RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

First Quarter 2021 Market Commentary
April 2021

Update on Economic and Market Recovery from COVID-19 Shutdown

Just over one year since the COVID-19 crisis was declared a pandemic, economic and market conditions continued to improve through the first quarter of 2021, reflecting improving dynamics in the fight against COVID-19, increasingly widespread deployment of several vaccines, and gradual economic re-openings domestically and abroad. The Fed now estimates 2021 GDP to be + 6.5% and the S&P 500 has risen ~ 6% year-to-date as of quarter-end. Further, unemployment is on the decline, with weekly jobless claims in mid-March reaching the lowest level since prior to the pandemic in 2020. While the labor market has seen gradual improvement as some businesses re-open and re-hire, employment in the hard-hit hospitality, leisure and travel segments remains extremely challenged (due to lack of demand). These industries will be some of the last to recover, however there is economic upside from their recovery going forward into the latter half of 2021 and 2022.

Monetary and Fiscal Stimulus Have Supported Swift Rebound

This economic crisis is particularly unique in that it has disproportionately hit hard many areas of the service and retail economy that require in-person experiences with consumer spending shifting to e-commerce and the collapse of travel and leisure spending. In contrast, many economic crises historically have impacted manufacturing and other areas of the economy more evenly, because they did not also involve stay-at-home mandates. During the COVID-19 recession, outside of industries reliant on in-person interaction, many businesses were able to adapt to the shift of economic activity involving more remote work, virtual experiences and e-commerce.

Much of this economic resilience can be attributed to extraordinary monetary and fiscal stimulus measures enacted swiftly to keep businesses afloat and workers employed during the economic shutdown. Similar to a natural disaster, the COVID-19 lockdown recession was caused by a single catastrophic event, namely a global pandemic and related draconian public health measures. The aforementioned economic stimulus served to protect the economy from an even more complicated crisis by providing funds to keep consumers afloat until such time that businesses can re-open and the public can get back to work more fully. Further, continued low-interest rate and accommodative monetary policy ensured that businesses had no trouble accessing capital and the financial system could continue to operate smoothly.

Recently, the Biden administration and Congress passed a $1.9 trillion stimulus package. This is on the heels of trillions in stimulus passed last year by the Trump administration. While some of this money has surely gone to inefficient projects unrelated to COVID-19, a great deal has gone to support the unemployed, small businesses, families with young children and others disproportionately impacted by the pandemic. Ideally, the economy will re-open and return to a growth trajectory similar to pre-pandemic levels without the need for further massive stimulus. However, the government's willingness to act when necessary is re-assuring and injects confidence into the financial system if pandemic dynamics worsen in the future. Down the road, we will have to carefully monitor inflation consequences and monetary policy implications of the Fed's response to this extraordinary crisis, but the near-term economic outlook finally appears more promising after a difficult year.

Rotation from Growth to Value Equity Continued in First Quarter

Beginning in late 2020, markets experienced a notable shift from growth to value equity, after years of relative strong growth equity returns, particularly from large tech stocks. These same large tech stocks also benefitted during the pandemic from a seismic shift towards e-commerce, remote work and virtual experiences. However, the tide began to turn as the outlook for vaccination and economic re-opening improved, as well as expectations for higher inflation and interest rates in the near future. In the first quarter, the Russell 1000 Value rose ~11% while the Russell 1000 Growth rose less than 1%, reflecting this change in equity style leadership. Traditional value-oriented stock sectors such as energy (+35%), Financials (+17%) and Industrials (+11%) led market returns in the first quarter.

Our view is that this trend is likely to continue as the economy continues to re-open and interest rates eventually begin to move higher along with economic growth in a maturing economy. The recent years of zero interest rates are unprecedented in historical context and have distorted equity market returns in favor of growth tech stocks that will always benefit from lower rates due to the market typically assessing their valuation on the basis of longer-term projected earnings growth. Conversely, some value stock sectors, such financials and energy, benefit from higher interest rates and inflation in a growing economy, as they benefit from higher interest rate spreads on loans and higher commodity prices, respectively. Investors often look to invest in these sectors for their relatively more predictable near-term earnings potential and therefore their valuations are less dependent on low rates and long-term profitability projections.

