SfG STEARNS FINANCIAL GROUP

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Update on the Economy and Investment Markets

Welcome to the Stearns Financial *Fireside Chat.*

Coronavirus variants remain at the forefront of possible economic and investment risks given their propensity to spread more quickly and be more deadly. While this risk, if realized, has the potential to disrupt economic re-openings, most COVID-19 data is currently trending in a positive direction. We continue to hear more positive news from that portion of our network directly involved with the initially rocky but improving rollout of the vaccine.

Treasury Secretary Yellen continues to advocate for a $1.5 to $1.9 trillion U.S. government stimulus package, stating the benefits of a larger package will far outweigh its costs and that potential inflation pressures resulting from the stimulus will be modest compared to the deflationary and disinflationary pressures we now face.

The epic debate surrounding too much stimulus (risk of inflation) versus not enough (risk of deflation) was the subject of our recent SFG Live Chat (to view, click link below). The biggest takeaways from that session are summarized below:

1. Of the four major trends creating inflationary or deflationary pressures, we believe that one trend area is inflationary, one is deflationary and two trend areas are deemed a draw.

   The Four D's that create strong inflationary or deflationary effects:

   - **Détente** – global economic and political forces – periods of war have been inflationary while peace and global competition are often disinflationary or even deflationary. Today's conflicts are different than we've experienced in the past (cyber-conflict is one example), creating more complex inflationary and deflationary forces. The "rise of the rest," the growing worldwide middle class, is inflationary. **SFG assessment: Draw** (offsetting inflation and deflation)
   - **Disruption** (Technological) – from tele-medicine to Chematica-type drug breakthroughs to automation of factories to new ways to create low-carbon concrete, the techno-industrial revolution is accelerating. The pandemic has accelerated the "Amazon effect," consumer shopping power via e-commerce. **SFG assessment: Deflationary**
   - **Demographics –** spending and saving habits of aging boomers and the silent generation versus the powerful mellennial generation. **SFG assessment: Draw**
   - **Debt –** the combination of consumer loans (currently modest), student loans (large but stable), business debt (somewhat elevated but at low interest rates), and government debt (strong increases) will likely create price pressures later this decade. **SFG assessment: Inflationary**

   These macro forces are powerful – **it's the micro forces that affect you that really matter to your personal budget.**

2. **One size fits one when it comes to the impact of inflation on individual consumers** – how you spend money matters, even down to whether you're a brand buyer or not. In the Live Chat, we highlighted common spending patterns and described what "extra" inflation looks like for younger clients, recently retired clients in their "go-go" years and older clients in their "slow-go" or "no-go" years.
3. We noted also that our **business clients are generally facing higher inflation risks in the post-COVID-19 environment**, caused in part by increasing commodity shortages in the pandemic and disruptions to existing supply chains.

To view this special extended Live Chat session, visit: https://youtu.be/Ifp8aWwvDdc

COVID-19 Updates

Per Stephane Bancel, CEO of Moderna Therapeutics, in a private briefing we attended: **"There could be a dramatic shift in a positive direction in coronavirus fear and consumer attitudes by the end of May"** based on accelerating COVID-19 vaccine supply and better distribution expected in the next three months and the ability of vaccines to adapt to new mutations of the virus.

Part of his optimism – vaccine #3 is on the way – The FDA staff endorsed Johnson & Johnson's COVID-19 vaccine for emergency use last Wednesday, a critical step in bringing a third shot to the U.S. marketplace. The FDA's Vaccines and Related Biological Products Advisory Committee met Friday to review J&J's request for emergency use authorization. During similar requests by Pfizer and Moderna, the agency authorized EAU one day after the committee of outside medical advisors backed emergency use authorization. The committee is expected to recommend J&J's vaccine.

The vaccine's level of protection varies by region, J&J said, with the shot demonstrating 66% effectiveness overall – 72% in the United States, 66% in Latin America and 57% in South Africa, (where the B.1.351 variant is rapidly spreading). However, the FDA staff documents also show the vaccine was 64% effective in South Africa after approximately one month. **The company said the vaccine prevented 100% of hospitalizations and deaths.**

No specific safety concerns were identified when analyzed by age, race and comorbidities, according to the agency. There were no reports of anaphylaxis, a severe and potentially life-threatening allergic reaction. The FDA said the most common side effects reported were headache and fatigue, followed by muscle aches, nausea and fever. Vaccine effectiveness was similar across age, race and people with comorbidities, the FDA staff said. However, according to the agency, **the effectiveness of the vaccine appeared to be lower in people who were 60 years or older who also had comorbidities, like diabetes or heart disease.** In such cases, the efficacy rate was 42.3% about a month after getting the shot.

