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WEALTH ADVISORS

Redhawk Quarterly Commentary

March 31, 2021

Each quarter, Redhawk's Investment Committee provides a Quarterly Commentary. We look at what is going on in the investment landscape and provide our perspective on a variety of topics. These are not predictions, and it represents our perspective on important market and economic information designed to help make decisions affecting your long-term financial strategy. Our goal is to help you understand what is going on in the markets so you can more clearly define investment goals, diagnose unintended risks, and utilize portfolios that can achieve a better financial outcome.

Market Commentary

Despite a bout of volatility that surfaced in the back end of the quarter, U.S. equity markets surged higher in the first quarter because of two overriding themes, greater than expected stimulus and vaccine progress. The stimulus at the end of 2020, which was $900 billion, and the relief package signed in early March - an additional $1.9 trillion, equate to nearly 14% of U.S. GDP. The American Jobs Plan announced on the last day in March proposes an additional $2.25 trillion in spending geared largely toward improving transportation, communication, and power infrastructure. The infrastructure plan will be paired with an additional $1 trillion in spending focused on social programs and is expected to be unveiled in April. Time will tell how much stimulus will be passed by Congress; however, overall fiscal spending is unprecedented and clearly larger than what markets were pricing at the start of 2021. To fund the infrastructure plan, the Biden administration suggested hiking the corporate tax rate to 28% from 21%, which one estimate indicated could cost 9% of next year's S&P 500 earnings.

Equity markets began 2021 in the same manner as they closed 2020. The markets came out strong and with a decided tilt towards value and cyclical stocks. Vaccine momentum, reopening progress, and $3 trillion in fiscal stimulus hitting the economy provided the positivity for the risk-on sentiment for the quarter. Both traditional asset classes such as stocks and commodities along with non-traditional asset classes such as cryptocurrencies, NFTs (Non-fungible Token - it is unique and cannot be replaced with something else), SPACs (Special Purpose Acquisition Companies, a newly formed corporation by a qualified sponsor for the purpose of raising capital in an initial public offering), and meme stocks (a stock that has seen an increase in volume not because of the company's performance, but rather because of hype on social media and online forums) performed well in the first quarter. On the back of a strong and strengthening near-term

economic outlook, large cap value was up +11.3% and outperformed large cap growth at +0.9%. Additionally, small cap stocks increased +12.7% and performed better than large cap stocks at +6.2% (see the chart below)[1]. Congruent with the equity market rotation and boosted by heightened growth and inflation expectations, the 10-year Treasury yield skyrocketed from 0.93% at year-end to as high as 1.77% in March.

	Trailing Returns (%)						Annual Returns (%)			
Asset Class	Last Qtr	YTD	1-Year	3-Year	5-Year	10-Year	2020	2019	2018	Benchmark
U.S. Stocks										
Large Cap	6.2	6.2	56.4	16.8	16.3	13.9	18.4	31.5	(4.4)	*S&P 500*
Large Cap Value	11.3	11.3	56.1	11.0	11.7	11.0	2.8	26.5	(8.3)	*Russell 1000® Value*
Large Cap Growth	0.9	0.9	62.7	22.8	21.0	16.6	38.5	36.4	(1.5)	*Russell 1000® Growth*
Mid Cap	8.1	8.1	73.6	14.7	14.7	12.5	17.1	30.5	(9.1)	*Russell Midcap®*
Small Cap	12.7	12.7	94.8	14.8	16.4	11.7	20.0	25.5	(11.0)	*Russell 2000®*
International Stocks										
Developed Markets	3.6	3.6	45.2	6.5	9.4	6.0	8.3	22.7	(13.4)	*MSCI EAFE USD*
Emerging Markets	2.3	2.3	58.9	6.9	12.5	4.0	18.7	18.9	(14.2)	*MSCI Emerging Mkts USD*
Bonds										
Short-Term Taxable	(0.0)	(0.0)	1.6	3.0	2.0	1.6	3.3	4.0	1.6	*BBgBarc 1-3 Yr Govt/Credit*
Intermediate-Term Taxable	(1.9)	(1.9)	2.0	4.4	2.8	2.9	6.4	6.8	0.9	*BBgBarc Intermed. Govt/Credit*
Short-Term Municipal	0.2	0.2	2.4	2.2	1.6	1.4	2.1	2.8	1.8	*BBgBarc 1-3 Yr Municipal*
Intermediate-Term Municipal	(0.5)	(0.5)	5.6	4.7	3.0	3.9	5.1	6.7	1.7	*BBgBarc 7 Yr Municipal*
Cash										
Cash/Cash Equivalents	0.0	0.0	0.1	1.5	1.2	0.6	0.7	2.3	1.9	*BBgBarc 3 Month T-Bill*
Satellite										
High Yield	0.8	0.8	23.7	6.8	8.1	6.5	7.1	14.3	(2.1)	*BBgBarc US Corporate High Yield*
Real Estate	8.5	8.5	37.0	10.4	7.3	9.1	(5.7)	28.2	(4.0)	*DJ Composite All REIT*
Commodities	6.9	6.9	35.0	(0.2)	2.3	(6.3)	(3.1)	7.7	(11.2)	*Bloomberg Commodity*

