Smith Group
ASSET MANAGEMENT

MARKET PERSPECTIVES

JUNE 30, 2021

Equity Market Summary

U.S. Equity Markets	2Q'21	1 Year
S&P 500	8.6%	40.8%
Russell 1000 Growth	11.9%	42.5%
Russell 1000 Value	5.2%	43.7%
Russell 2000	4.3%	62.0%
Russell 2000 Growth	3.9%	51.4%
Russell 2000 Value	4.6%	73.3%

Top/Bottom Sectors	2Q'21	1 Year
Real Estate	14.0%	32.9%
Technology	11.7%	42.7%
Comm. Svcs.	10.9%	48.9%
Industrials	3.7%	50.4%
Cons. Staples	3.1%	22.4%
Utilities	-0.2%	16.0%

Non-US Equity Markets (in USD)	2Q'21	1 Year
MSCI AC World Ex U.S.	5.5%	35.7%
MSCI EAFE (Developed)	5.2%	32.4%
MSCI Emerging Markets	5.1%	40.9%
MSCI China	2.9%	28.5%
MSCI United Kingdom	7.0%	32.0%
MSCI Brazil	25.7%	49.8%

Non-US Regions (in USD)	2Q'21	1 Year
Developed Americas	10.3%	47.3%
Developed Asia	1.9%	28.8%
Developed Europe	9.1%	36.9%
Emerging Americas	16.9%	47.4%
Emerging Asia	3.8%	41.8%
Emerging EMEA	7.6%	38.7%

Market Review:

In a bit of a twist on the "buy the rumor and sell the fact" axiom, bond yields that surged in the first quarter due to fears of inflation halted their upward march in the second quarter when surging inflation became a reality. Instead, yields fell in April, then again in May, and ended June even lower. Similarly, the growth to value shift that took place in the early months of 2021 ran out of steam, and many of the beaten down growth darlings from last year reclaimed their leadership position as the current quarter came to a close. The powerful six month surge in small caps relative to large ended in March. In April large caps regained some ground versus small caps, then prices moved in lockstep with smaller peers (excluding meme stocks). While stock prices ended at new highs, the quarter was a trading range affair with an orderly upward sloping channel defined by modestly higher highs and higher lows. With the exception of oil, worrisome commodities peaked in May and the U.S. dollar recovered some lost ground. Lumber prices are 50% off their peak, copper is down 10%, with corn and soybeans dipping 12% and 18% respectively. This may have helped to douse some of the inflation fear flames and allowed stock prices to continue an upward bias. Reported earnings nicely outpaced expectations and upward momentum has continued throughout the quarter. In April, 74% of revisions were upward, May improved to 80%, and June was even higher at 81%. The magnitude of upward earnings revisions were roughly equivalent to the rise in stock prices. The quarter began with value strongly in favor but ended with a big rotation toward growth. It would be natural to focus on sector rotation in the final month as Information Technology and Consumer Discretionary replaced Energy and Real Estate as top performers. However, growth outpaced value in ten of eleven sectors, indicating a broader shift.

Vaccination momentum, which admittedly peaked in the U.S. in April, is leading to economic momentum. While on balance economic surprises are positive, the magnitude of those surprises has moderated from very high levels. Real first quarter reported GDP was less than 1% below the peak reached in the fourth quarter of 2019. It has not, however, been an even recovery. Some of the winners are data processing, computer equipment, retail trade, and warehousing. But oil & gas drilling, air transport, non-motor vehicle transport equipment, accommodation, and arts & entertainment services were all still deeply depressed. On a positive note, timely data suggests some of these depressed segments of the economy are rejoining the recovery and will contribute to growth in the current quarter.

Market Outlook:

The U.S. economy is well on the way to delivering historic growth numbers. Fiscal policy is looking to pour more fuel on the fire and there is an output gap to be filled in important segments of the economy. The Fed is loath to douse the flames until employment becomes more "inclusive". Some Fed watchers are even suggesting the Fed is now focused on a single mandate - employment. Vaccinations are ramping up in some important trading partners and global economic data is outpacing estimates by close to a record margin per the Citi Economic Surprise index. Exports have been a hole in U.S. GDP numbers and a healthier global economy would help to plug it.

Supply is emerging as the main inhibitor to economic growth. In most industries demand is not a problem and in those where it has been constrained re-opening is unleashing pent-up activity. Car lots are often almost empty, bike order backlog can run over a year, and popular restaurants have long waitlists. Restauranteurs bemoan the disappearance of experienced hospitality staff and manufacturers are scrambling to find qualified workers to fill an increasing backlog of orders. The most recent Bureau of Labor Statistics report showed job openings 21% in excess of the pre-pandemic peak for private employers. Some of the largest gaps were: nondurable goods manufacturing at 85% above the previous peak, durable goods manufacturing 49%, accommodation & food service 31%, and entertainment 63%. Clearly, these gaps are an impediment to business output in the near term. But employment in many of these areas is still below pre-pandemic levels. The number of workers employed in leisure & hospitality is 15% below peak levels and manufacturing employment is 4% below peak. That represents slack that could eventually be put to productive use.

