MORSE ASSET MANAGEMENT, INC.
23 Old Kings Highway South, Suite 200, Darien, CT 06820

April 19, 2021

2021 Q1 Investment Outlook

"Bull markets are born in pessimism, grow on skepticism, mature on optimism, and die in euphoria,"
- Sir John Templeton

The first quarter of 2021 was choppy, but the US markets continued to grind higher, with the S&P 500 +6.17% and notching new all-time highs. The main driver of volatility in the equity and fixed income markets was a vicious move higher in interest rates, with the 10-year Treasury rate nearly doubling from 0.93% to 1.74%. Once rates stabilized, the market found footing, and has since rallied for 4 straight weeks on optimism around positive Covid data, reopening of the economy, and additional Fiscal stimulus heading into Q1 earning reports.

The rise in interest rates during the first quarter was not unexpected due to improvement in GDP expectations, but the rate of change caught the market off guard. As investors adjusted expectations for the impact of higher borrowing costs, equity valuations contracted. The key question is, will earnings growth outpace the impact of a rise in rates, and thus allow valuations to normalize gradually? We believe they will.

The secular rotation from "growth" stocks and stay at home beneficiaries towards "cyclicals", accelerated in the first quarter. While Q1 ended positively for the market, sector performance was notably mixed. Consumer Staples, Technology, and Consumer Discretionary, trailed the market. Cyclical sectors outperformed, led by Energy, Financials, and Industrials. Despite this divergence in price performance, all sectors finished the quarter positive, reflecting broad and persistent fundamental strength.

Fundamentals and leading indicators continue to broadly improve as our recovery has regained momentum. Services, a notable laggard due to Covid restrictions, are now expanding and catching up with the continued strong Industrial production numbers. The Conference Board's recent CEO confidence survey reflects a 17-year high. Employment statistics are also now back on track and continue to trend positively. According to the OECD, global GDP growth is now projected to be 5.6% this year.

According to Factset's *Earnings Insight* on April 16, the S&P 500 is expected to report a year-over-year earnings growth rate of +30.2% for Q1 2021, notably above the estimate of 23.8% at the end of the first quarter on March 31. We continue to believe that earnings estimates are significantly trailing actual results. During the past three quarters (Q2 2020 through Q4 2020), actual earnings reported by S&P 500 companies have exceeded estimated earnings by an average of +19.0%, well above the 5-year average margin of +6.3%. But even if we close out the quarter at the current rate, it would be the highest earnings growth rate in more than 10 years. The bottom-up target for the S&P 500 is 4,525.33, which is +8.5% above Friday's closing of 4,170.42. (Chart 1)

The continued success of vaccine rollouts has been a notable bright spot, boosting confidence and allowing economies to reopen. As of Friday, the current pace of administering vaccines is over 4 million doses per day. At this rate, the <u>US will reach adult herd immunity in the next two weeks</u> ("adult herd immunity," as defined by the CDC, is 60% of the population over 18 either fully vaccinated or having prior tested positive). (Chart 2)

The Federal Reserve has been clear that more accommodation is necessary. They continue to provide liquidity through a steady pace of asset purchasing, averaging $120 billion a month. Chairman Powell has also continued to indicate that rising inflation pressures, due to supply and demand chain dynamics, will be transient. With unemployment still well above target, the Fed is not near a threshold to tighten. As of the most recent meeting, members expect to hold the Federal Funds rates near zero through 2023.

Fiscal Policy came through as expected, providing necessary support to households and businesses, and accelerating vaccine distribution. A major infrastructure spending bill is also in the works. Additional spending is not required for economic recovery but could provide a targeted boost to growth. Tax hikes will need to be included to pass further spending, and the level of balance will be important.

An area for concern at this point in the cycle is markets overheating, as experienced during the euphoric run up in 1999 and culminating in the dotcom crash of 2000. Aside from small pockets, the market has been self-regulating. We prefer to see markets climb up a wall of worry, even if at times choppy, allowing earnings to keep pace with price action rather than pushing extremes. The Fed has historically been a negative trigger late in the cycle, but thus far seems benign.

We continue to be excited about the ongoing secular innovations in technology, software, healthcare, e-commerce, and payments. Advancements in areas like genomics, artificial intelligence, blockchain, robotics, energy storage, and technology continue to provide new opportunities. Investment opportunities are abundant, and we are bullish.

