EQUITY MARKET UPDATE

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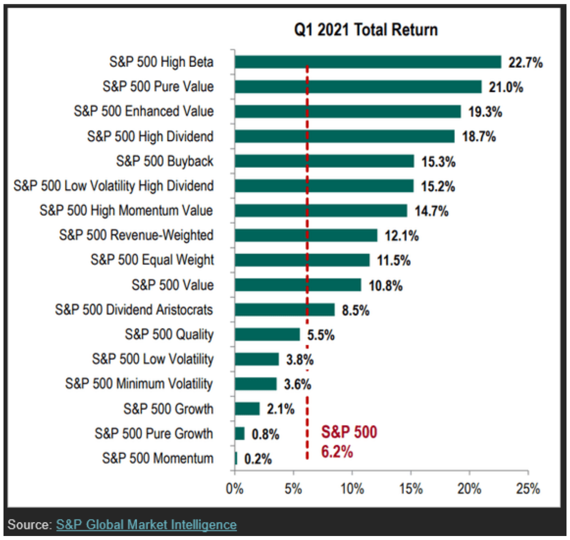
Stocks moved higher in March and closed the quarter at record high levels. Increased vaccinations, along with better than expected jobs data and stimulus checks, provided the fuel for the rally. Positioning continues to center around ultra-cyclical stocks that tend to outperform in the early stages of an economic recovery. However, some firms on Wall Street have begun to warn investors that most of the good news has already been priced into the market.

<u>US Stocks Advance Led by Mid & Small-Sized Companies</u>

The S&P 500 increased 4.38% in March and closed above the 4,000 mark for the first time. The rally from 3,000 to 4,000 was the fastest 1,000-point gain in history for the index. The S&P 500 is up 6.17% year-to-date, and it has advanced 56.33% in the past year, marking the best 12-month rolling return for the index since 1936.



The Dow Jones Industrial Average performed even better rallying 6.78% for the month. Large gains in Home Depot and Boeing accounted for one-third of the increase. Year-to-date, the Dow is up 8.29% with 50% of the rise coming from Goldman Sachs, Caterpillar, Home Depot, and Boeing.

The weakest performer continues to be the NASDAQ. The index only increased 0.48% for the month, and it has gained 2.96% so far in 2021. A broadening of the economic recovery, along with higher interest rates, has resulted in a rotation out of technology favorites, especially among the companies that are not profitable. The NASDAQ briefly fell into correction territory (a decline of 10% or more from the recent high) before recovering in the final week of the quarter.

Mid and small-sized companies continue to have the yearly best results. The S&P 400 Mid-Cap Index increased another 4.67% in March, while the S&P 600 Small-Cap Index gained 3.33%. Both indexes are benefitting from a rotation towards more economically sensitive stocks. Thus far in 2021, mid and small-sized companies have rallied 13.47% and 18.23%, respectively.

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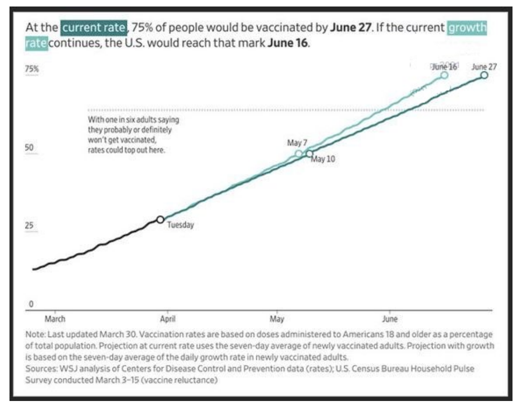
<u>International Stocks are Mixed</u>

Europe continues to struggle with the rollout of COVID-19 vaccines. This has resulted in further lockdowns and weak economic data compared to the United States and China. The Eurozone IHS Markit PMI increased to 52.5 in March signaling expansion. The strongest results were seen in Germany which is benefitting from exports to the US and China. Further impacting results are rising interest rates. The ECB announced they would accelerate their bond buying to stop unwarranted tightening of financial conditions. The MSCI EAFE Index gained 2.39% in March, and it is up 3.61% year-to-date.