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Workers previously in those roles may be slow to return for a variety of reasons, may need to be retrained for a new role, or may have moved to a new industry. It is not realistic to believe that industries that were largely shutdown a year ago would be able to ramp up at the pace currently demanded. A similar dynamic exists outside the U.S. Global supply chains have been disrupted and are having difficulty catching up. As the busiest goods-import season approaches port congestion remains a problem. There are still an average of 30 ships waiting for a berth to unload at the ports of Los Angeles and Long Beach, and the jam is not expected to clear until next year. It is rumored that Target has already taken delivery of back-to-school and some Christmas inventory to reduce the risk of delayed arrivals. Manufacturers reported to the ISM that supplier deliveries are slowing at the steepest pace on record at the same time as backlog is rising at a record pace. Clearly, the logistics world is scrambling to meet the demands of the current environment. Like slack in employment this supply shortfall is a short-term obstacle, but a long-term opportunity. Supply chains will adapt, shipping and loading capacity will adjust, and global production will eventually recover from the pandemic. The pace of vaccination for the world as a whole is picking up and the global economy will eventually do so as well.

Understandably inflation has escalated to be one of the hottest investment debates. Prices are adjusting to reflect that demand is currently overwhelming supply, and we are seeing inflation rates that many investors have not experienced in their lifetime. Yet the Fed is sticking to a “transitory inflation” view and has convinced a majority of market participants of its logic. Declining bond yields are a good indication of that acceptance. But the debate is far from over and it would be pollyannaish to dismiss the risk of more permanent inflation completely. Rising input costs are undeniable. Lumber is a prime example. At one point prices were up 400% on a year-over-year (yoy) basis. But they have since fallen 54% from their peak. Copper was up 100% yoy, but has backed off 10%. These are just a couple of examples. Commodity prices are driven by supply and demand. While demand is highly variable, supply is much slower to adjust and, as in the case of food, can be dependent on mother nature. Suppliers are reluctant to put on new capacity in response to short-term price swings, preferring to wait for signs that demand is more durable and not just a short-term cyclical blip. Once that decision is reached, new capital projects can take years to complete. Eventually new supply does come on line to meet durable demand. The current input cost question is, with central banks keeping the pedal to the metal, has the demand curve permanently shifted up or is the current buying surge pent-up demand that will eventually tail off? Previously discussed were the shortages in the labor market and supply chain bottlenecks. There is no shortage of supplier price increases and higher pay packages as businesses attempt to fill the supply gap. Those costs will have to be passed on to the consumer or eat into profit margins. The crux of the transitory argument is that increased costs are not likely to be repeated. If those output gaps abate in a timely manner employers will not have to increase wages again and pricing power will equalize between intermediate and final stage manufacturers or service providers.

Exhibit #1

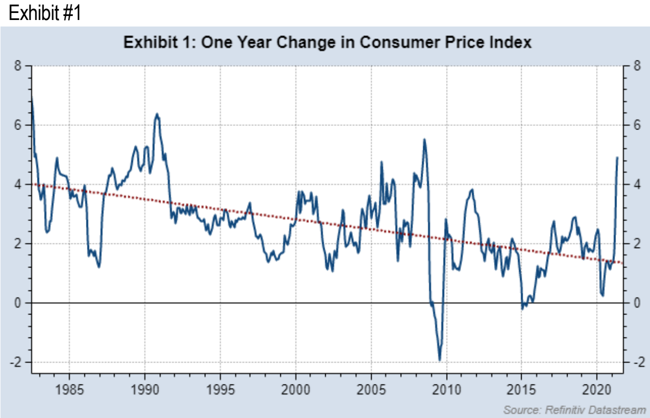
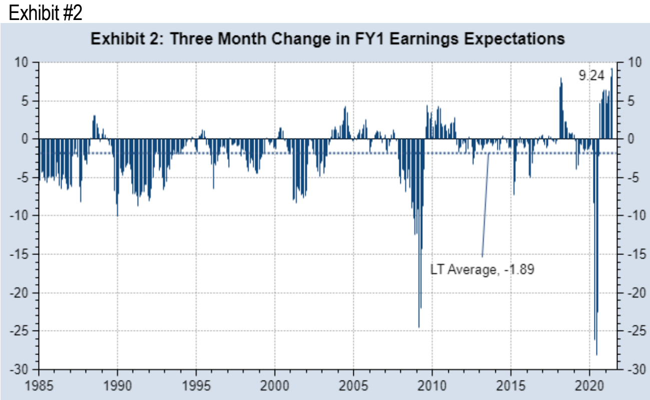


