ACCESS FINANCIAL SERVICES, INC.

Quarterly Review and Outlook

April 15, 2021

First Quarter, 2021

Table 1: Benchmark Returns as of March 31, 2021

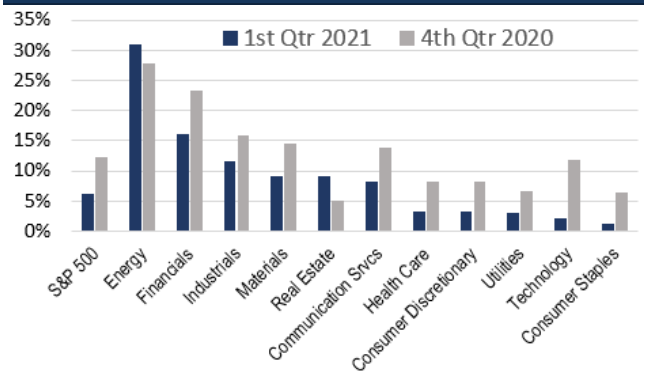
INDEX	3 Mo.	6 Mo.	12 Mo.
US STOCKS			
S&P 500 Index (large-cap stocks)	6.17	19.07	56.35
Dow Jones Select Dividend Index	19.70	42.55	61.70
Russell 2000 Index (small-cap stocks)	12.70	48.05	94.85
FOREIGN STOCKS			
MSCI EAFE Net Total Return Index (US$)	3.48	20.08	44.57
S&P Europe 350 Index Net TR Index (US$)	8.52	20.43	35.42
MSCI Japan Net Total Return Index (US$)	1.57	17.07	39.73
MSCI Emerging Markets Net TR Index (US$)	2.29	22.43	58.39
COMMODITIES & CURRENCIES			
US Dollar	3.66	(0.70)	(5.87)
Euro	(3.98)	0.08	6.34
Gold	(10.04)	(9.44)	8.28
Oil (West Texas Intermediate)	21.93	47.09	188.87
BONDS			
BBgBarc US Aggregate Bond (inv. grade)	(3.37)	(2.73)	0.71
BBgBarc US Treasury 20+ Year	(13.92)	(16.52)	(16.31)
BBgBarc US Treas. Inflation Protected Secs.	(1.47)	0.12	7.54
BbgBarc Municipal Bond	(0.35)	1.46	5.51
BBgBarc US Corporate TR (corporate bonds)	(4.65)	(1.74)	8.73
BBgBarc US Corp. High Yield Bond	0.85	7.36	23.72
S&P International Sov Ex-US Bond US$	(5.49)	(2.48)	2.08

BBgBarc: Bloomberg Barclays; Source: Bloomberg and Morningstar

As shown in Table 1 above, stocks and other risk assets posted strong gains again during the first quarter.

The shift from pandemic losers to pandemic winners following the presidential election we highlighted in last quarter's *letter* persisted with energy, financials and industrial stocks delivering strong returns while consumer discretionary and technology stocks lagged (Chart 1).

Chart 1: Stock Market Sector Returns

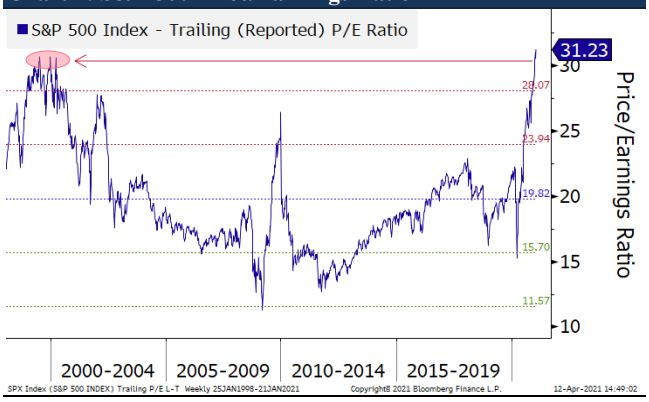


Source: Access Financial Services using Bloomberg Data

Likewise, most of the other "reflation trades" (trades believed to benefit from super easy monetary and fiscal policy, and the reopening of society) we discussed continued their outperformance during the quarter.

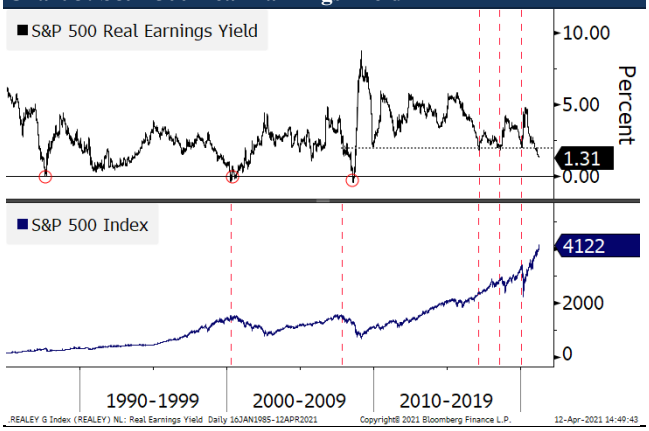
Valuations for the stock market remain stretched by most measures with the trailing price/earnings ratio for the S&P 500 higher today than it was at the end of the dotcom stock market bubble before the market's collapse in 2000 (Chart 2) and the real earnings yield (the inverse of the market's price/earnings ratio deflated by headline consumer price inflation) having continued its move lower since highlighting this measure last quarter (Chart 3).

