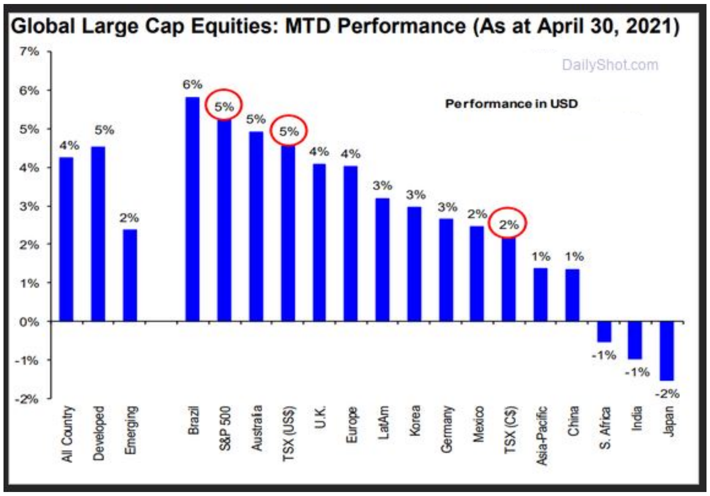
EQUITY MARKET UPDATE

As of 4/30/21 | Volume 10, Issue 4 | FFTAM.com

Stocks moved higher in April as investors focused on COVID-19 infections, fiscal policy, and earnings. The best results were seen in the US as economic data continued to point towards a recovery. A surge in COVID-19 infections in Japan and India weighed on international stocks. Investors are debating whether the increased spending proposals from President Biden will outweigh the tax increases needed to pay for the massive programs. The Fed left interest rates unchanged and vowed it is still too early to discuss tapering of quantitative easing measures. Finally, corporate earnings are exceeding analyst estimates by the largest margin on record signaling the economic recovery is gaining steam.

US Leads Global Stock Rally

The S&P 500 jumped 5.34% in April. The index was powered by the largest tech companies after the group had trailed the overall market during the first quarter. The S&P 500 has made 25 record closes already in 2021 as investors are optimistic about the reopening of the economy. Year-to-date, the index is up 11.83%.



The Dow Jones Industrial Average gained 2.78% last month. A smaller allocation to technology, along with a sharp pullback in shares of Boeing, detracted from performance compared to the S&P 500. Year-to-date, the index is still up a strong 11.30%.
The NASDAQ was the best performing US index for the first time in 2021 with a total return of 5.43%. A relief rally in the largest tech names aided results; however, the outperformance was short-lived as the index showed signs of weakness yet again in the final week of the month. Thus far in 2021, the NASDAQ is up 8.55%.

The best yearly results continue to come from mid and small-sized companies. The S&P 400 Mid-Cap Index increased another 4.50% in April, while the S&P 600 Small-Cap Index gained 2.04%. Both indexes are benefitting from a rotation towards more economically sensitive stocks. Thus far in 2021, mid and small-sized companies have rallied 18.58% and 20.64%, respectively.

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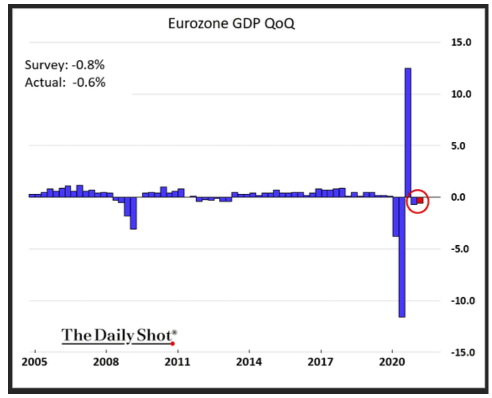
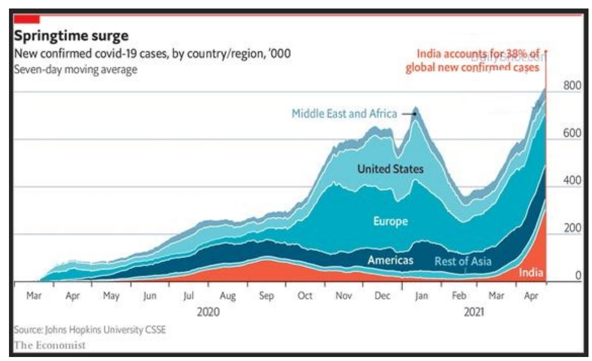
International Gains Trail the US as COVID-19 Infections Rise



Europe continues to struggle with the rollout of COVID-19 vaccines. This has resulted in further lockdowns and weak economic data compared to the United States and China. Eurozone first quarter GDP was -0.8%. This was the second straight quarter of economic contraction and triggered an official "double dip" recession. Economists are expecting robust growth for the region in the second half of the year as vaccination campaigns accelerate throughout the spring and summer. European Commission President Ursula von der Leyen announced vaccinated US travelers will be allowed unconditionally by summer to aid the economy which is heavily dependent on tourism during the summer months. However, Japan declared a state of emergency for the third time as COVID-19 infections rise just three months before the Olympics in Tokyo. The MSCI EAFE Index gained 3.08% in April, and it is up 6.82% year-to-date.

