

INVESTMENT REPORT



LYNCH FINANCIAL GROUP LLC
— Retirement Wealth Management —

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www.LynchFinancialGroup.com

Investment Review and Outlook

Cryptocurrency Speculation: A Case of FOMO?

Cryptocurrencies were back in the headlines throughout 2020 and into 2021, with some high-flying returns that attracted investor attention. Tesla CEO Elon Musk tweeted support for Bitcoin, and a few of the largest university endowments have begun to endorse cryptocurrencies as potentially viable investments. In times like these, with growing concerns about potential U.S. dollar devaluation and increasing inflation, investors often turn their eye to alternative options for hedging these risks. Given that cryptocurrencies are gaining broader acceptance, it is not surprising to see some investors considering whether they deserve a place in portfolios. So where do cryptocurrencies fit in?

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Market Recap

Global stocks continued to power upward this quarter from their pandemic bear market low on March 23, 2020. The S&P 500 Index gained 6.3%, developed international stocks gained 4.5%, and emerging-market stocks gained 4%. These benchmarks are now up an astonishing 80.6%, 74.8%, and 74.6%, respectively, since the bottom. The S&P 500's one-year trailing return, as of March 23, 2021, was its best since the 1930s. Clearly, it paid not to panic and get out of the markets last spring.

While the “meme” stocks (like GameStop) and the social media-fueled speculation behind them caught investors' imagination earlier this year, we think the recent “reflation rotation” will be the more enduring equity market trend: For a couple of quarters now, equity investors have been betting on more economically sensitive small caps and value stocks and eschewing large caps and previously highflying growth stocks.

The reflationary winds tore through the bond market as well. The prospect of higher growth and higher inflation caused interest rates to jump. The 10-year Treasury yield more than tripled from the historic low it set last August. Correspondingly, the core bond index fell 3.6%, suffering its worst quarter since 1981. On the flipside, floating-rate loans, which benefit from reflation, gained 1.8%. And most of the flexible, active bond strategies we invest with delivered positive returns this quarter, despite higher rates (and all outperformed core bonds).

Investment Outlook

The primary variables that will determine the direction of the economy and markets remain COVID-19 developments and the fiscal/monetary policy response. These currently imply a base case for a strong economic rebound, particularly in the United States but also globally. This will support the fundamentals underpinning higher-returning asset classes (stocks, credit sec-

Benchmark Returns (Periods Ended 03/31/2021)

	Quarter	12 Months
Large-Cap Benchmarks		
Vanguard 500 Index	6.2%	56.2%
Russell 1000 Growth iShares	0.9%	62.4%
Russell 1000 Value iShares	11.2%	55.8%
Mid-Cap Benchmarks		
Russell Midcap iShares	8.1%	73.4%
Russell Midcap Growth iShares	-0.6%	68.3%
Russell Midcap Value iShares	13.0%	73.4%
Small-Cap Benchmarks		
Russell 2000 iShares	12.7%	94.7%
Russell 2000 Growth iShares	4.8%	90.1%
Russell 2000 Value iShares	21.1%	96.8%
Other Benchmarks		
Vanguard Developed Mkts Idx	4.0%	50.9%
Vanguard Emerging Markets	3.6%	58.0%
Vanguard REIT Index	8.6%	36.4%
Vanguard Total Bond Mkt Index	-3.6%	0.4%
Credit Suisse High Yield Index	1.4%	24.1%

We welcome questions or comments regarding this newsletter at dlynch@lynchfinancialgroup.com. Lynch Financial Group provides Retirement Wealth Management Services to individuals within 15 years of retirement, retirees, and surviving spouses. We also provide specialized assistance to professionals, fiduciaries and heirs in wealth transfer situations.

Investment Review and Outlook (Cont.)

tors of the bond market)—as long as interest rates do not move sharply higher.

Substantial progress has been made on the vaccine rollout. Ninety-three million Americans have received at least one dose. At the current vaccination rate, experts estimate the United States could achieve herd immunity by late summer. Daily new cases, hospitalizations, and deaths from COVID-19 have plummeted. We are not out of the woods yet. There is still a risk of letting down our guard too early or that new infectious variants could prove resistant to the current vaccines. But overall, the light at the end of the pandemic tunnel certainly appears brighter.

