Exencial
Wealth Advisors

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Market Update

A little over one year ago markets hit their recession low on March 23rd, 2020. Since then markets have experienced one of the strongest recoveries in history. International large caps are up about 70% to 80% while US large caps are up 80% to 90%. In the early months of the recovery returns favored those companies that were growing faster and were unaffected by the shutdowns. In more recent months returns have favored companies that were the most sensitive to the recession. The total returns over the last year of both company types are now nearly identical. Small companies have performed even better, with international small companies up 90% and US small companies up 125%. In March most asset classes continued to move higher although commodities, bonds, and emerging markets were slightly negative. Considering that we went through a bear market and a condensed depression in 2020, the S&P 500's returns of 20% since the pre-pandemic high on February 19, 2020 are remarkable.

The reason these returns have been so strong is that events have largely played out as markets had hoped. Vaccine creation, approval, and distribution have surpassed most investor expectations. Aggressive Fed and government actions have kept consumer and investor confidence from eroding. US GDP growth for 2021 is being revised higher and most recently is expected to reach the 6% to 7% range as deferred spending revitalizes the broad economy. The recovery timeline has given markets multiple points to be optimistic about the 2021 recovery. Investors though will now want to see hard data confirming this.

Anecdotally we can see improvements occurring as people re-engage with the economy - longer waits for restaurants and higher prices on more crowded flights. Investors will be looking for rising consumer and business confidence surveys, higher monthly spending levels, increased shipping volumes, and progress on employment numbers. Most importantly, the market needs to see momentum from 4th quarter earnings continue and accelerate into 1st and 2nd quarter earnings numbers. Many companies focused on survival in 2020, but investors are likely going to demand seeing signs of thriving this year.

One variable that could move markets over the next several months is spending and tax policy change. Increased government spending has at least been partially responsible for interest rate increases over the last few months. Changes in tax policy may cause investors, particularly larger investors, to reposition portfolios and their long-term planning. This could at the least cause increased market volatility and may alter valuations as new tax rates are factored into prices. We will continue to monitor these developments and will have an update once details are more clear.

As we've noted for several months, our base case remains that the recovery will continue into 2021 with longer-term interest rates and inflation slowly rising as the economy moves towards some level of normalizing. We are not forecasting a market correction but we should acknowledge that a market pullback following an 80% plus move higher in stock prices would be normal and healthy for markets. We continue to analyze company and asset class valuations in light of current prices and interest rates and incorporate this into our strategies.

Performance Summary

The S&P 500 index moved 4.4% higher in March and is now up 6.2% YTD. Other markets across the globe are also higher (developed markets +3.5% and emerging markets +2.3%). As it did in late 2020 the market is favoring stocks and sectors that are more economically sensitive such as financials, energy and materials, transportation and industrials, and home construction/improvement. Best performers in 2021 are small companies (+12.7%) and commodities (+10.8%).

In another sign that markets are trying to normalize interest rates have continued to move higher. Bond returns are now down 3.4% YTD in the US and are -6.5% for international bonds because of rising rates. As they have for some time now market fear measures have mostly stayed flat or declined. There has been very little change in the US dollar, the VIX Volatility Index has now fallen under 20, and gold has lost 9.8% YTD. We currently have little exposure to gold within our strategies but may increase exposure if circumstances warrant.

Fixed Income Strategy

Most U.S. Treasury rates rose significantly in the first quarter and the yield curve steepened, as shorter maturity rates were modestly higher, and the 10-year benchmark note rose to 1.74%. The sell-off was driven by an improving economic outlook, based on sizable fiscal stimulus and an accelerating Covid vaccination rate. A steep yield curve will likely remain thematic as the Federal Reserve expects to maintain its funds rate near 0% for the next few years; however, the future path of rates will be determined by the pace of the economy's progress toward, and ultimate achievement of, the Fed's economic goals.

Corporate spreads were relatively steady in the quarter, with investment grade tightening slightly to 91 bps. High yield spread tightening was more pronounced, decreasing 50 bps, to 310 bps. Improving economic fundamentals and highly accommodative monetary policy, as well as low global yields, have been supportive of the corporate market.

