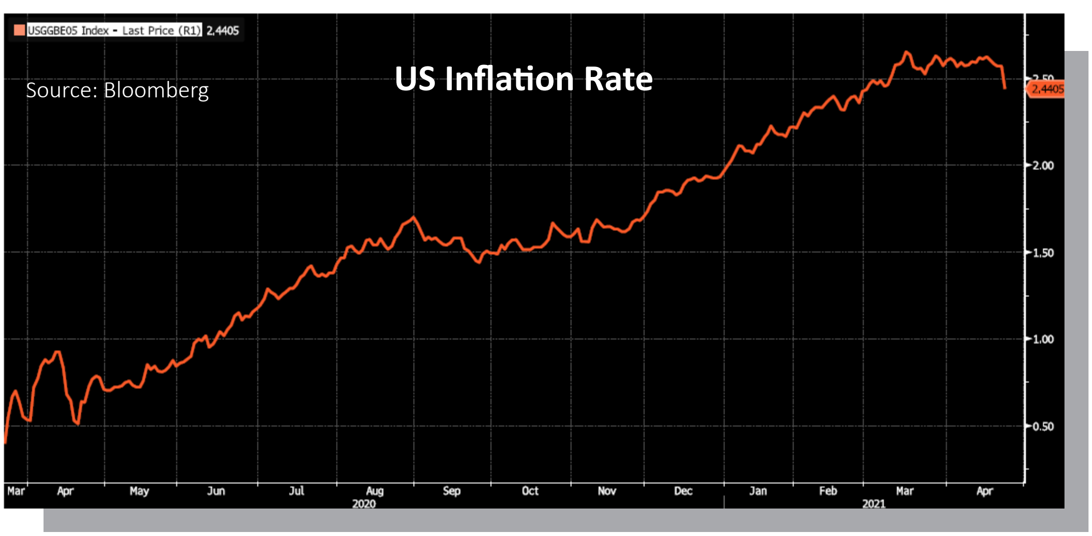
Hemenway Trust Company LLC

Spring 2021 Investment Report

The market continued to show strength during the first quarter of 2021, as the S&P 500 Index gained 6.2%. The market's performance was notable for the continuation of trends that emerged in the latter portion of 2020, primarily due to investors anticipating a robust economic resurgence. Bond investors also priced in the economic rebound as yields on longer maturity securities moved significantly higher. Specifically, the yield on the 10-year US Treasury bond more than doubled in the quarter, ending at 1.74%. The Bloomberg Barclays US Aggregate Bond index, comprised of a broad range of fixed income securities, had a 3.4% negative return in the first quarter. Created in 1976, it was the worst quarterly performance since 1981's third quarter, when the Federal Reserve was in the midst of aggressively raising rates to combat high inflation.

How can we go from one of the worst economic crises in recent history to a GDP growth rate not seen since the early '80s so fast?

First and foremost, the government took extraordinary steps to support the economy and provide fiscal stimulus - these steps have been a key driver of stock performance and will fuel the economic recovery in 2021. The US Federal Reserve slashed short-term interest rates to zero, pledged to buy government bonds in unlimited amounts, and to buy specified quantities of investment grade corporate debt and high yield exchange-traded funds. This stimulus added roughly $4 trillion of liquidity to the US economy during the pandemic, dwarfing the $1 trillion of stimulus throughout the Global Financial Crisis from 2007-2009. To date, $5.5 trillion in fiscal stimulus has been pumped into the economy, 25% of 2019 GDP. Unlike any other recession in history, transfer payments from the government caused personal incomes to rise, while shifts in consumptions resulted in record consumer savings. As a result, we are now faced with increasing inflation expectations, which are now at an 8 year high of 2.6%. Many (including Fed Chair Jay Powell) believe inflation will be transitory, rather than longer term; however, increases in inflation expectations, and interest rates began to erode investors' appetite for risk. It remains to be seen whether or not secular forces, including aging demographics, high government debt levels, and technology-driven disinflation, will keep inflation manageable over a longer-term horizon.



Why do we focus so much on interest rates?
Warren Buffet is often quoted that, "The most important item over time in valuation is obviously interest rates. If interest rates are destined to be at low levels, it makes any stream of earnings from investments worth more money. The bogey is always what government bonds yield." Expectations for rising interest rates and higher near term inflation reflect confidence in the economic recovery but are still low on an absolute and relative basis to history. And we believe a strong recovery in corporate earnings and favorable policy backdrop should provide continued support to equity markets. Current valuation levels are higher relative to the past, but equities offer higher future return potential. The S&P 500 earnings yield (a measure of the amount of corporate earnings for each dollar invested in a company's stock) currently exceeds the 10-year US Treasury yields by 150 bps; however, this is all supported by low interest rates and low inflation.

We continue to own a high-quality basket of stocks, many which pay and increase their dividends regularly. This is important, as dividend increases can provide excellent protection against inflation in the long run. Also, dividend growth stocks have outperformed the stock market over time. While it may seem counterintuitive, companies that consistently pay and increase their dividends have historically outperformed non-dividend stocks.

Regardless of the shifting market conditions, asset allocation remains critical to our overall strategy. We remain disciplined in paring back equity exposure and maintaining a core position in fixed income. Sometimes, maintaining our fixed income weighting causes investors to question why we still hold bonds. Over the last quarter, bonds have been disappointing assets, the total returns for bonds of all stripes from US Treasury to invest grade corporates to mortgages are negative, underperforming cash and the broader market. Additionally, bonds have not just had poor returns, but also have been more correlated with the stock market. Both dynamics undermine the idea that bonds provide diversification. We commonly field questions asking whether or not bonds can be diversifiers and continue to think they can for a few reasons, at least at relatively short maturities. Many investors place too much emphasis on whether or not bonds will zig, while the market zags and too little on the fact that bonds are a much less volatile asset class. As an asset class, bonds fluctuate one-third as much versus the overall market and this lower volatility of bonds contributes to a more stable portfolio. A balanced portfolio (60/40) has half the volatility of an all equities portfolio!

Given these factors, we are continuing with a measured approach and continue to trim equities and lock in gains while the stock market rallies to new highs. Our investment process favors trimming on strength and we remain tilted toward high quality US stocks (we allocate across regions, countries, market caps, factors, styles, sectors, and industries). On the fixed income side, we continue to focus on achieving ballast, stability, and income while accounting for short-term cash needs.

Our office phone numbers and emails continue to be the best way to reach us, while many of us continue to work remotely. Our contact information is on our website.