Controlling the pandemic will enable us to start getting back to normal lives, boosting economic activity. Growth forecasts had already reflected a rebound. Now they are being revised higher with the massive American Rescue Plan Act fiscal stimulus signed into law. The Federal Reserve forecasts the U.S. economy will grow at its fastest pace since 1984. Economic growth should feed into company earnings. The Wall Street consensus expects S&P 500 earnings to grow over 40% in 2021.

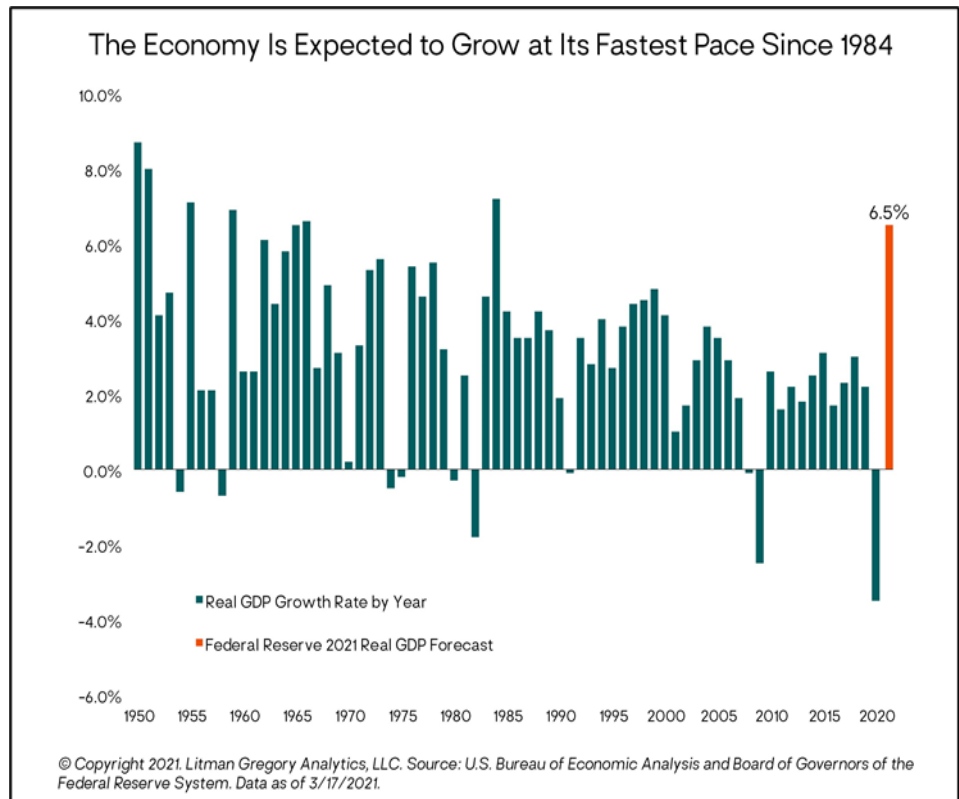
Yet the Fed continues to reiterate that it will not preemptively raise interest rates. It intends to wait till it sees inflation above its 2% target for an extended period of time, a new policy that suggests this economic cycle has plenty of room to run. The Fed has to taper its asset purchases first, which are still going strong at \$120 billion per month, before they even think about raising rates. We take the Fed at its word that it won't be raising rates anytime soon.

So high economic growth, strong earnings growth, but low interest rates? Equity investors couldn't ask for more. A bull market has roared to life. The main threat is our old friend valuation risk. However, shorter term, historically high valuations need not impede it with all the other positives in place. While stock valuations are high they look more reasonable *relative* to bonds.

Speaking of bonds, longer-term interest rates have risen in anticipation of a higher-growth, more inflationary environment. That has hurt bond investors this year. Though, our funds have felt less of an impact as we were significantly underweight to core bonds to protect against just this occurrence. While rates could rise further leading to greater bond price declines, they should stay contained unless inflation spikes up *and* stays higher ...

What About Inflation?

Inflation has been at the top of investors' list of concerns lately. Governments all over the world have passed large fiscal stimulus packages in the wake of the pandemic. The United States takes the cake: Congress has spent the equivalent of 25% of GDP on the emergency in a single year and may spend even more with an in-



Investment Review and Outlook (Cont.)

infrastructure plan on tap. That is a lot of *potential* pent-up spending. Add in an expected economic rebound from the pandemic, and the Fed doing everything it can to stoke a healthy level of inflation, and investors and consumers are understandably worried about maintaining their purchasing power. An inflation spiral would be bad for stocks, bonds, and pocketbooks.

