The Cobblestone Advisor
Investment Brief

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COBBLESTONE
CAPITAL ADVISORS

A Historic Year

A month remembered all too well, March marked the one-year anniversary of the COVID-induced US shutdown. Students were abruptly notified that they would not return to school, and a large swath of the labor force would not return to their place of employment. Considering the trajectory of the virus and everything that has transpired since—in our personal lives and economically—it is hard to believe, even in hindsight, that the S&P 500 bottomed just one week after the shutdown began, rising largely uninterrupted from there to post new all-time highs less than five months later.

From its March 23rd trough through the end of the first quarter of this year, the S&P 500 rose +80.7%, or +78.4% annualized. The recent backup in interest rates notwithstanding, even US bonds delivered a +2.8% return over the holding period. While it was a lost year for many on a personal level—even optimists always keen on finding the silver lining—it was certainly not a lost year for investors who remained disciplined and stayed the course.

Fast forward to today, and we now stand at the crossroads of another potential inflection point. Vaccination rates are on the rise, COVID case and fatality counts have notably improved year-to-date, and many states are making material progress on reopening plans. These milestones are being reflected in markets, both in how investors are repositioning their portfolios and in how they are expressing their improved economic outlook.

As we highlighted in January, capital has been shifting into smaller, domestic-oriented and economically sensitive stocks, an indication that investors expect the cyclical recovery to continue. Though momentum in these trades stalled in the latter half of March, the trend that began in late 2020 remains intact, with small-caps outperforming mega-caps during the first quarter (+12.69% vs. +5.11%) and value stocks outperforming growth stocks (+21.03% vs. +0.83%).

Other market dynamics are giving off similar signals. Real estate, commodities, and other real assets that stand to benefit as aggregate demand rises have delivered notably strong year-to-date returns. As growth and the forward expectation for it has become more broad-based, investors have also been rotating out of tech names that traditionally benefit when growth is scarce. Bonds, meanwhile, have suffered, as intermediate- and longer-term yields have steadily risen in anticipation of a strengthening US economy. Further, signs of inflation are on the rise as seen in breakeven rates—market-based measures of expected US inflation—which have sharply increased off of post-global financial crisis lows plumbed during the depths of the pandemic.

Based on these changing market conditions, it is safe to say that investors are signaling expectations of rising economic growth accompanied by higher rates of inflation in the months and years ahead. While many of these developments could be taken at face

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Total Return (%), Ending 3/31/2021				Annualized		
	Qtr	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 Stock Index	6.17	6.17	56.33	16.75	16.27	13.89
Russell 2000 (Small-Cap Stocks)	12.69	12.69	94.82	14.71	16.32	11.67
MSCI EAFE (International Stocks)	3.48	3.48	44.57	6.02	8.84	5.52
MSCI EM (Emerging Markets)	2.29	2.29	58.39	6.47	12.06	3.65
Bloomberg Barclays US Aggregate Bond Index	-3.37	-3.37	0.71	4.65	3.10	3.44
Dow Jones US Select REIT	10.00	10.00	36.57	7.52	3.91	7.87
Consumer Price Index (% Chg over Period; One-Month Lag)	0.86	0.61	1.73	1.82	2.06	1.72

value as good news, massive monetary and fiscal stimulus injections are stoking runaway inflation fears. Investors are concerned that if inflation does heat up to unpalatable levels, Federal Reserve policymakers may step in and raise interest rates, turning off one of the spigots that has provided free-flowing liquidity throughout the crisis and thereby putting the brakes on the economic recovery.

