1st Quarter 2021

Market Recap
Performance Review
and Near-term Outlook

Market Recap

Studying actual Q1 investment and economic data versus popular commentary throughout the quarter brings to mind tempests in teapots. Of sound and fury, signifying nothing! Of clickbait versus insightful narrative. The constant fretting, the wailing, the gnashing of teeth over what I believed then to be, and is now proving to be, transitory conditions, was wildly overdone.

Reading the headlines, one would think Q1 was a chaotic wash-out rather than a solidly positive quarter. Sure, we saw three periods of general market decline. And household-name technology and consumer stocks continued to lag. But mean reversion and sector rotation are ordinary forces in healthy markets. Particularly so when historical relationships are stretched to extremes. As anticipated, markets quickly rebounded each time. And long-unloved sectors continued to shine, providing support to broad market averages.

As measured by the Russell 3000 Index, a measure of the largest 3,000 US companies and a proxy for the complete US stock universe, stocks climbed +6.35% during Q1, for an eye-popping one-year return of +62.53%. The tech-heavy growth component climbed a more modest +1.19%, for a one-year return of +64.31%. And while the long-unloved value component climbed ten-fold the growth component's contribution — a Q1 gain of +11.89% and a one-year return of +58.38% — that would only close some of its years-long performance gap. Not all.

> Our real discoveries
> come from chaos,
> from going to the place that
> looks wrong
> and stupid
> and foolish.
>
> **Chuck Palahniuk, Invisible Monsters**

Reviewing quickly, for most of 2020 the opposite was true. It was a small group of mega-cap technology and consumer stocks that lifted broad-market averages from the lows of the pandemic downturn. The technology and consumer stock recovery was driven by the "stay at home" trade, monetary and fiscal stimulus, and historically low interest rates. Other market sectors were helpless victims of the pandemic shutdown. Cyclical, value oriented sectors such as industrials, energy, materials, and banking, along with travel/leisure, and the small-company space watched as their revenue and stock prices collapsed.The divergence in performance of the largest of the US technology and consumer company stocks versus essentially the rest of the market reached historical extremes.

US Real GDP decreased -3.5% in 2020. Surpassing the worst year of the Great Financial Crisis (2009 at -2.5%), 2020 saw the most severe contraction of economic activity of the last 75 years. The decrease in Real GDP reflected decreases in nearly every category; personal consumption expenditures, exports, private inventory investment, non-residential fixed investment, and state and local government spending. Decreased imports, residential fixed investment, and federal government stimulus were all that kept recession from becoming depression.

Again, mean-reversion is a powerful force. By year-end, Real GDP was already back on the upswing, increasing at a rate of +4.3% during Q4 2020. The late-January release of the Federal Reserve Bank of Atlanta's GDPNow™ first estimate for Q1 2021 GDP came in at +5.2%. The "blue sweep" of the US Presidential election cycle, and with it approval of additional economically expansive policy measures, along with the ramping up of world-wide COVID-19 vaccine efforts, further stoked growth expectations. The most recent GDPNow™ estimate for Q1 2021 GDP stands at +8.3%. Early projections for Q2 2021 reach as high as +10.0% growth. With confidence widening that further economic reopening during Q1 would most benefit sectors and stocks yet to fully recover, investor attention remained on still-cheap small-company and value-oriented cyclical stocks.

- When looking at small-company stocks a similar and as eye-popping pattern is exposed. The Russell 2000 Index climbed +12.70% during Q1, twice the return of large-company counterparts, for a one-year return of +94.85%. While the small-company growth component climbed +4.88% during Q1, for a one-year return of +90.20%, the value component climbed four-fold with a return of +21.17%, for a one-year return of +97.05%.
- The rotation pattern reveals itself clearly within market sector returns. The long-unloved, value-oriented, cyclical sectors, such as Energy (+30.61% Q1) and Financials (+15.92% Q1), those which we have avoided for several years, did lead during Q1. Each did best our growth-oriented sector portfolio overweights of Technology (+2.13% Q1), Communications (+8.76% Q1), and Health Care Tech/Medical Devices (+0.95% Q1).

The most lamented fear during Q1 was the return of run-away inflation. For all the worry, and the impact on both bond markets and growth-oriented stocks, both the January and the February year-over-year CPI increases,+1.4% and +1.7% respectively, were well below the Federal Reserve's long-run inflation target of +2%. However, the March report showed that CPI rose by 2.6% on a year-over-year basis. At first glance, the March number might justify inflation fears as it is above the Fed's long-run target. There are two key reasons why I am unconcerned, and expect CPI to fade moving forward.

