THE EXUBERANT INVESTOR

Through these quarterly commentaries, RMC tries to communicate our general insights into current market and economic conditions, yet this is often interrupted with the "big news" at the time. Our last commentary was originally a year-in-review of 2020, but that gave way to a discussion on Investor Activism that took center stage at the start of this year. We will attempt to communicate some issues defining the market now, and how they relate to your investments: proposed fiscal policies including tax changes and unprecedented government spending; the Federal Reserve and its balance of near zero rates, purchasing program and rising inflation; and the "reopening" theme that pushed government bond yields and equity markets higher in Q1. In the context of these market dynamics, we also want to shine a light on The Exuberant Investor, who has rapidly driven pockets of the market to record highs.

- The Biden administration has introduced the American Jobs Plan ($2.3 Trillion), aimed to rebuild the country's infrastructure, and the American Families Plan ($1.8 Trillion), aimed to support families through education, childcare, and healthcare investments. To pay for these programs, the top income-tax rate would be raised to 39.6% from 37%, and for households with income greater than $1 million, the tax rate on capital-gains and dividends would be raised to 39.6% from 20%. The "step-up in basis", a favorable tax strategy used to transfer assets tax-free, would also be eliminated, with unrealized gains taxable at death (with an exemption of $1 million per person).

- The Federal Reserve continues its dovish approach to monetary policy, maintaining near zero rates and purchasing at least $120 million of bonds each month, providing liquidity for economic recovery. While acknowledging inflation has risen, the Fed notes this is from transitory factors and will continue to allow it to run higher than 2% until the U.S. has achieved full and inclusive employment levels. Fed Chair Powell also noted that a tapering of asset purchases would only begin if substantial economic progress is achieved.

- The 10- and 30-year treasuries rose to 1.71% (+81 bps) and 2.41% (+76 bps), respectively, in Q1, indicating expectations of economic growth and higher inflation. Rapidly rising treasury yields, and the equity market's sector rotation, were reflected in the performance of the Nasdaq (+2.8%) versus the Dow (+7.8%) and the S&P 500 (+5.8%) in Q1. The cyclical sectors outperformed the broader market for the quarter (Energy +29.3%, Financials +15.4%, Industrials +11.0%), as investors turned away from the "digital economy" to the economic reopening.

Despite the pandemic abruptly ending a 11-year bull market in March 2020, the equity markets are back to record highs. The S&P 500 realized the fastest recovery following a bear market (defined as a decline of more than 20%), taking just 126 trading days to reach a new record high[i]. Initially driven by significant government stimulus, then positive vaccine news in the fall, the S&P 500 and Nasdaq gained 16% and 44%, respectively, to end the year. Supported by liquidity from the Fed, stimulus checks from Congress and anticipation of "back-to-normal", investors poured money into the markets for fear of missing out. With bond yields at record lows, inflows to stocks over the five months between November 2020 and March 2021 totaled $569 billion, *compared to $452 billion over the prior 12 years combined*[ii]. A record $56.8 billion was invested in March alone as stimulus checks were distributed. Over this time, individual investors sought "risk-on" investments or short-term trades, fueling a record number of SPACs to the market (special purpose acquisition companies), a record volume of options transactions, the rise of "meme stocks" (increase in trading volume from social media hype) and the surge in the price of Bitcoin and other cryptocurrencies.

These “risk-on” investments are quite different in nature, however, they can all credit their recent rise to the seemingly endless supply of stimulus flowing to the market. For example, SPACs are “blank check” companies, which raise capital in an initial public offering then use those funds to acquire a private company and take it public. Many have involved electric vehicle, artificial intelligence, or space technology companies, as examples. These are exciting areas to invest in, but often these companies are several years away from real products or revenue, and the reality is many will fail. Another example is cryptocurrency, with Bitcoin and Ethereum the most widely recognized, which have surged in popularity that coincided with the Coinbase direct listing. Coinbase is a cryptocurrency exchange and the first major crypto business to go public. While crypto investing is still viewed as a speculative asset class by some, both individual and institutional investors view Bitcoin has a form of “digital gold” with a store of value and potential diversification benefits. While the Exuberant Investor has caused SPAC valuations and cryptocurrency prices to soar recently, it remains to be seen if these are in bubble territory, and the most likely risk outside of lofty valuations is in regulatory headwinds. The enthusiasm for these investments does not mean they should be avoided, rather it is dependent upon an investor’s ability and desire to take risk.

It can be tempting to chase returns in a bull market, through these risk-on investments or over allocating to certain stocks or sectors, but remaining committed to your portfolio objectives is paramount. Likewise, it is ill-advised to make investing decisions based on your political beliefs or stance on fiscal policy, as the many market forces at play make outcomes unpredictable. The stark sector rotation and most recent Presidential election are testament to remaining invested in a diversified portfolio. While any adjustments to the tax code may impact your income or prompt a reevaluation of your investment plan, history shows that in the 13 previous instances of tax increase since 1950, the S&P 500 has shown higher average returns[iii]. These tax hikes were usually associated with significant government stimulus, as is the case today. The outlook for the economy remains strong, with the U.S. GDP forecast to be between 6% and 8% for 2021. In his annual letter to shareholders, JPMorgan CEO Jamie Dimon stated, “I have little doubt that with excess savings, new stimulus savings, huge deficit spending, more QE, a new potential infrastructure bill, a successful vaccine and euphoria around the end of the pandemic, the U.S. economy will likely boom.” RMC consistently monitors client holdings for risk and opportunities, as some equity valuations may or may not have this priced in. We will rebalance if there is an unfavorable change in fundamentals, valuation, or tailwinds for your investments, with a focus on long-term earnings potential.

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[i] Dow Jones Market Data
[ii] Bank of America Global Investment Strategy, EPFR Global
[iii] “History lessons from past tax hikes.” *Fidelity Viewpoints.* 9 September 2020. www.fidelity.com/learning-center/trading-investing/tax-hikes-history. Accessed 2021.