Hughes Investment Advisory Service LLC

April 1, 2021

Dear Clients and Investors,

For Q1 the S&P 500 was up 5.8% It was a busy quarter for the economy and the markets the last 3 months. A new president took office and we saw good progress rolling out the Covid-19 vaccine across the country. In the markets we had hedge fund blowups, huge SPAC rollouts and generally extreme speculation in certain corners of the markets. I like this paragraph written by Charles Dow written in 1900 which seems very apt today given all that has occurred the last 15 months. Charles Dow's thinking is truer today than it was in 1900 as change is occurring at a more rapid pace due to innovation in technology and communications.

"There is always a disposition in people's minds to think the existing conditions will be permanent. When the market is down and dull, it is hard to make people believe that this is the prelude to a period of activity and advance. When prices are up and the country is prosperous, it is always said that while preceding booms have not lasted, there are circumstances connected with this one, which make it unlike its predecessors and give assurance of permanency. The one fact pertaining to all conditions is that they will change." Charles Dow, 1900

My big picture view of US economic activity is positive at this juncture. With 2020 total Covid-19 relief of 3.4 trillion plus the recently signed 1.9 trillion Covid-19 relief packages and todays 2.3 trillion-dollar infrastructure package introduction, we are looking at blow out record amounts of stimulus spending coming from Washington. All of this aid arrives at a time when both the industrial and consumer sectors are already clearly on the mend thanks to the successful rollout of 3 approved vaccines. The recovery should be hitting its stride by the second half of 2021, when GDP growth likely will surpass 6%. This projected economic improvement will be underpinned by the financial infusions cited above plus additional monetary support from the Federal Reserve and pent-up demand on the consumer side as progress is made defeating the pandemic.

With the US recovery now underway, I'm paying attention to four major themes which are likely to drive the narrative for the balance of 2021 and into 2022. They are Taxes, Corporate Earnings, Debt and Inflation.

Taxes and Corporate Earnings are of course linked. Since last quarter I've revised my earnings outlook higher for 2021 S&P 500 earnings. I have bumped up my 2021 earnings total from $165 to $185 a 12% upward adjustment to what would be a record number. Earnings are recovering faster than expected which helps to explain and justify the record high stock market that we are experiencing today. As far as taxes go, it appears likely that Congress will be raising corporate taxes in the months ahead. The current corporate tax rate is 21% and under the current Biden tax plan proposal could go as high as 28%. Goldman Sachs is currently predicting a compromise rate of 25%, in the middle. This will directly affect the corporate earnings estimates stated above so we will be watching the outcome on corporate taxes carefully. The Biden administration is currently hoping to coordinate corporate tax rates on a worldwide basis, I do not expect that to succeed.

Debt and Inflation are also joined at the hip! Many in Washington are determined to ignore nearly all of human history prior to 2008 and conclude that there really are no limits to the ability of a government treasury to issue debt, much of which is later purchased by another arm of the same government with money created out of thin air. There will be consequences that come with pumping an endless amount of dollars into the economy through the stimulus measures mentioned above. Total Federal debt will have more than doubled in just the past decade. As a result of the Georgia Senate election runoff with the democrats winning both seats, all three branches of the Federal government are now in one party's hands. The democrats will continue to pass more spending bills including the current 2.4 trillion infrastructure plan announced today and all of this new spending is likely to be deficit spending since the republican minority is unlikely to support the tax increases necessary to finance all the new spending. As the borrowing increases the deficit will increase.

At times it seems as though there may be no downside to this deficit spending as evidenced by consistent record highs in the stock market. Maybe the deficit isn't so bad if risk assets are hitting record highs, but all of this money pumped into the economy dilutes the relative value of existing dollars in circulation. And what about the consistently rising levels of debt? This is where inflation comes into the picture. Last quarter questions were rising about inflation and where it might be headed, now it's becoming clear that inflationary pressures are mounting in more and more places throughout the economy. Will the Fed do anything to slow the current inflationary pressures? So far it appears unlikely that the Fed will do anything in the near-term as Chair Powell has consistently raised the bar on how high inflation can go before the central bank takes action recently stating that they expect to keep rates at zero through 2023. It's important to remember what happened in late 2018 when the Fed slowly tried to normalize (raise) rates, the market plunged 20% in three weeks and the Fed quickly reversed themselves back to a dovish stance.

So why not stay dovish and keep rates at zero? Because a rise in inflation is leading to a rise in the long end of the Treasury yield curve. The quadrupling in Treasury note yields in the past year (albeit from a very low base) acknowledges such inflation jitters. Higher yields mean falling bond prices. In fact, 30-year treasury bond losses over the last 12 months are significant at over 21%. Will the Fed try yield curve control where they leave short rates low and try to manipulate long rates, AKA "Twist" as they have hinted at? "Twist" operations have not been successful in the past so I have my doubts that it will work now. What we are left with is a tug of war between investors who see optimism in risk assets due to the Covid-19 vaccines and a global economic recovery and those fearing a rapid rise in inflation and higher interest rates which all results in a recipe for higher volatility going forward in 2021. Are these inflation fears overblown? My sense is no. Inflation is real and inflationary pressures are mounting, something we haven't really seen since the early 1980's. This is a game changer and has and will influence our investments moving forward. Equities in companies that can raise prices, earnings and dividends act as an excellent hedge in inflationary environments. Commodities and other hard assets can also do well.

So, what else can we do from an investment standpoint? Bottom-up stock picking and stock selection will be critical. Continue to differentiate between the winners and losers in the late and post-pandemic economy. Where do I find winning industries and companies today? Industrial/Defense, technology especially financial and medical tech, and pharma. The utility and consumer staples sectors stand out as income producers in a low-rate environment but can be susceptible to higher rates as outlined above.

At this time, I continue to favor large-cap, dividend paying, US based multi-national companies with strong balance sheets. We love businesses with irreplaceable brand names, high barriers to entry, wide margins, grow their dividends, and have modest debt. Risk/reward continues to favor equities over fixed income. A few select REIT's and specialized bond and income funds continue to look good as income producers. I will continue upgrading and adjusting portfolios accordingly and look for special situations as conditions on the ground change. Please do not hesitate to give me a call to discuss the above analysis.

Sincerely,

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