Chart 2: S&P 500 Price/Earnings Ratio



Source: Access Financial Services using Bloomberg Software & Data

Chart 3: S&P 500 Real Earnings Yield



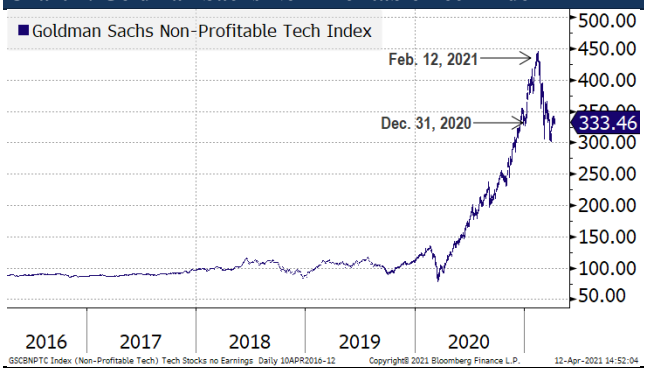
Source: Access Financial Services using Bloomberg Software & Data

There has, however, been a bit of a cooling in some of the most speculative areas of the stock market. The Goldman Sachs index of technology stocks (using a broad definition) that are not profitable peaked on February 12 and has declined back to where it stood at year end (Chart 4). The same is true for call option volume which is an indication as to the amount of leverage investors are employing (Chart 5).

In the market for initial public offerings (IPOs), signs of weakness have been emerging among the latest market debuts. Traditional initial public offerings have been

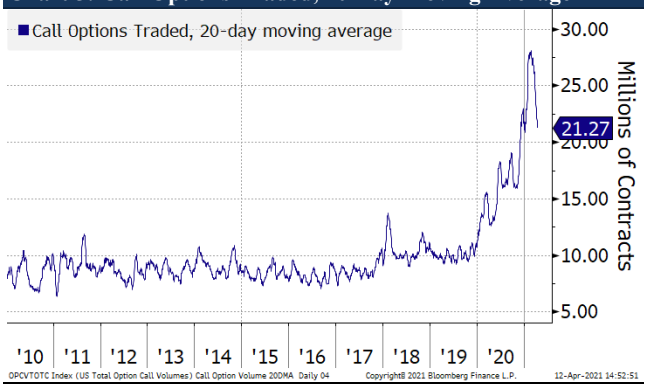
increasingly sold off during their first sessions. Others are getting postponed or downsized at an unusually high rate. Listings by special purpose acquisition companies have also dwindled after fueling a record quarter for IPO activity at the start of the year.

Chart 4: Goldman Sachs Non-Profitable Tech Index



Source: Access Financial Services using Bloomberg Software & Data

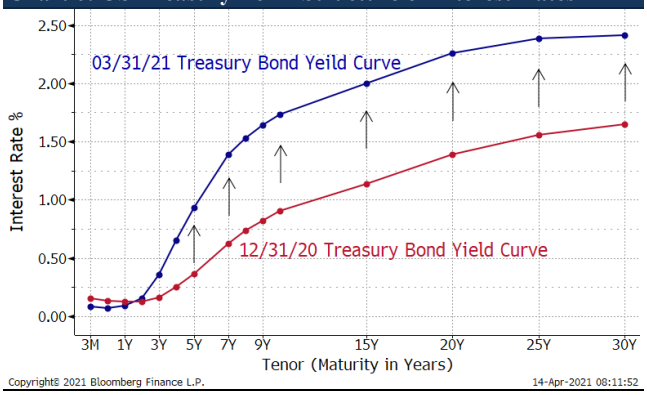
Chart 5: Call Options Traded, 20 Day Moving Average



Source: Access Financial Services using Bloomberg Software & Data

The strength in risk assets helped overshadow an unusually weak bond market as interest rates on bonds with maturities greater than two years rose significantly (Chart 6 and Chart 7 top panel) causing bond prices to decline (Chart 7 bottom panel).

