Just like that, the month of March marks the one-year anniversary of the World Health Organization's declaration that COVID-19 is a worldwide pandemic. Global equity markets continued to move upward, with **all major indices in positive territory** to begin the year. A few key themes helped lift stock prices higher—central banks keeping interest rates low, governments continuing to provide needed stimulus, businesses returning to operations, and vaccines being disseminated globally.

Canadian equities, as measured by the S&P/TSX Composite, returned an impressive 8.1% for the first quarter of 2021. This is largely due to the **outperformance of two key sectors** in the Canadian equity market—**energy and financials**—which had returns of 28.9% and 13.7% year to date, respectively. While other sectors recovered well at the end of last year, these two industries lagged behind and are now playing catch-up. Interest rates remain unchanged as the Bank of Canada held rates steady at 0.25%.

In the US, President Biden signed a new US$1.9 trillion COVID-19 relief bill to help bolster the economy, one of the largest in US history. The funds will serve many purposes, including unemployment aid, tax credit expansion, and support for vaccine distribution across the country. The US Federal Reserve noted the **strength of the country's recovery**, adjusting its forecasts higher but keeping its key lending rate unchanged (currently at a range of 0% to 0.25%). The S&P 500, a broad measure of the 500 largest US companies, returned 4.7% (CAD) for the quarter.

As wide rollout of vaccines continues around the world, internationally developed and emerging market stocks returned 2.0% (CAD) and 1.7% (CAD) for the quarter, respectively. More than 129 million cases of the COVID-19 virus have now been reported globally with as many as 2.8 million deaths. Even so, investors remain optimistic, and **most major equity indices have now returned to pre-COVID-19 levels, with some continuing to hit new highs**.

Higher inflation expectations resulting from stronger economic growth caused global yields on long-term bonds to bounce from their historical lows. Canadian and US 30-year maturities yielded 2.0% and 2.4% respectively at the end of March. These levels are still relatively low but represent a big jump compared to the near 1.0% they were yielding at this time last year. A basket of short-term Canadian government bonds returned -0.6% for the quarter.

Following are the returns for major indices for the period ended March 31, 2021:

	Q1 actual	YTD actual	1-year actual	3-year annualized	5-year annualized	10-year annualized
Canadian Short Term (FTSE 30-Day T-Bill)	0.0	0.0	0.2	1.1	0.9	0.9
Canadian Bonds (FTSE Short Term Bond)	-0.6	-0.6	2.8	3.2	2.1	2.5
Canadian Stocks (S&P/TSX Composite)	8.1	8.1	44.3	10.2	10.1	6.0
US Stocks (S&P 500)	4.7	4.7	39.2	15.8	15.6	16.9
Non-North American Dev. Stocks (EAFE)	2.0	2.0	28.7	5.1	8.2	8.3
Emerging Markets Stocks (FTSE / MSCI Emerging)*	1.7	1.7	38.7	5.6	10.5	6.4

* Q1, YTD, 1-year, 3-year, and 5-year returns are FTSE Emerging. 10-year returns are MSCI Emerging. All returns in Canadian dollars. Source: SS&C Technologies and Vanguard.

Outlook

As we enter Q2, investors will spend the next several months monitoring factors that could add further fuel to the market rally or potentially derail it. The progress and pace of vaccinations in the US have been very encouraging for the world's largest economy and its stock market. While variants of the virus are leading to higher case counts there, severe outcomes appear to be falling. European nations and Canada, on the other hand, have unfortunately not fared as well, dampening optimism over the timeline for reopening. Some market participants are wary that a return to a more normal life in the back half of 2021 may cause meaningful price inflation. However, others believe any price pressure we experience in the near term will be short lived. **What actually ends up happening with regard to inflation this year will certainly have ramifications for both stocks and fixed income investments**.

In response to the increase of treasury yields to levels not seen in over a year, the Fed made a point of stressing that **accommodative policy will remain in place until the economy is fully recovered, despite the potential for inflationary pressure**. The possibility of interest rates staying low until as early as 2023, as suggested by Fed chairman Powell, is without a doubt helpful for stock prices. This is because stocks currently offer a more attractive return profile than low-risk and low-yielding fixed income investments. Higher stock valuations can also be somewhat justified, since company operations tend to benefit from lower borrowing costs. The possibility exists, though, that if inflation does pick up, yields on fixed income investments could rise to levels that would induce investors to look to bonds as an alternative to equities sooner than anticipated.

At current levels, **certain pockets of the stock market will have a higher degree of sensitivity to rising yields—growth stocks in particular**. This classification of companies, such as technology and communication services, was already viewed to be pricey heading into Q1. Many of the less established growth names also rely heavily on debt to expand their operations, so rising interest costs are not ideal for them. The rapid bump in treasury yields we saw in Q1 contributed to the lagging performance in growth stocks to begin the year. It is possible that this trend will continue if yields creep higher, despite efforts from central banks to quell worries over inflation.

Depending on how the battle with COVID-19 plays out, stocks that will benefit from a reopening economy could continue to be in favour in 2021 even if yields climb. **Stocks that fit the "value" profile are still below their all-time highs in many cases, leaving room for price appreciation even in inflationary conditions**. Companies with a history of paying and growing dividends may also be resilient to rising interest rates. Unless there is a very significant spike in bond yields, **dividend yields will likely remain relatively appealing**. Several dividend payers also have the luxury of adjusting contracts to reflect the higher cost of borrowing, and financial services companies may actually benefit from the ability to earn a higher margin on their customer loans.

Widespread speculative activity has been a by-product of the current landscape, where money is cheap, liquidity is plentiful, and people are stuck at home. Examples include demand for fringe assets like collectibles, cryptocurrencies, and other digital assets, and also participation in crowd-driven investing behaviour via social media. The coming months will demonstrate how robust these phenomena are, particularly as restrictions on movement are eased.

A cause for concern is the amount of debt built up over the last year. **The Institute of International Finance estimates that the world added an additional US$24 trillion in debt, to a record US$281 trillion in 2020**. Finding the funds to pay this debt down is a problem, but likely one for the future, as the current priority for policy makers is to get past this pandemic.

Portfolio Strategy

Given the wide range of possible outcomes as the global economy emerges from the ongoing pandemic lockdowns, we continue to emphasize broad diversification in portfolios. **Fixed income returns will likely be below average** in coming months as the bond market adjusts to an improving economic outlook. Although central banks have committed to keeping short-term interest rates at current levels for the next few years, longer-dated bond yields are moving back toward pre-pandemic levels, which is to be expected. While headline inflation numbers will likely move higher in the short run, central banks are still of the view that this will likely be more transitory, and the outcome may be an eventual return to an economic environment of modest inflation. As we move through this transition phase, we continue to emphasize a high-quality fixed income portfolio that is tilted toward **maturities in the one- to five-year range, with some corporate bond exposure to modestly enhance yield**.

In equity markets, we continue to rebalance as appropriate. **US equities have been very strong over the past few years**, which is primarily a result of a higher weighting in technology-oriented companies. As the global economy gradually starts to reopen this year, we may see more demand for companies that will benefit from a post-lockdown economy at the expense of these technology companies. We continue to see **value in large blue chip dividend-paying companies** in Canada that offer dividend yields in the 4.0% to 5.0% range.

Overall, the **future still looks uncertain**, with rapidly increasing government deficits and inflationary pressures starting to build. Equity valuations are reasonable if interest rates remain low, but stocks may become more vulnerable if rising inflationary pressures prove to be more permanent. We continue to maintain discipline in portfolios by trimming stocks on strength, given their exceptionally strong returns from the pandemic lows, and adding to fixed income where appropriate.