Key Private Bank

Key Investment Perspectives

First Quarter 2021

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Capital markets

Risk assets experienced far less volatility in the first quarter of 2021 than they did during the same quarter of a year ago. However, risk allocators did have to combat exogenous news and trading shocks from multiple sources. Large multi-directional moves in risk markets occurred during the quarter in reaction to civil unrest and to more promising economic and company earnings data.

In domestic affairs, the year began with the US Capitol being stormed by election deniers, which was followed weeks later by the inauguration of President Biden in front of hundreds of National Guard members. January ended with a short squeeze in many of the stocks widely shorted by hedge funds, although strong company earnings reports paved the way for a market recovery as the quarter unfolded. Inflation expectations in the US leapt back into the investment conversation during March after remaining in the shadows for the better part of a decade — something we identified as a possibility in our 2021 Outlook. US interest rates rose quickly on strong demand for goods and services as pent-up discretionary income and stimulus spending began to be unleashed on parched local economies.

Globally, vaccine rollouts have been strong in some countries and weak in others. Sadly, while cases and deaths from the COVID-19 virus have fallen sharply in the US, they remained higher than the 2020 peak in the eurozone, the UK, and select emerging market countries such as India and Brazil. Moreover, the eurozone has had trouble meeting its vaccine quotas and, as a result, lockdowns have been reinstated. Continued failures in vaccinations would put that region far behind the rest of the world as economies continue to dig out from the most unusual year.

Conversely, a strong vaccine push among older high-risk patients in the US led to a shift in COVID case demographics. Many new cases are cropping up in younger people, who are less susceptible to the worst symptoms and side effects of the virus and also recover quicker. As a result, most local economies are beginning to remove lockdown restrictions. While cases began rising late in the quarter, hospitalizations and deaths remained steady or declined. Elsewhere, China continues to lead the way in getting back to normal and announced new initiatives for their next 5-Year Plan at the National People's Congress during March.

All told, risk assets had a strong rally during the last quarter of 2020, and this year has started with a continuation of such outsized performance. However, market leadership has been shifting toward more-expansionary/cyclical assets and away from the narrow market leadership of the past few years — another trend we foresaw in our beginning-of-the-year forecast.

First Quarter 2021 Market Data

Asset Classes	3 Month	YTD	1 Year	3 Year*
US All Cap	6.35	6.35	62.53	17.12
US Large Cap	5.91	5.91	60.59	17.31
US Small Cap	12.70	12.70	94.85	14.76
US Large Cap Growth	0.94	0.94	62.74	22.80
US Large Cap Value	11.26	11.26	56.09	10.96
US Small Cap Growth	4.88	4.88	90.20	17.16
US Small Cap Value	21.17	21.17	97.05	11.57
Developed International	4.06	4.06	50.25	6.70
International Emerging Markets	3.12	3.12	57.10	6.47
US Treasury	-4.25	-4.25	-4.43	4.09
US Investment Grade	-4.65	-4.65	8.73	6.20
US High Yield	0.85	0.85	23.72	6.84
Municipal Bonds	-0.35	-0.35	5.51	4.91
Real Estate	8.32	8.32	34.24	10.78
Commodities	6.92	6.92	35.04	-0.20

Sources: S&P GSCI, Russell, Barclays, Key Private Bank.

* Annualized returns

Global equities

US equities had a strong start to the year, finishing the first quarter up 6.4%. Large cap securities returned 5.9% while small cap securities (up 12.7%) continued their market leadership that began late in 2020. There was also a wide dispersion between growth and value stocks. Value stocks tend to be economically sensitive in nature and outperform in the early stages of an economic recovery. In the US, large cap value outperformed large cap growth by 10.3% during the quarter. In small cap, the gap was even more pronounced as small cap value outperformed small cap growth by 16.3%. Sectors hurt most by the global shutdown last year – particularly Energy and Financials – are the leaders so far this year.

International equity markets have been more volatile than US equity markets. While emerging economies, especially China, accounted for leadership early in the first quarter, performance reversed late in the quarter. At the end of March, developed ex-US markets were up 4.1% while emerging markets gained 3.1%. Developed markets have been hurt by continued COVID-19 lockdowns in the UK and the eurozone, though market style factors have seen the same change of leadership that has occurred in the US. Emerging markets have lagged recently because China and other Asian countries that comprise most of the indices don't have the same reopening tailwinds and release of pent-up demand the developed world is experiencing.