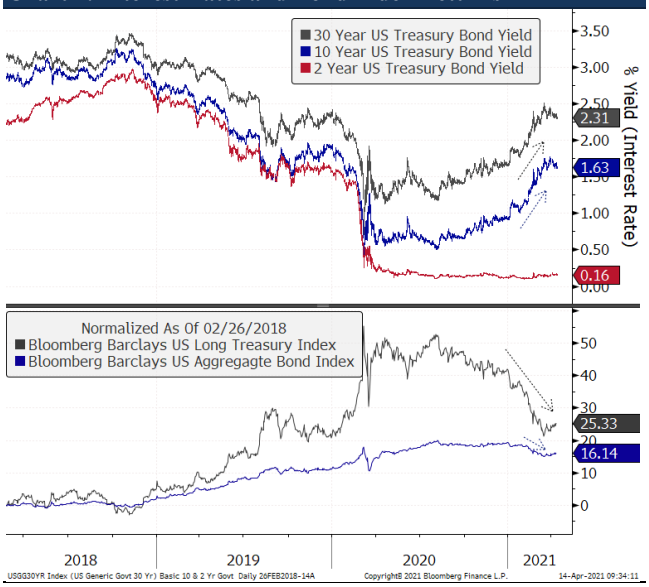
Chart 6: US Treasury Term Structure of Interest Rates



Source: Access Financial Services using Bloomberg Software & Data

The Bloomberg Barclays US Aggregate Bond Index (a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market) declined by 3.4%, posting its worst quarterly loss since the third quarter of 1981 when it lost 4%.

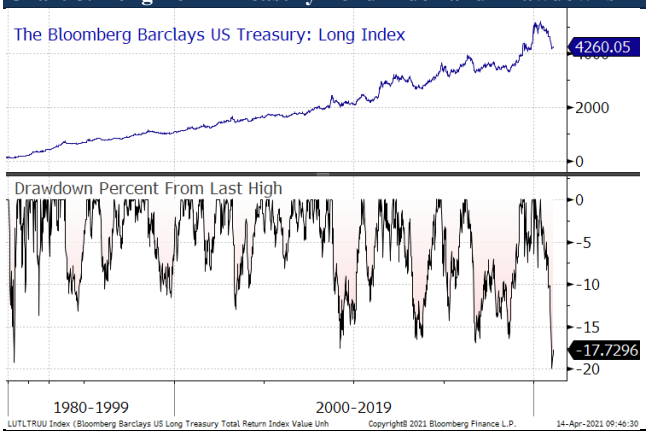
Chart 7: Interest Rates and Bond Index Returns



Source: Access Financial Services using Bloomberg Software & Data

During the quarter, the ten-year Treasury yield (interest rate) increased from 0.91% on January 1 to 1.74% on March 31. While the move may seem insignificant in absolute terms, the relative increase is one of the strongest from a historical perspective and has brought long term US Treasury Bonds as proxied by the Bloomberg US Long Treasury Index into bear market territory (declining by over 20% from peak prices last year) as shown in Chart 8.

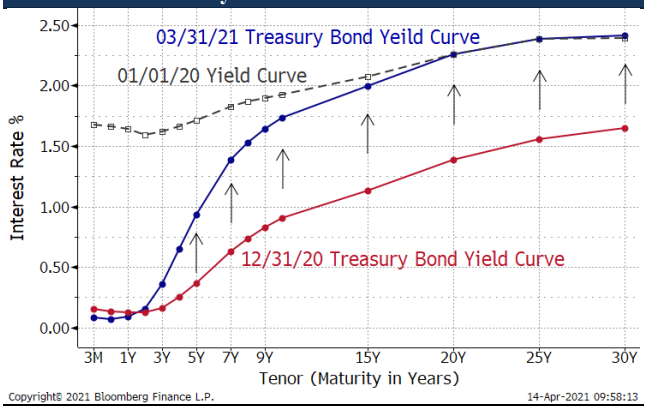
Chart 8: Long Term Treasury Bond Index and Drawdowns



Source: Access Financial Services using Bloomberg Software & Data

While the magnitude of the move higher in interest rates has been significant, long term yields have really just worked their way back to pre-Covid levels while the Fed continues to hold short term interest rates at the zero bound (Chart 9 – gray yield curve). The rise in yields is consistent with the current environment characterized by multi-trillion-dollar stimulus, the vaccine rollout, and the Federal Reserve's (the Fed) formal notice to markets that it is willing to tolerate higher inflation.

Chart 9: US Treasury Term Structure of Interest Rates



Source: Access Financial Services using Bloomberg Software & Data

Fed projections of a 0% federal funds rate (the target interest rate set by the Fed at which commercial banks borrow and lend their excess reserves to one another overnight) for the next 2 ½ years coupled with the extraordinary size of fiscal stimulus have understandably stoked investor concerns about a significant rise in inflation. Larry Summers' recent interview with Bloomberg was representative of the concern, during which he criticized the Biden administration's fiscal policy as the "least responsible" that the US has experienced in four decades and warned of the potential inflationary consequences of overheating the economy.

We know the Biden victory changed the fiscal policy setting, producing a Democratic majority in the US Senate and enabling the Biden administration to project three budget reconciliation bills (for FY2021, 2022, 2023) that require zero Republican votes.

The first of these bills was signed into law quickly as expected. The $1.9 trillion American Rescue Plan Act consists of short-term cash handouts and social spending that will add fuel to an economic recovery that is rapidly accelerating due to the rollout of vaccines for Covid.