The MSCI Emerging Markets Index underperformed the US and Developed International indexes with a monthly total return of 2.50%. Results were impacted by worsening coronavirus trends throughout Asia. India remains the epicenter with over 400,000 new cases being reported daily. Deaths in the country are at record highs, and there is a shortage of hospital beds, oxygen, and vaccines to stem the tide. Chinese first quarter GDP growth of 0.6% was below market estimates. This followed lackluster PMI data as supply chain disruptions continue to hinder exports. Year-to-date, emerging markets remain the weakest performer gaining only 4.79%.

COVID-19 Infections Rise in Asia While Vaccinations Slow in the US



As previously mentioned, COVID-19 daily infections are rising at alarming rates in Asia. The worst results are seen in India. Globally, over 800,000 people are being infected daily, a record surpassing the winter surge in January. Vaccine availability remains sparse outside of the US, Europe, the UK, the UAE, and Israel, so it will be difficult to contain the spread. This increases the possibility of new mutations, along with the prospect of weaker economic results in the emerging markets. In the US, the CDC and FDA voted to resume the JNJ vaccine in adults aged 18 and over with a warning about blood clots as a rare side effect. Since the pause in the JNJ vaccine, daily vaccinations are declining with the CDC reporting a drop of 85% in JNJ vaccine usage, along with declines of 18% and 11% in the Pfizer and Moderna, respectively. Currently, half of the US population has been vaccinated, but there are 60 million doses allocated but not used. President Biden has set the goal of 70% vaccination by July 4th, and many states are beginning to offer incentives to entice people to get the shot.

US Economy Advances on Stimulus Checks & Biden Announces Spending Initiatives

Economic data showed further improvement in April. Household incomes surged as stimulus checks continue to hit bank accounts. With substantial savings, consumers went on a spending spree lifting retail sales by nearly 10%! Initial jobless claims are drifting lower which signals strong employment data in the months ahead. Job postings on Indeed are up 24.2% since the start of the pandemic, and employers across most industries are reporting labor shortages. As a result, consumer confidence is nearing the record levels seen in 2019. However, strong consumer demand, along with record low inventory levels and supply

ABILENE
400 Pine Street
Suite 300
Abilene, TX 79601
325-627-7100

BEAUMONT
3515 Dowlen Road
Beaumont, TX 77706
409-600-6460

BRYAN/COLLEGE STATION
1716 Briarcrest Dr
Suite 400
Bryan, TX 77802
979-260-2134

FIRST FINANCIAL TRUST
LOCATIONS

ODESSA
3555 Billy Hext Rd
Odessa, TX 79765
432-367-8912

SAN ANGELO
222 S. Koenigheim St San Angelo, TX 76903 325-659-5987

SAN ANTONIO
9601 McAllister Fwy
Suite 1204
San Antonio, TX 78216
210-864-4774

FORT WORTH
1000 Forest Park Blvd
Suite 200
Fort Worth, TX 76110
682-703-6404

HOUSTON
24080 Hwy 59 N
Kingwood, TX 77339
281-318-4625

STEPHENVILLE
2201 W. South Loop
Stephenville, TX 76401
254-918-6262

SWEETWATER
201 Elm Street
Sweetwater, TX 79556
325-235-6644

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chain disruptions, are rapidly increasing input prices. The IHS Manufacturing PMI data was weaker than expected, although it was still firmly in expansionary territory. The biggest downfall to the report was the inability to deliver orders on time due to input constraints and labor shortages. CPI data remained tame, which means manufacturers are eating the rising costs, but investors are debating how long this can last before the consumer sees much higher prices. The area of the economy where inventory shortages are clearly signaling higher consumer prices is housing. Nationwide, the overall supply of homes is sitting at a record low of 1.1 months, and inventories are rapidly decline across all price points. The Case-Shiller Home Price Index showed housing prices are up 12% year-over-year, and existing home prices are up 17%, the highest reading ever.

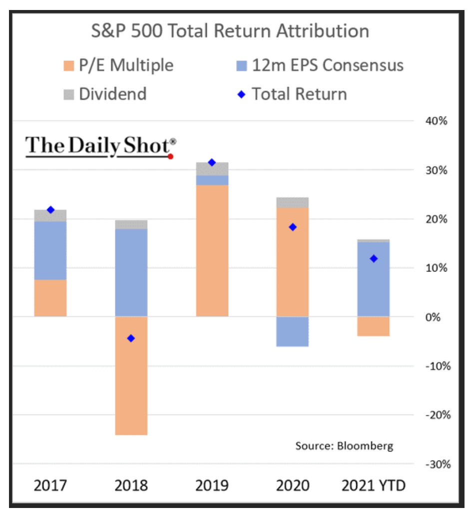
With inflation signals strengthening, President Biden unveiled his American Families Plan that includes $1 trillion in new spending and $800 billion in tax cuts and credits. This comes on top of his proposal last month to spend $2.25 trillion on various infrastructure and elderly care initiatives. The President told members of Congress he plans to raise taxes on corporations to 28% while also instituting a minimum corporate tax rate of 21% on foreign profits. He is also proposing to taxes on families making more than $400,000 per year to 39.6%, while eliminating the capital gains discount and step-up in basis adjust at time of death. Given his slim majorities in both the House and Senate, the market is betting his plans get watered down significantly prior to passage.

