IRONWOOD
Investment Counsel, LLC

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What a Year It Has Been

Ironwood Investment Counsel, LLC constructs and manages customized investment and wealth management programs designed to meet our clients' unique goals and objectives. Our distinctive process maximizes performance through return enhancement, risk reduction, tax efficiency, and cost containment.

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A year ago, the U.S. registered its deepest economic contraction since the Second World War. One year later, the economy is poised to post its strongest year of growth in almost four decades. Economic activity is gaining traction, thanks to expanding vaccine distribution, lowered public health restrictions and substantial fiscal support. For the first time since the outbreak, the economic risks for the U.S. are tilted to the upside. The outlook is generally brightening, but uncertainty around the efficacy of current vaccines against mutated versions of the virus, which could cause a return of lockdowns, remains a key risk.

The labor market has renewed its recovery, as reflected in the strong March employment report. Specifically, hiring increased by 916,000 jobs, the highest monthly total since August of last year. The headline unemployment rate declined by two-tenths to 6.0%, down from a peak of 14.8% in 2020. However, the recovery is far from complete, with total employment still 8.4 million below the pre-COVID level. We expect the hiring surge to continue for the next several months as employers position themselves for growth in the most beleaguered sectors.

Household discretionary spending is another driver of recovery. The recently passed American Rescue Plan (ARP) will add to already elevated excess savings, which should fuel consumption during the balance of the year. The ARP will not only provide support to households through checks, unemployment insurance, and new tax benefits, but will also deliver assistance to businesses and state/local governments.

The Federal Open Market Committee reaffirmed its dovish stance, despite higher projections for economic growth. The Fed also ruled out the need to contain long-term rates, noting very easy financial conditions overall. With no planned FED funds rate increases on the horizon, equities continued to perform well in the first quarter. The 4.7% year to date global equity return masked a significant rotation into stocks likely to benefit from economic reopening, such as value and cyclicals. U.S. equities led the major regions with a 6.3% gain driven by our world-leading effort to administer vaccinations. Businesses with smaller market capitalization increased by over 12%, as many stand to benefit from domestic reopening and accommodative monetary policy. Despite Europe's ongoing virus troubles, developed markets outside the U.S. benefitted from cyclical exposure to rise 4.3% for the quarter. Overall, rising interest rates and inflation concerns weighed on equity returns, but inoculation, economic reopening, and stimulus tailwinds proved too powerful.

Though there is valuation risk for equities, this risk seems to be subsiding. In 2020, the forward P/E ratio for the S&P 500 hit a multiple of 27 times earnings, a level that most investors would consider elevated. While stock prices have risen, the primary culprit for recently elevated P/E ratios was the collapse of earnings. As the economy opens up, actual and estimated earnings are rising sharply. The result is a decline in P/E ratios to a level around 21 times earnings, not cheap, but at the higher end of reasonable.

Rising inflation and the return to economic normality have pushed intermediate and longer-term interest rates higher. However, the Fed's commitment to maintain an ultra-accommodative policy in the face of increased economic activity has kept short term rates low. The yield on the 10-year U.S. treasury increased to 1.7% at the end of March from less than 1% in the fourth quarter in 2020. As a result, some bond sectors experienced their largest quarterly declines in years with the Bloomberg Barclays Aggregate Index down more than 3% for the quarter. Ultimately, this sharp increase in rates will create more opportunity in fixed income and validates the economic recovery.

In summary, our return expectations are derived from our economic and earnings growth projections. While we acknowledge the short-term volatility that investor sentiment can cause, our emphasis on the longer-term allows us to focus on the economic fundamentals. Gross Domestic Product (GDP) is estimated to have declined by 3.5% last year. We expect that GDP growth will soar to 6% this year, and then gradually return to a sustainable rate of around 2%. This scenario implies manageable increases in inflation and interest rates, and solid earnings growth. The risk to this scenario would be an overheated economy, probably due to excessive monetary stimulation. This situation would prompt the Fed to raise interest rates in an attempt to control inflation. On the other end of the spectrum, aggressive fiscal policy could spur job growth and consumer spending, allowing GDP to grow at 2.5 to 3.0%. We regard the path to 2% GDP as probable, but any of these three scenarios is possible.

Finally, after a period of rampant speculation in equities like GameStop, with no supporting economic fundamentals, we are pleased to see evidence of a re-emergence of quality companies as market leaders. Respected investment advisor Jonathan Morgan stated it this way: "*We remain loyal to quality because it reduces the range of potential outcomes and provides a higher level of confidence that the result of an investment will be favorable.*" We believe our commitment to quality serves our clients well.

We value the confidence that you place in us, and appreciate the opportunity to be of service. Please let us know if you have any questions, or would like to meet to discuss your portfolio in greater detail.

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