The American Rescue Plan Act reinforces a new era of "Big Government" that should be ascribed not to any particular party but to underlying populist pressures in the United States. President Trump's big spending ways and pandemic relief packages had already produced a major step up in the government contribution to economic output and this will go higher once Biden's 8.7% of GDP bill is added to the mix.

The President recently spoke in Pittsburgh where he unveiled his economic vision and policy proposals going forward. He proposed a $2.3 trillion American Jobs Plan infrastructure and green energy package to be implemented over eight years which will be part of a $4 trillion-plus Build Back Better legislative agenda that will be partially offset by an estimated $3 trillion in tax hikes to take effect over 15 years. The result will be an additional pro-cyclical boost to fiscal thrust, GDP growth, and inflation expectations, some potential for a productivity boom, a possible expansion of the social safety net, and tax reform that reduces US corporate profits.

So far, the financial markets are signaling approval despite the confirmation that corporate tax rates will go up. The details of the plan are shown in Table 2 which makes it clear that over $500 billion can easily be subtracted from the plan during negotiations as not having to do with infrastructure. However, we think most of the new spending, including the social welfare components, will pass, since Democrats will use the budget reconciliation process.

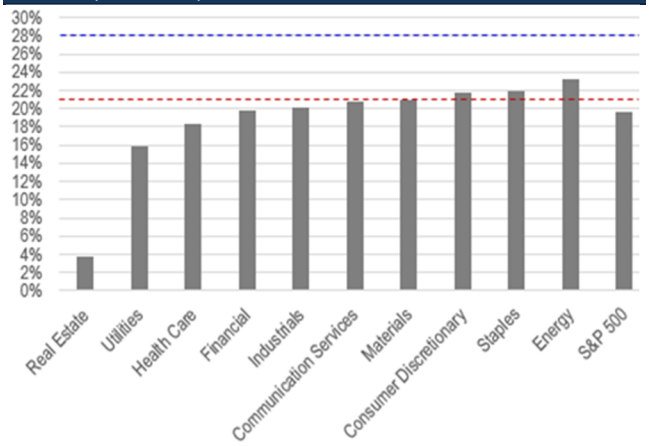
Table 2: Biden's American Jobs Plan Spending Policy

Transportation Infrastructure	$621 billion
Power Infrastructure	$100 billion
Clean Water	$111 billion
Affordable Homes and Retrofits	$213 billion
Broadband	$100 billion
Modernize Public Schools	$100 billion
Community College	$12 billion
Childcare	$25 billion
Upgrade VA Hospital & Federal Buildings	$28 billion
Long Term Care - Elderly and Disabled People	$400 billion
Research and Development	$180 billion
Manufacturers & Small Business	$300 billion
Workforce Development	$100 billion
Workforce Enforcement	$10 billion
	$2,300 billion

Source: BCA Research using data from WhiteHouse.gov

A big question is tax hikes. While there is some support for limiting the corporate tax rate increase to 25%, investors should be prepared for the negative impact on corporate earnings based on the 28% corporate tax rate that Biden has presented. This is a 33% increase from the current rate of 21% (Chart 10).

Chart 10: Corporate Tax Rates – Current (Red Line) & Biden's (Blue Line)



Source: Access Financial Services using Bloomberg Data
Computed using the average tax rate across companies that had data available and excluding outliers for 2020.

It will take time to draft and negotiate the spending and tax provisions and then get them passed in both the House and Senate. The Democrats also face tight margins in the

House, where they can only lose four votes. The earliest possible passage – based on historical precedent – is in May. The average length of time would put passage in November.

While the timing of the Bill's passage is uncertain, I think the odds of it passing are high. First, because Democrats have control of Congress and second, because public opinion not only favors infrastructure but also favors tax hikes on corporations – especially if they are to pay for infrastructure. The solution has been to rebrand renewable energy, broadband Internet, subsidized housing, and a range of other government programs as "infrastructure," and to rebrand social welfare as "human infrastructure." Consider the following:

> The public favors higher taxes on corporations: 69% of Americans believe corporations pay too little in taxes, while only 6% believe they pay too much.
> The public favors higher taxes on high-income earners: 62% of Americans believe that upper-income earners pay too little in taxes and only 9% believe they pay too much.
> Infrastructure is bipartisan: The gap in the views of Republicans and Democrats is narrow when it comes to infrastructure.
> The public approves of Biden's corporate-tax-hikes-for-infrastructure tradeoff: About 54% approve outright, in line with Biden's overall approval rating, including 52% of independents and a non-negligible 32% of Republicans.
> Ballot measures on the local level for transportation funding usually win high levels of voter approval, meaning that people vote to increase their own taxes if they think traditional infrastructure will be improved. The average approval for such measures stood at 74% in 2016 and rose to 94% in the 2020 election cycle.