- A large component of the March surge came from gasoline prices, a particularly volatile component of CPI. Gasoline's +9.1% March increase was almost entirely a function of February's Gulf Coast cold snap and the resulting grid-failure in Texas shutting down a significant percentage of US refining capacity. Excluding energy and food, the March year-over-year CPI increase falls to +1.6%. Essentially, in line with trend.
- March's CPI increase is also unduly influenced by the *base effect*. "Base effect" is a term describing distortions in data that occur when one observation is compared to another uncharacteristically high or low observation. In this case, the March 2021 report is compared to numbers from March 2020, when underlying data collapsed due to the COVID-19 shutdown. During 2020, the US experienced three successive months of deflation, from March through May, leading to uncharacteristically low CPI levels. Now, 2021 recovery data is being measured against those uncharacteristic, deflationary, 2020 observations creating distorted 2021 results. We will continue to see skewed inflation readings throughout 2021 as the year-over-year base effect fades.

As Q1 closed, more investors joined our long-held view that inflationary pressures are transitory. Pressures that do exist are largely COVID-19 related pent-up demand, and "bottleneck" supply chain disruptions. Nonetheless, fear that holding portfolios of low yielding bonds in an environment of rapid inflation and rising interest rates would bring down bond prices was a self-fulfilling prophesy of falling bond prices and rising interest rates. Watching this about to unfold, mid-quarter we moved most client bond allocations to an "inverse" bond ETF, one that via swap agreements provides the opposite return of the underlying Treasury bond portfolio. With this move, we secured positive returns for those bond investments, while most traditionally managed bond products experienced some measure of loss.

Performance Review

Lake Jericho managed and advised portfolios are typically invested in some variation of either one of two strategies - either (1) a global-macro strategy broadly diversified by geography, asset type, and sector, executed via exchange traded funds, or (2) a concentrated individual stock/bond strategy heavily biased towards US large-company technology, health care, and consumer-focused stocks. Within each strategy the sector, asset type, and geographic diversification or concentrations have meaningful impact upon returns.

Given our recent sector overweight performance lag, one would conclude that client portfolios failed to keep pace. It is true that our individual stock strategy has lagged since the Presidential election due to concentration within the large US technology and consumer spaces amid the unwinding of the "stay-at-home" trade. Thus far during Q2, those influences have softened, moving back towards long-run trend, and the strategy has begun to close the recent performance gap. In contrast, our global-macro strategy, constructed with broad diversification linked to top-line total market performance factors independent of individual sector performance, and with a constant commitment to small- and mid-sized company stocks, provided for meaningful outperformance during Q1.

The iShares Core Allocation ETF Portfolio Benchmark Series
Total Return Comparisons For All Periods Ending March 31, 2021

Core Allocation Portfolio (Ticker)	Q1 2021	YTD 2021	1 Year Return	3 Year Total Return	5 Year Total Return
Conservative (AOK)	-0.15%	-0.15%	16.51%	21.68%	35.86%
Moderate (AOM)	0.76%	0.76%	21.42%	24.13%	42.40%
Growth (AOR)	2.51%	2.51%	31.96%	29.00%	56.01%
Aggressive (AOA)	4.22%	4.22%	43.24%	33.66%	70.16%
S&P 500® Index Total Return	6.17%	6.17%	56.35%	59.25%	112.67%

The iShares Core Allocation ETF Portfolio series is designed to meet the needs of investors who would like to maintain fixed target levels of exposure through a portfolio diversified across domestic, international, and emerging market equities, bonds, and other instruments. The Core Conservative Allocation Strategy seeks approximately 30% exposure to global equity markets. The Core Moderate Allocation Strategy seeks approximately 40% exposure to global equity markets.. The Core Growth Allocation Strategy seeks approximately 60% exposure to global equity markets. The Core Aggressive Allocation Strategy seeks approximately 80% exposure to global equity markets. Presented here is the iShares Core Allocation ETF Portfolio Benchmark NAV total return performance as reported by iShares, constructed with no investment advisor fees, and with no transaction costs, while Lake Jericho portfolio performance is actual performance, net of all fees, including investment management, administration, and transaction expenses.

Reviewing the bulleted benchmark returns that follow, you will see where and how Lake Jericho managed and advised portfolio returns were impacted. Within the tabled data we present the iShares (by Blackrock) Core Allocation ETF Portfolio Series benchmarks. Lake Jericho provides the tabled information for a relative performance comparison against independent, balanced, globally diversified strategies managed to similar risk profiles.