Our preference is to defensively position portfolios in high-quality bonds with an average duration of 5 years and shorter or structured bonds with coupons that will step up if rates rise.

Equity Income Strategy

The Equity Income strategy's primary goal is to provide reasonable income while also offering the potential for capital appreciation. Given the strong economic backdrop, we will continue to widen the risk spectrum in the strategy as financial and economic conditions improve.

Last year, we decided to decrease our exposure to Reits and Energy companies as we became increasingly worried regarding their ability to pay dividends during a global pandemic. This move benefitted us throughout the year, as many companies in those sectors decided to preserve cash, reduced their dividend payout and consequently saw their stock performance suffer. Our thinking at that time was that once the economic conditions improved, we would revisit those sectors. As such, this past quarter with widespread vaccination efforts on the way, we decided that it was time to add some risk to the strategy by adding exposure to companies like Equity Residential, Royal Dutch Shell, and to Emerging Markets debt via the EMB ETF.

Additionally, given the strong economic backdrop for the equity markets, we have reduced our cash balance down to 1% and sold out of our gold exposure.

Defensive Equity Strategy

The Defensive Equity strategy remains focused on identifying companies with stable operating results and reduced stock price volatility relatively to the broader market.

As such over the past quarter, we added exposure to companies like Alphabet, Transunion, and Verisk. All three companies fit our investing criteria by operating in markets that have a very small number of participants (oligopoly) which tend to limit price competition and margin compression. We are particularly attracted to their ability to collect, analyze and consequently monetize large data sets. As the world becomes more and more technologically intertwined, we believe that access to multiple unique sets of data can be a valuable resource.

Given the strong economic backdrop for the equity markets, we have reduced our cash balance down to 3% and sold half of our gold exposure down to 1%.

Core Equity Strategy

The first quarter of 2021 witnessed the acceleration of the vaccine rollout which global equity markets viewed very positively. Investors have gravitated towards cyclical, GDP sensitive sectors as the US economy has continued to pick up steam from the re-opening efforts. As such, the Energy and the Financial sectors, which lagged the most in 2020, have started 2021 very strongly. The backdrop for the markets and economy seems very strong with an (1) accommodative Fed, (2) another round of stimulus working through the system and a (3) "booming" housing market.

Core Equity Strategy (continued)

We continue to look to buy high quality companies that have strong balance sheets that are led by capable management teams. We initiated a handful of new positions in the portfolio in the 1st quarter of 2020. We bought industry leading names such as EOG Resources, Alaska Airlines, and Northrop Grumman. We also added to the portfolio names that are benefiting from renewed growth such as F5 Networks, Fleetcor, Inmode and Ebay.

While we cannot predict near term risk factors, we can control the companies we invest in. Our disciplined approach of owning high quality, financially viable and intrinsically cheap companies form the Core Equity portfolio.

SELECT Equity Strategy

The SELECT Equity Strategy focuses on quality companies with strong corporate citizenship. We prefer organizations that are innovative and helping to transform industry for better customer and company outcomes. Our intention is to hold preferred names for extended periods of time in order to reap potential compounding benefits. We tend not to make major strategy shifts but continually seek ways to improve the quality and opportunity set for the portfolio. In the first quarter we did some rebalancing of existing positions. We also eliminated two names – Colgate-Palmolive and U.S. Bancorp. Both positions had been held for nearly a decade. We felt their opportunity for operating improvement was limited. We introduced Visteon, a maker of auto cockpit electronics and electric vehicle battery management systems and Stanley Black & Decker, one of the world's largest tool manufacturer in January. Array Technologies, a producer of solar tracking systems, was added in February.

International Equity Strategy

International markets were generally strong in Q1 even against a strong US dollar backdrop. Cyclical and GDP sensitive names have outperformed as the global economy continues its recovery. While different regions of the world are moving at different speeds in dealing with the pandemic, we believe that we are on an upwards moving economic trend throughout the globe.

