

“It was the best of times, it was the worst of times” – Charles Dickens

The themes of Dickens’s great novel *A Tale of Two Cities*, are contrast and resurrection: and so too as we reflect on the end of the first quarter of the year, we contrast the starkness of the pandemic to the tremendous future opportunity embedded in the U.S. economy. For everything we’ve been through, we are still rather fortunate. The United States by all accounts is in the final stages of the pandemic, and as we transition to what we hope are “normal” times, we take note of the historic changes that are afoot. Not only did we elect a new President, we also elected the first woman and person of color as Vice President. Congress passed the largest stimulus package in history of \$2 trillion in March 2020, a \$900 billion stimulus package in December 2020, and the \$1.9 trillion American Rescue Plan in March 2021 – all of which will likely be followed by a \$2 trillion infrastructure/climate change bill. This extraordinary government stimulus is coupled with a record-breaking “quantitative easing” program by the Federal Reserve, purchasing \$120 billion of bonds per month. These unprecedented government actions helped tide Americans over during the deep economic contraction that accelerated during the national lockdown. Fortunately, and again groundbreaking, medical science has manufactured several Covid-19 vaccines in record time. The vaccination rollout has come swiftly enough so that consumers are contemplating and planning for a “back to normal” lifestyle in the coming months. As a result of this pent-up demand, the Federal Reserve expects GDP to grow 6.5% in 2021, the strongest in over 35 years.

With the expectation that the Covid-19 pandemic will soon be firmly in the rearview mirror, investors have begun to recalibrate their outlook, taking into account the stimulus and its effect on the economy; this has led to an increase in inflation expectations over the next 6-12 months. During the first quarter, after hitting a low of 0.51% last August, the yield to maturity on the 10-year Treasury note increased from 0.92% on January 1, 2021 to 1.74% on March 31, 2021. This rapid rise in yield – and concomitant decline in intermediate/long-term maturity bond prices – is in response to the higher growth and inflation expectations. Given this post-pandemic new era, we believe that it is possible that the multi-decade bull market in fixed-income may be coming to an end. To calm the nerves of the bond market, in early March the Fed announced that there would be no tapering of the quantitative easing nor any interest rate increases until “substantial further progress” was made on jobs and inflation.

The AHB taxable and municipal bond portfolios are structured in evenly-laddered maturities which provide regular opportunities to reinvest maturing bonds at higher rates when they are available. The portfolios are skewed to the short and intermediate term – not long term – and are therefore relatively insulated against changes in rates. Despite a decline in bond prices, the portfolios will receive the full return of principal at the rolling maturity dates. The trend toward a “normalized” rate of inflation and higher bond yields is a boon for future retirees and those who seek to protect principal yet desire a reasonable low-risk return.

Although bond prices decline as interest rates rise, stocks typically rise in an environment with modest inflation when it coincides with an acceleration of economic growth. As mentioned earlier, the Federal Reserve has held interest rates *historically low* for a *historically long* period of time. Pre-Covid-19, monetary policy had been expansionary in an attempt to stave off deflation and nudge inflation closer to the Fed's 2% annual target rate. After the onset of the pandemic, these expansionary policies were maintained to manage the economic slowdown caused by the pandemic. As investors are aware, stocks' long term average return is 8-10%. With bond yields well below 1% last year, investors were willing to pay more for stocks, particularly high-growth equities, driving up multiples. During the first quarter, as inflation expectations have increased, investors are rethinking the appropriate valuation for high valuation stocks in a potentially higher interest rate world.

The Information Technology and Biotechnology sectors, which had the highest valuations due to the expected faster rate of earnings growth, have been the most negatively impacted during the quarter. The best performing areas included Financial Services, Industrials, and Energy, all of which are expected to benefit from consumer and government spending, and in the case of financials, from higher interest rates. During the quarter, AHB Custom Balanced and Equity portfolios added positions in industrial companies that we expect to benefit from the anticipated infrastructure bill, and financial service companies that will benefit from the steeper yield curve. The market and portfolio rotation is a repositioning for the economic growth that we expect this year. Although the client portfolios hold a significant position in the information technology sector, the stocks are diversified to include software, hardware, semiconductors and those that benefit from the continuation of the shift to a cashless society. We believe the decline in the technology stocks will be a transient trend until investors gain more visibility on the inflation rate. The highest earnings growth will still be achieved by companies delivering technological innovations that is, both traditional tech and biotech. The assessment of what is a reasonable valuation for this growth in a higher interest rate environment will continue to influence investors' decisions

There is a great deal of uncertainty about the future. It is a time of more questions than answers. How will the US be transformed by the pandemic? What will the transition look like when employees come back to the office? How will consumers make choices about where and when to travel? What impact will higher corporate and individual taxes have on economic growth, inflation and capital spending? Will the dollar devalue as a consequence of massive government spending? How will the acceptance of cryptocurrencies affect global growth? How will Robinhood and Reddit provoke affect the younger generations' perception of investing?

As stewards of client assets, we will evaluate, measure, analyze and, anticipate changes, as we forecast the probabilities of the various outcomes. Our team is tenacious and diligent in its pursuit of answers to achieve attractive risk-adjusted returns. We look forward to watching the post pandemic world unfold and positioning client portfolios to benefit from these dynamic changes.

April 2021

Thank you for your confidence, support and friendship as we move together through these turbulent times.

In good health,

AHB Investment Team