



A Message from the TOPS® Portfolio Management Team

1st Quarter 2021 Market Commentary

“The V-Shaped Economic Recovery Accelerates”

First Quarter 2021 stock market returns were strong, yet somewhat volatile, particularly for U.S. indexes. A driver of market movements was a clear message from the Federal Reserve and the newly inaugurated Biden administration that additional trillions of dollars would be flowing into the economy. The longer-term effects of this experiment are unknown, but the near-term impact is undoubtedly beneficial for the economy.

Further, the efficacy of the COVID vaccines and the relatively rapid vaccination process are also positives for the economy. Although geographic “hot spots” may pop up at any time, the overall picture is one of solid progress against the pandemic. It seems likely further widespread lockdowns will be avoided, and herd immunity may be achieved this summer. While this may not be the case everywhere (i.e., France is returning to lockdown mode as we write this piece), the global economy is clearly recovering from the severe COVID recession.

Financial market returns indicate investors expect this economic growth to create a powerful earnings tailwind for stocks, but perhaps an inflationary headwind for bonds. As a result, the TOPS portfolios earned a wide range of returns for Q1 (+1.5% to +8.0%). The more aggressive TOPS portfolios (higher equity allocations) were aided by the continued resurgence of diversified market leadership during the fourth quarter, as we discuss below. In addition, the TOPS fixed income strategy of shorter duration ETFs worked to our advantage as bond yields rose in Q1.

We continue to note all TOPS portfolio returns for the trailing one year, three-year, five-year, ten-year and fifteen-year timeframes remain well into positive territory, with many recording double-digit returns over differing timeframes.

After discussing Q1 2021 financial market results, we address three topics that are important to TOPS portfolio returns and strategies:

- Stock market leadership broadened beyond US Large Cap
- Strong economic data suggests financial and monetary stimulus is making an impact
- How serious is the risk of rising inflation?

First Quarter Market Review

Although the focus of this Commentary is on the first quarter of 2021, it is impossible to ignore the trailing twelve month (TTM) returns which are among the strongest ever recorded. The horrific Pandemic Bear Market had just ended a year ago, yet we finished Q1 2021 at new all-time records. The circumstances of the comparison are quite unusual, but still worthy to note.

The TTM return for the large cap S&P 500 is +56.4%. That is a tremendous return, except in comparison to the gains from S&P MidCap +83.5% and S&P SmallCap +95.3%. We will discuss this potential leadership change later in this Commentary.

The Q1 story was one of strength from sectors that diversify the portfolio and have historically provided improved risk/return characteristics over time, led by S&P SmallCap's +18.2% and S&P MidCap's +13.5%. Dollar strength hindered International equities, with MSCI Emerging Markets +2.3% and MSCI EAFE (developed international) +3.5%. S&P GSSI NA Natural Resources is another diversifier that was very strong in Q1 at +19.4%. Of course, we were happy to see our largest allocation – the S&P 500 – recording another solid gain of +6.2%. In another possible harbinger of trend change, S&P Value +10.8% easily beat S&P Growth +2.1%.

Inflation worries caused negative bond market returns for Q1 as the Barclays US Aggregate Bond was -3.4% and Barclays US TIPS -1.5%. Most bond market sectors posted negative returns for Q1 as the yield curve steepened (yields for longer maturities rose while the Federal Reserve held short rates flat). The yield on the benchmark 10-year US Treasury rose sharply from 0.93% at yearend to 1.73% on March 31. Short duration Barclays US Treasury indexes were basically unchanged while bond indexes such as the Barclays US Treasury 3 -10 Years lost nearly 3%. Longer maturity Treasuries were hit hard, as the Barclays US Treasury 20+ Years returned -13.9%. More economically-sensitive diversifying sectors were mixed: the JP Morgan Emerging Markets Bond Index was -6.6% and IBoxx USD Liquid Investment Grade Index -5.5%, but Solactive USD High Yield Corporates was +0.6%.

Stock Market Leadership Broadened Beyond US Large Cap

Smaller (small-cap and mid-cap) US stocks were leading performers in Q4 2020 and the momentum carried through the first quarter of 2021. For the past few years, we have stated our belief that small-cap stocks had relatively attractive return opportunities compared to large-cap growth stocks selling at higher valuations.