Exhibit #2



What appears clear is that when it comes to fiscal and monetary policy around the world a flock of doves has chased the last hawk out of the building. Economic growth over the last decade without broad prosperity has set the stage for an experiment in inclusiveness. Full employment under this scenario is not achieved until the lot of under-employed segments of the labor force improves. Given these drivers, demand for the foreseeable future is unlikely to abate and could actually accelerate on a global basis. Government is focused on stimulating aggregate demand, with little attention to aggregate supply stimulation. If market forces are able to adapt and meet this demand with improved supply dynamics then price pressures can equalize. There are many moving parts to the inflation equation right now. But it is useful to keep in mind that lasting inflation is really a state of mind. Some of us recall the days when you accelerated purchases because you just knew the price would be higher in the future and expected prices were a key component of labor negotiations with management. It took decades of declining inflation (see Exhibit #1) to change the fear of inflation to a fear of deflation mindset. Only time will tell if the disinflation mindset proves to be as durable as the inflationary mindset of the 70’s and 80’s. In the mean time, it is unlikely the mismatch between supply and demand will normalize as quickly as Fed officials hope. Even if the “transitory” label proves correct it could very well turn out to be a longer road to normal. The longer that transition takes the more pressure there will be on bond yields and stock valuations, but as long as there is hope that in the end price pressures will normalize the bond vigilantes should be kept in check.

In the meantime, earnings momentum continues to be strong. In the last three months, expectations have risen 7% for the current quarter, 4% for the third quarter, and 3% for the fourth quarter. Combine those increases with the large positive earnings surprises of

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the first quarter and expectations for the full year have risen 9% over the last 3 months - the largest upward revision ever (see Exhibit #2). Much of the movement is tied to industries benefiting from a cyclical recovery.

Exhibit #3

'21 quarter EPS estimate compared to same quarter actual in '19	2Q21	3Q21	4Q21
S&P 500	10%	17%	25%
Cons. Disc.	-13%	-4%	9%
Cons. Staples	3%	17%	6%
Energy	-4%	-5%	1165%
Financials	-3%	-6%	-14%
Health Care	38%	53%	52%
Industrials	-21%	-9%	16%
Technology	37%	47%	48%
Materials	62%	84%	87%
Comm. Svcs.	18%	35%	40%
Utilities	9%	7%	12%
Real Estate	-35%	-25%	-24%

It is instructive to compare current year expectations with 2019 (see Exhibit #3). There are some clear sector winners like; Information Tech, Health Care, Communication Services, and Materials. But the laggards are interesting and the gap between current expectations and what they were able to deliver pre-Covid may be viewed as potential to normalize and surprise. Rising oil prices and greater global demand have provided a significant boost to Energy earnings expectations, but if 2019 is normal they still have room to grow and as the world moves toward broader re-opening this trend is likely to be reinforced. Financial earnings leapt in the first quarter and expectations have been moving higher, largely as a function of reserves for bad loans that did not eventuate being reversed. Loan growth has not picked up yet. This sector is generally the largest contributor to S&P 500 earnings, accounting for 20-25% normally, so what happens to business prospects here matters. First quarter Financial earnings handily beat expectations and exceeded the first quarter of 2019. But expectations for the rest of the year lag two years ago. Reserve releases cannot replace loan growth indefinitely so a return to normal for this sector ultimately needs to see a return to loan demand. The Industrial sector is another large one where expectations are for a slow return to normal. It is not expected to take place until the fourth quarter. Of the big three industries in the sector machinery is showing the best momentum with a 10% positive revision and is expected to deliver earnings in the next twelve months 18% higher than the peak in in 2019. The outlook for the other two are less rosy.

Consumer Discretionary is the other large sector where the outlook is a delayed recovery. Retailing is the majority of the sector where the outlook for internet retailing continues to brighten, but its more traditional counterparts have joined the party as well. A combination of store re-opening and greater technology proficiency is proving to be a recipe for a powerful recovery. Multiline and specialty retail stores are expected to deliver earnings in the next twelve months 35% and 43% higher than pre-Covid peaks respectively. Restaurants are also showing some positive momentum as re-opening gains pace. On a twelve month forward basis earnings are expected to be 17% higher than the pre-pandemic peak in actual earnings driven by the apparent pent-up demand to get out and socialize. That could even prove conservative. The laggard is the automobile industry, which is the second largest component of the sector. Supplier problems for this group are well known. While expectations have seen some positive momentum lately it is muted compared to other consumer companies and is back-end loaded on projections that some of their supply issues will abate later in the year. There are some rumblings that the semiconductor shortage is already starting to resolve itself but the jury is still out on how quickly it can normalize. In a year when earnings momentum and growth are so high there is a large margin of error in projections. At this stage of a recovery it is unusual for analysts to be over estimating earnings and there are still significant pockets that can improve. On the other hand, there are some eye-popping expectations that make us nervous as well. But expansions rarely have a life as short as the one we are currently in and economic growth is supportive of earnings growth.

What does all this mean for stock prices? Even though interest rates have backed off from highs, as long as the threat of inflation lingers rates are apt to ebb and flow from here. A trading range for rates is likely and a tick above 2% for the 10-year is not out of the question. So valuations could come back into play and the tug-of-war with very strong earnings momentum would then continue. The year so far has been defined by very strong earnings momentum with moderating valuations as forward earnings increase. Earnings are growing into stock prices but valuations are still high. It is not unusual to see a bull market go sideways in its second year as it adjusts to evolving drivers and the thrill of the powerful surge off the bottom becomes more common place. Barring a sharp Fed turn to fight inflation a large drawdown does not seem likely, but a normal bull market correction could easily be in the cards.