Key Points to Consider

- **Stock buybacks are back** – Stock buyback announcements have notably increased from the low levels seen at the onset of the COVID-19 pandemic. This is good news for investors as stock buybacks have historically provided some downside risk cushioning. Reasons for the uptick include a stabilizing economy (companies are more confident in future revenues and cash flow) and the desire to deploy accumulated excess cash resulting primarily from tax savings.
- **Yields on U.S. Treasuries, especially at the longer end of the curve, have risen sharply in recent weeks** with the U.S. 10-year treasury bond yield topping 1.40% this week. Yes, this sounds low by historical standards (it is), but SFG is watching several ripple effects happening as a result of rising rates. If this rise continues, it will remain a

headwind for bonds and potentially the equity markets as some stock investors move to less volatile bonds for yield.

This increase in rates may also cool the housing market as new mortgage applications may take a pause.

- **Cryptocurrency watch** – Elon Musk may like Bitcoin, but Bill Gates is not a fan. "Elon has tons of money and he is very sophisticated," Gates said, noting his concern for investors who don't have enough money to take on as much risk. **"If you have less money than Elon, you should probably watch out,"** Gates told Bloomberg.

  Gates further explained that he is not keen on Bitcoin, primarily because of the amount of electricity it consumes and the promotion of irreversible anonymous transactions. He added he is more enthusiastic about digital currencies.

  "Digital money is a good thing," Gates said, saying the difference lies in terms of being regulatory-compliant and still giving the convenience and low-cost associated with cryptocurrency transactions.

  Janet Yellen joined the Bitcoin debate stating it's an **"extremely inefficient way of conducting transactions" unless, that is, your aim is "illicit finance."**

  The price of Bitcoin took a breather from recent highs after Gates and Yellen made these remarks. **SFG views bitcoin as a "hyper-explore" strategy and advises that clients interested do extra homework to understand the pros and cons of what has become a hot craze.**

- **Office vacancies may be a short-lived phenomenon** – CBRE's latest survey of employers indicates 85% of workers will be required to return to the workplace after COVID-19 restrictions are lifted and widespread vaccinations have been completed.

  David Solomon, Goldman Sachs CEO, stated this week that remote work is an "aberration," not the new normal post-pandemic. https://www.bloomberg.com/news/articles/2021-02-24/goldman-ceo-warns-remote-work-is-aberration-not-the-new-normal

Frequently Asked Questions

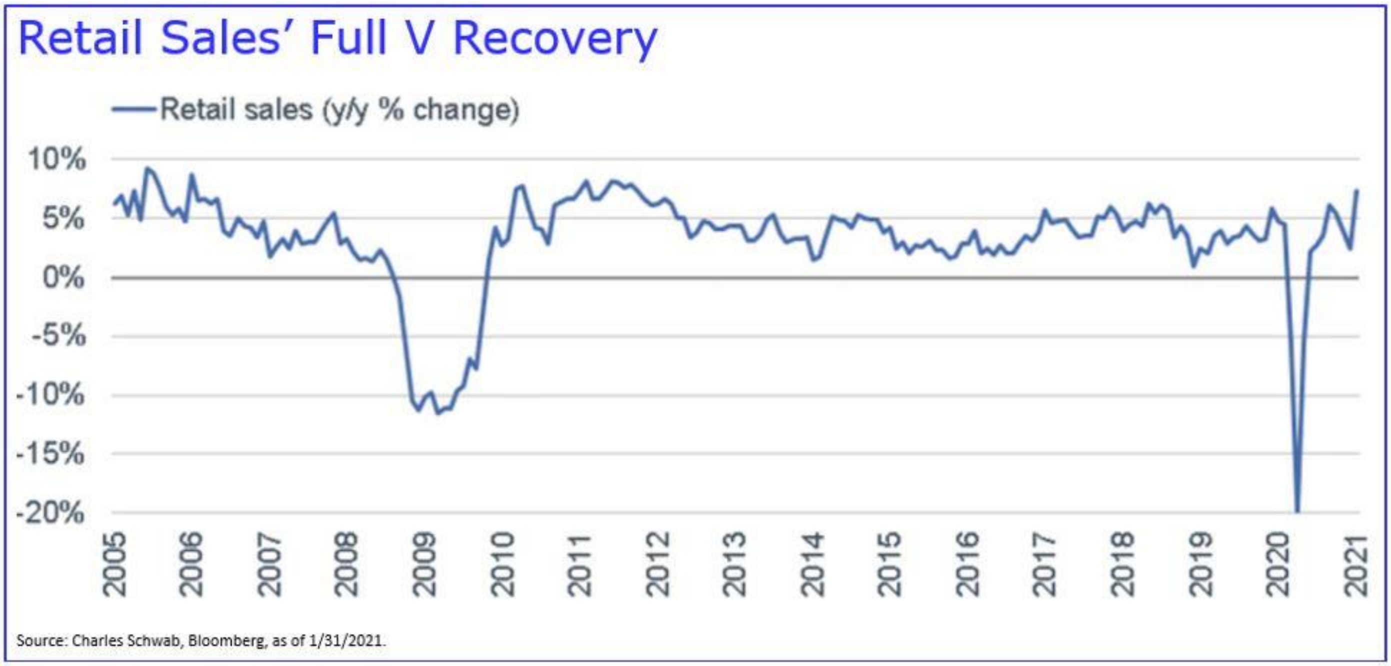
Q: In the COVID-19 endgame, how will we know when the U.S. economy is actually getting healthy again?