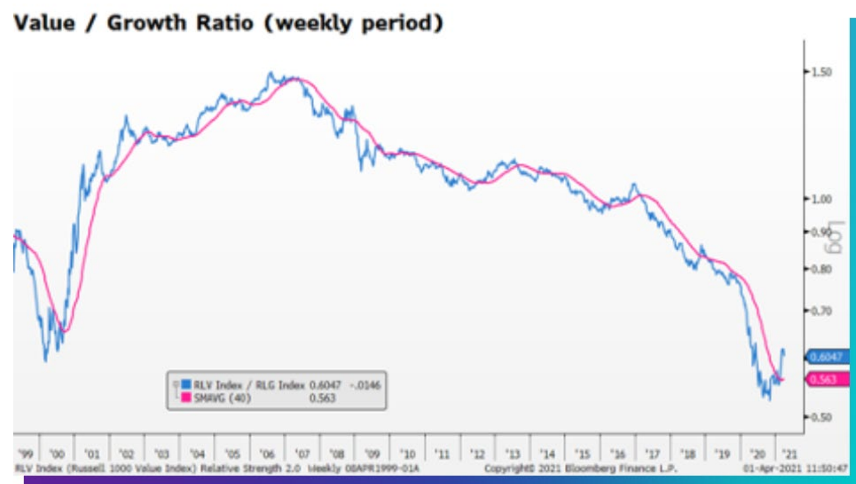
Source: Factset; Russell, MSCI, Bloomberg, Barclays, FTSE, and Dow Jones benchmarks. Performance greater than one year is annualized. Performance is represented by the benchmark listed in the "representative benchmark" column. See important disclosures and definitions included with this publication.

We all witnessed the largest vaccine rollout in history during the quarter and more than 590M doses have been administered worldwide. Bloomberg estimates more than 150M doses have already been given in the U.S., which exceeds the total number of positive cases since the start of the pandemic. The administration hopes to have enough supplies available to all adults in the U.S. by the end of May. While global cases are on the rise, including a recent uptick in the U.S., the average rate of inoculation has vastly outpaced the rise in new cases.

Another important event that occurred was when Federal Reserve (Fed) Chairman Jerome Powell provided an economic update to the House Committee on Financial Services and reaffirmed the central bank's commitment to support the recovery. Powell expressed limited concern about the

recent volatility in the capital markets due to the well-capitalized banking system and reiterated the Fed's stance on monetary stimulus. He made clear substantial progress will be required before any changes are made to the asset purchase program and noted the Fed will pull back support very gradually, and with great transparency, when the economy has all but fully recovered. He also sees the sharp rise in rates as an "orderly process" and a sign of economic confidence.

The chart to the right[2] compares the weekly ratio of value versus growth (blue line) and its 40-week simple moving average (SMA) (violet line). In March, the spread of the ratio to the 40-week SMA rose to more than 10%, which has not happened since the early 2000's when value started a multi-year trend of outperformance.



Source: Bloomberg Finance LP.