Fixed income

In a reversal from 2020, bond yields have risen in early 2021 as the economy revs its engines and heats up after sitting stalled for much of 2020 due to the global pandemic. As demand for goods and services rises without a corresponding increase in supply, prices rise. This inflation has been higher than expected so far this year and has been a main culprit in the rapid rise in interest rates. As yields rise, prices decline. The Bloomberg Barclay's Aggregate Bond Index fell 3.4% during the quarter while corporate bonds declined a bit more, 4.7%.

US Treasuries fell 4.3% during the quarter, with the shorter end of the yield curve faring better than the long end. While 3-month T-Bills barely changed in value, 30-Year Treasuries lost 15.8%. Gains from the long end of the curve during last year's flattening are reversing. Interestingly, high-yield bonds have performed well this year as spreads have not increased with yields. The US High Yield Corporate Bond Index has risen 0.9% this year. The bellwether US 10-year bond increased in yield from 0.9% to 1.7% during the quarter. We believe performance will remain challenged in fixed income due to inflationary pressures and a rising interest rate environment. Low or even negative real yields can persist in the market for a long time.

Alternatives

Real Estate

Real estate continued its upward climb during the first quarter. The overall market as measured by the FTSE Nareit Real Estate Index rose 8.3%, led by lodging/resorts, regional malls, and shopping centers, the segments of the real estate market hit hardest in the initial stages of COVID-19. Each increased by more than 20% in the first three months of the year. The largest detractor within the real estate market was data centers, the lone classification to fall in value during the quarter after outperforming meaningfully in 2020. The residential segment of the market (up 11.9%) continues to outpace the broader real estate market.

Hedge Funds

Hedge fund returns were relatively modest during the quarter, even though there were large volatility events. The retail trading short squeeze in January, which targeted the most heavily shorted hedge fund stocks, hurt equity long/short managers, but they rebounded nicely and posted a positive 1.8% for the quarter. Multi-strategy managers were the largest beneficiaries of increased market volatility, and their performance was aided by the greater diversification of their books of business. They rose, on average, 10.9% during the quarter. Absolute return funds were challenged by shifting tendencies and strong, narrow pockets of volatility. As a result, they returned 0.7% for the quarter.

Commodities

Commodity futures continued their rise begun late in 2020 because of a release of pent-up demand worldwide as economies loosened lockdown restrictions caused by COVID-19. Profit-taking in the safe-haven of gold lowered its price by 9.8% in the first quarter, and other precious metals followed suit. Energy futures increased 21.5%, led by crude oil's increase of 22.3%. Industrial metals (up 9.0%) also rose on higher demand. Overall, the Bloomberg Commodity Index gained 6.9% as rising inflation, stimulus spending, and the release of repressed demand contributed to more activity around the globe.

As strong as an ox

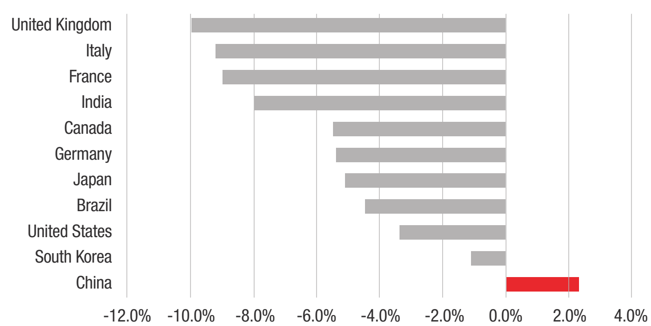
During the Chinese Lunar New Year in February, the zodiac representation changed from the Year of the Rat to the Year of the Ox. In Chinese mythology, the Ox signifies focus, stability, diligence, and the ability to reach a goal through hard work. Just as the Ox provides sturdy focus, China emphasized its own focus and methodical plan for the future during the Two Sessions meeting held in Beijing from March 4-14.

China is unique among world powers in that it annually announces clear and concise goals for what the government will spend time and effort on moving forward. Its leaders routinely formulate plans for capital investment in five-year increments, the 14th of which was announced during this year's party meeting. These goals provide a blueprint for issues that the rest of the world will be tackling at the same time. China's huge economy means that its future ventures are also the world's future ventures. Knowing policy plans and investment goals from one of the world's two superpowers is important for understanding the potential drivers of the future world economy.

