INVESTMENT PERSPECTIVES

>>SECOND QUARTER 2021

Lessons from a half-century of investing through bull and bear markets

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Editor's note: Rose Grant-Brooks is retiring this spring after more than 45 years of providing outstanding equity investment expertise to our clients.

The natural path of stock prices is upward, so perhaps it's not surprising that a walk down memory lane summons the times that shook investors' faith: the most severe bear markets over the past 50 years. Most bear markets are caused by rising interest rates and inflation, by structural unwinding of economic imbalances, or by asset bubbles.

The 1973 bear market began with OPEC's oil embargo aimed at nations supporting Israel during the Yom Kippur War. The price of oil quadrupled to nearly $12 per barrel, leading to high inflation followed by a recession. Stock prices lost 50% over two brutal years as many companies struggled with lower profits.

A dozen years later, Black Monday became the biggest single-day decline in the stock market, with the S&P 500 retreating 22% on October 19, 1987—the only one-day bear market in history. The market decline was a worldwide event with 23 major stock markets affected. The cause is still being debated, but one item that stands out was the valuation of the market as interest rates climbed. Key central banks jumped in to provide liquidity to the financial system, and the equity market regained all of the value it had lost.

Another dozen years later, the introduction of web browsers and the internet prompted investors to purchase technology and dot-com companies without regard to valuation or profit. Frothy valuations inflated the dot-com bubble until it burst with Nasdaq's 78% collapse. Not until after the Great Recession of 2007 to mid-2009—triggered by another valuation bubble, this time in housing and credit—did the Nasdaq regain its highs.

What do these bear markets have in common? They eventually recovered and moved to new market highs. Over the past 50 years, the average decline of a bear market was about 40% spread over 15 months. In the same period, the average bull market ran for 78 months and provided a cumulative return of over 220%. The lesson of a lifetime in the markets is clear: Although bear markets are painful, it has been proven time and time again that investors who refrain from attempting to time the market are rewarded.

>> PERSPECTIVES ON THE ECONOMY

U.S. economy is cleared for takeoff

By Timothy Garvey, CFA
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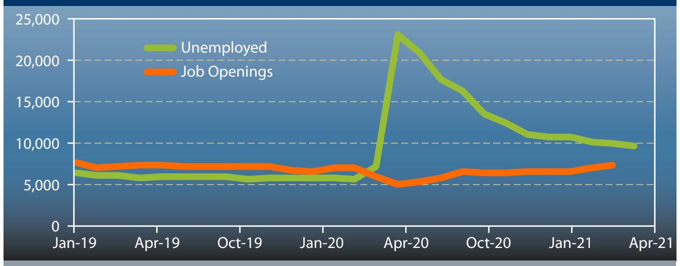
More than a year after the pandemic slammed the U.S. economy, spring has brought signs of regrowth. The housing market has accelerated at a rapid pace, as low mortgage rates spur increased demand for homes. Manufacturing has also been a bright spot, recently recording the strongest readings for orders and production in 17 years. Ultimately, though, the U.S. economy is propelled by consumer spending, which constitutes 70% of GDP. For the economy to reach cruising altitude, consumers must be willing to start spending on discretionary items again.

Widespread vaccinations will provide the foundation for rising discretionary spending and a sustainable economic recovery. Vaccine production and distribution have been ramping up and economic restrictions are being lifted. The labor market is showing signs of momentum—unemployment claims are drifting lower, labor force participation has rebounded, and job openings are back to pre-pandemic levels.

Consumer confidence has been quite slow to recover, but recent readings suggest the consumer is developing a more optimistic outlook. Unlike in past recessions, both personal income and personal savings remain elevated, which provides the means for stronger consumer spending. As more and more people are inoculated, the high-touch personal service industries should begin to thrive once again. Consumers will regain confidence in traveling, eating at restaurants, and going to movie theaters. And as demand in these industries grows, it will bring back more of the 8.5 million jobs still lost from the pandemic. We are early in the recovery process, but if this positive momentum proves sustainable, it appears the economy is indeed cleared for takeoff.

LABOR MARKET TRENDS (000s)



Unemployment has fallen and job openings have grown, but the U.S. still has 8.5 million fewer jobs than it did pre-pandemic.