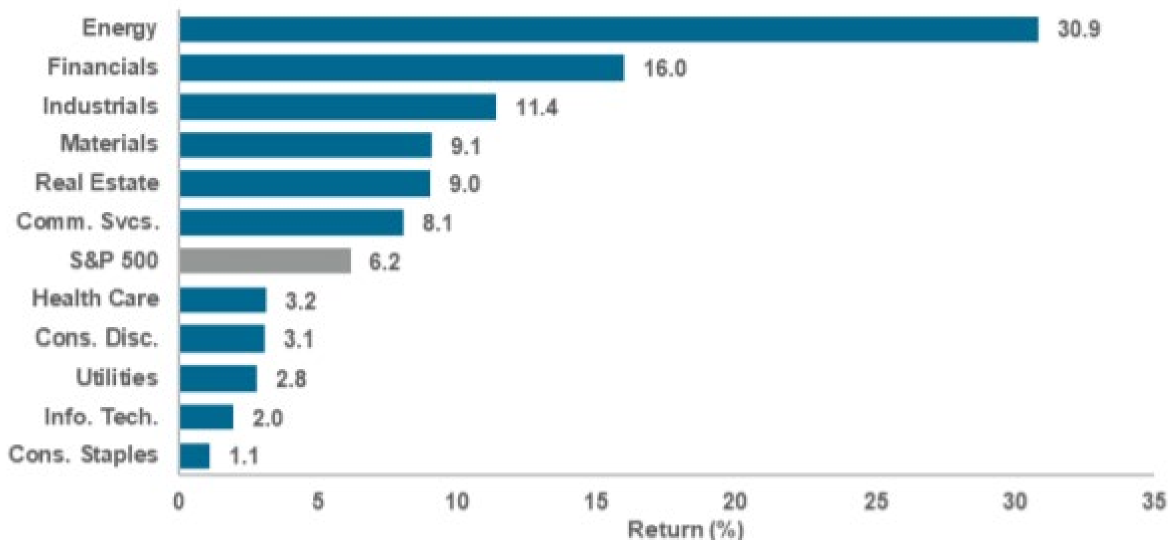
U.S. Market

The U.S. economy sustained its recovery in the fourth quarter of 2020, with real GDP at +4.3%, and it continued in 2021. Labor markets continued their steady improvement, though remain well off pre-COVID levels and will likely remain that way until vaccination-led reopening allows service sector employees to return. Though February data was choppy due in part to a stimulus gap, weather issues, and supply-side bottlenecks, forward-looking data looks very positive. Consumer confidence spiked to a post COVID high and mobility and consumer spending have improved rapidly.

Small cap stocks which are typically more economically sensitive, outperformed larger stocks in the first quarter. The Russell 2000 more than doubled the return of the S&P 500, gaining 12.9%, while the Micro-Cap Index fared even better, advancing 23.99%. Bond yields increased (and prices decreased) due to heightened inflation expectations, but the very accommodating Fed pledged to maintain its policy of near-zero short-term interest rates, given its forecast for employment and inflation conditions. The yield on the Ten-Year Treasury steadily increased from 0.93% to 1.77%, without negatively impacting equities. There were a couple of brief spikes in

volatility early in the quarter, but the VIX (commonly called the "fear" index) declined 10% to finish at its lowest level since the onset of the pandemic. The record number of new SPACs, as well as the wild rides for "meme" stocks are proof of the "risk on" attitude that prevailed.

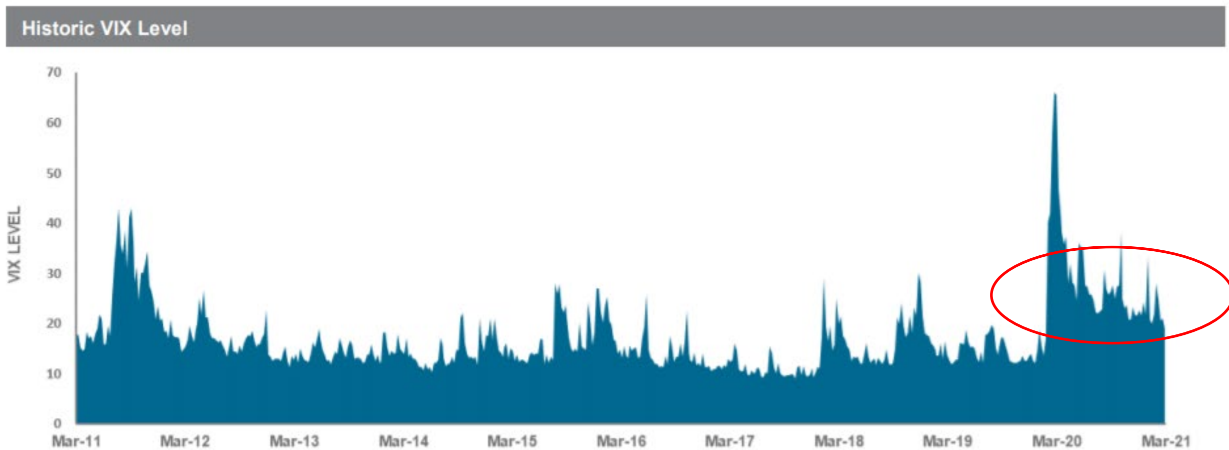
Value continued its stretch of recent outperformance versus growth and turned in its best quarter since 2001. Similarly, small cap stocks continued their outperformance over the large and mega cap stocks that dominated most of last year. Small cap value led all asset classes with +21.2% for the quarter. In-line with the value and cyclical outperformance described above, energy was up +30.9%, financials had a strong quarter with a +16.0%, and industrials came in at +11.4% were the top returning sectors over the quarter (see the chart below). Rising commodity prices and the strong growth outlook provided strong tailwinds for these areas of the market as yield-sensitive and defensive sectors like consumer staples came in at +1.1% and utilities at +2.8%.