Occurring within a month of every Lunar New Year, China's Two Sessions are annual meetings of two large legislative groups that include over 5,000 participants. The first group, the Chinese People's Political Consultative Conference (CPPCC), is composed of elite business professionals, entrepreneurs, and stars in entertainment and sports, and it serves in an advisory role. It suggests potential laws and regulations to other groups within the Chinese Communist Party but has no real power. The other session is the National People's Congress (NPC), the legislative arm of the Chinese government. While the Communist Party makes the real decisions, the NPC rubber stamps the party's initiatives each year and signs them into law. No party law or initiative has ever been voted down by the NPC.

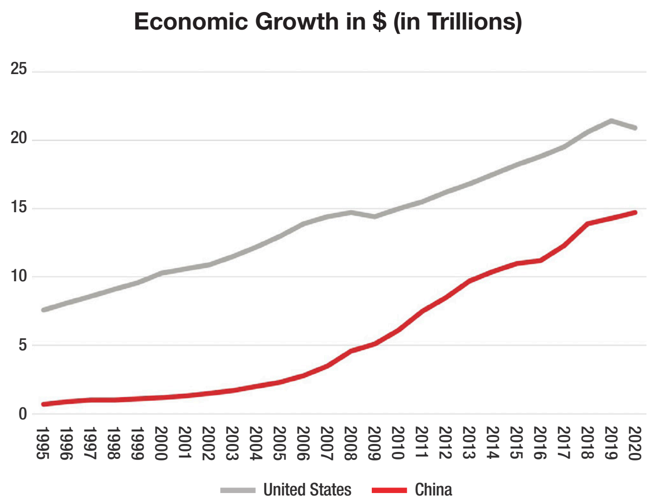
Each year's sessions usually contain an estimate for China's GDP growth over the next year. After not providing guidance for a number last year as the nation dug out from under the COVID-19 shutdown, China announced a target of 6.0% GDP growth for 2021. This forecast is less than many prognosticators had estimated and shows a conservative pivot for the country. Rather than pursuing growth at any cost, China's leaders will concentrate on high-quality growth and a continuation of the shift in their drivers of economic growth from manufacturing to domestic consumption. They want to internalize growth and create a self-sufficient society as many developed nations have done. The other two major initiatives are to decrease reliance on western nations for innovation and to eliminate poverty within the nation.

% GDP Growth for 2020

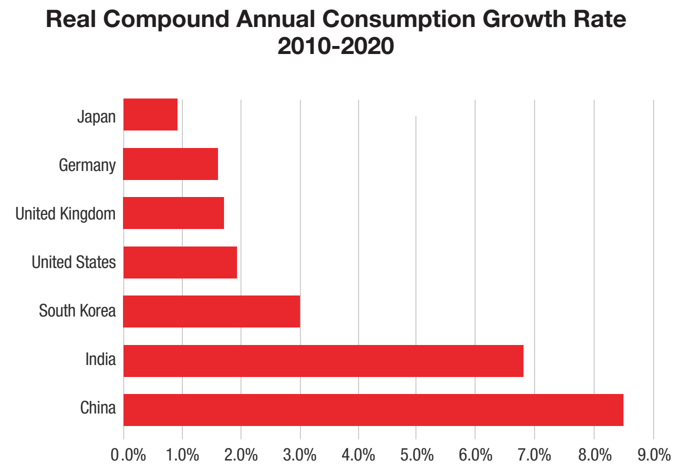


Sources: IMF

China's 6.0% GDP growth target for the year may not seem like a high number, especially after emerging from a pandemic. But China didn't experience the same economic setbacks due to COVID-19 that other nations did. The country was shut down in early 2020, but it reopened quickly and brought its juggernaut manufacturing capabilities back up to speed by mid-summer. In fact, China was the only major country to have positive GDP growth last year (up 2.3%) whereas every other economy contracted. Consequently, China is gaining on the United States: At present rates and based on International Monetary Fund (IMF) estimates, China will catch the United States and become the world's largest economy between 2026 and 2028.



