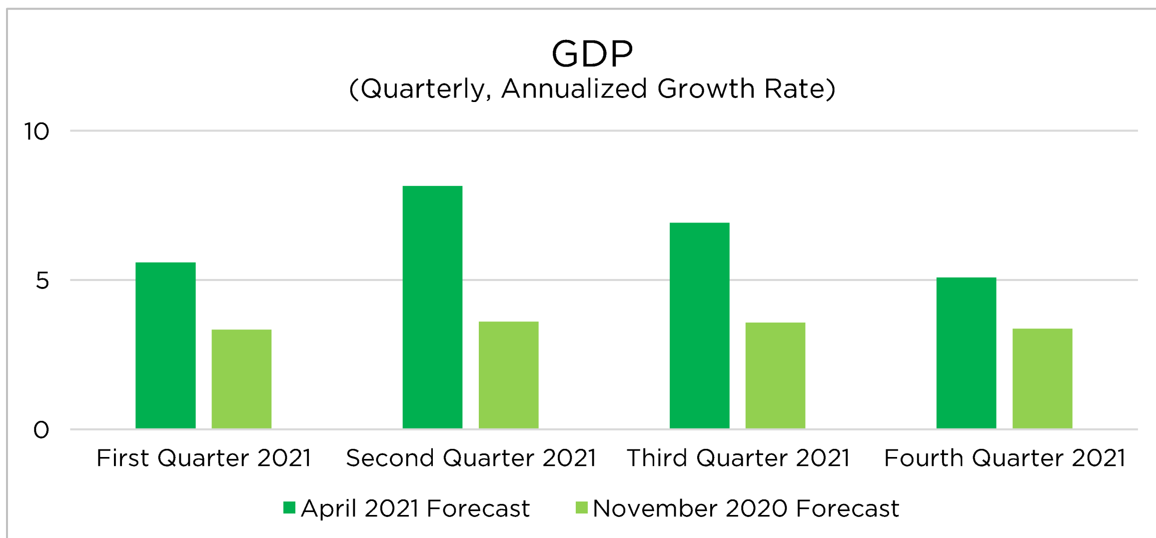
"We continue to experience high demand and limited supply. And, as we begin to see the light at the end of the tunnel that is the coronavirus pandemic, increasing consumer confidence and decreasing unemployment create market conditions that led to sizeable price gains in the first quarter."

– Cox Automotive Chief Economist, Jonathan Smoke

Things have changed.

Vaccines and the latest round of government spending are ushering in burgeoning optimism. Anticipating a return to a more normal environment, consumers have begun spending more, while employers resume hiring, and manufacturers race to keep up with a surge in demand for certain goods. Sentiment has rapidly shifted from negative to positive as economic forecasts point to higher-than-average growth accompanied by signs of inflation. Longer term interest rates have risen from historical lows.



Economists' Optimism Grows

Each month the Wall Street Journal Economic Forecasting Survey asks 70 economists about their forecast for GDP growth (among other indicators). In this chart, the darker bars represent the most recent survey, while the lighter bars represent the one taken last November.

Starting in mid-November, stock investors began to turn their attention away from so-called Covid beneficiaries (all those businesses that support work-from-home, for example) and toward a myriad of businesses that should benefit from a resumption in economic activity. In extreme cases, this resulted in certain stocks bouncing back from depressed levels (energy producers and

cruise ships come to mind). But more generally, investors began to anticipate stronger earnings from a broad range of businesses. As always, Wall Street and its universe of media followers produced a couple of catchy names for this phenomenon, some calling it the "reopening trade" others the "reflation trade".

The result has been a marked change in market dynamics. The decade long trend of stock index performance being dominated by very large tech focused companies reversed. Smaller, more economically sensitive companies went from laggards to leaders.

	2020 Pre-Vaccine	Since Vaccine	Description
S&P 500	8.63	13.21	Dominated by largest companies
S&P 500 Equal Weight	-1.37	24.33	More broad-based
Growth Stocks	30.30	6.02	Technology heavy
Value Stocks	-9.99	23.13	More economically sensitive
Russell 2000	-1.46	35.06	2000 smaller companies

Fixed income markets displayed a similar change of leadership. Before vaccines were announced, longer term U.S. Treasury bonds benefited the most from declining interest rates. High-quality corporate bonds outperformed junk bonds, as investors were concerned that lower quality borrowers might struggle to meet repayment obligations. Now that investors are more sanguine about economic recovery, high-yield bonds have been the best performing sector, as fears of defaults recede. Municipal bonds shared a similar benefit, thanks to the most recent federal stimulus package.