In the coming months, we will in fact see year-over-year inflation increase, most likely to the 3%-plus range. But this is largely due to prices rebounding from the pandemic lows. However the market reacts to this well-expected data, we want our clients to know that what really matters is meaningful, *sustained inflation*. That could be the catalyst to raise inflation expectations further. And fear of inflation can work like a self-fulfilling prophecy. If consumers think future prices will be higher, they will increase their spending today. Increased near-term demand raises prices for goods and inputs across the economy. Eventually workers will demand higher wages to compensate for higher inflation. Then businesses must raise prices to offset higher labor and input costs and off the wage price spiral goes. It's critically important that the Fed anchors inflation expectations before price trends get out of control.

The jury will still be out even after the next couple of months as to whether this higher inflation will be transitory or the beginning of a longer-term trend. Our leaning at the present time is that it should not be an imminent concern. We'll explain why:

- GDP growth will sharply rebound this year, but we likely won't be close to full employment for at least a few years. Wage spiral inflation can't really take hold as long as there is slack in the labor market.
- The size of the fiscal stimulus that's been issued is staggering, but it is a one-time injection. The fiscal impulse will turn into a fiscal drag next year.
- Also, not all of it will be spent or spent right away. A meaningful portion will be saved and some will go to paying down debt.
- Finally, offsetting structural disinflationary forces such as demographic trends and technology adoption have not gone away or, in the latter's case, have accelerated during the pandemic.

Still, at the backend of our five-year tactical horizon, a potential broad, long-lasting shift to stimulative fiscal and monetary policies could trigger a return to an inflationary "regime" we haven't seen since the 1970s. If that comes to pass, we could see the negative correlation between stock and bond prices that has been so beneficial to investors switch to a positive correlation, as happened back then. In that world, stocks and bonds move up and down together; bonds don't provide the diversification they normally do, challenging asset allocators.

Closing Thoughts

As the macroeconomic regime evolves, we will tactically, but prudently, adapt and adjust our portfolio exposures based on our assessment of risks and potential return. But today, we believe the most likely scenario over the next year at least is a reflationary one.

This reinforces our strong belief that what has worked so well for decades—simple portfolios consisting of U.S. stocks and bonds—won't work nearly as well over the next five to 10 years. We expect many of the asset markets and market sectors that have been laggards over the past five to 10 years to continue their re-

bound. Reflation favors non-U.S. stocks and more cyclically sensitive or value equity sectors. Reflation also increases the potential for rising rates and inflation, both negative for core bonds. We are already accounting for this in our portfolio positioning. Our portfolios tilt toward non-U.S. stocks and cyclical/value stocks. Floating-rate loans have a natural inflation-protection component with their resetting coupons. And we have diversified into flexible bond strategies that, with their yield advantage and active management flexibility, that we believe will outperform core bonds.

We thank you for your continued trust in us and invite you to reach out to your advisor with any questions about the markets or your portfolio.

Cryptocurrency Speculation: A Case of FOMO? (continue from page 1)

Bitcoin Is a Speculation, Not an Investment

For clients concerned about a falling U.S. dollar or inflation, we believe an approach of protecting against those risks (diversification, scenario planning) is both more effective and reliable. For context, our investment framework revolves around a fundamental approach to building globally diversified portfolios across asset classes, each serving a distinct role in the portfolio (some targeting the aforementioned risks):

- **Global stocks** provide a source of long-term growth (and some inflation protection) and U.S. dollar devaluation protection (from exposure to non-U.S. stocks).
- **High-quality fixed-income** can provide protection during periods of equity market stress and deflation.
- **Hybrid investments** like flexible bond strategies and floating-rate loans exhibit qualities of the first two: some capital appreciation potential (and some potential inflation protection) but with less short-term downside than stocks.
- **Alternative strategies and assets** can provide diversified sources of return and protection to reduce a portfolio's overall volatility (there are also tactical options available to us in this category if we feel the need for greater protection against unexpected inflation).

