ACADEMY FINANCIAL, INC.
EVALUATE • ENVISION • EXECUTE

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Chief Investment Officer

1st Quarter, 2021 Review

"Listening to and understanding our client's financial goals allows us to provide the highest level of investment planning advice and service."

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Overview:

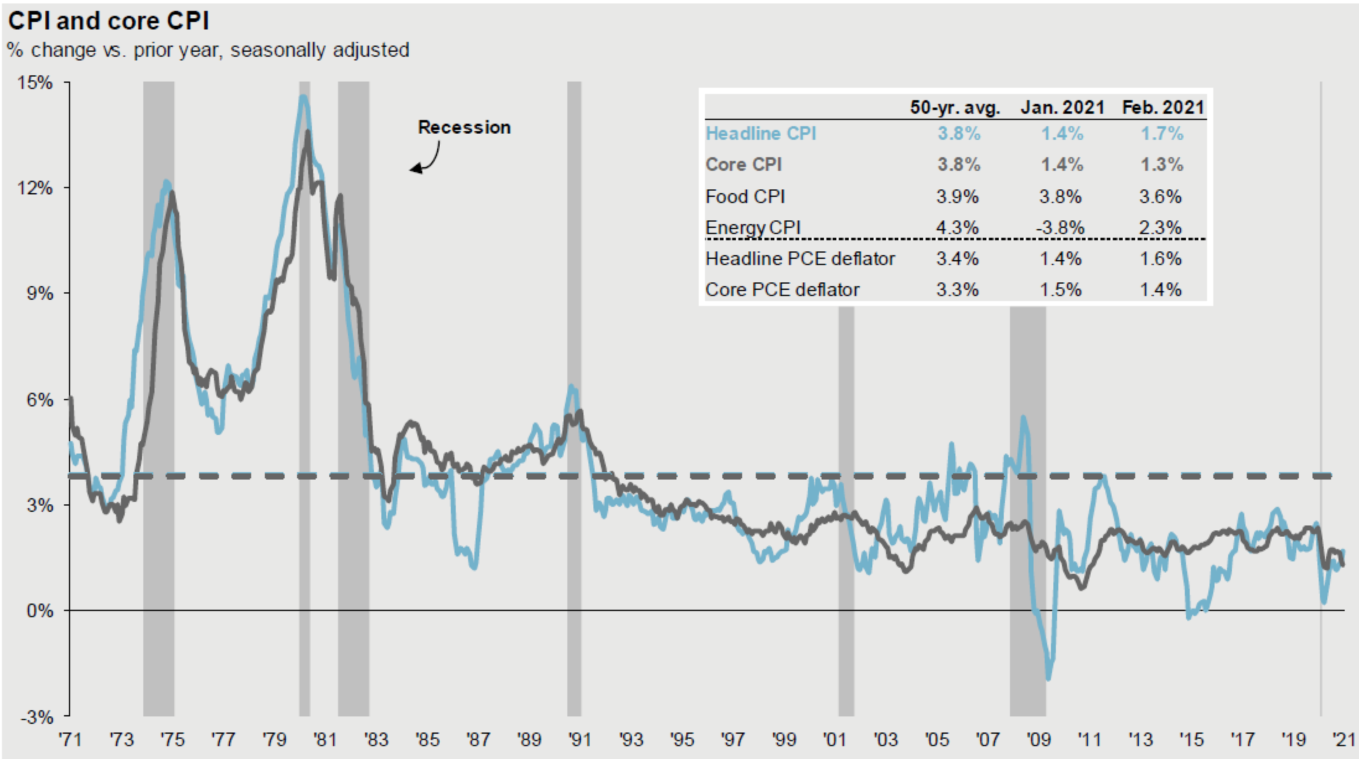
% Return as of 3/31/2021[1]