We are disciplined, focused on the facts, fundamentals, and long-term trends most relevant to your investments. Our investment playbook continues to focus on significant secular trends, durable and high-quality businesses, and above-average growth potential. We remain flexible and patient for the right opportunities.

Morse Asset Management Investment Team

Robert B. Morse, Jian Wang, James Cushing

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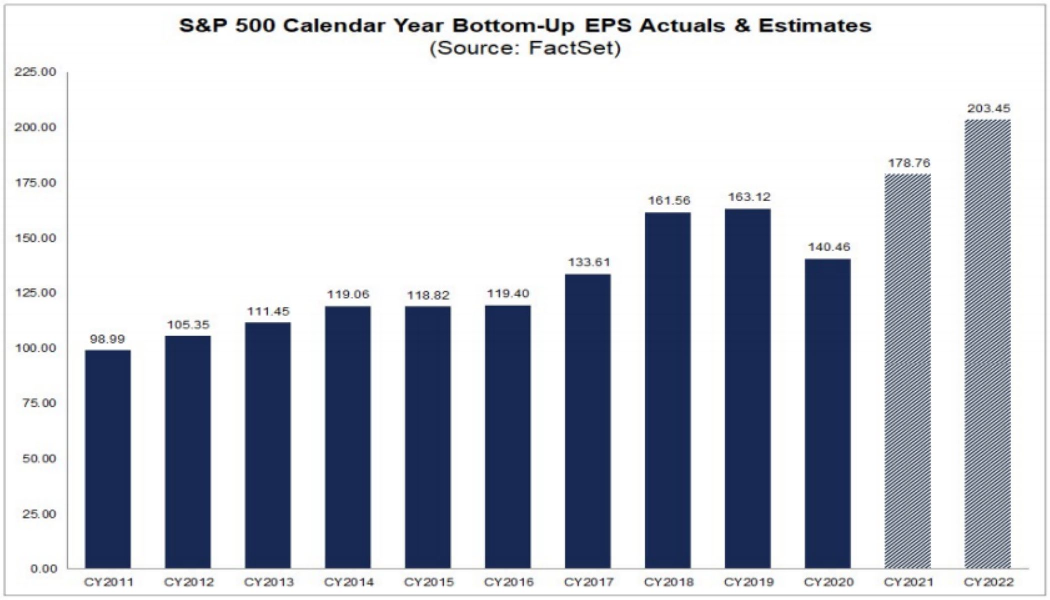
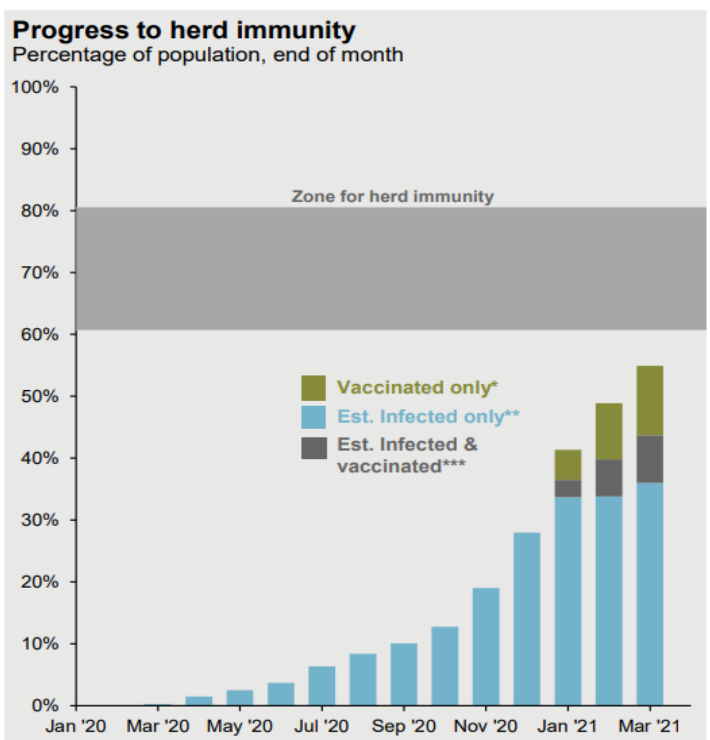
1. **S&P 500 Earnings.**



Source: Factset

2. **Progress to Herd Immunity in the United States.**



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