Path of Future Economic Growth Dependent on Vaccine Success and Herd Immunity Timeline

The trend of markets in the near term will be closely aligned with trends in the COVID-19 caseload and success of vaccinations in suppressing serious cases that lead to hospitalizations and deaths from the virus. Much of the market return in late 2020 and so far in 2021 has been due to the pace of economic re-openings in the U.S. and abroad and expectations of investors for a more normal business landscape. Many businesses have already adapted to maintain operations in the COVID-19 world. New virus variants, however, threaten to increase more serious cases that could stall the reopening process and portend future lockdowns.

We do not believe that the pathway to pre-COVID-19 normalcy will be smooth or that progress will continue unabated. However, we do think that advancements in protective practices, therapeutics, and, of course, vaccines, will allow the economy to continue to function despite the virus ebbs and flows. Nevertheless, large segments of the economy cannot function in a virtual or remote fashion and a return to widespread lockdowns would clearly hurt the economy's cyclical recovery. Assuming no major setbacks, we anticipate a more normal economic growth environment in 2022 as most Americans will have been fully vaccinated.

Wealth Planning Update – Tax Proposals

Recently, multiple legislative tax proposals were announced that implicate investors and high net worth families alike. Most significantly, the Biden administration announced a $2 trillion infrastructure proposal that includes tax increases for corporations to provide funding. In the bill, the corporate tax rate would increase from 21% to 28%, yet this is still below the 35% rate that was law prior to 2018. Also included are multiple other corporate tax proposals that would increase the tax burden of U.S. corporations in other ways, such as a minimum tax rate on foreign earnings of U.S. corporations. As we've written in prior market commentaries, higher corporate taxes directly flow through to corporate earnings and therefore, in isolation, have a direct negative impact on stocks with higher U.S. profit exposure. While this bill doesn't directly raise taxes on individuals, the Biden administration has foreshadowed that higher individual tax rates for wealthier Americans will be proposed in the near future.

Separate from the infrastructure bill, on March 25th, Senator Bernie Sanders introduced a bill (the "99.5% Act") that raises important estate tax implications for high net worth families. Under the proposed legislation, the estate tax exemption would revert to the 2009 level of $3.5 million per individual or $7 million per married couple, with no inflation-indexing adjustments. The $3.5 million exemption corresponds with campaign policy proposed by President Biden, although the rates proposed by Sanders are higher. Under the current proposal, estates above this exemption amount would be taxed at a higher rate than current law, with tax rates increasing to 45% from 40% for estates up to $10 million. Rates would progressively increase as the size of the estate increases from there, to 50% for estates over $10 million, for example. Importantly, the unified estate and gift tax would be broken such that the new gift tax exemption proposed is set at a lower exemption of $1 million in lifetime gifts.

Lastly, both Senators Elizabeth Warren and Sanders have proposed legislation called the "Ultra-Millionaire Tax Act", which would enact an annual wealth tax of 3% on families with wealth over $1 billion and 2% on families with wealth over $50 million. In addition to the administrative and enforcement difficulties of this proposal, considering that the U.S. does not currently tax wealth in addition to income, this proposed legislation would be a significant change in tax policy and is probably the least likely to become law.

In summary, if the above-outlined legislation were enacted into law, many more Americans would potentially be exposed to federal estate tax consequences, requiring the thoughtful consideration of wealth planners and estate attorneys. Additionally, all investors could be affected by changes in corporate tax law that impact their portfolios. While any proposed legislation is inevitably diluted through political negotiation before becoming law, these proposals are an indication of the potential future path for federal estate law under the current administration, particularly in light of the increasing federal need for tax revenue for pandemic stimulus spending, infrastructure spending and other initiatives currently being proposed. Ultimately, the estate tax legislation that is passed through Congress will likely fall somewhere in the middle between current law and the recent proposals, but developments bear monitoring going forward.

As usual, all comments are welcome and appreciated.