Equity Indexes	YTD	12 Mo	3 Yr
S&P 500	6.2	56.4	16.8
Russell 2000	12.7	94.8	14.8
MSCI EAFE	3.5	44.6	6.0
Emerging Market	2.3	58.4	6.5
Wilshire REIT	8.8	34.7	9.0
Bond Indexes			
TIPS	-1.5	7.5	5.7
Aggregate	-3.4	0.7	4.7
Government	-4.1	-4.3	4.1
Mortgages	-1.1	-0.1	3.7
Investment Corporate	-4.6	8.7	6.2
Long Corporate	-8.5	9.2	7.7
Corporate High-Yield	0.8	23.7	6.8
Municipals	-0.4	5.5	4.9
Cash Equivalents			
3-Month T-Bill	0.0	0.1	1.6
Inflation	*0.7*	*1.6*	*1.7*

Interest rates remain historically low as we come out of the yearlong pandemic. Economically we are still recovering, but nearly all signals point towards the potential of a dramatic recovery. The data and economic trends as well as the anecdotes on the street all bode well for markets and the world economy. One of the recent concerns of the 1st quarter is whether the easy monetary policy will cause inflation even as stocks go ever higher. Other concerns are the above average valuations of equity markets, specifically U.S. equity markets. Furthermore, low risk investments such as bonds are paying low interest rates and any spike in interest could result in a loss in principal. The economic positives are just as important to consider. Growth and consumption in 2021 are likely going to be 7%-9%, with pent up demand due to Covid-19, GDP could top 10%. A typical GDP growth number is 2.5%. To put it mildly, those that stayed employed through last year and those that received unemployment and stimulus checks, are ready to spend money – in a big way. The regulatory environment is still pro-business as is the tax environment. Government spending is high which is generally a short-term boost to equity markets. Taxes will likely increase during the Biden administration, but new tax policy and new spending may be tempered by the senate. We'll see. Interest rates have increased in Q1 and that does give us pause, but the rate of increase is steady and rates across the globe remain low.

This seems contradictory, but it's encouraging to note that the economy isn't perfect. There is room to improve and potential for upside. Interest rates can stay low for longer periods than expected. Earnings of companies can accelerate to grow into the current higher than average PE multiples. Businesses can continue to develop and innovate as we enter a peaceful recovery, albeit the usual political headlines. All in all, the environment to invest continues to remain strong in equities. Fixed income reduces the risk in a diversified portfolio but is not a highly attractive alternative to stocks for upside performance. Seeking out alternative investments is becoming a crowded space and creates additional risks that may not be warranted.

Other signs in the economy forecast recovery. Value and small cap stocks have rebounded from the lows. Energy has dramatically increased in price as have other industrial commodities. Real estate has pockets of growth; for example, residential housing having double digit returns. The questions to explore are two-fold: Is GDP growth driven by monetary expansion or consumer demand? Second, what is the best investment strategy for either possibility or a combination of the two? A diversified portfolio hedges for either scenario.



