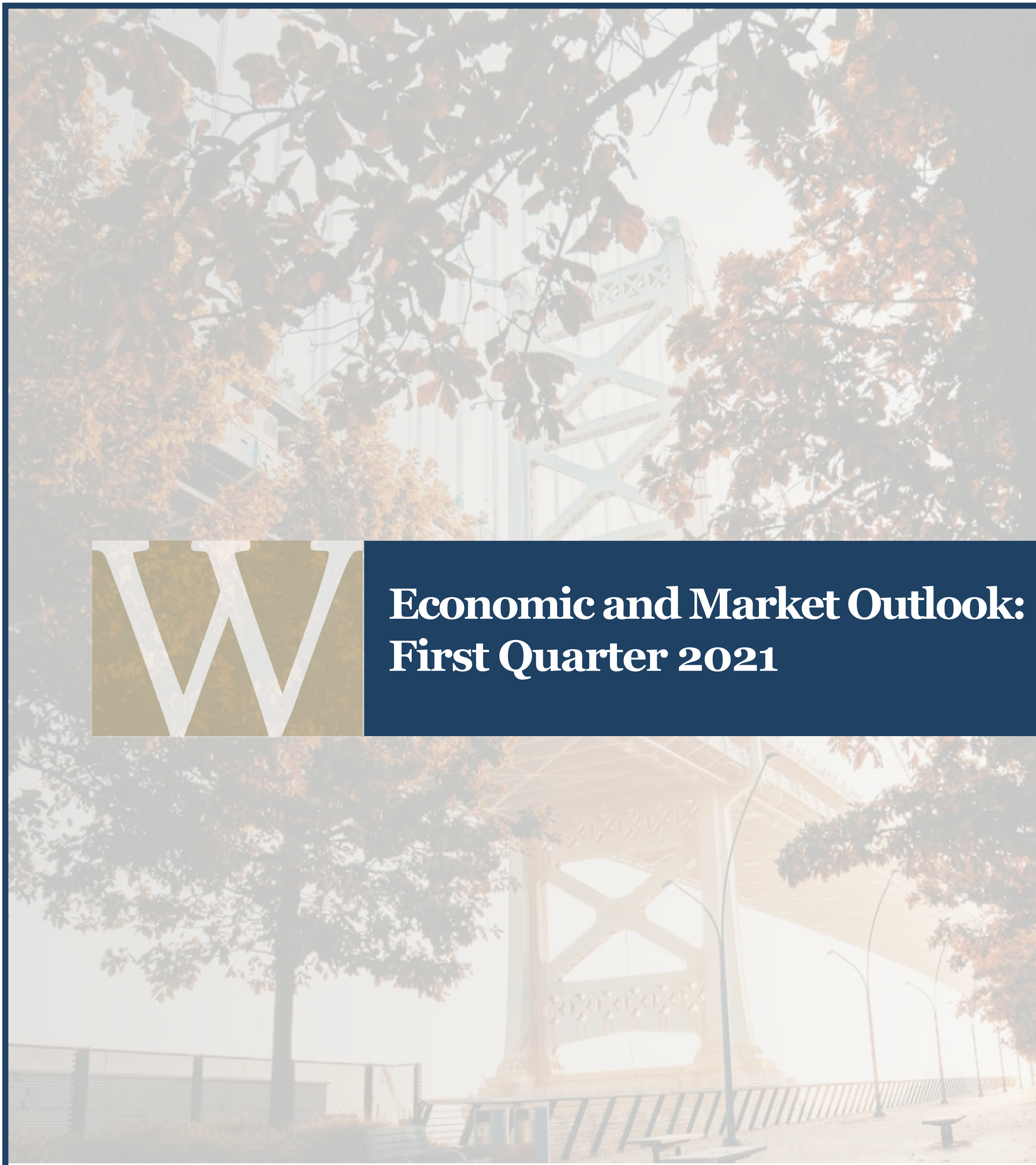

Economic and Market Outlook: First Quarter 2021

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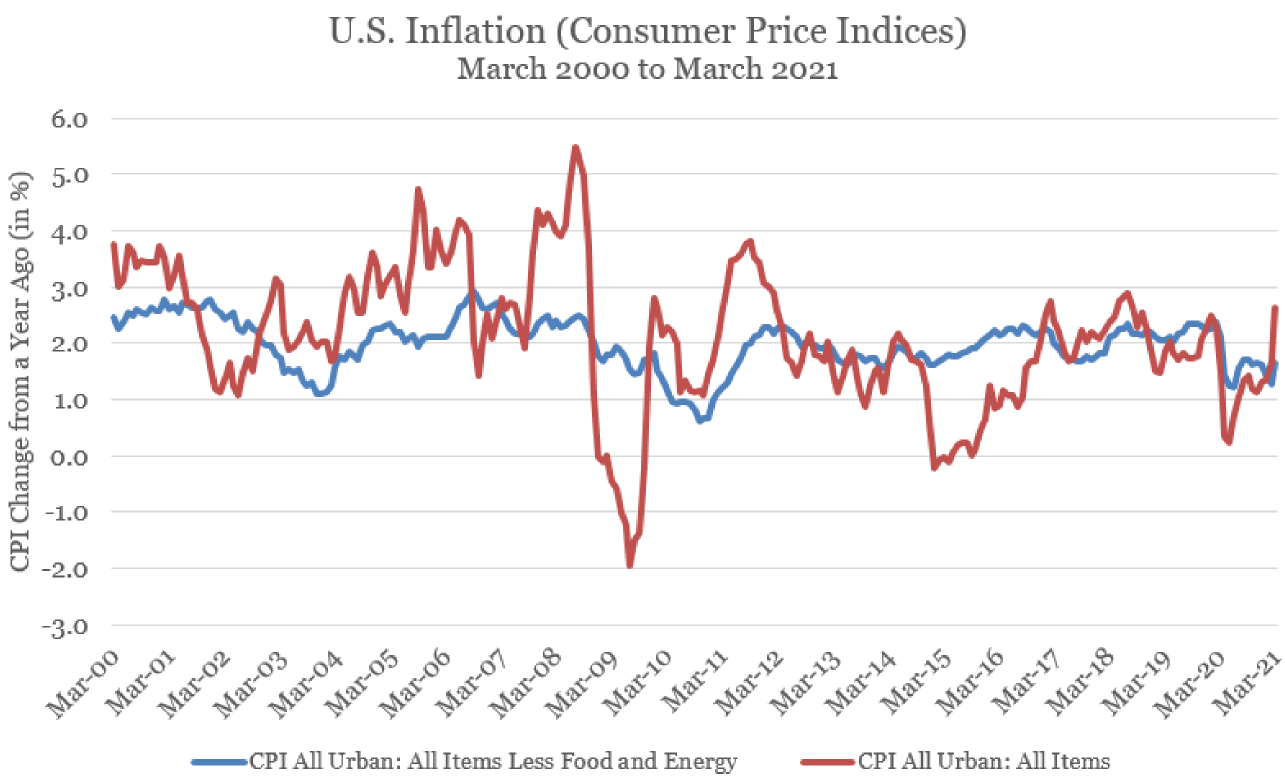
The economic recovery that followed the onset of the Pandemic in March of 2020 is accelerating on the back of generous fiscal stimulus, accommodative monetary policy and a generally successful roll-out of COVID-19 vaccines. Many businesses are reopening, employers are hiring again and consumers are spending. Growth is likely to remain strong in both the U.S. and Non-U.S. markets for the remainder of this year and into 2022.

Non-U.S. equities tend to outperform U.S. markets when global growth is improving. In addition, stock markets outside of the U.S. tend to do better when the U.S. dollar is weakening, and cyclical stocks do better in a weak dollar environment. Bond markets tend to weaken during periods of accelerating economic growth and this has been the case since late 2020. Wescott portfolios are currently positioned to benefit from this recovery environment.