In the quarter we did take the opportunity to add to new names. We started positions in NXPI Semiconductor, Royal Dutch Shell, Bank of Nova Scotia, Sony, Unilever and Inmode. We feel that economic growth will continue to be strong in the second half of the year and the portfolio should benefit from its exposure to cyclical and GDP sensitive names.

The approach is to have a portfolio of high-quality businesses with competitive advantages that can withstand changes in economic conditions and thrive through a business cycle. Companies with established moats often expand market share and strengthen their business during a downturn. These are the companies that we continue to evaluate for purchase in the International Equity strategy.

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Opportunity Equity Strategy

The US economy is recovering at a rapid pace. There is pent up demand in housing and automotive, good data is coming from manufacturing and industrial, the unemployment rate is still a bit high but falling at a reasonable rate, and consumer savings rates are over 20%. All these factors are causing some investors to fear an overheating of the economy as it reopens, causing volatility in treasury yields and inflation fears. Investors are shifting flows out of quality names/growth names into the forgotten areas (value, non-quality names). This transition out of growth stocks is considered healthy as valuations were getting overvalued. This selloff is creating good opportunities for quality growth names. We added 8 disruptor names in the Opportunity strategy, with most of these companies benefiting from this economic recovery. We expect the turnover of this strategy to decrease for the rest of the year.

Thematic Equity Strategy

Over the past couple quarters, we used some of the cash "dry-powder" and invested in themes that offered an attractive risk/reward proposition. We continue to believe that as the global economy reopens a lot of the cyclical names within the strategy should outperform. More specifically, we think that the demand for rare earth materials and semiconductors will surprise to the upside as industrial and manufacturing output accelerate.

As ever, we remain vigilant in our efforts to identify new themes of secular growth that would benefit the strategy.

Covered Call Strategy

The primary goal of the Covered Call strategy is to obtain exposure to equities, with greater income potential at the cost of reduced upside participation. The high level of market volatility in 2020 created challenges for us but also opportunities. Options premia remain higher than pre-Covid levels, so the income potential from covered call sales is higher. In addition, support from global central banks and fiscal stimulus have provided significant protection for equity investors thus far. High valuations at the broad market level, new variants of the Covid-19 virus, slower than expected vaccination in the Eurozone and some emerging markets, fraught relationships with our trading partners, supply-chain bottlenecks or dislocations, and the potential for policy change including higher taxes and greater regulation remain risks in the near-term. Should the broad US equity market continue to rise but at a slower pace, or become range-bound, constrained by high valuations on the upside but buoyed by fiscal and monetary stimulus on the downside, this may be a fruitful period for the Covered Call strategy.

As market conditions evolve, we will continue to monitor our exposure to the tech-heavy Nasdaq 100 index, which we pared from ~30% to ~20% down to ~14% over the course of 2020. In Q2 of 2020 we added the capability to purchase protective puts or replace equity exposure with purchases of in-the-money calls and we are monitoring options prices as volatility normalizes post-crisis and looking for the opportunity to add some downside protection at reasonable prices. As the economy stabilizes and we continue to see signs of a sustained pickup in global economic growth it is likely that we will begin to raise the strike prices of our calls relative to the benchmark and leave a higher proportion of shares uncovered to obtain greater upside exposure. However, given the exceptionally strong performance of equity markets since the lows of March 2020, the possibility of a correction in price or time remain and management of the strategy is intended to be defensive / conservative. Investors in the growth and accumulation phase of their investing life-cycle or those with a strong bullish outlook may wish to look at other strategies while those in the distribution phase or with a more neutral market outlook may find Covered Call an attractive complement to their traditional portfolios.

The 10-year Treasury note is a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.

The Nasdaq 100 Index is a basket of the 100 largest, most actively traded U.S companies listed on the Nasdaq stock exchange. The index includes companies from various industries except for the financial industry, like commercial banks. These non-financial sectors include retail, biotechnology, industrial, technology, health care, and others.

The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities. There is over USD 9.9 trillion indexed or benchmarked to the index, with indexed assets comprising approximately USD 3.4 trillion of this total. The index includes 500 leading companies and covers approximately 80% of available market capitalization.