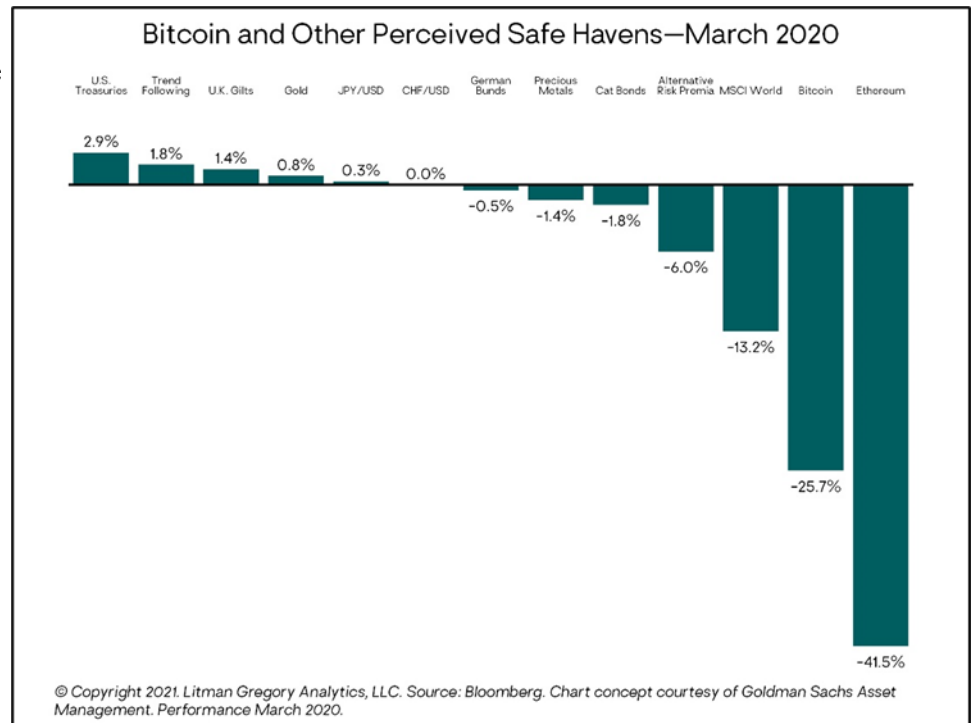
As fundamental investors, we invest in assets that we can reasonably value; that offer transparency and defined liquidity; and finally, that we can be confident are subject to a reasonable amount of regulatory oversight and legal protection to minimize the risk of price manipulation. We have a very difficult time applying any of these criteria to cryptocurrencies. Based on our current understanding, there are reasonable scenarios where the price of Bitcoin, at some point, could go to zero. As a rule, we don't tend to favor investments that have zero as their downside! Even as currencies, cryptocurrencies fail to meet the requirements to be a reliable "store of value" or "unit of account."

At this point, we see cryptocurrencies as a speculation:

- Bitcoin has acted more like a speculative "risk-on" asset than a safe haven (see the chart on the next page).
- Bitcoin is extremely volatile and has suffered multiple massive drawdowns during its short-lived existence.
- And given its volatility, Bitcoin will likely be an extremely difficult investment for most people to stick with.

Speculating can be a fun game for some people with some small portion of their money. But we aren't hired to speculate with the assets our clients have entrusted to us. And we don't need to own Bitcoin or play the cryptocurrency game to achieve our clients' investment goals.

As the capital markets continue to rally and valuations get increasingly stretched across nearly all asset classes, thus muting future returns, investors have inevitably cast a wider net. More speculative investments have lured investors after delivering spectacular short-term returns, including cryptocurrencies, special purpose acquisition companies (SPACs for short), and "meme" stocks. At times, these have been driven higher by an army of retail investors, fueled by zero-cost trading and information that is quickly shared via social media.



These spectacular returns have reintroduced the age-old, dangerous behavioral risk: FOMO, or the Fear of Missing Out. FOMO can tempt investors to take risks beyond what they would normally consider acceptable in search of incremental return. This behavior is often reinforced by reports that "smart money" endowments are making these same investments (likely in small size, limiting downside). Our guidance to clients and investors broadly is to regularly revisit your risk tolerance and return objectives and ensure that your portfolio remains well aligned with these objectives. If you find yourself lured into taking increasingly risky positions, we ask that you take a hard look in the mirror and ask yourself whether you are falling victim to FOMO.

We believe blockchain is a technology that is here to stay. Further, we have attended numerous sessions on cryptocurrencies and their potential. Equities have suffered several periods of significant price declines in recent decades but we have had confidence in advising clients to "stay the course" during such periods based on underlying fundamentals. After huge price gains and a history of huge price declines in cryptocurrencies, the lack of any fundamental basis for current prices leaves us unable to recommend a purchase except for amounts you are willing to speculate and potentially incur large losses on.

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