A: First we have to consider what sector(s) of the economy we're talking about. Businesses that are currently operating at 50 percent or less capacity will likely not be considered "healthy" until 2022. Some businesses we work with are achieving record revenues using virtual strategies, have increased free cash flow through "digital pivot" strategies and consider themselves "healthy" today. In short, the economic recovery will be uneven, with businesses such as travel and leisure rebounding more slowly and only when consumers are confident it is safe to "go out" again.

Often, when considering economic performance, we look at retail sales. However, the ability of consumers to purchase virtually anything on-line has made this indicator a bit less valuable when assessing a "healthy" versus "normal" trend in our new environment. As shown in the following graph, the year-over-year change in retail sales is now above pre-pandemic levels, while clearly the economy is not in full recovery mode. Again, this is because companies doing well during the pandemic are now offsetting the lower performance of those companies faring poorly.

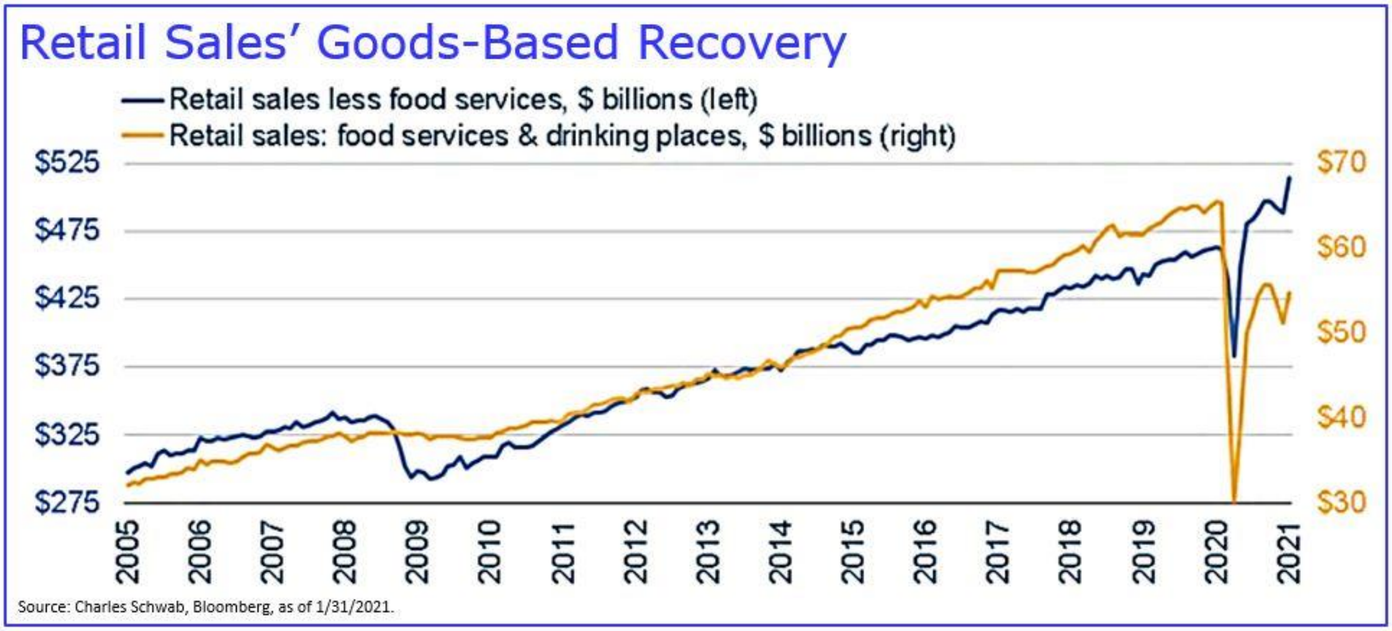
Still, it's an interesting stat to review. In January, for example, retail sales hit a new record high, helped in part by the latest round of stimulus checks that began arriving in December. This trend is likely a preview of what's to come after Congress passes the "American Rescue

Plan," currently under review. There have only been two other times in history that retail sales have beat expectations by such a wide margin - June of 2020 (coming out of the lockdown phase) and November 2001 (after 9/11).