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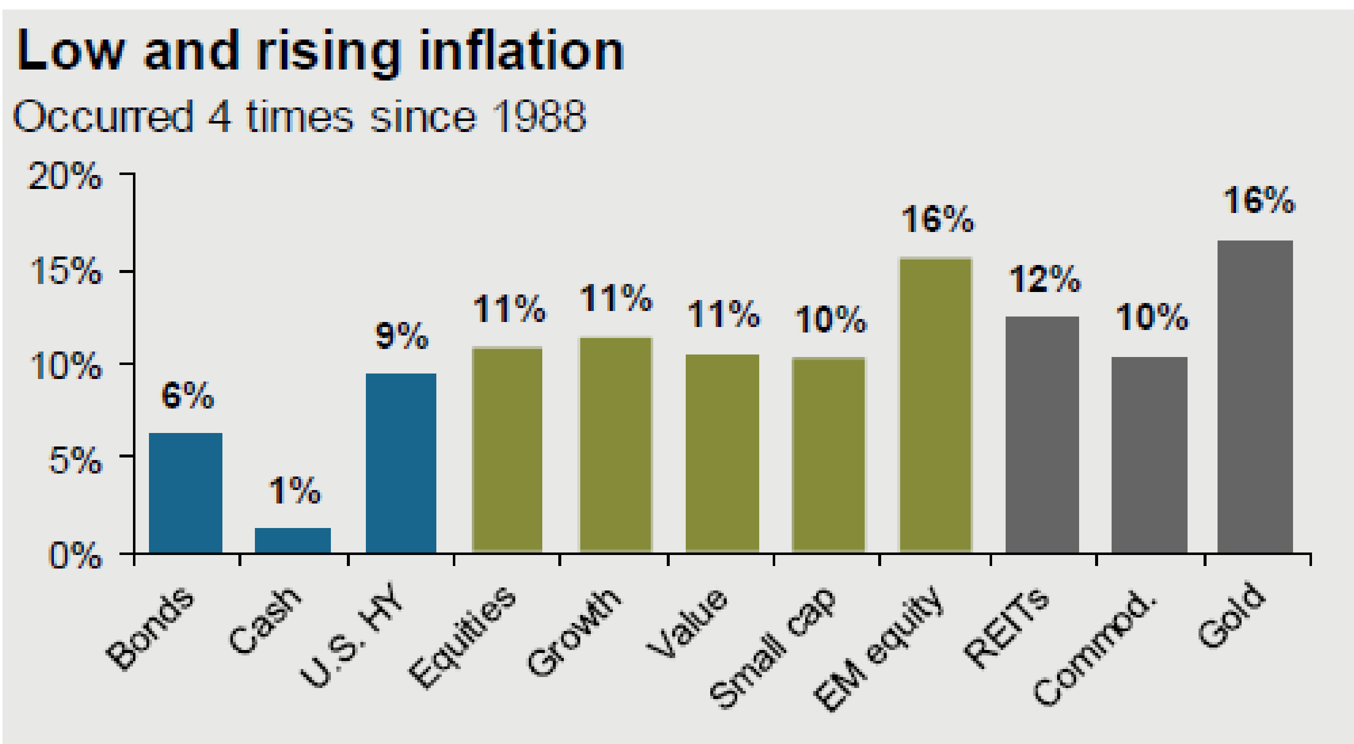

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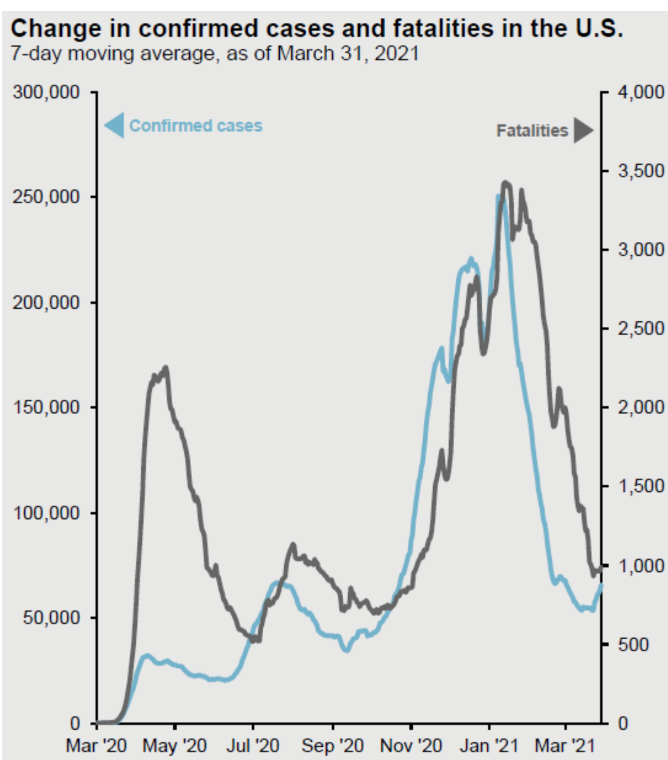
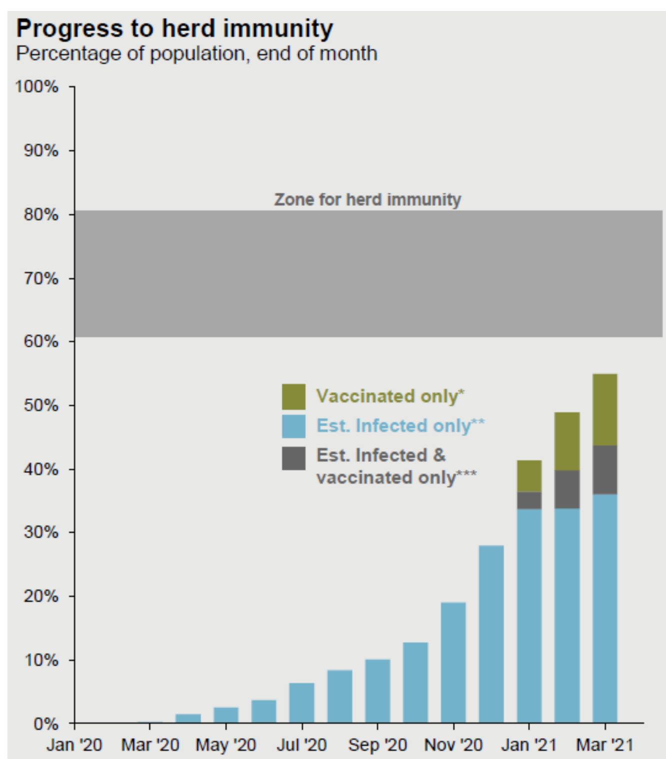
Equity Markets:

The 1st quarter of 2021 started out with significant concerns as covid cases and death rates peaked in mid-January (see below). At the same time the vaccines were being approved and distributed country wide. The consensus is that herd immunity occurs around 70% of the population. the prediction is that by May over 70% of the U.S. will have received a vaccine or had the infection. Combined with spring and summer weather, the consensus is that we will be back to some sort of normal in the coming months. The accelerated speed of vaccine distribution has reduced the attraction of the "stay-at-home" stocks and boosted the more cyclical stocks such as industrials, financials, and energy. Small caps, after being laggards through the 2nd and 3rd quarter have continued to rebound and outperformed large cap equity in the 4th quarter 2020 and 1st quarter 2021.

Interest rates (10-Year Treasury) have increased, though not to a worrying extant. They are still below what they were pre-pandemic in, January 2020. Interest rates are expected to increase slightly over the next two years with the Fed signaling that they will not increase the fed funds rate until 2023. Bond markets are forecasting that may move up to early 2022. Either way, rates may stay range bound between 1.50% to 2.0% for the next 18-24 months. With expanding GDP growth and falling unemployment, this presents a goldilocks opportunity for equity markets. Note the low and rising inflation chart above. Even with rising rates, equities across the board saw historically strong gains.

The real concern is an unforeseen recession with rates falling to near 0.5%, or unexpected acceleration of inflation above 2.5% in the short term. Those kinds of shocks would likely increase volatility and risk in the stock markets.





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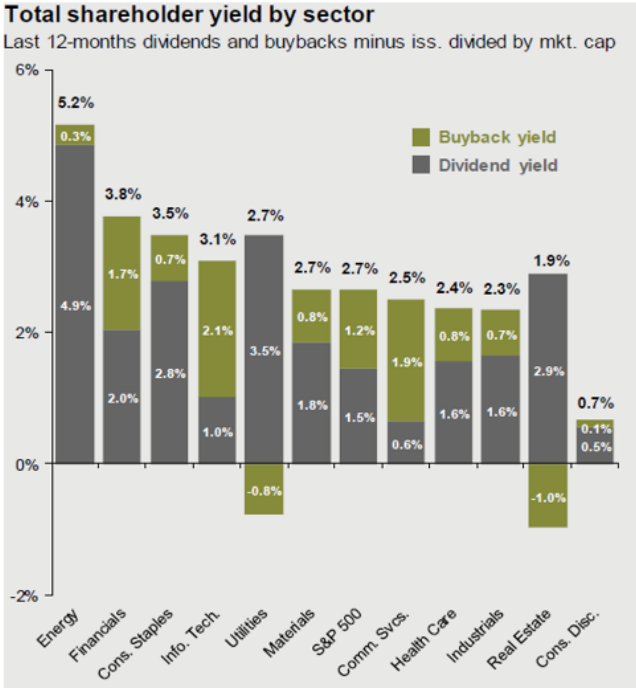