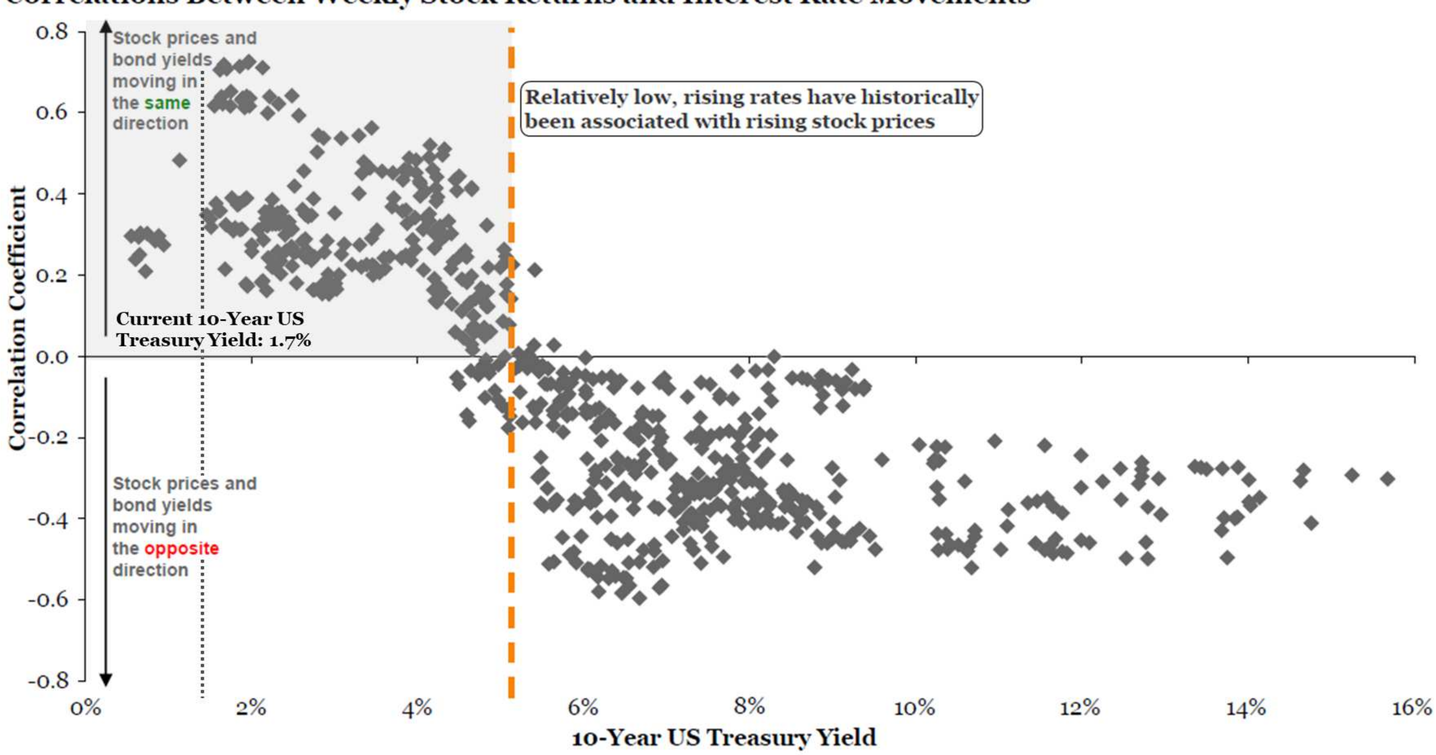
Given that rising inflation significantly contributes to rising interest rates, it is understandable that the prospect of higher inflation and rates is causing consternation among investors. Of specific consideration is how portfolio returns will be impacted and what action, if any, is necessary to prepare for the inflationary, rising rate environment that may lie ahead.

As we consider the paths that may unfold in the coming months and years, it is worth noting that over long time horizons, globally diversified stocks have been very effective at hedging against inflation. This is especially true for companies with pricing power, as they have the ability to raise prices and insulate profits from inflationary impacts. International equity exposures also provide inflation protection for US investors via foreign currency appreciation that would likely follow an extended period of rising domestic inflation. Alternative asset classes (including private investments) such as real estate, commodities, and other real assets can effectively hedge against inflation risk as well. As long as an investor's portfolio contains exposure to the aforementioned asset classes and is appropriately positioned for their individual circumstances, we do not recommend taking any additional action in anticipation of rising inflation.

To the extent that higher levels of inflation do ultimately materialize and usher in a period of rising interest rates, the analysis shown below should assuage investor fears. Over 57 years of data show that when the 10-year US Treasury yield was relatively low—as is the case today—rising interest rates have been associated with rising stock prices. This makes sense, as relatively low, rising interest rates signal a healthy, well-functioning economy. Once rates move beyond a certain threshold, however, rising rates can choke off growth: as the cost of borrowing increases significantly, it slows the amount of borrowing, which slows overall economic output.

With modest inflation and the 10-year US Treasury yielding 1.7% as of April 1st, we are a long way from what history has shown to be problematic interest rates for equities. Even so, a well-diversified portfolio has the potential to not only hedge inflation risk, but benefit from it.

Correlations Between Weekly Stock Returns and Interest Rate Movements



Source: FactSet, FRB, Standard & Poor's, J.P. Morgan Asset Management. Returns are based on price index only and do not include dividends. Weekly S&P 500 returns, 10-year US Treasury yield, rolling 2-year correlation. Markers represent monthly 2-year correlations only. Data range of May 1963 through December 2020.