Many economists, including Fed Chair Jerome Powell, do not expect the strength in inflation will persist beyond the so-called base effects driven by easier comps. Additionally, Nobel Laureate economist Paul Krugman rejected the threat of inflation getting out of control – like it did in the 1970s – as a result of President Joe Biden's $1.9 trillion pandemic-relief bill. Krugman noted that the worst-case scenario out of the fiscal stimulus package would be a transitory spike in consumer prices similar to what was experienced early during the Korean War (1950).

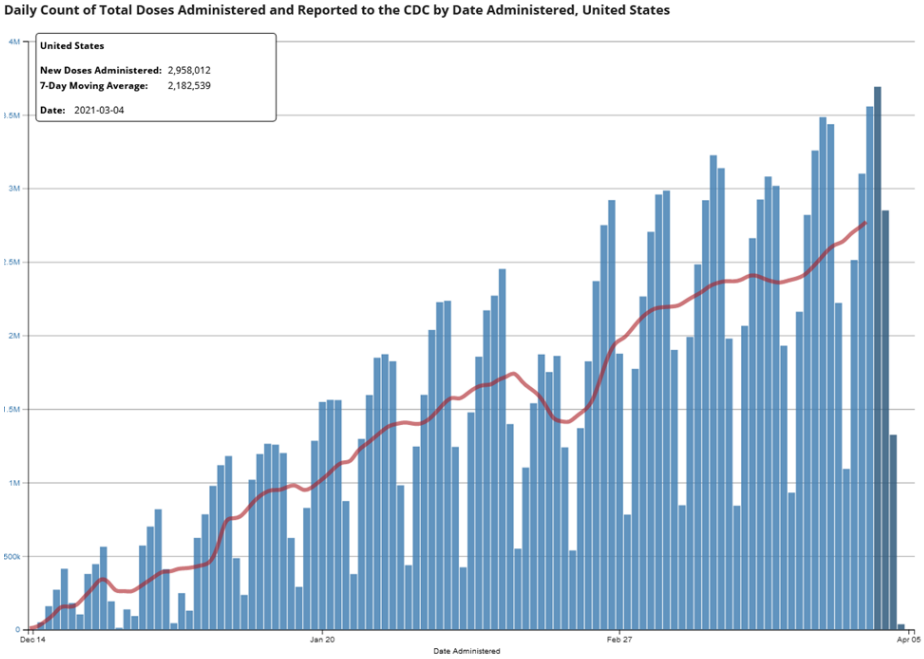
Krugman believes that the relief bill is "definitely significant stimulus but not wildly inflationary stimulus."

Sustained inflation remains unlikely as excess spending from one-time fiscal impulses should subside and labor slack will take time to absorb.

Low base effects and transient supply chain constraints should push U.S. core Personal Consumption Expenditure Price Index (PCEPI) above Fed target in April to 2.3%. However, sustained inflation remains unlikely as excess spending from one-time fiscal impulses should subside and labor slack will take time to absorb. Several economists also noted disinflationary pressures driven by rental flight from urban settings and bipartisan support for drug price control may help to keep inflation digestible in the medium-term. Economists currently predict that the core inflation measure tied to consumer spending that the Fed uses in its forecasts will remain under 2% this year and next, according to a Bloomberg survey. Similarly, the Consumer Price Index (an inflation measure) is forecast to be 2.4% in 2021 and 2.2% in 2022.

Covid Vaccine Rollout Update

The biggest vaccination campaign in history is well underway. In just about three (3) months, more than 673 million vaccine doses have been administered across 155 countries, according to data collected by Bloomberg. The latest vaccination rate was roughly 16.2 million doses per day.



Source: https://covid.cdc.gov/covid-data-tracker/#vaccination-trends

In the U.S., the vaccination rate is currently running at an average of about 3.1 million doses per day. At this pace, it will take another 3 months to cover 75% of the population. It takes about two weeks after a final vaccine dose for immunity to fully develop. After that, a person can safely meet indoors with other vaccinated people without wearing masks, according to CDC guidance issued in March.

Based on the number of vaccinations that have already been administered, as well as findings from a recent study by Columbia University, some scientists estimate the nation may reach herd immunity as early as May.

