AIG Retirement Services

Keeping focused on your long-term goals

Quarterly Market Commentary | Jan. 1, 2021 - Mar. 31, 2021

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Quarterly Market Performance Snapshot (as of March 31, 2021)

- Dow Jones Industrial Average®: +7.8%
- S&P 500® Index: +5.8%
- NASDAQ Composite® Index: +2.8%
- Russell 2000® Index: +12.4%
- 10-year U.S. Treasury note yield: 1.74%
  - Up 82 basis points from 0.92% on December 31, 2020
- Three best-performing S&P 500 sectors this quarter:
  - Energy, +29.3%
  - Financials, +15.4%
  - Industrials, +11.0%
- Three weakest-performing S&P 500 sectors this quarter:
  - Consumer Staples, +0.5%
  - Information Technology, +1.7%
  - Utilities, +1.9%

Past performance is not a guarantee of future results.

Equity rotation, higher Treasury yields, and more stimulus highlight first quarter of 2021

Stocks continued to move upward in the first quarter of 2021, though sector performance differed from what we saw in most of 2020. The yield on the benchmark 10-year Treasury rose more quickly than many anticipated, sending ripples through equity markets. The $900 billion fiscal stimulus package passed at the end of December and the $1.9 trillion package approved in March set the stage for growth in consumer spending and employment.

- While technology and growth stocks dominated equity performance in 2020, the first quarter of 2021 brought a rotation toward other sectors. Energy was a top performer thanks to expectations of renewed travel and increased economic activity later this year. Financial stocks benefitted from higher yields, a loosening of pandemic-related capital restrictions, and expectations of economic growth. Industrials rose on the better growth outlook.
- Small-cap stocks, which are more sensitive to economic conditions, continued an upward run that started in the fourth quarter of 2020. However, small caps have experienced a bit of a pullback in the past few weeks.
- Technology and growth stocks sputtered in the first quarter, as rising Treasury yields dented the valuations of firms with less reliable revenue and profit streams. Expectations of a return to more normal life have also created headwinds for some stay-at-home and work-from-home stocks.

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- As evidence of the rotation in stocks in the first quarter, consider that the Russell 1000 Growth Index returned 0.75%, while the Russell 1000 Value Index returned 10.7%.
- The 10-year Treasury yield ended the quarter at 1.74%, up from 0.92% at the end of 2020. This 82 basis point increase is the largest quarterly surge in more than four years.
- The 10-year Treasury is linked to a significant proportion of consumer lending, so a rise in the yield can lead to rising consumer interest rates. As a result, the run-up in Treasury yields generated questions about how the Federal Reserve might respond to interest rates rising faster than expected while the economy is still not fully healed.
- The jump in Treasury yields also reflects market expectations for rising inflation, stemming from a re-normalizing economy and increased debt associated with the $2.8 trillion in fiscal stimulus approved in the past three months. Investors expecting higher inflation typically demand higher yields for holding Treasury bonds. Federal Reserve Chair Jerome Powell has said repeatedly that the Fed anticipates some inflation this spring, but that the inflation should be temporary and not enough to persuade the Fed to raise interest rates.
- The Fed increased its forecast for U.S. economic growth in 2021 to 6.5% following the fiscal stimulus bills. Most private economists also raised their forecasts.
- Consumer spending grew in the first quarter, as stimulus and enhanced unemployment benefits made their way to individuals.
- Supply chain problems were magnified by increasing consumer demand. A shortage of semiconductor chips, in particular, has affected multiple industries and led to factory shutdowns in the automotive sector. Rising demand and crimped supply could factor into inflation in coming months.
- Internationally, the first quarter was marked by an increasing divergence between the U.S.'s relatively smooth vaccine rollout and the vaccine challenges afflicting Europe.
- On China, the Biden Administration has so far shown little divergence from the Trump Administration's tough line. Early interactions between Biden officials and the Chinese government suggest that relations between the world's two largest economies will continue to be complicated, with potential market implications.
- As the quarter drew to a close, the sudden wind-down of hedge fund Archegos Capital Management generated steep losses for certain investment banks, as well as large fluctuations in the prices of several stocks, including ViacomCBS and Discovery Communications. While the economic fallout of the Archegos failure appears to be contained, it serves as a reminder that risks can arise at any moment and create volatility in markets.

Vaccines, consumers, inflation, and public policy could shape the second quarter

While the future is always unknowable, and investors should always proceed with caution, events in the first quarter suggest certain trends to keep an eye on in the second quarter.

- As has been the case for the past year, the path of the virus and vaccines will likely remain a key driver of market behavior. Investors are cautiously optimistic that successful vaccines will allow a return to normal economic activity this year. However, any hiccup in that process, or a more severe virus resurgence, could upset expectations and bring severe volatility to markets. Europe currently serves as a cautionary tale.
- Investors are hoping Q2 will see further rises in consumer spending and employment increases. Consumer confidence is now higher than it's been since the start of the pandemic. Thanks to fiscal and monetary stimulus, household balance sheets are also strong. If these conditions hold, and reduced economic restrictions give consumers more ways to spend money, consumer spending – which accounts for about 70% of U.S. economic activity – could ramp up quickly.
- With restaurants, theme parks, and other entertainment venues reopening, expectations are high for increased

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hiring in the hospitality sector, which has been hit hard during the pandemic. The monthly ADP report on private sector hiring, released on the last day of the quarter, revealed an increase of 517,000 jobs in March – the largest increase since September. Investors will be watching to see if those gains are confirmed by the official March and April employment reports from the U.S. Department of Labor.

- With more people employed, higher consumer spending, and the potential for continued supply disruptions, investors will be watching for signs of inflation that's higher or more permanent than the Federal Reserve anticipates – and continue to guess about whether the Fed will take action in response.
- On March 31, President Biden unveiled his proposal for $2 trillion in infrastructure investment over the next 8 years, as well as tax increases to pay for the spending. The proposal includes investments in roads, utilities, broadband, U.S. manufacturing, green energy, and more. Many companies in sectors that stand to benefit from the proposal saw their stock prices appreciate in anticipation of the announcement.
- The Biden tax proposal would see corporate taxes rise from 21% to 28%, still below the 35% rate that prevailed prior to the 2017 tax reform. International tax structures would also be altered. These changes could affect the way companies report profits.
- The Administration has signaled that another large investment proposal, this one focused on childcare, education, and health care, and potentially in the $1-2 trillion range, could be offered in April.
- The Biden proposals will have to pass Congress, which means it's too early to know what the final scope of spending and taxes will be. Investors should watch for further developments.

Final thoughts for investors

The first quarter of 2021 brought a rotation in equities, higher bond yields, and additional fiscal stimulus that's boosting consumer demand. These trends may continue into the next quarter, as markets see a bright outlook for the U.S. economy. Whether prices for goods and services increase, and whether the increases are temporary or permanent, is something investors and policymakers will be watching closely. Volatility is always possible – whether it's from known sources such as the virus, or not-yet-known sources such as the travails of a bank or hedge fund. It's important to have a portfolio constructed to deliver over multiple economic cycles and in a variety of market conditions. The end of a quarter is a good time to speak with a financial professional about how to stay on track toward your long-term goals.

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