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SUMMARY

- We believe any weakness in stock prices would be a buying opportunity.
- We prefer taking credit risk over interest rate risk for generating income.
- We believe inflation will be transitory in 2021.

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FAQ with RiverFront's Chief Investment Officers

Global Equity CIO, Adam Grossman & Global Fixed Income Co-CIO, Kevin Nicholson

Since November, we've participated in many calls with financial advisors and their clients to talk about the implications of the election and how to think about markets in 2021. This week, we would like to highlight their most frequently asked questions and concerns because many of our readers are probably wondering about the same things. Specifically, I had the opportunity to sit down with our Global Equity CIO Adam Grossman, and Global Fixed Income Co-CIO Kevin Nicholson, to hear their responses to these frequently asked questions. *Some of the comments have been edited for brevity and clarity.*

Stocks are at an all-time high, despite the ongoing COVID-19 crisis. Are we due for a pullback in stocks?

Adam Grossman:
In the near term, we do think stock prices are a little vulnerable, whether due to a surge in COVID-19 or the uncertainty surrounding a new administration. So, we are mentally prepared for a pullback, but believe any weakness in stock prices would be a buying opportunity, in our view.

We think longer term, if the economy continues to recover, there will be more volatility as the Fed tries to end its Zero Interest Rate Policy (ZIRP). The Fed has said the Fed Funds rate will remain at zero through 2023, but that stance could be tested if inflation picks up, which might be a headwind for stocks.

Regardless, we believe any pullback should be considered healthy as pullbacks can serve as a "relief valve" for removing some of the optimistic sentiment that's been created in the rally since last March.

So, what sectors have the most opportunity moving forward?

Adam Grossman:
We think value and cyclical-oriented sectors (Banks, Industrials, Materials) stand to benefit from a continued COVID-19 recovery and likely stimulus package. However, we believe stock selection will become increasingly important within these sectors. In our view, there are many 'value traps' that exist in these more cyclical industries and many companies are trading cheap for a reason.

That all said, we still think growth areas such as technology and consumer discretionary will remain attractive considering the environment of extremely low interest rates. In fact, we would argue that growth companies that are not wildly overvalued will shine whenever volatility returns.

Our portfolios don't have much exposure to small cap stocks. What would you want to see before adding them to our equity allocation?

Adam Grossman:
Small caps are very similar in profile to our value discussion – they are cheap because of a prolonged period of stress that might now be abating. One of the issues we have with adding broad small cap exposure is that the characteristics of some industries,

such as REITS, energy, and retail still seem very risky to us so we would look to add smaller companies very selectively. The volatility of these individual stocks would make them too risky for our Advantage portfolios to own at a size that would have a meaningful impact to the total return of the strategy.

Because of this, we've sprinkled the theme of smaller companies through our ETF selection. For example, we own an infrastructure-focused ETF that covers some of our Industrial/Materials exposure, while also leaning into some of the smaller companies that we think are more attractive. We also own an ETF focused on medical devices which also backs us into some smaller companies. If our views changed in some of the riskier sectors mentioned earlier, there is always a possibility that broad small caps would be preferred.

In your view, which market sectors benefit from the new Presidential administration?

Kevin Nicholson:
As Adam noted, we think further fiscal stimulus implemented by the new administration will benefit industrial and material companies due to the emphasis on renewed infrastructure. We also think the size of the proposed stimulus package could put some upward pressure on interest rates, which would benefit financials, assuming banks can grow their loan books in this environment.

Lastly, additional stimulus might weaken the dollar further which will help companies that derive a significant portion of their revenue overseas such as technology and other materials companies.

What about sectors or industries that might be at risk from new administration?

Kevin Nicholson:
We think utilities and real estate are two sectors that could come under pressure, largely due to interest rates moving higher. This is not a direct impact of the new administration but a secondary impact stemming from the administration's emphasis on stimulus. With interest rates rising, both sectors could become out of favor as there will be other alternatives to find yield.

Adam Grossman:
We are also a bit cautious about energy as a potential political risk. We've already seen some executive actions blocking the Keystone XL pipeline, and we imagine other environmental impacts will continue to be a focus of this new administration. Considering the secular decline in oil demand, which has been exacerbated by COVID-19, we think there will be some continued headwinds for the sector.

Where should investors look to generate income from their portfolio?

Kevin Nicholson:
Given the low level of yields, investors are limited in their choices for income. For investors with a lower risk tolerance, we think BBB rated corporate bonds with maturities 1-5 years are somewhat attractive, yielding about 1% with less interest rate risk than the broad fixed income market, as measured by the Bloomberg Barclays US Aggregate Bond Index. For investors with a higher risk tolerance, we recommend short-maturity high yield bonds due to the yield pickup relative to their interest rate sensitivity. Currently*, short term high yield bonds are yielding more than 4%.

In both cases, we think investors can incrementally increase their income without the added interest rate risk. Another overlooked point is that income generation can come from equities, if one can stomach the added volatility relative to bonds. Currently*, many equities in the S&P 500 have dividend yield and earnings yields that are higher than the 10-year Treasury.

**As of the time of writing*

Adam Grossman:
I think Kevin's point about using equities for income is a good one, assuming the investor is comfortable with the volatility in their principal to achieve those higher yields. However, we would add one caveat to Kevin's point: we would favor dividend-paying stocks with a history of dividend growth, since we believe dividend-growers will be more defensive than companies that pay static dividends when the Fed finally lifts off from their zero-interest-policy.

With low interest rates and all the stimulus packages, is inflation bound to return in 2021?

Kevin Nicholson:

Our view is that inflation will be transitory in 2021 and will not become an issue until 2022 or later. The mechanics behind the inflation calculation might temporarily create the appearance of higher prices in the spring, but that is just because the March and April price figures from 2020 were so depressed that the year-over-year change could be somewhat elevated.

In our view, unemployment must drop significantly, and wages will have to increase to create the conditions to induce inflation. Some will argue that the huge savings rate highlights pent-up demand that could lead to a surge in spending when the economy finally reopens. While that may prove correct, we're not convinced that this demand surge would be sustainable for long enough to impact inflation (see our 1.04.21 Weekly View on inflation here).

So meaningful inflation doesn't happen in 2021, but could it be enough to spook the Federal Reserve?

Kevin Nicholson:
The Fed also understands the mechanics behind the inflation calculation. They understand that if inflation is not sustainable, the economy could experience deflationary problems years from now. Therefore, we believe that the Fed will stay the course and let inflation run hot in alignment with its new policy guidance of average inflation targeting of 2%. Given that inflation has been well below 2% for some time we think it makes sense that it must be well above the target for a while before raising interest rates. We believe the Fed will stay the course and remain on the side of investors until at least the second half of 2022.

Final Thoughts

It has already been an eventful start to 2021 and we expect investors to continue having more questions like the ones discussed above. In fact, this highlights why we so strongly believe in the value that a financial advisor brings to the investment journey. With a tailored financial plan, these questions can be answered with a perspective that is unique to the investor's goals and objectives. At RiverFront, we'll always try to keep our readers informed and to help advisors manage the ever-changing risks and opportunities that exist in the market. Thanks for reading and stay tuned for future updates from our investment team.

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In a rising interest rate environment, the value of fixed-income securities generally declines.

Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.

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Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

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An obligation rated BBB exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.

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The ETF Advantage portfolios differ from our Advantage portfolios in they only invest in exchange-traded products (ETFs and ETNs). ETF Advantage is offered through separately managed accounts or on model delivery platforms, depending on the Sponsor Firm.
Index Definitions:
Standard & Poor's (S&P) 500 Index TR USD (Large Cap) measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.
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