Source: FactSet. Performance greater than one year is annualized.

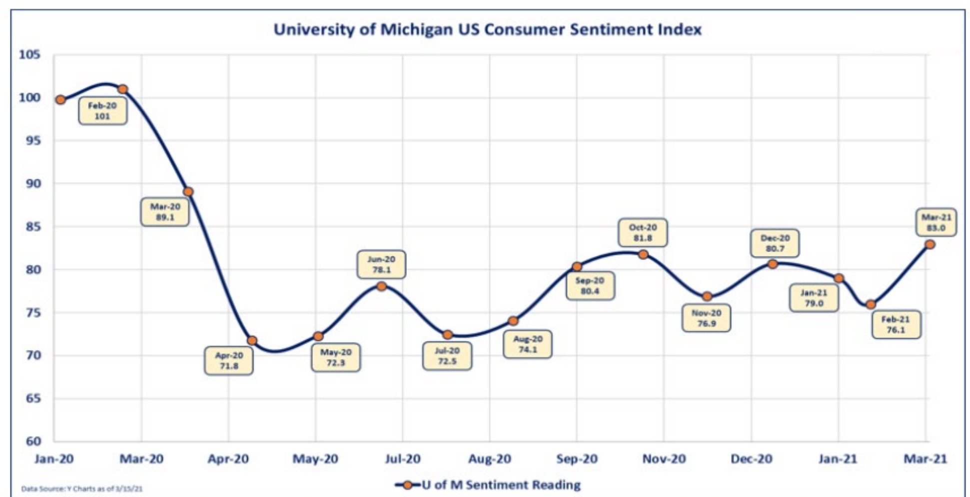
Additionally, technology with a +2.0% took a pause from 2020. Elevated valuations, near-term economic growth prospects, and rising yields severely hurt the technology sector, which had been one of the benefactors of the COVID-19 pandemic.

During the first quarter, the VIX remained elevated, but constant (as shown in the chart below). The VIX measures the implied volatility of S&P 500 future options. In other words, it measures the expected volatility of the S&P 500 Index over the next 30 days. The higher the index, the higher the expected volatility. As mentioned previously, it is also commonly referred to as the "fear" index. When the markets are calm, the VIX typically ranges in the 12-15 range. As you can see in the first quarter, it has been in the 20-25 range (see the red circle in the chart below).



Source: Standard & Poor's; FactSet; Baird Analysis.

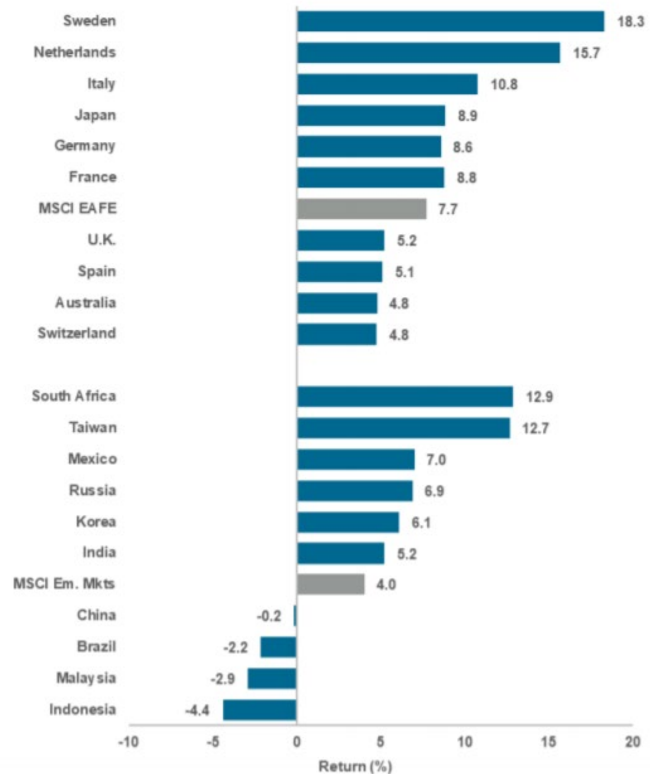
One cannot write about the U.S. economy and outlook without talking about the main driving force of the consumer[3]. Consumer sentiment has reached a new high since the pandemic began (see the chart to the right), a good sign for the economy and future spending. As vaccine dissemination spreads to a younger population, assuming more people choose to be vaccinated, consumers and governments will continue to feel more comfortable with social activities (e.g., going to restaurants, sporting