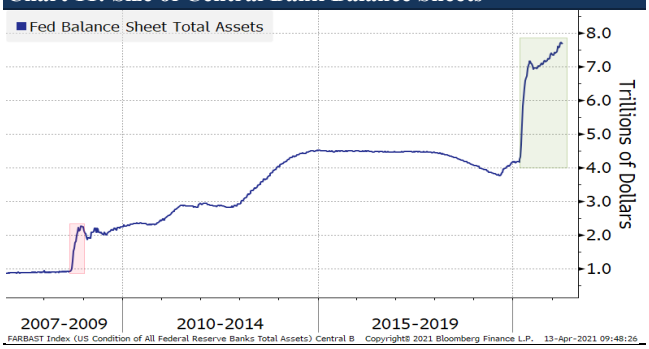
The bottom line is that the Democrats have the votes for an infrastructure package, they have the votes for at least some degree of corporate tax hikes, and they have popular opinion behind the principle of tax hikes in exchange for infrastructure upgrades.

A bill with Biden's spending measures and only half of the tax hikes would increase the budget deficit by $1.4 trillion. A bill with all spending and all tax hikes would increase the deficit by $400 billion.

Where we are less certain is in the second part of Biden's economic plan, the $1.9 trillion American Families Plan, which contains social welfare spending, an expansion of the child tax credit and other tax cuts for the lower and middle classes, and the tax hikes on upper-middle class and wealthy individuals and households. This program will be outlined this month. It will be a challenge to pass it prior to the 2022 midterm elections, depending on how fast infrastructure moves through Congress.

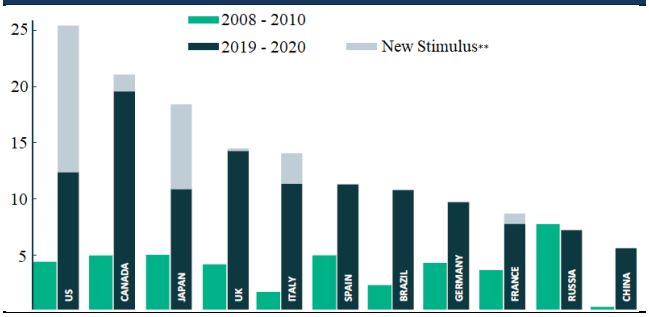
Unlike during the Great Financial Crisis (GFC) of 2008 – 2010, central banks and federal governments were swift in their response to the pandemic (Chart 11 and 12). Now, in the aftermath, the combination of historically low interest rates and unprecedented levels of fiscal stimulus has set the stage for inflation to accelerate.

Chart 11: Size of Central Bank Balance Sheets



Source: Access Financial Services using Bloomberg Software & Data

Chart 12: Fiscal Stimulus as a % of GDP*



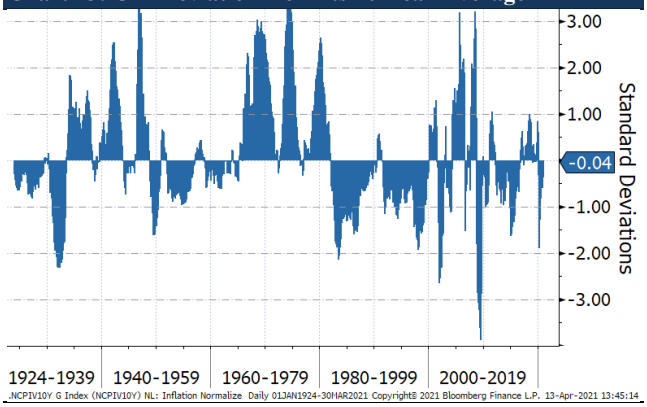
** Calculated as the absolute value of the change in overall balance (Net Lending/borrowing as % of GDP).*
*** New stimulus plans revealed after October 2020.*
Source: BCA Research using IMF Fiscal Monitor (October 2020)

The macroeconomic backdrop since the GFC has bordered on arcadian from an inflation perspective. While you will rarely hear anyone without an economics PhD complain that inflation is too low, that has been a persistent concern for the Fed and other central banks throughout the post-GFC era. Yet over this period inflation volatility, as well as its average level, has been especially low and that is the very definition of price stability which is one of the Fed's primary mandates. Maybe it is base effects, and perhaps it is transitory, but that environment is coming to an end, if only temporarily. As investors, this is important because stocks have become increasingly sensitive to inflation.

While central bankers concern themselves with the constraints of the zero lower bound on short term interest rates and the potentially destructive impact of price deflation, out in the real world no one actually wants to pay more for their basket of goods and services and the sad fact is that the food and energy inflation that economists urge us to look beyond has a disproportionate impact upon the lower income cohorts that the Fed itself claims that it wants to help.

In truth, inflation has been remarkably well behaved since the GFC if we look at price trends by comparing them to the normalized deviation of headline consumer price inflation (CPI) from its ten year average. For all the concern about insufficient inflation, we have not had a CPI reading two standard deviations above or below the ten year average since 2009 (Chart 13). That is the third longest such streak over the last century. You have to go back to the 1950s and 1960s to find a period where there were so few inflation observations more than one standard deviation from average.

