Q2 21 QUARTERLY INVESTMENT LETTER

Making Sense of Base Effects

Quick Look

- Stocks are hot, posting fresh all-time highs and their fifth consecutive quarter of meaningful gains.
- Economic reports are also hot, though numbers are somewhat distorted by base effects, which are the comparisons to readings from a year ago when the nation was in the throes of a pandemic-induced shutdown.
- Like most economic reports, inflation has been unsteadied since COVID, jumping 5% over the past year, the hottest reading in 12 years.
- The categories that are driving the current spike in inflation are COVID-sensitive items largely concentrated in transportation and expected to fade later in the year.
- The next quarter is expected to largely shake out COVID-impacted forces impeding employment gains. As these obstacles are cleared and as base effects dissipate, wage growth is presumed to return to more historical norms.
- At 13.1%, the past decade has provided annualized real (after-inflation) returns well above the 50-year average of 6.5%, thanks in part to average inflation of just 1.7% since 2011.
- Going forward, wage growth will likely be the key to any permanence of lasting inflation, as well as the duration of the current expansionary cycle.

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Quarterly Investment Letter, Q2 2021

Everything is hot, and not just because it's summer. Stocks are hot, posting fresh all-time highs and their fifth consecutive quarter of meaningful gains. U.S. stocks (as measured by the Russell 3000) have gained an astounding 100% from their March 2020 low.

Economic data may be even hotter. Consider:

- Q2 GDP could reach double-digits, setting the stage for the best full-year of economic growth since Reagan's first term.
- Retail sales are up 50% compared to last year.
- Car sales are up 110% from last year and are only held back by a lack of inventory from chip shortages.
- This spring, personal income reached its highest monthly increase on record.
- Purchasing manager surveys are at, or near, all-time highs.

The $1.9 trillion American Rescue Plan in March no doubt played a part in juicing the reports above, but the numbers are also boosted by base effects, which are the comparisons to readings from a year ago when the nation was in the throes of a pandemic-induced shutdown. These easy comps are making economic data appear to be soaring, when in some cases it might simply be getting back to its pre-pandemic track.

Unfortunately, not all things were welcome as spring turned to summer. While the economy was blossoming, inflation sprouted like a patch of poison ivy.

Inflation has been both tame and steady for the past decade, averaging just 1.7% over the past 10 years. If anything, a primary criticism has been the inability to see inflation consistently hit the Fed's 2% target. A low level of predictable inflation is good, as it gives consumer and businesses an incentive to spend or invest, facilitating economic growth. But like most economic reports, inflation readings have been unsteady since COVID, which brought a brief period of deflation at the onset followed by a rapid rise in inflation in the first half of 2021.

Inflation can typically be traced back to one of three causes. We are experiencing all three right now.

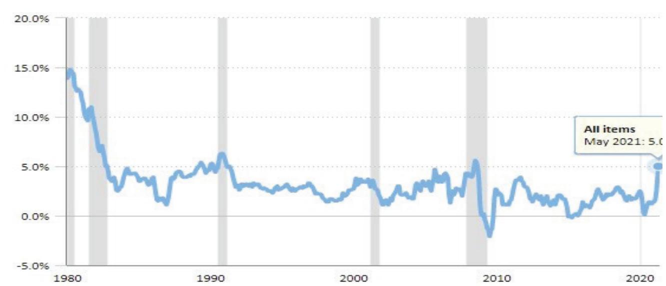
1. **Supply issues:** Inventories are at 20-year lows as the global supply chain was completely gummed up by the impact of COVID.

2. **Demand issues:** The economic reopening has unleashed a flurry of pent-up demand from consumers whose spending in 2020 was held back by the pandemic. Fresh stimulus in March of 2021 further added to consumer spending power.

3. **Monetary accommodation:** Unprecedented levels of stimulus have caused the M2 money supply to surge 30% since the start of 2020, the largest increase in history. M2 is the amount of currency in circulation, and money printing is a depreciating force on the purchasing power of the dollar. In fairness, the spike in money growth has coincided with a collapse in velocity, meaning the money growth is mostly sitting in bank accounts more than it is circulating through the economy.

These combined forces culminated in consumer prices jumping 5% over the past year, the hottest reading in 12 years. The core personal consumption expenditures rate, which is the Fed's preferred metric, is up 3.4% over the past year, its highest level since 1992.

CPI SINCE 1980



Source: Bureau of Labor Statistics

Big news, right? Not exactly, as markets this quarter have largely defied their natural textbook response to inflation. Stocks were mostly dismissive during their grind to all-time highs. Long-bond yields surprisingly fell, with the yield curve flattening nearly 40 basis points between 2- and 10-year maturities. A number of commodities have rolled over since May, highlighted by lumber prices, which have been cut in half over the past six weeks.