	2020 Pre-Vaccine	Since Vaccine
Long Term Treasury Bonds	19.17	-14.61
Investment Grade Corporate Bonds	8.87	-3.71
High Yield Bonds	0.97	3.84

Notwithstanding the positive performance of high-yield bonds, the first quarter of 2021 has been the most challenging three-month period for bond investors in decades. Though still historically low, interest rates rose rapidly from mid-pandemic troughs, leading to negative returns for most longer duration securities. This was primarily due to two major concerns: rising need for borrowing and the likelihood of at least temporary inflation.

Increased borrowing is likely to come from two sources. First, government stimulus programs are being funded by deficit spending; deficit spending is, by definition, funded by debt. Secondly, in a growing economy, many businesses rely on debt to fund expansion.

Inflation is more controversial. The consensus view is that there will be some inflation, particularly as we passed the one-year anniversary of the onset of the pandemic. The economists polled by the *Wall Street Journal* (cited above), on average, forecast inflation peaking in the second quarter of this year at a moderate 3%. The most extreme forecast was 3.8%. As can be expected, however, media reports are somewhat more inflammatory. The *Wall Street Journal*

itself greeted the Labor Department announcement of the 2.6% March increase in CPI with the front-page headline "Consumer Prices Leap". The business section of the *New York Times* was somewhat more sober: "We could be on the verge of a golden era of inflation nonsense".

While there is evidence of more severe pressures, it is generally episodic or anecdotal. There have been plenty of stories about employers being forced to raise hourly wages to attract enough employees to keep up with rising demand. A shortage of semi-conductors has forced auto manufacturers to idle plants, leading to fewer cars on dealers' lots and higher prices. Used-car prices have increased even further, rising 26.2% in the last year and nearly 6% in the month of March alone, according to the Manheim Used Vehicle Index.

Like autos, gasoline prices are dramatically higher than they were a year ago. According to AAA, the national average price for regular gas was $2.86 per gallon at the end of March, about a 40% increase over 12 months. However, context is everything. The increase appears as dramatic as it does because the comparison is being made against the extraordinarily depressed levels of last spring. In fact, gas prices are roughly the same as in 2018 and 2019 and well below the peak of $4.15 back in 2008. This is a perfect example of distortion caused by the so-called "base-effect" that we can expect to hear more about in the coming months.

As we lap the extraordinarily weak results of last year, we can expect more robust than usual economic statistics and reports of what appear to be shockingly large price increases. For now, at least, most market observers will point to the base-effect as explanation, forecasting a return to more modest growth and inflation by next year. If this view is correct, supply chains will be repaired, and shortages will be reversed. As more people are vaccinated, health fears should recede and many of the close to four million people who stopped looking for work should start to rejoin the labor force. Employers should find it easier to fill open positions. Semi-conductor production should return to pre-pandemic levels, auto plants should reopen and dealer lots should refill, the thinking goes. This reasoning extends to gasoline. Refiners are currently operating at only 82% of capacity according to the U.S. Energy Administration, leaving plenty of room to increase production, and keeping a lid on prices.

In this narrative, the Federal Reserve should remain accommodative, and interest rates should stabilize.

We do not feel the need to take a contrary view. However, we think it is important to acknowledge the possibility that upcoming economic data are stronger than currently expected. If this is the case, participants may start to question this orthodox view of reversion to the mean. Upside surprises may lead forecasters to predict more upside surprises, perhaps much stronger growth, and greater risk of more sustained inflationary pressures. This might cause investors to be even more optimistic about cyclical businesses while at the same time worrying about the potential of rising interest rates. If this were to occur, one could expect widespread speculation about whether the Federal Reserve might be forced to reverse course and tighten monetary policy.

We see greater than normal uncertainty, which, in our opinion, creates opportunity. We think investors will focus even more than usual on making broad stroke predictions. Will interest rates

rise or fall? How fast will the economy grow? Will we have longer term inflation? While these are important questions, they are truly difficult to answer. And harder still to act on.

When big-picture investors actively trade index funds based on growth versus value, or small versus large, individual stocks can become mispriced. We believe that security selection will be even more important and will be amply rewarded. We are heartened to see investors already broadening exposures and steering away from just the biggest companies. We believe this trend will persist. As always, we will evaluate businesses by their individual characteristics, strengths and weaknesses. We will continue to work to identify well-valued businesses that benefit from specific rather than vague, general trends.

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