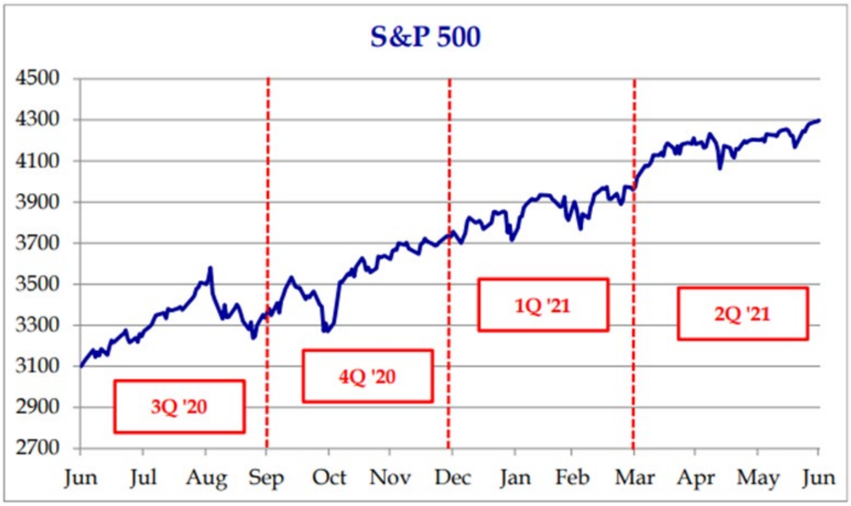
GROWTH, VALUE AND EVERYTHING IN BETWEEN
SECOND QUARTER REVIEW AND OUTLOOK

Chart I



Source: Strategas

The stock market continues to move higher almost regardless of the various headwinds that periodically arise (Chart I). Excluding geopolitical issues, the equity markets seem focused on the recent spikes in inflation, most notably in many key commodities such as oil, lumber, copper and various chemicals. This, in turn, has led to price increases in many consumer products as manufacturers try to pass on some, or all, of the recent rise in material costs. Concurrently, the market is also focused on interest rates again. The U.S. and global economies are beginning to bounce back from the COVID-19 impact of deferred consumer consumption. As a result, we saw a sharp jump in the government 10-year benchmark bond interest rate to 1.75% at the end of the first quarter, only to see it fall back to 1.30% currently as the Federal Reserve continues to emphasize that they see the recent rise in inflation as transitory and that they have no desire to reduce their bond buying programs.

While the market focuses on inflation and interest rate trends, corporate profit growth continues to shine with expectations of a 25-30% rebound in profits this year off the depressed levels of 2020. This combination of low interest rates, contained inflation expectations and strong corporate profits has moved the equity markets to all-time highs and also moved valuations to 21-23x projected earnings. Given the historic average P/E of 16-17x, current valuations are high, but not excessive, given the current economic outlook and benign low interest rate environment.

Looming in the background are the lingering concerns over COVID-19 and the possibility of a resurgence of the virus as the year progresses. A number of countries have increased precautions and reinstituted mask wearing indoors. The equity market is priced for a strong economic rebound in 2021 and a further recovery in 2022. Anything that inhibits the expected recovery in the U.S. and global economies should have a negative impact to equity values near term.

At this juncture, we believe the equity markets should grind higher over the next twelve months barring a geopolitical event or a resurgence in COVID-19 infections that necessitate a tapering of economic growth.

A LOOK AT THE THREE-LEGGED STOOL

Most economics can be summarized by examining three variables: inflation, interest rates and corporate profits.

I. Inflation

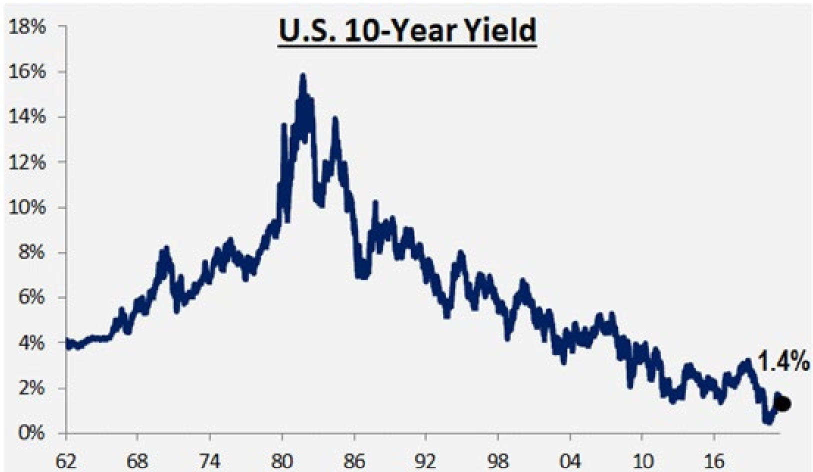
Chart II

Source: Wolfe Research

For the first time in years, inflation has jumped sharply higher (Chart II). The Federal Reserve has stated that they believe this sharp increase (now running 5-6%) is transitory and should recede in 2022 forward. We tend to agree with the Fed on this issue. The rapid adoption of COVID-19 vaccines in the U.S. and other countries is resulting in a surge in pent-up consumer spending. This surge is particularly obvious in the leisure and travel industries although auto demand (resulting in a semiconductor shortage) and housing are also seeing unusually strong demand. Conversely, industries are not able to ramp up production fast enough to meet current surging consumer demand. Thus, prices in lumber, oil and other commodities have jumped 40% or more. These factors are likely to stabilize or reverse as we enter 2022. We are already seeing lumber return to last year's pricing from May's record high. Once supply and demand return to normal, prices and, therefore, inflation rates should move lower than current levels. We believe this is likely to happen by the end of the current year.