The "breadth" of the latest retail sales report was strong with all retail sales' categories higher on a month-over-month basis. Shown in the following graph are the categories' year-over-year growth, with all but gasoline, clothing and food services showing positive growth.

Most of the explanation around retail sales' robust recovery is that it is largely **a goods-based economic indicator –** with food services being the only services-related category. You can see in the following chart the stark difference in the recovery of retail sales without food (compare on the left hand scale) and the food services and drinking places sales by themselves (right hand scale in gold).



Health Status Check

Sadly, the U.S. adult obesity rate is now at 42.4 percent, the first time it has surpassed the 40 percent mark in the nation's history. The national adult obesity rate has increased by 26 percent since 2008 and 50% over the last 40 years. Rates of childhood obesity are also increasing with the latest data showing that 19.3 percent of U.S. young people, ages 2 to 19, are obese. In the mid-1970s, this number was only 5.5 percent.

Being obese can hinder quality of life and have serious health consequences including heart disease, stroke, Type 2 diabetes, cancer and arthritis. Rising rates of obesity in the U.S. and many industrialized countries is due in large part to the changing nature of work which now requires less physical exertion than that of a generation ago. Advancing technology may be good for the back, but it's certainly not good for the gut. The obvious solution for Americans sitting in front of a computer all day is to increase physical activity away from work – a trend that has not been widely adopted.

Turning to the mental health of Americans, it appears some are enjoying the new virtual world while others are struggling with the lack of direct social interaction. It appears age and stage is a factor in how one views working from home with Millennials largely eager to return to the workplace and Boomers happy to stay put.

SFG's Take: The U.S. economy is already "healthy" for some workers and businesses and not-so-healthy for others. Looking ahead, **we expect all economic indicators to show improvement during the balance of 2021.** Pent up demand will likely allow the economic laggards (airlines, tourist attractions and restaurants) to catch up quickly, though recovering to pre-pandemic levels remains unlikely for many of these areas in 2021.

Meanwhile, the personal health index for the country has slipped backwards even as many of our clients report being in the best condition of their lives. **Simple advice from SFG's health network: break a sweat every day and find ways to channel pandemic anxiety away from food.**

Summary

SFG is balancing numerous opportunities and threats in our portfolios, customized to our clients' unique circumstances. We are being more cautious as parts of the U.S. stock market have exhibited irrational exuberance in response to positive developments related to our “three pillars” of recovery: 1) ongoing government stimulus, 2) higher corporate earnings and 3) positive news surrounding the COVID-19 vaccine strategy. **While we feel some exuberance is warranted (all three pillars are seeing positive trends), we remain cautious in areas that are more overvalued.**

In **growth** portfolios, we are leaning into a variety of short- and intermediate-term asset classes and trends that we believe have favorable forward-looking risk/reward relationships.

In more conservative **growth and income** portfolios, we are still somewhat defensive, while striving for positive real returns over inflation.

Our COVID-19 endgame investing approach can be summed up by six themes:

- Diversification with a balance of offensive and defensive measures, depending on the desired risk tolerance of our clients,
- Underweighting, or avoiding areas of higher future concern,
- A focus on higher-quality investment themes,
- Identifying and implementing buying opportunities that may be appropriate for more growth-oriented portfolios,
- Maintaining a more defensive stance using different portfolio tools for more conservative growth and income portfolios, and,
- Utilizing select alternatives to traditional bonds and stocks.

~ Dax, Dennis, Glenn, Jason, John and PJ
(the SFG Investment Committee)

REMINDER THAT COVID-19 OFFICE HOURS ARE STILL IN EFFECT

Please keep in mind that we continue to maintain limited in-person service hours at our offices in Chapel Hill and Greensboro, NC until we can all return to the office safely.
If you have a need to meet with us in person or to pick up or drop off documents, we are glad to accommodate you. We also have a number of traditional and virtual tools to facilitate document transfers. Please contact us in advance if an in-person meeting is needed.