Source: Bureau of Labor Statistics

>> FOCUS ON EQUITIES

Can value stocks continue to outperform?

By Allen Laine, CFA
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Growth stocks have enjoyed superior returns versus those of their value-oriented counterparts over the past decade. In fact, growth outperformed value in 8 of the last 10 years, and often by a wide margin. Growth stocks have been aided by a low interest rate environment that has helped trading multiples expand; coupled with robust profit growth, these high-flyers have screened attractively to investors. The valuation difference between growth and value stocks is historically wide today, suggesting that a long overdue "reversion trade" could give value stocks a boost. Since last November, this valuation dichotomy has rotated in value stocks' favor.

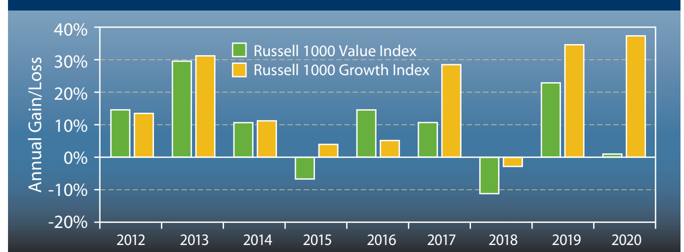
Can this trend persist? Value indices heavily focus on sectors like industrials, energy, basic materials, and financials, all of which are highly correlated with economic activity. These areas have performed well recently because they possess more leverage to an improving economy. We think they will continue to outperform with a sustained economic recovery, especially as earnings move sharply higher off a low 2020 base that was impaired by the onset of the pandemic.

There is clear evidence that demand is rebounding across many hard-hit industries. Profit growth forecasts look attractive for value stocks; if those forecasts are right, these stocks will see improved financial flexibility while dissipating the threat of financial hardships. Many of these same stocks would also be large beneficiaries of the infrastructure package that President Biden has been advocating. However, that program may not win approval in Congress, and it may be scaled down from its original form; these doubts suggest that enactment could still represent another catalyst for the group.

With a backdrop of years of underperformance, cheap valuations on normalized earnings, and excellent growth prospects as the economy recovers, value stocks today are poised to perform well for many months to come.

Of course, financial markets don't always cooperate and perform the way we expect. There is likely to be volatility along the way too. The threat from the pandemic still exists and these cyclical companies are more susceptible to economic stumbles. A balanced approach is still prudent and necessary. We find ourselves favoring value but not abandoning growth stocks. Both have a place in a well-diversified stock portfolio.

VALUE VERSUS GROWTH RETURNS



Growth stocks have outperformed value meaningfully over the past decade.

Source: FactSet

>> FOCUS ON FIXED INCOME

Treasury yields rise in anticipation of strong GDP

By Tom Bussone
Fixed Income Strategist,
Eastern Bank Wealth Management

This has not been a good year for investors in Treasury or investment-grade corporate bonds. Shunning safe bonds, investors were comfortable owning riskier assets in anticipation of strong economic growth during the second half of the year as the pace of vaccinations against Covid-19 continues to increase. For the first time in a decade, investors began to worry about inflation, further pressuring Treasury debt prices. The 5-year breakeven rate (which measures the bond market's inflation expectations) rose above 2.50%, touching its highest level since 2008. The Federal Reserve, however, continues to dismiss worries about inflation. The Fed remained accommodative by keeping the federal funds rate near zero while continuing to buy about $120 billion of Treasury and mortgage-backed securities every month.

The 10-year U.S. Treasury yield almost doubled during the first quarter, closing at 1.74%, its highest level in over a year. The iShares 7-10 Treasury ETF and the iBoxx Investment Grade Corporate Bond ETF, with durations of about 8 and 10 years respectively, were both down approximately 5.50% in the first quarter.

As money flowed out of high-quality debt, weaker issuers outperformed. High yield bonds, preferred stocks, and bank loan fund returns were slightly positive during the quarter. We expect this trend to continue because of easy monetary policy, markets flush with liquidity, and improving economic conditions. Therefore, we maintain our emphasis on lower quality credit in our portfolios and will continue to get our exposure through actively managed ETFs and mutual funds.