events, and traveling). The "service" side of the economy was severely impacted during the pandemic but is starting to show signs of life.

International Markets

International equities, both developed at +3.6% and emerging garnered +2.3%, were positive for the quarter, though they again lagged U.S. equities. A combination of a stronger U.S. dollar and new strains of COVID caused international markets to underperform, though local currency developed markets beat the S&P because of a more cyclically based market. The chart to the right shows Sweden came in at +18.3% and the Netherlands at +15.7% led the developed markets, while South Africa at +12.9% and Taiwan at 12.7% performed well in the emerging markets. China, surprisingly underperformed with a negative -0.2% and took a backseat to other countries despite a strong growth outlook and control over COVID-19. For China, the heavy technology emphasis for the country's economy contributed heavily to the negative performance.



Source: FactSet.; MSCI Indices; Baird Analysis. MSCI EAFE (Developed markets) and MSCI EM (Emerging markets) are broad benchmarks representing many countries. Includes the 10 largest countries by weighting in the benchmark.

Fixed Income Markets

The broad U.S. bond market, measured by the Bloomberg Barclays Agg Index, fell -3.4% in the first quarter as rising rates, increasing inflation expectations, and strong near-term growth prospects negatively impacted fixed income. Long-duration and high-quality debt were especially weak as the Bloomberg Barclays Treasury Index turned in its worst quarter since 1980.

The rise in interest rates was very rapid, with a low of 0.93% on the 10-yr at the end of 2020 and as high as 1.77% in March represented a very rare event that led to a lot of anxiety in the markets.

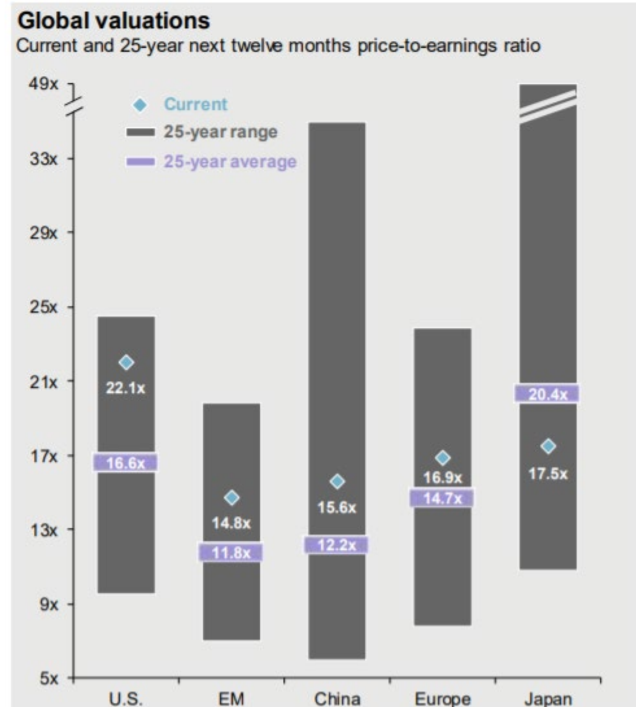
Interest rate volatility has been heightened over the last year and the first quarter was no exception. For taxable bonds, there was a general underperformance across the fixed income landscape. High yield corporate bonds had a slight gain of +0.8% (see the chart below under the YTD column)[4] and high yield municipal bonds fared the best with a +2.1% (not shown in the chart below). These were the only fixed income sectors in the positive last quarter as the economic environment painted a better backdrop for riskier debt. Global bonds were down -5.3%, investment grade corporates underperformed with a -4.7%, and Treasuries at -4.2% were among the weaker performing areas. Duration was hit especially hard when rates skyrocketed as the Bloomberg Barclays US Aggregate 10+ Year Index fell -10.4% for the quarter as long-term Treasuries entered a rare bear market. Municipal bonds returned -0.3% in Q1, outpacing taxable peers by 3.0%. Amid trillions in fiscal stimulus and better-than-feared state and local tax revenues, the outlook for municipal bonds held up fairly-well despite the broad weakness in the fixed income space. Lower quality and shorter duration instruments performed the best, as mentioned above, high yield municipal fixed income was one of the best performing sectors across the bond landscape.