U.S. EQUITY RETURNS (%)

As of 06/30/21	Q2 2021	1-Year	3-Year	5-Year	10-Year
S&P 500	8.6	40.8	18.7	17.7	14.8
Russell 1000 (Large Cap) Growth	11.9	42.5	25.1	23.7	17.9
Russell 1000 (Large Cap) Value	5.2	43.7	12.4	11.9	11.6
Russell 2000	4.3	62.0	13.5	16.5	12.3
Russell 2000 (Small Cap) Growth	3.9	51.4	15.9	18.8	13.5
Russell 2000 (Small Cap) Value	4.6	73.3	10.3	13.6	10.9

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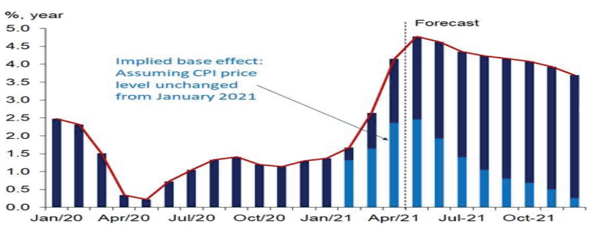
Understanding this bizarre market response brings us back to base effects. The categories that are driving the current spike in CPI are COVID-sensitive items largely concentrated in transportation. These include used vehicles, auto rentals, hotels, airline fares, and other items whose prices collapsed during the shutdown. Their surge this year is coming off a depressed "base", and these effects will fade later in the year, as should the current bottlenecks in the global supply chain. As can be seen in the chart below, the light blue color portion of the columns represent the implied base effect, which are currently peaking. Intuitively, this makes sense, as nobody can rationally expect used car prices to keep increasing 20%. It is worth noting that while inflation pressures are expected to recede from current levels, they are still expected to remain higher than past-decade levels, acknowledging some permanence seeping into pricing.

U.S. HEADLINE CPI INFLATION

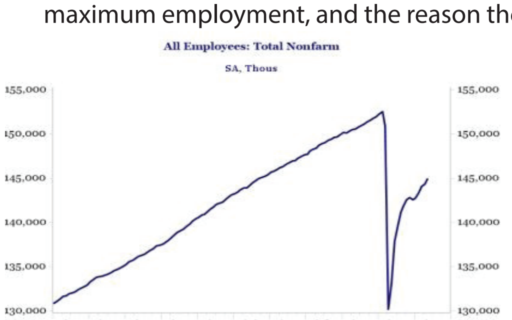


Source: Oxford Economics

The Fed's current stance on the matter is that the overshoot in inflation is transient, and they have done a marvelous job convincing market participants that current inflation pressures will be fleeting. A well-documented change in policy during COVID is that the Fed intends to let inflation run a little hot to ensure a 2% average core inflation rate, which consistently came up short in the prior decade. At his June Congressional testimony, Fed Chair Jay Powell remarked that they would not consider raising rates until it saw "actual inflation", and that continued pandemic-related aid was still necessary.

Watch Wage Growth

The other half of the Fed's dual mandate, besides price stability, is maximum employment, and the reason the Fed's foot remains on the pedal. 22 million jobs were lost in the spring of 2020. 15 million of those jobs have been added back, but payrolls still show more than 7 million jobs lost to COVID.



Source: Strategas Bureau of Labor Statistics

Like everything else, the shutdown has distorted wage gains, pushing average hourly earnings above its pre-COVID trend line. The initial jump in hourly earnings was a mirage, driven artificially higher not by true wage growth, but by the loss of jobs concentrated in lower-wage workers who did not have the luxury of working from home. As jobs below the median $25.60 per hour have come back online, hourly earnings have receded to 2.4% reported annualized growth, which is close to historical average.

Almost four in ten jobs lost during COVID were in the leisure and hospitality industry, which was triple the number of any other industry. On a positive note, as the nation has reopened, this industry is where the highest concentration of jobs has been added, with most in food services and drinking establishments. Over the past two months, 623,000 leisure and hospitality jobs have been added nationally, representing 75% of the gains in overall non-farm payrolls. That said, those gains have not kept up with worker demand; there are more than 1.5 million job openings in leisure and hospitality, which is about 2.5 times normal levels, and helps to explain why seemingly every fast-food sign panel is advertising hourly wages rather than menu items. Competition for this segment of workers is fierce, as wages for this industry sector are up 9% over the past year, which is the highest annual increase in 40 years.

The next quarter should finally shake out COVID-impacted forces impeding employment gains. Federal unemployment runs through early September, though half of the states have or will eliminate enhanced federal benefits ahead of the scheduled expiration. Schools are on schedule to fully reopen next fall, reducing the inability to work because of childcare. Vaccines are now widely available to any willing American. As these obstacles are cleared, and as base effects dissipate, wage growth is presumed to return to more historical norms.