Fed & Market Continue to Disagree on Timing of Interest Rate Hikes

The FOMC met on April 28th and decided to take no action on interest rates. During the press conference Chairman Jerome Powell told reporters "the recovery remains uneven and far from complete." He added it is premature to begin tapering asset purchases because the economy is a long way from the Fed's goal of maximum employment and sustained inflation above 2%. The Fed's dot plots indicate an interest rate hike is not likely until after 2023. The market, however, appears to disagree with the Fed about the timing of interest rates hikes with the Fed Funds Futures Curve showing an 80% chance of one rate increase in 2022. Investors are also betting Mr. Powell announces a quantitative easing tapering in September.

Earnings Exceed Estimates by Largest Margin Ever, but Market Remains Pricey

This earnings season is becoming one for the record books. Thus far, 87% of companies have reported profits better than forecasted, according to Refinitiv. That is far above the average of 65%. The size of the beats is truly remarkable with companies announcing profits that are 22.8% above expectations, while the historical average is only 3.6%! However, stock price reaction has been muted on announcement dates, so investors are wondering if most of the good news is already priced into the market. Currently, the S&P 500 is trading at 22.9x 2021 EPS estimates. If you fast forward to the 2022 and 2023 profit forecasts, the index trades at 20.3x and 18.3x, respectively. All these valuations are well above the historical median of 16.64x, and they do not consider President Biden's proposed tax increases.



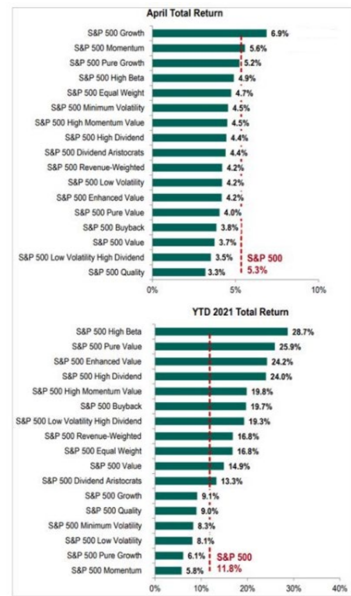
As I have mentioned many times before, the rally since November is being driven by a sharp rise in the price of cyclical stocks. A research piece from Bank of America showed investors are still 30% underweight value stocks versus growth. With the global economy reopening in various stages, along with rising inflation expectations, lower valuations, and easy monetary conditions from the Fed, further outperformance from cyclical stocks is likely.

Overall risk taking remains high according to models across Wall Street. Retail investors, in particular, are taking the highest risks through the usage of margin debt and options strategies. *The Wall Street Journal* reported household stockholdings increased to 41% of total financial assets in April. That is the highest level on record.

All these indicators signal the market has baked-in much of the upcoming improvements for the economy; therefore, stocks are vulnerable to further consolidation or pullbacks in the next few months. We expect volatility to remain high as we enter the full reopening of the economy.

Our Outlook & Strategy

Last month, I wrote that elevated risk taking and preference for the most economically sensitive stocks is coming at the expense of companies with strong balance sheets. In April, financial quality was the lowest performing factor, and it trails the market year-to-date.



This has impacted our results. First Financial has historically underperformed during the early cycle stage of the business cycle which typically lasts around one year. Our focus on owning financially strong companies with durable competitive advantages is not in vogue in the early days of the economic recovery. Since we tend to hold high quality companies for several years, our best relative performance has historically occurred during the mid and late cycle stages which last several years.

As we evaluate our roster of holdings across our equity styles, we remain highly selective about which companies to own. We are constantly searching for companies that will benefit from long-term secular trends that can produce top-line revenue growth and sustainable cash flows. The increased appetite for economically sensitive stocks that do well in inflationary environments has negatively impacted our holdings in technology and healthcare more so than other sectors.

The effects of COVID-19 will likely create a new "normal" for investors to consider. We have accelerated the time frame on the use and adoption of mobile technologies for education, shopping, entertainment, doctor visits, etc. We have also adapted to a non-centralized workforce. We have seen from the past two administrations that the United States wants to encourage domestic manufacturing of semiconductors, medical equipment, and other items deemed to be of national security importance. The rush to develop a vaccine has also brought many new healthcare related technologies to marketplace.

Finally, elevated valuations on stocks and the likelihood of higher interest rates as we progress through the business cycle will serve as challenges for all investors. When stocks have historically traded at these PE values, forward one-year and five-year total returns are well below average. This makes stocks very sensitive to changes in central bank policy, taxation, and regulations. The market is likely entering a period of consolidation in which PE ratios compress as earnings grow into the price. This creates a headwind for unprofitable companies or those with excessive valuations. Investors should also be on the lookout for any unexpected event that could trigger a market correction.