2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	YTD
EMD LCL. 15.2%	EMD LCL. 18.1%	Treas. 13.7%	High Yield 58.2%	EMD LCL. 15.7%	TIPS 13.6%	EMD USD 17.4%	High Yield 7.4%	Muni 9.1%	Muni 3.3%	High Yield 17.1%	EMD LCL. 15.2%	ABS 2.7%	EMD USD 15.0%	TIPS 11.0%	High Yield 0.8%
High Yield 11.8%	TIPS 11.6%	MBS 8.3%	EMD USD 29.8%	High Yield 15.1%	Muni 10.7%	EMD LCL. 16.8%	ABS 1.3%	Corp. 7.5%	MBS 1.5%	EMD USD 10.2%	EMD USD 10.3%	Muni 1.3%	Corp. 14.5%	Corp. 9.9%	ABS 0.6%
EMD USD 9.9%	Treas. 9.0%	Barclays Agg 5.2%	ABS 24.7%	EMD USD 12.2%	Treas. 9.8%	High Yield 15.8%	MBS -1.4%	EMD USD 7.4%	EMD USD 1.2%	EMD LCL. 9.9%	High Yield 7.5%	MBS 1.0%	High Yield 14.3%	Treas. 8.0%	Muni -0.3%
Asset Alloc. 5.8%	Barclays Agg 7.0%	Asset Alloc. -1.9%	EMD LCL. 22.0%	Corp. 9.0%	Corp. 8.2%	Corp. 9.8%	Corp. -1.5%	MBS 6.1%	Treas. 0.8%	Corp. 6.1%	Corp. 6.4%	Treas. 0.9%	EMD LCL. 13.5%	Barclays Agg 7.5%	MBS -1.1%
MBS 5.2%	MBS 6.9%	TIPS -2.4%	Corp. 18.7%	Asset Alloc. 7.6%	Barclays Agg 7.8%	Asset Alloc. 7.6%	Asset Alloc. -1.7%	Barclays Agg 6.0%	Barclays Agg 0.6%	Asset Alloc. 4.8%	Muni 5.4%	Barclays Agg 0.0%	Asset Alloc. 9.8%	High Yield 7.1%	TIPS -1.5%
Muni 4.8%	Asset Alloc. 6.2%	Muni -2.5%	Asset Alloc. 16.5%	Barclays Agg 6.5%	Asset Alloc. 7.7%	TIPS 7.0%	Barclays Agg -2.0%	Asset Alloc. 5.4%	ABS 0.2%	TIPS 4.7%	Asset Alloc. 5.3%	Asset Alloc. -0.6%	Barclays Agg 8.7%	Asset Alloc. 6.6%	Asset Alloc. -2.4%
ABS 4.7%	EMD USD 6.2%	Corp. -4.9%	Muni 12.9%	TIPS 6.3%	EMD USD 7.3%	Muni 6.8%	Muni -2.6%	Treas. 5.0%	Asset Alloc. -0.4%	Barclays Agg 2.6%	Barclays Agg 3.5%	TIPS -1.3%	TIPS 8.4%	EMD USD 5.3%	Barclays Agg -3.4%
Barclays Agg 4.3%	Corp. 4.6%	EMD LCL. -5.2%	TIPS 11.4%	Treas. 5.9%	MBS 6.2%	Barclays Agg 4.2%	Treas. -2.8%	TIPS 3.6%	Corp. -0.7%	ABS 2.0%	TIPS 3.0%	High Yield -2.1%	Muni 7.5%	Muni 5.2%	Treas. -4.2%
Corp. 4.3%	Muni 3.4%	EMD USD -12.0%	Barclays Agg 5.9%	ABS 5.8%	ABS 5.1%	ABS 3.7%	EMD USD -5.2%	High Yield 2.5%	TIPS -1.4%	MBS 1.7%	ABS 3.0%	Corp. -2.5%	Treas. 6.9%	MBS 3.9%	Corp. -4.7%
Treas. 3.1%	ABS 2.2%	ABS -12.7%	MBS 5.9%	MBS 5.4%	High Yield 5.0%	MBS 2.6%	TIPS -8.6%	ABS 1.7%	High Yield -4.5%	Treas. 1.0%	MBS 2.5%	EMD USD -4.3%	MBS 6.4%	ABS 3.4%	EMD USD -4.8%
TIPS 0.4%	High Yield 1.9%	High Yield -26.2%	Treas. -3.6%	Muni 2.4%	EMD LCL. -1.8%	Treas. 2.0%	EMD LCL. -9.0%	EMD LCL. -5.7%	EMD LCL. -14.9%	Muni 0.2%	Treas. 2.3%	EMD LCL. -6.2%	ABS 3.8%	EMD LCL. 2.7%	EMD LCL. -7.4%