We noted above the massive outperformance of S&P SmallCap and S&P MidCap since the Pandemic Bear Market ended a year ago. The gains were concentrated in the past two quarters during which the S&P SmallCap and S&P MidCap recorded explosive moves of +55.3% and +41.1%, respectively versus +19.1% for the S&P 500. The shift away from large-cap high-growth is further seen in the six month returns for S&P 500 Value at +26.8% and S&P 500 Growth +13.0%.

We believe small-cap stocks continue to exhibit good growth prospects, as they tend to benefit from higher economic growth environments. Larger stocks can also continue to do well as earnings recover and Value outperformance has the opportunity to endure due to its economic sensitivity and lower valuations.

Fiscal and Monetary Stimulus Is Making an Impact

The recently-passed \$1.9 trillion American Rescue Plan has many components, including \$360 billion for state and local government support, \$176 billion for schools, \$410 billion of individual stimulus checks, and \$246 billion for extended unemployment programs. Added to the \$2 trillion CARES Act passed a year ago, the stimulus into the American economy is astounding. In addition, the Federal Reserve is doing its part through extensive monetary support, slashed interest rates and bond buying. President Biden also recently unveiled a \$2 trillion infrastructure spending bill. Although all the funds in these plans will not be spent in any one year, the \$6 trillion total is nearly 30% of 2020 US nominal GDP of \$21.5 trillion. The longer-term results of these experiments are unknown, but the short term impact should keep the V-Shaped economic recovery on track.

The success of the COVID vaccine development and vaccination process has created an optimistic scenario of “herd immunity” in America by this summer. Stimulus checks, unemployment pay extensions, and rent forbearance have allowed many consumers to pay off debts, add to savings and eagerly look forward to returning to a more-normal life. While many businesses have closed and will never reopen, many other businesses survived due to stimulus payments and many new enterprises are being created every day.

Economic data has been very strong in recent months as the economy is re-opening. A few examples include: March U.S. payroll employment increased by a surprisingly strong 916,000 jobs and January and February payrolls were revised up by 156,000 jobs. The unemployment rate dropped to 6.2 percent in March. A measure of the health of the manufacturing sector, the ISM Manufacturing Index, accelerated to a very strong 64.7 in March, the highest level for the

index since December 1983. Finally, The Conference Board's Consumer Confidence Index for the U.S. surged in March to 109.7 from a February reading of 90.4, its highest level since the pandemic began a year ago.

The bottom line of all of this is a red-hot economy. We are seeing forecasts ranging from +5.5% to 8.0% for 2021 US GDP, which is quite an uptick from the +2-3% growth experienced in recent decades.

How Serious Is the Risk of Rising Inflation?

The path of potential inflation in the coming years has led to heated debate among economists and investors. Many of the classical economic models indicate the historic surge in money supply (dollars created by the Federal Reserve) will debase the dollar and lead to high inflation. However, there are other inputs to the inflation equation, including aging demographics, technology and the heavy weight of record levels of debt. Globalization is still a strong force for disinflation despite recent talk of re-shoring and shortening supply chains.

Having noted that, we still find ourselves in agreement that inflation will perk up this spring, at least for a while. Many prices plunged in the midst of the severe 2020 recession and this year's price levels will likely be closer to (or above) the pre-recession levels. Federal Reserve Board Chair Jerome Powell reiterates over and over that this CPI increase will be a "transitory event" and we fervently hope he is correct. High economic growth, supply chain issues and strong pent-up demand will almost certainly result in rising inflation this spring and we will monitor further movements closely as the year progresses.

TOPS Portfolio Strategies

The stock market has clearly broadened into diversifying areas, such as smaller stocks, value and natural resources. This is a healthy change for the markets, as the valuations in large-cap growth had been sounding some alarms. The combination of economic and monetary stimulus, along with the desire of businesses and consumers to return to normal spending patterns suggests the US economy will be very strong throughout 2021. This could benefit the TOPS portfolios as we continue to strategically implement our philosophy of maintaining broadly diversified portfolios structured with risk/reward in mind.

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