2nd Quarter 2021 Review

Equity markets added to their gains for the year in the second quarter. The Dow Jones Industrial Average gained 4.6%, the S&P 500 was up 8.2%, and the NASDAQ rose 9.5%. International stocks as measured by the MSCI EAFE Index lagged the U.S. markets, rising 4%. The investment grade U.S. Aggregate Bond Index was up 1.32% for the quarter, as yields fell. For the year to date period through June 30, the respective gains for the Dow, S&P 500 and NASDAQ are 12.7%, 14.4%, and 12.5%.

The U.S. economy has continued its strong recovery with second quarter GDP growth expected to come in higher than the 6.4% real GDP growth in the first quarter. Gains in housing, durable goods manufacturing, and higher consumer confidence have all contributed to the improvement in the economic data. The improvement – as well as the higher levels of price inflation, drove a lot of debate, but only a bit of volatility in the second quarter. Some measures of inflation have risen to levels that have caused some to worry about inflation pressures getting out of hand. The Federal Reserve has yet to respond with a change in policy and views the inflation pressures that they are seeing as largely transitory. Given all of the distortions in supply chains from the pandemic, and the massive stimulus programs that have propped up spending, we tend to give the Fed the benefit of the doubt when it comes to the sustainability of high levels of inflation.

Indicators for the economy in the first half of the year have run hot, and the base effects of coming off the pandemic-driven lows amplified these gains. It is natural to expect some slowing in the economic data in the second half of the year. For now, we would view this as a normal pause, and will be monitoring the data as well as the official policy reaction for insight.

For markets, the easy money has probably been made in the aftermath of the pandemic. The exuberance that has driven both the economy and financial markets is being reflected in rich valuations for risk assets. This does not mean that it will end any time soon. The continued low interest rates and rebound in earnings are still supportive to many businesses, and the improved pricing power helps as well. Valuations are stretched for many, but there is still a cohort of companies that are priced to deliver better return potential than others.

On a price to sales basis, the S&P 500 now trades at a higher level than it did at the peak in the early days of 2000. On a forward earnings basis the S&P 500 trades at a large premium to its long-term average, at 21 x earnings versus 16x. With the S&P 500 tacking on a 14% gain year to date, much of this has come from an expansion of the PE multiple paid. This has driven the market capitalization of stocks to extreme levels relative to the size of the economy. Historically, when this condition exists, it means that forward returns for the stock index will be lower.

The challenging return environment given many measures of valuation, reinforces our focus on specific businesses and their respective prices relative to underlying value. With the median trailing PE of the S&P 500 Index at 34 times earnings, there are 250 stocks in that index with PE's higher than 34, and 250 with PE's lower than 34. The market capitalization weighting of the index over-weights those stocks that have increased the most, driving increased concentration risk.

Given the valuation dispersion that does exist, we cannot stress enough the importance of being in the right equities for both risk management and forward return expectations. Diversified portfolios need an equity component for the growth that they can provide. Also, in this low yield environment, they can provide much needed income and a growing income stream from well-covered dividends.

Areas of the market where valuations already reflect a high level of optimism are most precarious- and many times they are places where earnings and cash flows are most lacking. This combined with increased leverage, frothy investor sentiment and strong investor flows into equities makes it a market where we think investors will be rewarded for selectivity and patience over blind enthusiasm. We expect bond market volatility to pick up as well as the market and the Fed resolve inflation expectations and second half growth potential in the economy. If interest rate volatility rises, you can expect this to bleed into credit spreads and equity volatility as well. We remain focused on shorter duration and credit-quality-focused fixed income investments in bond portfolios. This market environment would also have the potential to favor alternative investment strategies that can provide diversified return streams and lower correlation to traditional markets. Across our portfolios, whether it be the stocks we manage, or the managers we entrust in other asset classes, we share the belief that volatility can create opportunity when both patience and discipline are employed in security selection.

As always, we thank you for your trust and confidence.

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