Sources: Win.d, CNBC



Source: World Bank

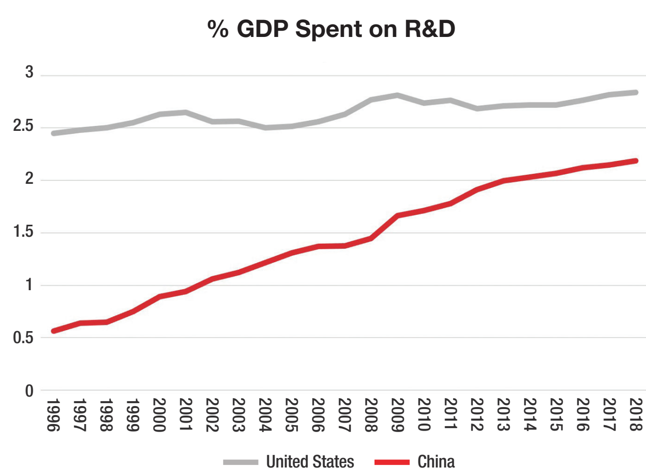
During the sessions, a new 5-Year Plan was also announced. It is ambitious. The main longer-term goal is to overtake the United States by 2035 in terms of economic might and scientific and technological capabilities, and to become a comprehensive national power with little or no reliance on western powers.

2020 was an odd year for all nations and China was no exception. China rode a V-shaped recovery to achieve strong economic growth, but that expansion was completely driven by the “old” China, where public investments in infrastructure, real estate, industry, and exports led to the gains. Moving forward, leadership wants to shift to a “new” China, one driven by private investment, consumption, domestic demand, and a more normalized fiscal and monetary policy. This initiative has been a part of the previous two 5-Year Plans, but the final push may just be contained in the current plan. China has steadily grown its services and consumption portion of GDP relative to construction and manufacturing, topping out at 56% of total GDP last year. The average developed nation relies on consumption for 73% of its GDP, so there is definitely room to grow.

The current 5-Year Plan has three main pillars:

1. Technological innovation

China believes innovation is the path to prosperity. As a result, the country will look to increase spending in research and development in the industries of the future in pursuit of greater self-sufficiency. The industries that could be the core of the digital economy burgeoning throughout the world are artificial intelligence, genetic technology, future networks, and deep sea and space development. As the years go by, China expects more gains in these sectors. They also represent China’s best bet for usurping the United States as the technological world leader. Expect strong countermeasures by the United States to fend off China’s growth in these areas.



Source: World Bank

2. Domestic demand

China considers this to be more important than continued world export leadership. While the country will continue to develop the Belt and Road infrastructure initiative to connect China and the region (a modern-day Silk Road), growth initiatives will emphasize consumer spending. China represents more than 25% of global consumption growth on a year-over-year basis and its leaders would like this number to get higher before leveling off. They see a greater social benefit from a large number of small, innovative, entrepreneurial firms than with behemoth companies.

3. Energy transition

This is a global initiative, and China is fully on board. Its leaders want to end the nation's reliance on fossil fuels, particularly coal; they expect their peak CO_2 usage by 2030 and strive for full carbon neutrality by 2060 – a significant goal for the world's largest polluter. To accomplish this, China will be investing in green energy initiatives, hydrogen power projects, new energy storage technologies, electric vehicles, and new battery structures. This is the easiest win for China in the eyes of the rest of the world.

While the first two main initiatives are in full opposition to western nations (technological innovations and self-sufficient domestic demand both take away market share from other countries), climate goals can lead to cooperation among nations and to future synergies instead of differences. Common ground with the developed world has been tough to come by over the past few years, but US-China relations are paramount for future worldwide economic development. There are no winners in the world when each of the two largest economies is defending its turf against the other on every detail.

Relations between the two countries has been poor for years, and there is much in the relationship that needs to be repaired. Such a repair would lead to economic tailwinds for the entire world. Beijing has been disappointed with the new President Biden administration, expecting a more give-and-take relationship. The new administration has instead taken the same hard-line stance that was in place over the past four years.

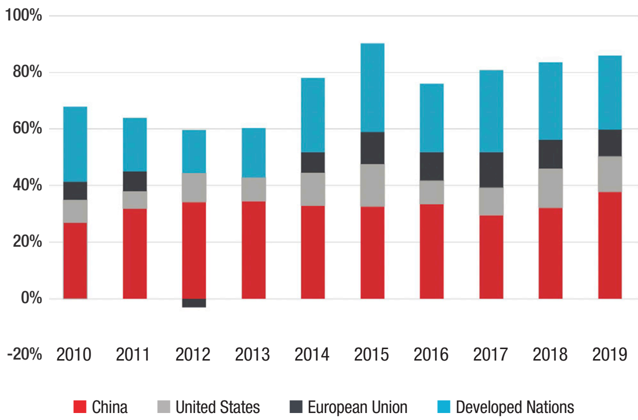
We expect China to use a tit-for-tat strategy through 2021 in dealing with the United States. China celebrates the centenary of the birth of the communist party within the country this year, and party leaders cannot be perceived to back down from threats from The West. They must save face with the public to maintain their strength in the eyes of the population.