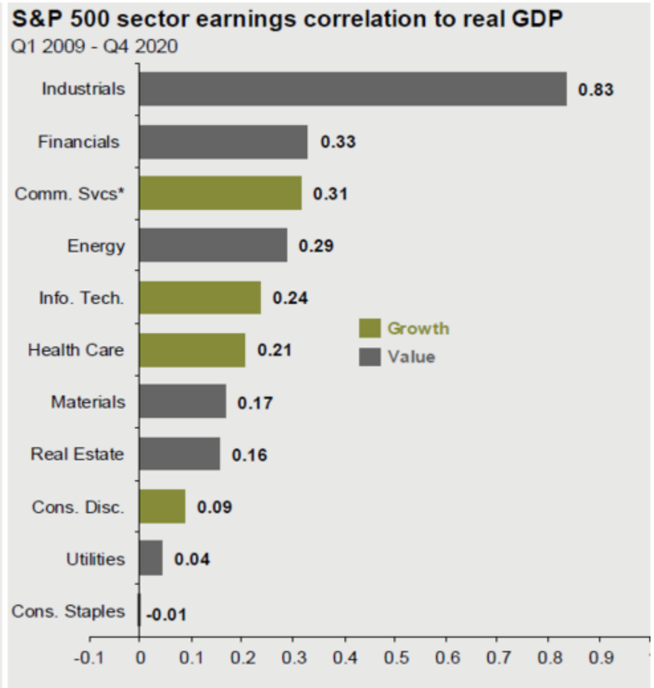

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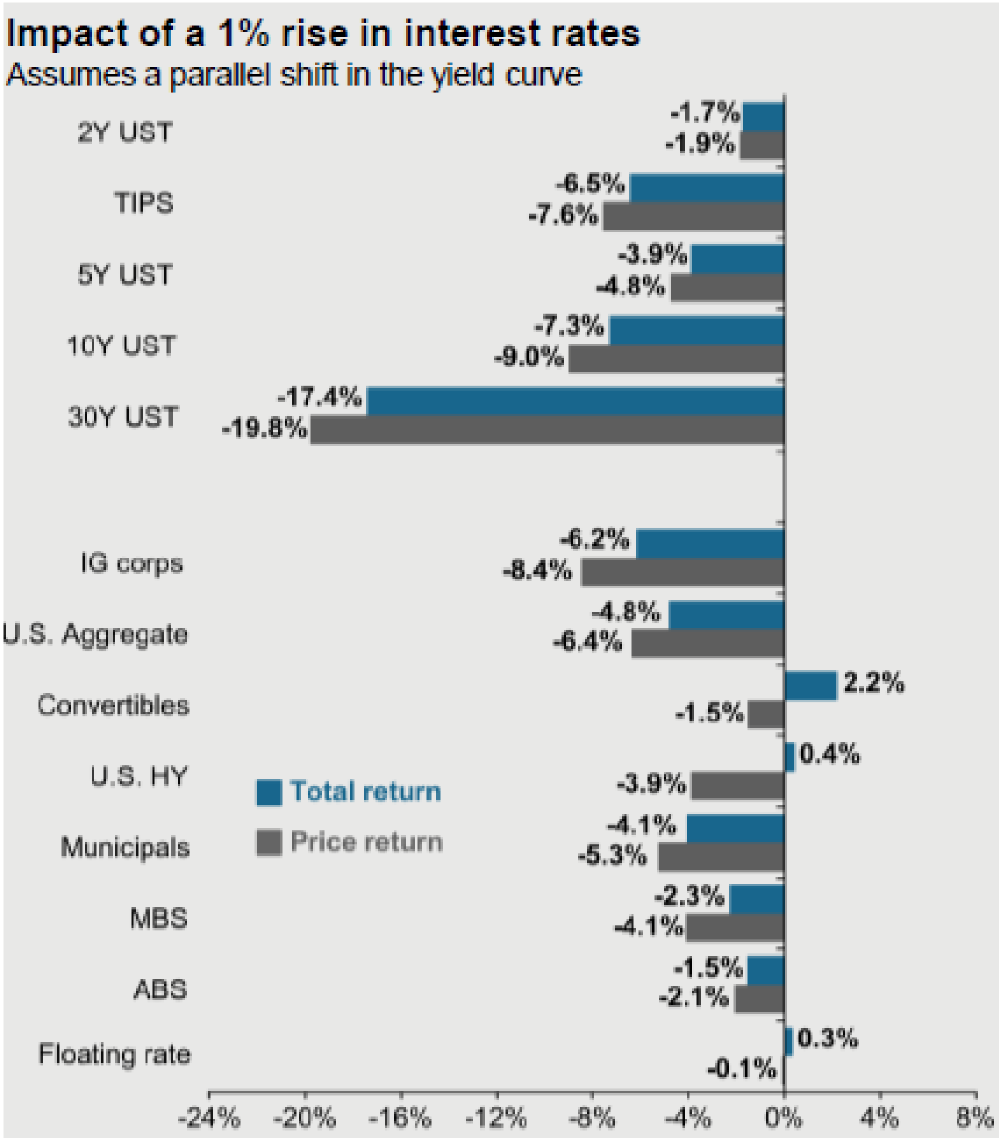
Looking at sectors within equity, value does show some promise even as it has started to catch up to the growth stocks that did so well in 2020. Dividends are an important part on equity investments and there are equity sectors paying well above the 10 year treasury. We see high cash flow, conservative companies, paying a 2.5% or 3.0% dividend as compelling investments in light of low interest rates.