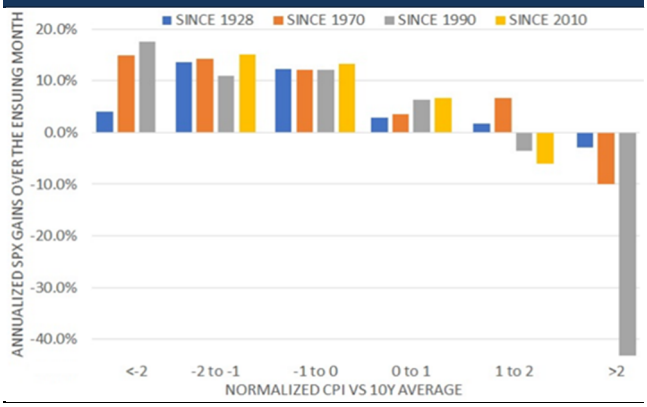
Chart 13: CPI Deviation from Its 10 Year Average*



**Last data point is month prior to March CPI data released on April 13, 2021.*
Source: Access Financial Services using Bloomberg Software & Data

There is a link between the volatility of inflation, as well as its level, and stock market valuations. They are not the only things that matter, but they are an important consideration. We can see this by looking at the performance of the S&P 500 during various normalized inflation regimes. Specifically, by dividing CPI into six different categories: +/- two standard deviations or more from the ten-year average, +/- one-to-two standard deviations from the ten-year average, and +/- zero-to-one standard deviations from the ten-year average and then calculating the annualized return for the month following each reading. The results are illustrated in Chart 14.

Chart 14: Normalized CPI and S&P 500 Performance



Source: Bloomberg Finance LP

Two clear trends can be seen. One, the performance of the stock market deteriorates when CPI rates are above the ten-year average, and the performance gets worse as the deviation increases. Two, this trend has strengthened over time.

On April 13, we exited the current stable inflation regime with a year-over-year inflation print of 2.6% which is 0.98 standard deviations above the ten-year average. It is true that much of the increase comes down to base effects, but it is false that all of it is. The annualized rise in CPI over the past three months versus the prior three is 2.8%; that has got nothing to do with the collapse in energy prices last spring.

What is notable in Chart 14 is that since 1990, equity returns have been negative when annual CPI rates are more than one standard deviation above average. That is now where we are today and where we will remain when inflation data for April and May are published barring another large drop in energy prices. The impact has intensified in recent decades, which we could probably attribute to the low interest rate regime and/or the increasing duration of stock market leaders.

Perhaps this time will be different given that investors seem certain that they have nothing to fear from the Fed. Then again, if long term bond yields resume their upward trajectory, the level of short term interest rates may not matter that much. At the very least, it seems reasonable to think that Goldilocks is beginning to look for the door. Exactly where she is going will be a key question for stock markets moving forward.

Support for a higher inflation outlook can be found in other economic data as well. The Institute for Supply Management (ISM) manufacturing and services purchasing managers index (PMI) surveys are two of the most widely followed economic indicators and stand out amid the mass of economic data that investors have to navigate. They are issued monthly with virtually no lag and provide a reliable read on the economy's direction. Index readings above 50 percent indicate that the economy is generally expanding; below 50 percent indicates that it is generally contracting.

The March composite releases were quite strong, with the manufacturing survey hitting a 37-year high and the services survey reaching the highest level in its 24-year history.

Chart 15 shows the ISM manufacturing PMI survey was strong across the board, with new orders and order backlogs at or near extended highs and the production and employment indexes pointing to broad pickups. The prices paid and supplier performance indexes indicate that upward price pressures and supply bottlenecks have taken hold across broad segments of the economy. Those components and the accompanying comments from survey respondents suggest that upward inflation pressures are building.

As shown in Chart 16, the ISM services PMI survey closely resembled its manufacturing counterpart. New

orders and business activity were very strong, though not as large a share of services employers are looking to hire. The share of respondents facing higher prices has broken out and lengthening supplier delivery times are prevalent. The services sector has more slack than the manufacturing sector, but it is not immune from inflation pressure.

It is important to note that the PMI surveys are diffusion indexes that capture share rather than magnitude. The record and near-record readings do not mean that respondents' businesses are growing at their most rapid rate in decades; they mean that the share of respondents who report quickening growth is at record/near-record levels. The same goes for the near-record prices paid readings; they do not reflect that prices are rising at close to record rates, they reflect that an unusually large proportion of companies report increasing prices.