II. Interest Rates

Chart III



Source: Wolfe Research

The Federal Reserve has reiterated that it feels no pressure to raise interest rates due to the current surge in inflation. They believe this is transitory. Importantly, the Fed is mandated to encourage full employment. This is particularly critical in our current environment. The Fed has already said it is willing to let the economy run "hot" even if inflation moves above its long-term goal of 2-2.5%. That certainly seems to reflect the current environment (Chart III). Thus, we expect the Fed to remain on hold for at least another six to nine months, if not longer unless current inflation appears more entrenched.

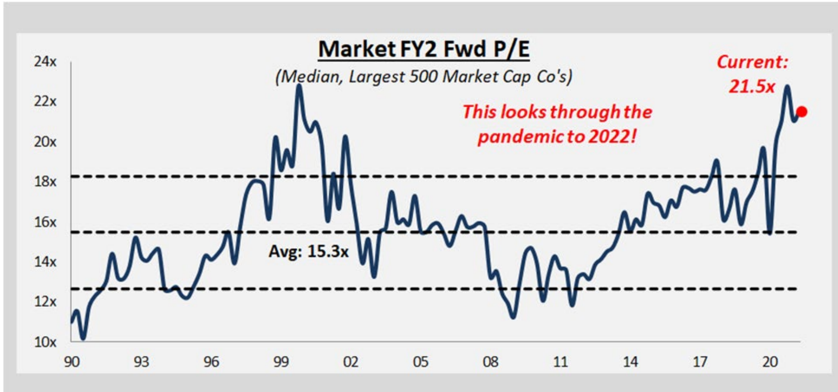
III. Corporate Profits

U.S. corporate profits (measured by S&P 500 earnings) declined to about $148 a share in 2020, down some 7% from the prior peak earnings of $158 a share in 2019. This decline was far less than expected given the surge in profit margins last year. Expectations are for earnings to reach approximately $195 a share this year (up about 30%) followed by another 11% rise in 2022. Of course, we are still faced with the second half of 2021 and the possibility of a rising corporate tax rate in 2022. Regardless, the strength in corporate profits is impressive given the economic problems that COVID-19 created.

Taken together, interest rates and the outlook for corporate profits looks good. Should inflation prove transitory, the stage could be set for a reasonable equity market in 2022.

VALUATION

Chart IV



Source: Wolfe Research

The S&P 500 is selling at about 22x estimated earnings for 2021 and about 20x estimated earnings for 2022 (Chart IV). The current estimates for 2022 can be tempered by 5-10% if the Biden administration follows through with an increase in corporate tax rates. The higher valuations are being supported by low interest rates and (up until recently) low inflation. Any material change in any of the three legs of the stool (inflation, interest rates and corporate profits) can move the current valuation of the stock market up or down. Realistically, we believe valuations may hold current levels but move downward over the intermediate term.

We doubt if all three can get significantly better than the last twelve months. Indeed, we suspect that the equity markets may remain sideways with modest to moderate corrections until trends become more consistent. This is likely to be the case as we enter 2022.

PORTFOLIO REVIEW

Our portfolios are balanced in that we focus on all industries and seek out the best and strongest companies in each market. We start with a quantitative screening focused on growth, cash flow, return on capital, valuation and quality of management. We then overlay our investment themes and analyze the individual securities that meet our criteria. Furthermore, we run a relatively concentrated but diversified portfolio of 25 to 40 equities. We don't get too focused on macro issues. Our equities have passed a rigorous analysis and represent some of the best managements in the world. While recession can pull all stocks down, our equities tend to gain significant market share during those periods and exit any economic downturn in a much stronger manner.

PORTFOLIO ADDITION – BETTING ON THE CONSUMER

More recently we added Ulta Beauty, a company that is an emerging leader in beauty and personal care products. It has weathered COVID-19 and emerged in a powerhouse position to gain significant market share in its industry. Ulta Beauty has more than 1,200 U.S. stores and $7 billion in annual revenue. Ulta benefits from two of our secular themes: i) a shift to digital revenue and ii) superior growth in the personal care industry. Management used the COVID-19 pandemic to invest in digital (i.e., expanded distribution centers, social media advertising and buy online and pick-up in store). These investments helped accelerate Ulta's e-commerce sales growth from +28% in 2019 to +107% last year. The company has a dedicated customer base of 30 million active loyalty members which make up 94% of overall sales. In a major partnership, Ulta will launch inside Target's stores and website this Fall. We believe it represents a category dominator in this highly fragmented market.

As always, we request that each client provide us with written notice about any changes to their investment needs, goals, objectives, risk tolerances, or investment restrictions to our advisory team. Should you have any questions, please contact us at your earliest convenience.

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