**LINCOLN CAPITAL – INVESTMENT UPDATE – MAY 11, 2021**

# MOVING IN A DEFENSIVE DIRECTION

Our accounts have participated in the positive equity returns following the Great Recession in 2007-2009, and we remain bullish on the prospects for economic growth and higher stock prices in the years and decades ahead. Yet, on a near-term basis, we see numerous signs that give us pause, as the odds of a possible decline of 5% to 10% or, perhaps, 15% or more are increasing. While discomforting, we doubt that it will become a bear market, as deeper declines are generally associated with a recession, which is unlikely. Within the spectrum of investment policies (Aggressive on one end, Defensive on the other end, Neutral in the middle), last week we began the gradual move of our investment stance to the defensive side.

**Rationale for Policy Change**: For more than a decade our federal government and the Fed have injected massive amounts of liquidity and stimulus into the economy with more on its way. These actions have worked as intended, as the economy is gathering momentum and is poised for above average growth. As expected, the stimulus has worked to reflate all asset prices (stocks, bonds, real estate, commodities, and others). A related development is global interest rates declining to a range of marginally positive to negative. These factors have forced all investors to take increased risk to earn rates of return resulting in increasing signs of excess, such as in special purpose acquisition companies (SPACs), electric vehicles, retail trading, margin debt, cryptocurrencies, to name a few.

The positives from excesses can develop into negatives, and it is difficult to determine when and how the good excessive stimulation converts into being bad with precision. What concerns us most for the near-term is the Federal Reserve's path of quantitative easing and interest rate hikes. We agree with the consensus that, with increasing vaccinations and COVID in retreat, we may experience the best economic growth seen in decades. As a corollary, we expect this rate of growth to result in pockets of inflation due to supply disruptions and a shortage of qualified employees. As this comes into view in the next few months, it may be increasingly difficult for the Fed to stay mum on reducing accommodation. Communication on how to wind down extraordinary bond purchases is likely by the end of the summer. This transition period is bound to create volatility, as can be seen with Janet Yellen's recent gaffe which caused some market ripples (it is a no-no for Treasury officials to comment on interest rates and monetary policy, even more so when directly contradicting the Fed Chairman).

**Implementation:** What does "defensive" mean for your portfolio? For one, this will be a methodical transition with several triggers such as equity valuations moving higher without a commensurate improvement in fundamentals. We become defensive through three channels – raising cash balances, changes in sector allocation, and security selection (placing more emphasis on downside scenarios when assessing risk/reward potential of securities). Note that, while we expect to further reduce risky asset holdings (stocks) and reach our most defensive position, our self-imposed portfolio disciplines, and the asset allocation ranges that we tailor to each client account means that ample amounts of long-term funds will still be invested in equities. The future has many different paths and probabilities; for example, the paths for 15%+ returns for the remainder of the year are limited, yet not impossible. As a hypothetical, if by implementing our defensive positioning we sold out of equities entirely, and then a low probability upside scenario did occur, it would be detrimental to client's long-term goals and objectives. In summary, despite a relatively placid start to 2021, we expect slightly rougher waters ahead, creating opportunities to profitably deploy client cash holdings.