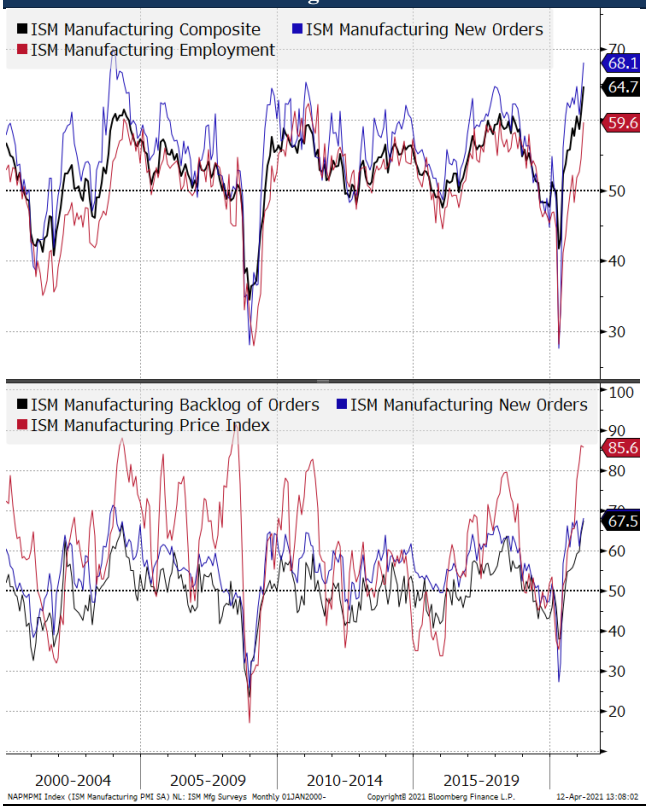
Companies on both the manufacturing and service sides of the economy are reporting steep increases in input prices, which offers up a difficult choice: accept margin compression, and therefore lower earnings, or try to pass the costs on to customers. History suggests that attempts at the latter are probably inevitable. There is a good fit between the composite ISM price indexes and headline inflation. The ISM gauge usually leads reported inflation and is currently suggesting an inflation rate well in excess of anything that can be explained by base effects (Chart 17).

Moreover, we can get a sense of underlying price dynamics by looking at higher-frequency rates of change. An annualized measure of the 3 month/3 month rate of change strips out both the sharp drop in prices last spring as well as the subsequent bounce in the summer. The new standard for the producer price index (PPI) which looks at final demand only has a history going back a little more than a decade, but it correlates very well with CPI, and again points to a sharp acceleration that cannot be explained by base effects (Chart 18).

As it stands today, the Federal Reserve is explicitly aiming to generate a temporary overshoot of inflation relative to its longer term target, the Biden administration's fiscal plan is unquestionably large, and there is a tremendous pool of excess savings that could be deployed later this year once the pandemic is essentially over. Clearly, the risks of overheating are higher than they have been in the past.

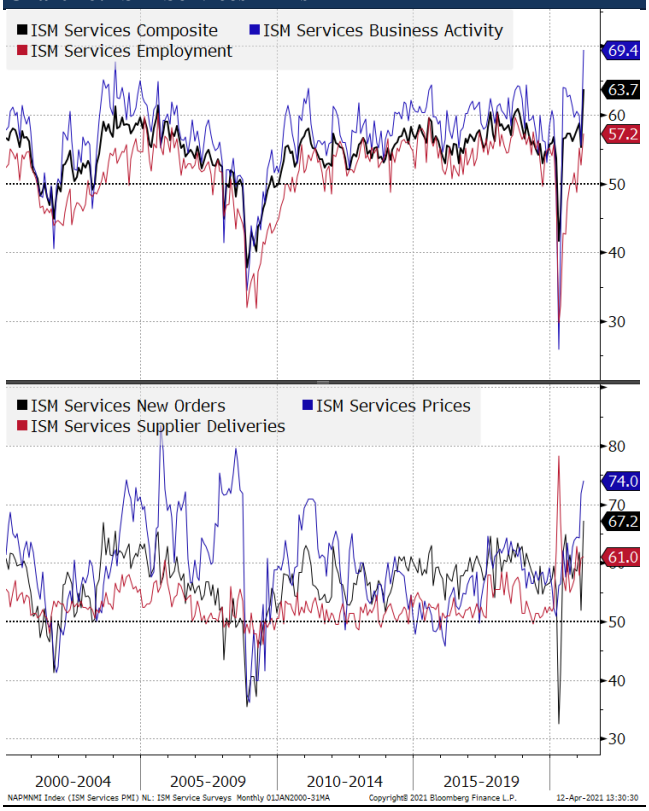
As it relates to investment strategy, inflation is not always bad for stocks and other risk assets. However, it is when inflation is rising, the upside volatility of the increase is high *and* when rising inflation forces central banks to tighten monetary policy that the outlook for stocks normally deteriorates.