Source: Barclays, Bloomberg, FactSet, J.P. Morgan Global Economic Research, J.P. Morgan Asset Management.

Economic Outlook

Many economists feel that it is 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[5]. Broad-based inflation pressures are unlikely to emerge until 2023. Additionally, market expectations for the U.S. Fed to increase interest rates is late 2023 or early 2024. U.S. equities remain expensive compared to the rest of the world (see the chart to the right). Sentiment is close to overbought, but not near dangerous levels of euphoria. The strong cycle delivers a preference for equities over bonds for the remainder of the year, despite expensive valuations. It also reinforces the preference for the value equity factor over the growth factor and for non-U.S. equities to outperform the U.S. market.



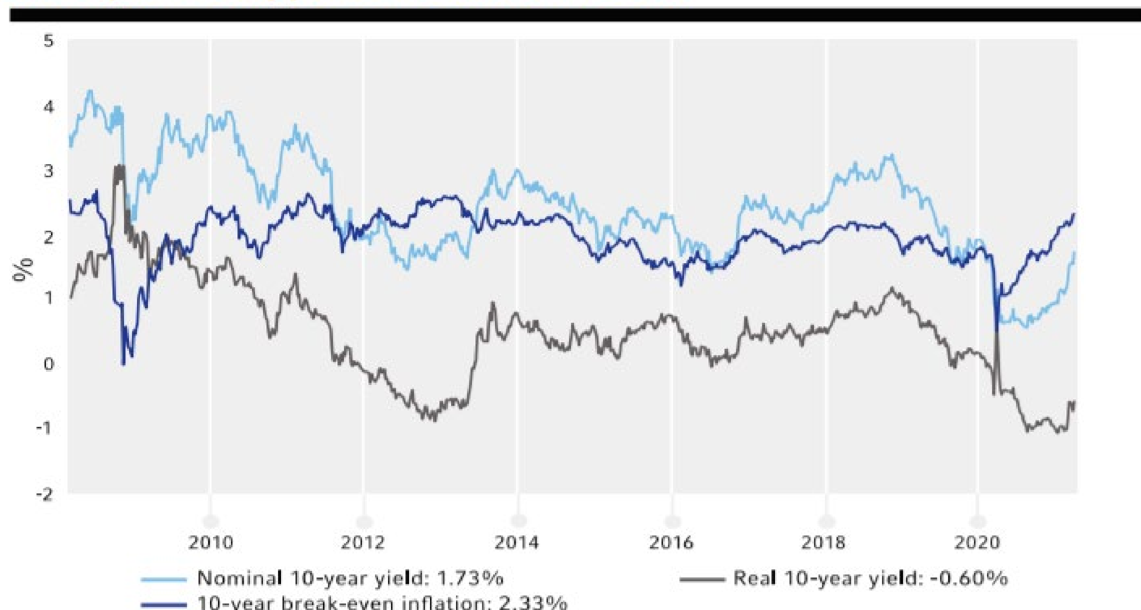
Source: FactSet, MSCI, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

The $1.8 trillion American Rescue Plan of 2021 is set to supercharge the U.S. recovery as COVID-19 restrictions are lifted. This is equal to 8.4% of U.S. gross domestic product (GDP) and comes on top of the $900 billion stimulus passed in late December 2020. The U.S. is leading the charge in terms of fiscal support and as a result is likely to be the fastest growing developed economy in 2021. Although the rest of the world cannot match the U.S. fiscal firepower, other countries will benefit from the spillover effects of the U.S. stimulus. According to the Organization for Economic Co-operation and Development's (OECD) macroeconomic model, the U.S. stimulus is likely to boost growth in Japan, Europe, and China by 0.5% over the next 12 months and lift global GDP growth by just over 1%.