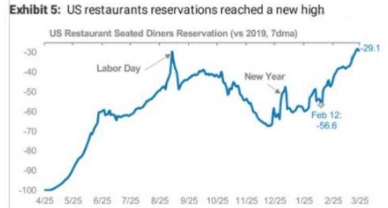
The MSCI Emerging Market Index fell 1.51% last month as Chinese policy makers confront the challenge of how to remove stimulus from the global pandemic without choking-off the economic recovery. They decided to move slowly by gradually tightening credit in certain parts of the economy, like housing, while avoiding interest rates hikes. Chinese Premier, Li Keqiang, said “some policies will be phased out, but we will introduce new structural policies like tax and fee cuts to offset the impact.” This varies widely from President Biden who just signed a new $1.9 trillion stimulus package while discussing the need to raise taxes for corporations and high-income earners. President Biden also signed an executive order that requires the federal government to do a 100-day review of supply chain deficiencies in four industries—semiconductors, batteries, pharmaceuticals, and strategic materials—that could have adverse effects on China’s export model. Year-to-date, emerging markets remain the weakest performer gaining only 2.21%.



<u>COVID-19 Vaccination Efforts Pick-Up Steam</u>

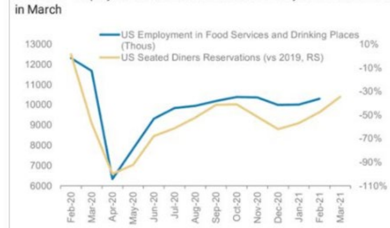
The vaccination drive progressed well globally in March with the UK and the US reporting that 41% and 25% of the population have received at least one dose. With three million Americans getting shots daily, 75% of the US population will have been vaccinated by June 16th. Pfizer announced their vaccine is 100% effective for kids ages 12-15. The Eurozone continues to struggle with only 9% of the population receiving at least one shot. They remain challenged because the bulk of their vaccine supply comes from AstraZeneca, which was investigated in March for concerns about blood clots.

Exhibit 5: US restaurants reservations reached a new high



Source: Opentable, Morgan Stanley Research

Exhibit 6: Employment in the restaurant sector likely to recover further in March

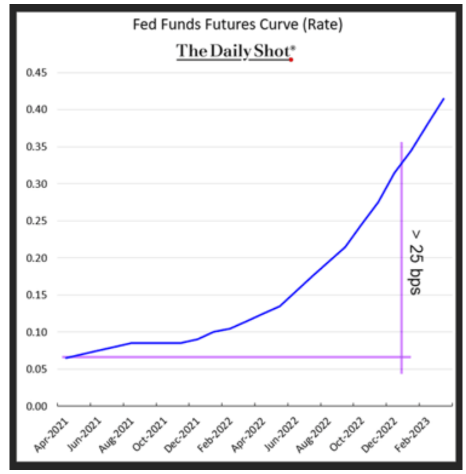


Source: BLS, Opentable, Haver Analytics, Morgan Stanley Research

<u>US Economic Data Improves Along with Inflation Concerns</u>

Several economic reports indicate the recovery has kicked into a higher gear. Consumers received a third round of stimulus checks, while COVID-related restrictions were eased in many parts of the country. High frequency data showed consumers are on the move and ready to spend. Manufacturing data was robust with the ISM Manufacturing Index recording a level of 64.7, its hottest reading since 1983. Meanwhile, the ISM Service Index registered a record high reading of 63.7. Inflation data was also much higher than expected. Strong consumer demand, along with record low inventory levels and supply chain disruptions, has rapidly increased input prices. US employers added 916,000 jobs in March, while the unemployment rate fell to 6%. A large percentage of the new jobs came from restaurants and hotels. There are 8.4 million fewer jobs than before the pandemic hit; however, the Bureau of Labor Statistics reported 7.3 million open jobs. This signals that we are likely entering a period in which monthly jobs data will be abnormally strong as the economy fully reopens. Finally, President Biden announced a $2.25 trillion infrastructure plan that includes $620 billion for transportation; $650 billion for clean water and high-speed internet; $580 billion for lab research, semiconductor manufacturing, and electric vehicles; and $400 billion for elderly and disabled care. The proposal promises a decade of government funded projects; however, Mr. Biden wants to pay for the initiative by raising corporate taxes to 28% while also instituting a minimum corporate tax rate of 21% on foreign profits.