With good news on vaccine deployment, the passing of the $1.9 trillion American Rescue Plan Act in March 2021 and the maintenance of lower borrowing rates, investors have gone from worrying that the U.S. economy was heading for recession to worrying that it is growing too quickly. Concerns that growth may be too fast are leading many to anticipate higher inflation and an increase in interest rates in the near future. However, the economy is still not operating at full capacity and as a result, it will be able to withstand temporarily higher inflation and even modestly higher interest rates as long as fiscal policy continues to remain supportive. The planned Infrastructure Bill being debated in Congress is good example of this.

Figure 1: U.S. Inflation Expectations are Rising



Source: U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items Less Food and Energy in U.S. City Average [CPILFESL], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CPILFESL, April 15, 2021.

The Consumer Price Indices are based on prices for food, clothing, shelter, and fuels; transportation fares; service fees (e.g., water and sewer service); and sales taxes. Prices are collected monthly from about 4,000 housing units and approximately 26,000 retail establishments across 87 urban areas in the United States.

Recent Inflation History

Since 2000, the core inflation index (less the most volatile components of food and energy) has remained quite stable, fluctuating between 1.0% and 3.0% over the past 20 years. In fact, since March of 2015, this particular measure of inflation has been well below the Federal Reserve's 2.0% target. The lack of inflation pressure has kept interest rates lower for longer, encouraging borrowing but discouraging savings. However, headline inflation (CPI for All Items) has had bouts of volatility over the past 20 years, the largest of which occurred during the Great Financial Crisis in 2008. During this period the housing bubble burst which immediately reduced household net worth, threatened the stability of the global financial system and led to recession and deflation (falling prices).

In late 2008 and early 2009, the Federal Reserve cut interest rates, initiated quantitative easing (a bond buying program designed to provide liquidity to the financial system and the general economy) and promised to keep their policy rates low until the economy recovered. In addition to this supportive monetary policy, U.S. Congress passed the Economic Stimulus Act of 2008, a $152 billion bill designed to stave off recession by providing tax rebates and other forms of financial support to individuals and businesses. The monetary and fiscal policies implemented in the wake of the last global recession were designed to offset the negative impacts from rising unemployment and general uncertainty about the future.

At the time, many investors feared that such accommodative policy would drive inflation higher, push the U.S. debt to GDP ratio well above sustainable levels and limit growth in the process. It turns out that this was not the case and while inflation did rebound from the initial decline in 2008, it leveled out at a modest annual rate of just under 2.0%. As we have written before, the 10 years following the last recession was one of the longest recoveries on record, but also one of the slowest. Because the economy did not rebound quickly and overheat, the pressure on prices that many feared never materialized.

Inflation Going Forward

The Pandemic-induced recession of 2020 was an external shock to the economic system and temporary compared to the internal economic shock of the financial crisis, which turned out to be longer lasting. Yet, the monetary and fiscal response this time was much stronger than it was in 2008 and that is what many investors are identifying as the reason why this time it may be different.

The most recent inflation reading by the U.S. Labor Department in March jumped 2.6% from a year earlier, driven mainly by a 9.1% increase in gasoline prices. The core CPI, which excludes food and energy, was up 1.3% for the year ended March and is expected to rise further in the months ahead, especially if input costs for raw materials continue to increase. In our view, inflation may in fact increase this year on a temporary basis, particularly as spending accelerates and energy use increases. However, U.S. inflation will only become a more permanent concern when the U.S. gets closer to full employment, and this is still some way off.

Our Current Outlook

The “Pandemic Trade” has given way to the “Reopening Trade”, and vaccinations will continue to enable sectors of the economy that have been closed to finally reopen in 2021. Economic growth will naturally accelerate as we return to our normal lives, both here and abroad. Pent-up demand will drive an increase in discretionary spending. Fiscal and monetary policy will remain accommodative to help repair the weakest segments of the economy and the planned infrastructure spending bill has the potential to “super charge” growth. We anticipate that the market rotation will continue to favor value stocks and global markets as global growth fully recovers.