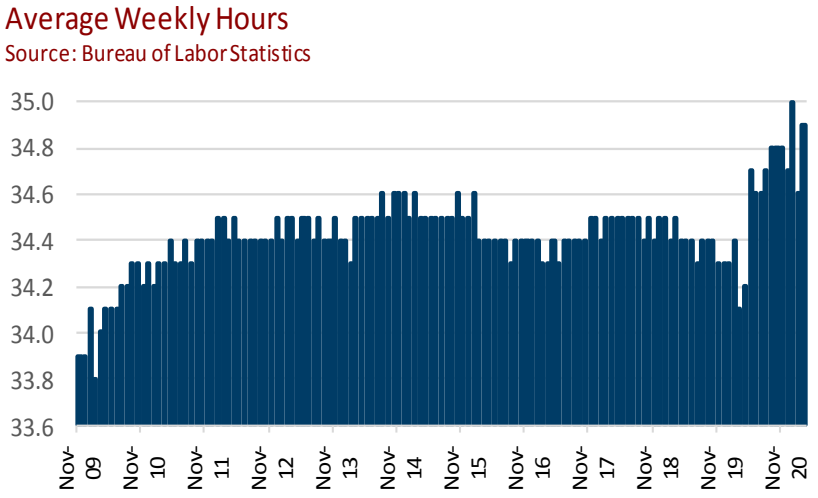
Based on the number of vaccinations that have already been administered, as well as findings from a recent study by Columbia University, some scientists estimate the nation may reach herd immunity as early as May. The study by Columbia University suggests that, as of the end of January, more than a third of the U.S. population has already been infected with coronavirus. Scientists believe 72 percent of the U.S. population needs to be either exposed or vaccinated for COVID-19 in order to reach this goal.

We believe that markets are priced for positive vaccine news, and while positivity is our base case, any disappointments in vaccine supply, distribution or adoption, or increased risk from virus variants, could temporarily stoke market volatility.

The Labor Market Appears to be Slowly Improving

While the labor market has been steadily improving, it still has a long way to go in order to recover to pre-pandemic levels. In fact, the number of unemployed persons in March stood at 9.7 million, and still remains 4.0 million higher than it was in February 2020.

On April 2, the U.S. Bureau of Labor Statistics data showed that the U.S. economy added 916,000 nonfarm payroll jobs in March, significantly above economists' expectations of 660,000. While the labor market has been steadily improving, it still has a long way to go in order to recover to pre-pandemic levels. In fact, the number of unemployed persons in March stood at 9.7 million, and still remains 4.0 million higher than it was in February 2020. The unemployment rate edged down to 6.0 percent in March; and while significantly down from it April 2020 high of 14.7%, it is still 2.5 percentage points higher than its pre-pandemic level in February 2020.

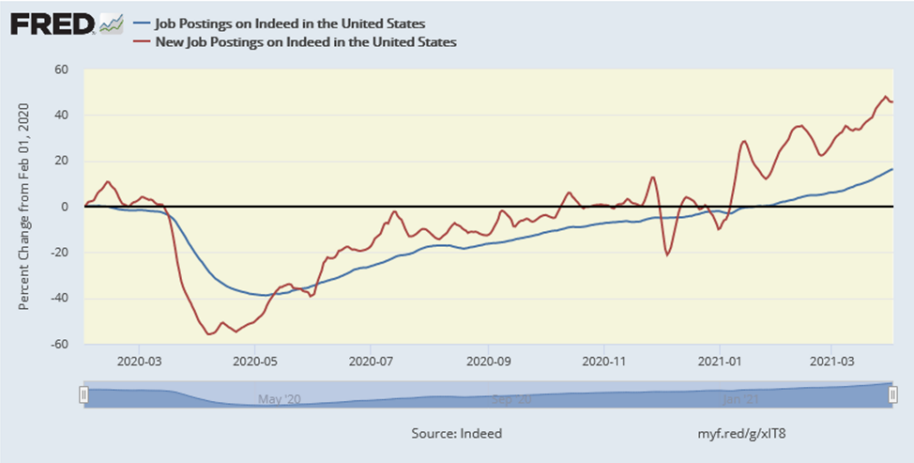


As the chart above shows, Americans have been working more hours per week as the economy recovers. The average workweek for all employees on private nonfarm payrolls increased by 0.3 hour to 34.9 hours in March, following a decline of 0.4 hour in the prior month (which was likely weather related). In manufacturing, the workweek increased by 0.2 hour to 40.5 hours over the month, and overtime increased by 0.1 hour to 3.3 hours. The average workweek for production and nonsupervisory employees on private nonfarm payrolls rose by 0.3 hour to 34.3 hours. When the average weekly hours worked rises above its historical mean it typically precedes companies hiring additional workers, which we anticipate will likely happen.

Companies Appear to be Looking to Add Additional Workers

The chart below, taken from the Federal Reserve Bank of St. Louis website (https://research.stlouisfed.org/), shows job posting trends on the Indeed.com over the past year. Indeed calculates the percentage change in seasonally-adjusted job postings since February 1, 2020, using a 7-day trailing average. February 1, 2020 was selected as the pre-pandemic baseline.

New Job Postings have been trending higher since its April low, and have been have experienced positive growth rates relative to its pre-pandemic baseline since early January. As of the April 2nd reading, New Job Postings had increased 45.7% relative to its baseline time period. Companies appear to be looking for labor!.