Chart 15: ISM Manufacturing PMIs



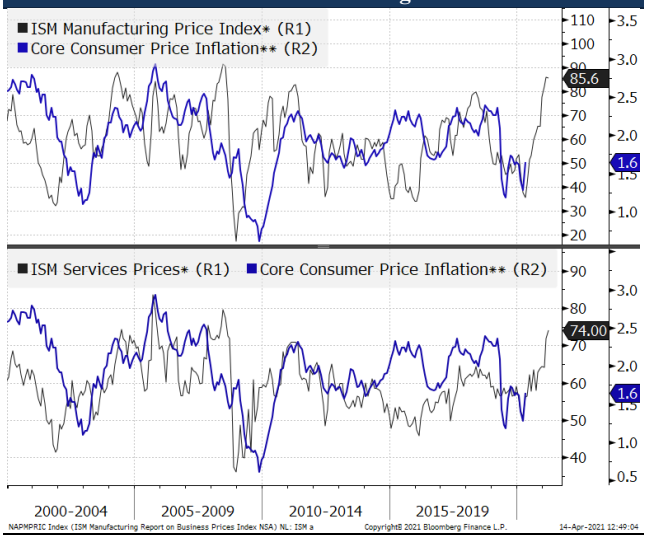
Source: Access Financial Services using Bloomberg Software & Data

Chart 16: ISM Services PMIs



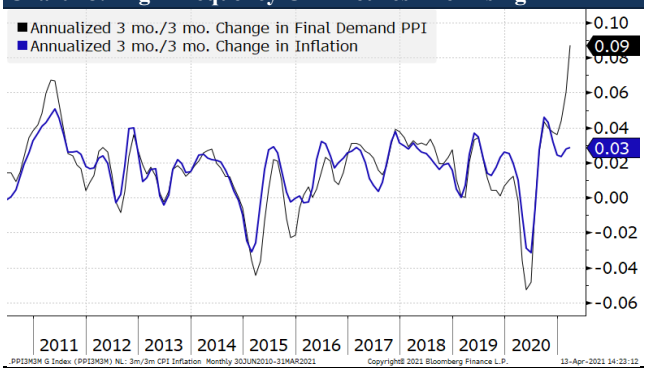
Source: Access Financial Services using Bloomberg Software & Data

Chart 17: Inflation Pressures Have Begun to Accelerate*



**ISM indices are advanced by 11 months.*
***Excludes food and energy.*
Source: Access Financial Services using Bloomberg Software & Data

Chart 18: High Frequency CPI Metrics Are Rising



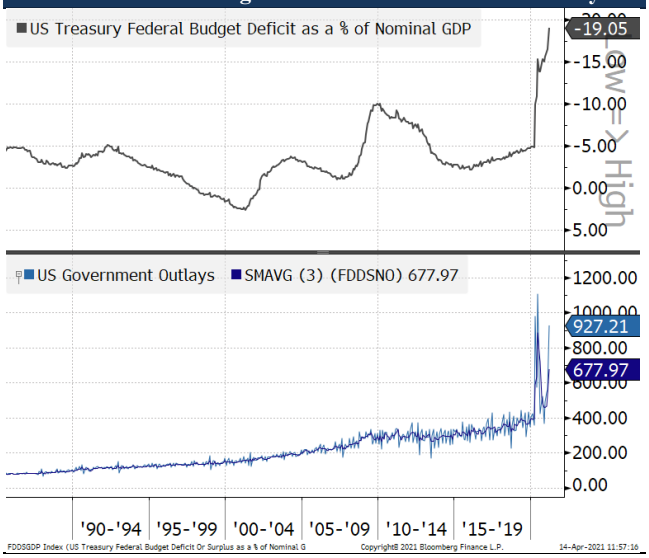
Source: Access Financial Services using Bloomberg Software & Data

The Federal Reserve has said it will allow inflation to rise above 2% to offset the effects of consistently missing their inflationary targets over the past decade. This means we can expect that the Fed will allow inflation to run up further than it has in the past before acting. Because the impact of monetary policy on inflation is felt with a significant lag, the risk is that the Fed gets behind the inflation curve and has to rapidly tighten monetary policy in an attempt to catch up. We are definitely not there yet.

Our base case outlook is that the Goldilocks backdrop of solid growth, easy monetary policy and mega-fiscal stimulus, along with the success of the vaccination effort and measures undertaken to limit defaults by households and businesses will remain in place for the immediate future. Stocks rarely experience significant reversals outside of recessions and this backdrop all but excludes the possibility of a recession and therefore argues for risk-friendly investment strategy.

Beyond the near term, higher taxes, the size of the federal deficit (Chart 19 panel 1), reduced government handouts (Chart 19 panel 2), unsustainably high stock market and other risk asset valuations, investor complacency, and higher interest rates will all weigh on the "reflation trade" and financial market returns.

Chart 19: Federal Budget Deficit and Government Outlays



SMAV (3): Three-month simple moving average
Source: Access Financial Services using Bloomberg Software & Data

Given our outlook, we will remain invested in the sectors and industries we believe have the best risk/reward profile in the stock and bond markets.

While Fed Chair Powell is very confident that inflation is of little concern, we will be monitoring the data for advance indications that it could be gaining a foothold and therefore change the course of monetary policy to the detriment of the financial markets.

Brant Kairies
952-885-2732