Economists expect strong post-lockdown growth that will create inflation pressures in some sectors. This is already evident in commodity markets and in the manufacturing sector. The prices-paid index in the U.S. Institute for Supply Management (ISM) manufacturing survey hit a 13-year high in February 2021. Consumer prices, however, are dominated by services. Spare capacity in the U.S. economy means that broad-based inflation pressures are unlikely until 2023. Average inflation targeting will allow the Fed to wait until the Consumer Price Index (CPI) measure of inflation has sustainably reached 2.5% before starting to tighten policy. This seems doubtful before late 2023.

The chart below shows the U.S. 10-year Treasury yield broken into its two components, the expected inflation rate, and the real yield, as measured by the yield on Treasury Inflation Protected Securities (TIPS). Most of the rise in the nominal yield this year was due to investors forecasting higher average inflation over the next 10 years. This expectation for the break-even rate of inflation has increased from 1.6% in early November 2020, before the announcement of a successful vaccine, to 2.3% in mid-March 2021. The other component, the real TIPS yield, has risen from -0.9% to -0.6% over the same period. The rise in the real yield, reflects the upgrade in Fed tightening expectations. As you can see in the chart below, both components of the nominal yield are near their limits for 2021.

U.S. 10-year Treasury yields since the Great Recession

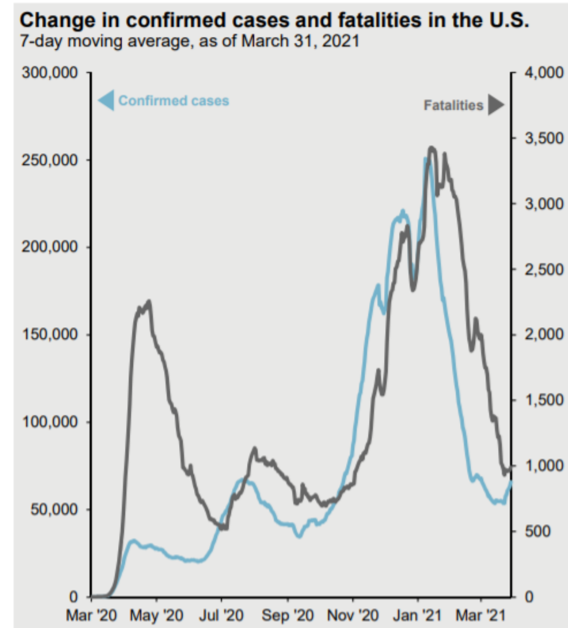


Source: Refinitiv Datastream, as of 18 March 2021.

Break-even inflation is the difference between the nominal yield on a fixed-rate investment and the real yield (fixed spread) on an inflation-linked investment of smilar maturity and credit quality.

The market rotation away from technology-heavy growth stocks toward more cyclical value stocks, continued in the first quarter. The MSCI World Value Index has gained over 10% since the beginning of 2021 while the technology heavy MSCI World Growth Index is unchanged. One reason has been the rise in U.S. Treasury yields. Technology stocks are regarded as long duration as they are expected to grow their earnings over the longer term. The rise in bond yields this year has made the present value of their future earnings less valuable. Higher bond yields have had the opposite effect on value stocks. Financial stocks are the largest sector in the value index, and these have benefitted from the increased spread between short-and long-term interest rates, which boosts the profitability of banks.

There are still lingering concerns about new COVID-19 variants that may be resistant to vaccines, as well as the slow vaccine rollouts in some countries. Some European countries have recently increased lockdown measures as infection rates have trended higher. It is possible that lockdown measures may be maintained for longer. The evidence so far, however, is that the countries with the most successful vaccination programs, such as Israel, the United Kingdom, and the United States are experiencing sustained downtrends in new confirmed cases and fatalities (as shown in the chart to the right). The path to herd immunity is not that far off and will contribute to the opening of the economy and growth.



Source: Centers for Disease Control and Prevention, Johns Hopkins CSSE, Our World in Data, J.P. Morgan Asset Management

Acknowledgements

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