Source: https://fredblog.stlouisfed.org/2020/11/how-to-read-indeed-job-posting-data/

As you can see from the chart, New Job Postings have been trending higher since its April low, and have been have experienced positive growth rates relative to its pre-pandemic baseline since early January. As of the April 2nd reading, New Job Postings had increased 45.7% relative to its baseline time period. Companies appear to be looking for labor!

Q2 Outlook: Staying the Course

During the quarter, cyclical stocks – those sensitive to economic momentum – continued to lead, building on outperformance that began with positive vaccine news in November of last year. We see both economic and market strength continuing in the second quarter driven by: a new $1.9 trillion fiscal package, continued monetary policy support, an uptick in vaccine supply and distribution, a general reopening of the economy as well as ample corporate and consumer cash waiting to be deployed
.

In general, many of the higher secular growth companies reported solid fourth quarters earnings results, with many of them raising revenue and earnings guidance driven by strong, or improving, business specific fundamentals. Despite this trend, the growth segment sold off heavily late in the first quarter, primarily due to inflation concerns as well as general sector rotation out of growth and into value. At the present time, we believe that our 2021 investment thesis is in the early stages playing out and think that cyclical stock will continue to experience a catch-up trade as the economy reopens. However, we also see a path in which the growth sector might participate in the back half of the year, driven by improving company fundamentals and subsiding inflation concerns. With that in mind, we believe that it makes sense to maintain our positioning in anticipation of a new economic cycle – while watching for signs of a downshift once the post-COVID bounce begins a transition back to growth.

At the present time, we believe that our 2021 investment thesis is in the early stages playing out and think that cyclical stock will continue to experience a catch-up trade as the economy reopens. However, we also see a path in which the growth sector might participate in the back half of the year, driven by improving company fundamentals and subsiding inflation concerns.

With regards to inflation, we intend to follow the data and adjust our outlook and portfolios positioning accordingly. At present, we believe that it's likely going to take until at least the middle of 2022 for the U.S. economy to recover the lost output from the lockdowns, and longer in other economies. This means that broad-based inflation pressures aren't likely to emerge until 2023. As such, with regard to our outlook, we're staying the course, while being cautiously optimistic.

With regards to inflation, we intend to follow the data and adjust our outlook and portfolios positioning accordingly. At present, we believe that it's likely going to take until at least the middle of 2022 for the U.S. economy to recover the lost output from the lockdowns, and longer in other economies.

Risks

Investors should be aware of the risks associated with all portfolio strategies, and variable market conditions. Monetary policy changes, military activity abroad, the level and change in market interest rates, corporate earnings, domestic and foreign governmental policies, global economic data, and other geopolitical events can have a substantial effect on portfolio performance, our macroeconomic theories, and the effectiveness of strategic and tactical portfolio approaches.

Important Disclosures: *This material is not intended as ERISA, tax or investment advice and is not an offer to sell a security or a recommendation, to buy a security. If you are seeking investment advice specific to your needs, such advice services must be obtained on your own, separate from this educational and informational report. This summary is based exclusively on an analysis of general market conditions and does not speak to the suitability of any specific proposed securities transaction. To determine which investments may be appropriate for you, consult your financial advisor prior to investing.*

All opinions and views mentioned in this report constitute our judgments as of the date of writing and are subject to change at any time. We will not advise you as to any change in figures or views found in this report.

Our judgement or recommendations may differ materially from what may be presented in a long-term investment plan. Investors should consult with an investment advisor to determine the appropriate investment strategy and investment vehicle. Investment decisions should be made based on the investor's specific financial needs and objectives, goals, time horizon and risk tolerance.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

Stock investing involves risk including loss of principle.

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Precious metal investing involves greater fluctuation and potential for losses.

Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

High yield/junk bonds (grade BB or below) are not investment grade securities and are subject to higher interest rate, credit, and illiquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

The MSCI EAFE Index is a free float –adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

The MSCI EM (Emerging Markets) Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of the emerging market countries of the Americas, Europe, the Middle East, Africa and Asia.

The S&P 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing the major sectors of the U.S. economy.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment grade fixed-rate bond market, including both government and corporate bonds.

Except for the historical information contained in this report, certain matters are forward-looking statements or projections that are dependent upon risks and uncertainties, including but not limited to such factors and considerations such as general market volatility, global economic risk, geopolitical risk, currency risk and other country-specific factors, fiscal and monetary policy, the level of interest rates, security-specific risks, and historical market segment or sector performance relationships as they relate to the business and economic cycle.

Economic and other investment forecasts set forth may not develop as predicted and there can be no guarantee that strategies mentioned will be successful.

All indices are unmanaged and may not be invested into directly.

Securities offered through LPL Financial, Member FINRA/SIPC. Investment advisory services offered through HB Retirement, a registered investment advisor and separate entity from LPL Financial.