The two countries have been at odds on many fronts. There are well-founded human rights concerns regarding treatment of historically autonomous Hong Kong and of the Uyghur minorities in Xinjiang Province. These concerns will continue. China is not inclined to comply with the expectations of western countries on how to treat Hong Kong, and Beijing will continue to deal harshly with the Uyghurs in an effort to dislodge their more extreme religious beliefs. These differences will not change.

Where there is room for negotiation is in goods and property. China and the US are embroiled in tech wars. The two nations are battling over intellectual property, the future of 5G and other networks, export controls, and unfair subsidies. The US has even gone so far as to restrict citizens from investing in companies deemed to be Communist China Military Companies. Common ground can be reached on many of these issues over time and, in many cases, in ways that are mutually beneficial to the two nations.

Competition with China is important because the country is on track to be the largest economy in the world before the end of the decade. It has contributed more than 30% of annual global growth over the past 20 years. It has been the world's top economic-growth driver since 2006. China really is a strategic competitor of the US, not an adversary. In order to build a coalition to fend off China's economic inroads, President Biden has initiated a multilateral approach with other developed nations, inviting a coalition or an alliance of allies to counter Chinese influence. A coalition would have the might to block some Chinese advances but wouldn't be able to eliminate consumption and demand growth within the country itself. A better tack to take would be to figure out how to work together to build new technologies and to work toward a globalization of technology just as the world worked together toward globalization of goods and services in previous decades.

Share of World GDP Growth (in %)



Sources: IMF, Key Private Bank

The United States remains in the position of power and we expect there will be continued efforts to fend off China's gains in technological sectors and industries over the next decade. But China understands this tactic and, as its latest 5-Year Plan initiative shows, it has plans to combat these efforts. It intends to build its own self-sufficient global technological platform and be at the forefront of world technological advances. Only time will tell if there will be more cooperation and sharing in the future or if the divergent paths of the two nations will continue to grow further and further apart.

Tactical asset allocation

Key Private Bank's Dynamic Allocation Research Tool (DART) continues to favor stocks relative to bonds based on recovery in the three main pillars of the model: macroeconomic factors, investor psychology, and corporate fundamentals. The tool scores individual indicators and provides a comprehensive view of the relative attractiveness of different sections of the worldwide equity market and the overall attractiveness of equities and fixed income.

Key Private Bank Asset Allocation Recommendations as of April 2021

Tactical Asset Allocation

Stocks	Bonds	Cash	Alts/Diversifiers
Emphasize	De-emphasize	Neutral	Emphasize–Client specific

Equity Geographic Emphasis

United States	International – Developed	International – Emerging
Neutral	De-emphasize	Emphasize

Fixed Income Emphasis

Duration	Treasuries/ Government	Investment Grade Corp.	High Yield
Neutral	De-emphasize	Emphasize	Neutral– Active Mgt.

Early in the year, we lowered our overweight to US equity as we sought to increase cyclical exposure that exists in overseas equity markets. With continued headwinds confronting the US dollar, increasingly favorable conditions for cyclical stocks, a robust fiscal and monetary stimulus backdrop for global equity, and strong reopening economic activity worldwide, the tactical shift was warranted.

In addition, we introduced an allocation to a diversified portfolio of real assets, which includes real estate, gold, and listed infrastructure. Funding for the allocation came from fixed income, given its lackluster performance potential in the near term. High fiscal and monetary stimulus can lead to higher yields and an inflationary environment, which may exacerbate low expected returns in fixed income. We continue to emphasize investment-grade, credit-oriented sectors. We also emphasize alternative strategies for appropriate investors. As always, we would welcome the opportunity to discuss our perspectives in greater detail.

For more information on how the current market climate might impact your portfolio, contact your Key Private Bank advisor.

About the Author

Don Saverno has nearly 20 years of investment experience in Asset Allocation, Derivatives Management, and Risk Assessment. As a Senior Lead Investment Analyst at Key Private Bank, Don applies his expertise in Asset Allocation and Derivatives Management and helps oversee the equities, alternatives, and real assets third-party research effort.

Don earned an MBA from the University of Chicago Booth School of Business with concentrations in Finance, Strategic Management and Managerial & Organizational Behavior. He also received a BA in Honors and English Literature from West Virginia Wesleyan University.