- The Dow Jones Industrial Average, 30 "blue-chip" US companies with an industrial company bias, finished Q1 with a total return of +8.29%, for a one-year total return of +53.78%.
- The S&P 500® Index, a broad, but committee selected index of 500 large-cap US companies, finished Q1 with a total return of +6.17%, for a one-year total return of +56.35%.
- The technology and consumer-cyclical heavy NASDAQ Composite Index finished Q1 with a total return of +2.95%, for a one-year total return of +73.40%.
- Small- and mid-sized companies, as a group measured by the Russell 2500™ Index, finished Q1 with a total return of +10.93%, for a one-year total return of +89.40%.
- International developed markets, as measured by the MSCI World (ex-USA) Investable Market Index, finished Q1 with a total return of +4.17%, for a one-year total return of +48.47%.
- International emerging markets, as measured by the MSCI Emerging Markets Investable Market Index, trailed their developed markets counterparts to finish Q1 with a total return of +2.86%, for a one-year total return of +61.09%.
- The Bloomberg Barclays US Aggregate Bond Index, a measure of the performance of the US investment grade bond market, finished Q1 with a total loss of -3.37%, for a one-year total return of +0.71%.

Near-term Outlook

The tl;dr version of this quarter's *Near-term Outlook* is that I expect market sentiment and sector leadership to move back in our favor. Of the "must see" factors discussed in last quarter's *Outlook*, all are now working to support our continued global growth thesis and our long-run portfolio positioning.

- Additional vaccine approvals and the wildly improved efficiency of widespread vaccination efforts are loosening COVID-19 restrictions in the US.
- Additional Federal stimulus is bridging the gap for consumer, small business, local and state government expenditures. Foreign developed markets continue to see ample support as well.

- As big banks kicked off the Q1 earnings reporting season, early releases suggested that even with almost non-stop upward revisions, Wall Street analysts have not kept up with where corporate results have trended over the last several months. The Q1 earnings season is off to an exceptionally strong start with 90% of the S&P 500® Index companies reporting thus far have topped expectations by more than 20% on average. The beat rate is three times the historical average.
- Market breadth continues to improve, meaning a larger number of stocks have been propelling the markets higher. Investors look to this technical measure for indications about where stock prices are headed next. The more stocks rising together, the stronger the signal that a rally has room to run. Lately, signs of strong breadth have rebounded, a reversal from much of the past year when a only that small group of large technology and consumer stocks drove much of the market's gains.
- The Fed continues to assure markets that it will not raise short-term interest rates any time soon, and suggests that short-term rates will remain near zero through 2023. Although transitory pressures driving long-term rates higher currently exist, I do not believe those pressures will persist.
- The trends in initial unemployment claims continue to the downside. Yet great gaps exist between those recovering, and those that are not. But headline averages continue to improve. The most recent week's initial claims report saw the four-week moving average fall to the lowest level since March 14, 2020. I expect the trend to continue downward as enhanced benefits expire and the labor market recovery gathers momentum. However, the US is still more than 8 million jobs below February 2020 levels, indicating the labor market recovery has a very long way to go. This fact continues to be reflected in stubbornly lower personal income, disposable personal income, and personal consumption expenditures in the US. On the bright side, the current personal savings rate doubles that of pre-pandemic levels, typically signaling pent-up demand waiting to be released.

Likely by late 2021, and into 2022, we will be grappling with the effects of another mid-term election cycle. One must assume that state and federal budgets deficits, and the tax implications resulting from COVID-19 support, will receive top-billing. Although I did not believe that Federal tax increases were ultimately necessary, they do seem increasingly likely. And they are increasingly so already being priced into equity markets. So I do not believe the passing of nominal additional tax legislation will dramatically impacts stock prices. However, the potential for significant tax increases purely for debt reduction, and the contractionary effects that has on economies, is among the reasons that I continue to model lower-than-trend long-run GDP growth rates. For now.

From the early days of the COVID-19 downturn, I held far more conservative expectations for economic recovery than consensus. My projecting of a negative-GDP growth rate for all of 2020 was spot on. My forecast of not returning to even lower sustainable growth rates until mid-2021 is certain to hold. However, done correctly, for the right reasons, tax increases to support significant domestic investment and jobs growth could dramatically increase *sustainable* long-run GDP growth rates. Absent that, shifting of our global growth thesis to "lower for longer", and of more subdued average equity returns going forward is likely to hold.

As always, I am available at any time, any day of the week, to discuss anything within this Outlook, or specific portfolio performance questions. Until then, be well. And thank you!

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