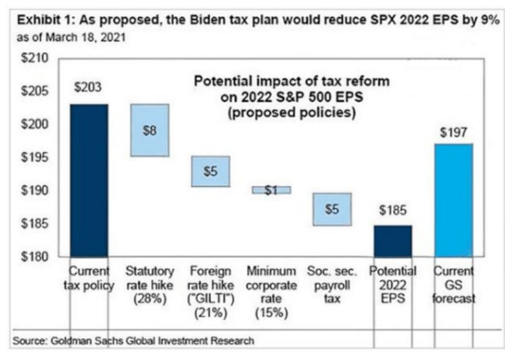
<u>Fed & Market Disagree on Timing of Interest Rate Hikes</u>



The Fed voted to keep interest rates at 0% and to maintain their $120 billion per month purchases of Treasuries and mortgages. They expect rates to remain at 0% until 2023 despite sharply raising their forecasts for economic growth and inflation. The Fed now expects US GDP to expand 6.5% in 2021, the fastest level of growth since 1983. They forecast inflation will be 2.4% in 2021 and remain slightly above their 2% target until 2023. During his press conference, Fed Chairman Jerome Powell told reporters that any uptick in prices this year will be temporary as consumers spend their stimulus checks. He said it is premature to begin tapering asset purchases because the economy is a long way from the Fed's goal of maximum employment and sustained inflation above 2%.

The market, however, appears to disagree with the Fed about the timing of interest rates hikes. The Fed Funds Futures Curve has fully baked-in one rate increase in 2022, while the probability of two rate hikes currently sits at 56%.

<u>Rally Has Increased Valuations & Risk Taking</u>



Stocks enter the 2nd quarter at elevated valuations. Currently, the S&P 500 is trading at 21.9x 2021 EPS estimates. If you fast forward to the 2022 and 2023 profit forecasts, the index trades at 20.36x and 18.30x, respectively. All these valuations are well above the historical median of 16.64x. They also do not take into account President Biden's proposed tax increases which will shave 9% off of S&P 500 earnings according to Goldman Sachs.

As I have mentioned many times above, the rally is being driven by a sharp rise in the price of cyclical stocks. Goldman Sachs issued a report that showed companies with weak balance sheets have outperformed those with strong balance sheets by almost 40% since the vaccine announcement in November! When holdings are reshuffled in early April, Blackrock expects value stocks to constitute the largest portion of their iShares Momentum ETF since 2012. The rally is also corresponding with higher levels of risk appetite. Almost every research firm on Wall Street is showing elevated levels of risk taking (Archegos and GameStop are perfect examples), while the VIX Index closed below 17 for the first time since February 2020.

All these indicators signal the market has baked-in much of the upcoming improvements for the economy; therefore, stocks are vulnerable to further consolidation or pullbacks in the next few months. We expect volatility to remain high as we enter the full reopening of the economy.

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Our Outlook & Strategy

Despite improving economic conditions, we question how much further cyclical stocks can outperform the overall market. Morgan Stanley's strategist Mike Wilson found with statistical significance that quality outperforms once we have seen the peak in year-over-year inflation, personal income, PMIs and GDP. It is likely we will see the peak during the 2nd quarter given the easy year-over-year comps caused by the economic shutdown last year. This means we could be nearing the start of the mid-cycle stage of the economic recovery.

First Financial has historically underperformed during the early cycle stage of the business cycle which typically lasts around one year. Our focus on owning financially strong companies with durable competitive advantages is not in vogue in the early days of the economic recovery. Since we tend to hold high quality companies for several years, our best relative performance has historically occurred during the mid and late cycle stages which last several years.

As we evaluate our roster of holdings across our equity styles, we remain highly selective about which companies to own. We are constantly searching for companies that will benefit from long-term secular trends that can produce top-line revenue growth and sustainable cash flows.

The effects of COVID-19 will likely create a new "normal" for investors to consider. We have accelerated the time frame on the use and adoption of mobile technologies for education, shopping, entertainment, doctor visits, etc. We have also adapted to a non-centralized workforce. We have seen from the past two administrations that the United States wants to encourage domestic manufacturing of semiconductors, medical equipment, and other items deemed to be of national security importance. Finally, the rush to develop a vaccine has brought many new healthcare related technologies to marketplace.

Finally, elevated valuations on stocks and the likelihood of higher interest rates as we progress through the business cycle will serve as challenges for investors. When stocks have historically traded at these PE values, forward one-year and five-year total returns are well below average. This makes stocks very sensitive to changes in central bank policy, taxation, and regulations. The market may be entering a period of consolidation in which PE ratios compress as earnings grow into the price. Investors should also be on the lookout for any unexpected event that could trigger a market correction.