The same can be said for Emerging Markets and International equity. 1st quarter, 2021, has continued the outperformance domestically making valuations overseas all the more compelling going forward. At some point this will turn and right now we maintain a diversified portfolio holding both international and domestic positions.

Fixed Income Markets:

1st Quarter, 2021 bonds took the brunt of the rise in interest rates with the Barclays Aggregate falling over 3%. The stimulus packages going through congress are making the headlines and drive discussion about rising inflation. The real driver, however, is the built-up demand of the consumer. Even without the stimulus checks and other government lending/spending, the consumer is ready to get back to doing what they do best; spending money! It will not happen overnight, but the consumer wants to buy cars, remodel kitchens, and go on an overdue vacation. There is still plenty of recovery that needs to take place, and not all sectors are expected to rebound to equal levels or at the same speed as other sectors.

We still see price increases, but it will be spotty and not immediate. Inflation won't be across the board but will hit each sector differently. Interest rates rising is part of the recovery and the expectation is that the rate of growth in interest rates will start to slow. The Fed certainly believes this is the case, at least for the next year or two.



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Real Estate:

Real estate was one of the areas that were hardest hit by the pandemic, especially commercial real estate. One area of surprise is the growth in residential real estate. It is now common to have multiple offers on homes and for those offers to be well above asking, especially in the right locations. Just like the rest of the economy, there are pockets of extreme price increases and areas that are still well below their pre-pandemic levels. Again, we don't see a need to overweight real estate in our portfolios, but we do believe that maintaining exposure is a prudent investment as part of our wealth management strategies.

Summary:

1st Quarter, 2021 showed promise that we are turning the corner towards recovery and away from the pandemic that was unescapable in 2020. Value, small cap, and real estate sectors outperformed growth, large cap, and bonds. Interest rates increased more than expected but stabilized towards the end of the quarter. Inflation is becoming a concern in the coming years, but the Fed is forecasting that short term rates will remain near zero through 2022.

Economic expansion through the remainder of 2021 is expected to be above 7%, which is well above normal. Growth should occur worldwide, with some sectors benefiting greater than others. Political events or market pitfalls are risks we watch for and protect against with a diversified portfolio. Even as bonds pay low interest rates, we understand that many of our clients don't want the higher volatility and potential for loss that occur with equities.

Your financial planner is here to help you protect your wealth while looking to grow with the economy at a risk level suited to your goals and needs. We thank you for trusting Academy Financial with you and your family's financial future. Here's to a prosperous 2nd quarter and remainder of 2021.

Sources:

1. Morningstar Data
2. https://am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/guide-to-the-markets/