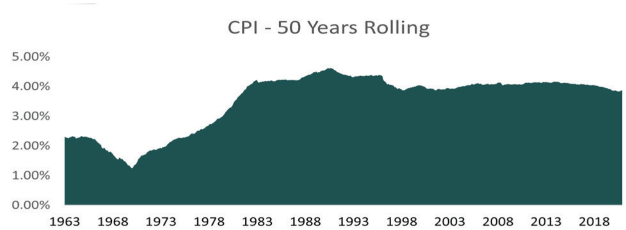
Perhaps that will be the case, as we have already seen statistical evidence of lower continuing claims in states with early elimination in federal benefits. But there is also a case that the past year has had a sizable psychological impact on how people view work, be it the type, flexibility, or compensation they require that is completely detached from prior recessions. According to the Federal Reserve of Dallas, 2.6 million workers have retired since February 2020, which is twice the expected amount prior to COVID. Recent surveys have shown that 25% of participants say they are looking for a new job. The current quit rate as a share of total employment is at its highest level on record. For comparative purposes, the quit rate is double what it was at the end of the last recession. The quit rate in leisure/hospitality is 5.3%, highest of all industries. The scarcity of labor may persist longer than consensus view, particularly with blue-collar workers.

Wage growth is sticky inflation, working its way up the entire hierarchy of a company's labor chain. Labor cost pressures must be passed through to the end consumer in the form higher prices, or else they begin to erode margins. The leisure/hospitality industry will be closely watched in the coming months to see if the surge in wage growth is simply due to base effects or something more permanent, as historically, wage growth above 5% in this industry has coincided with the end of business cycles.

The Impact of Inflation on Investment Returns

When examining stock market returns, it is important to consider the impact of inflation on the gains: Real Returns = Nominal Returns - Inflation Rate. At 13.1%, the past decade has provided some of the strongest annualized real (after-inflation) returns in history, thanks in part to average inflation of just 1.7%. According to a recent survey by Natixis of nearly 10,000 global investors with at least $100K in investable assets, investors expect long-term annualized equity returns to be 14.5% over inflation. This estimate is far too high, but in step with the tradition that strong recent returns often bring about unrealistic future expectations.

This may come as a surprise to investors, particularly younger investors who have never experienced a period of high inflation, but over the past 50 years, inflation has averaged 3.9% per year, double what has been reported over the past decade. During those 50 years, stocks have posted annualized real returns of 6.5% (nominal returns have been 10.4%). Bonds have provided real returns of just over 3%, and cash a little less than 1%.



Source: Federal Reserve Bank of St. Louis (FRED)

A primary focus for long-term investors should be the growth of purchasing power of their investment, and stocks have as good of a track record in accomplishing this goal, at least relative to other asset classes. All things considered, stocks post higher nominal returns in periods of low inflation than in high inflation, even before factoring in the erosion that inflation causes to real returns.

S&P 500 WHEN CPI > 5%		
YEAR	CPI	S&P 500
1973	8.9%	-14.3%
1974	12.2%	-25.9%
1975	7.0%	37.0%
1977	6.8%	-7.0%
1978	9.0%	6.5%
1979	13.3%	18.5%
1980	12.4%	31.7%
1981	8.9%	-4.7%
1990	6.1%	-3.1%
Average	**9.4%**	**4.3%**

Source: William Bernstein, Fama-French, Damodaran

The higher the inflation, the higher the hurdle. If we look at an extreme example, which is the nine calendar years since 1950 in which annual inflation was higher than 5%, stocks average positive nominal returns of 4.3%, but once inflation is factored in, real returns were negative.

During the first half of the year, our portfolios responded well to the recent rise in inflation. First, our equities held a modest tilt towards the value factor. Value stocks have historically outshined their growth counterparts in periods of rising inflation, in part because of the commodity-exposed tilt of value, but also because of the hurdle that a higher discount rate presents to future cash flows for growth stocks. Within bonds, we have maintained a shorter duration to mitigate interest rate risk that often accompanies inflation. Additionally, we believe a small allocation to high-yield bonds is a nice complement to core fixed income in an inflationary environment, so long as it coincides with economic growth.

In summary, both stocks and economic data are currently posting eye-popping numbers. Inflation is also hot, but both the Fed and market participants are betting current cost pressures are temporarily distorted by COVID-related base effects and dislocations. Going forward, wage growth will likely be the key to any permanence of lasting inflation, as well as the duration of the current expansionary cycle. In the meantime, investors would be wise to set their after-inflation forward return expectations to more historic levels, and be mindful that permanently low inflation is far from guaranteed.

INTERNATIONAL RETURNS (%)

As of 06/30/21	Q2 2021	1-Year	3-Year	5-Year	10-Year
Int'l Developed ex US	5.2	32.4	8.3	10.3	5.9
Emerging Markets	5.1	40.9	11.3	13.0	4.3

Source: Morningstar

FIXED INCOME RETURNS (%)

As of 06/30/21	Q2 2021	1-Year	3-Year	5-Year	10-Year
Aggregate Bond	1.8	-0.3	5.3	3.0	3.4
Muni Bonds	1.5	4.6	4.5	2.7	3.6
Int'l Bonds	1.2	4.8	3.6	2.4	1.3
High-Yield Bonds	2.5	14.7	6.2	6.2	5.5
Short-Term Bonds	0.6	2.6	3.4	2.4	2.0
90-Day T-Bill	0.0	0.1	1.2	1.2	0.6

Source: Morningstar

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