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2nd Quarter 2021 Commentary

The market continued its march higher in the 2nd quarter of 2021. The advance was to a lesser extent a result of continued fiscal and macroeconomic support and more a result of a record surge in corporate earnings. The strong showing from Corporate America led analysts to increase full year 2021 earnings estimates for the S&P 500 to nearly $190. The 37% increase in earnings over 2020 ($138), according to Jim Paulsen of Leuthold, significantly surpassed the 12-month rebound from each of the prior recession lows dating back to 1950 (9 in total)[1]. The 20% rebound, initially expected by Wall Street at the start of 2021, would have also comfortably bested any prior recovery. Not too shabby. Paulsen, for that matter, believes investors are still underestimating the speed and strength of the recovery. He expects earnings growth to continue to accelerate throughout the remainder of the year.

Jason Trennert of Strategas pointed out that each subsequent increase in the 2021 earnings growth rate has been followed by a corresponding decrease in the 2022 earnings growth rate.[2] This relationship suggests that earnings growth has been pulled forward from future years and is not sustainable.

Inflation is one of the prominent risk factors to future earnings growth. Management teams across industry groups and sectors were aligned after the 1st quarter in their announcement of increasing freight, logistics, and commodity expenses. These new costs will be passed to consumers in the form of higher prices despite the best efforts of management teams across the market. General Mills CEO Jeff Harmening recently proclaimed that "consumers see costs going up all around them, not just at the grocery store, but with automobiles, and restaurants". He continued, "no one wants to increase prices, but we've had to"[3]. General Mills will increase prices by nearly 7% over the course of the next year.

Inflation is starting to pick up in the broad economy as well with recent readings above 3%. Fed Chairman Powell and others continue to argue that the highest reading since the early 90s is a result of the extraordinarily depressed pricing environment from pandemic lows in 2020. They believe inflation rates will drop as the economic environment continues to normalize. The tremendous growth in money supply year over year and the anything but normal pricing environment in housing, auto, and commodity markets suggests otherwise.

Risks for Corporate America extend beyond inflation and include the resurgence of COVID 19, ongoing supply constraints, and the recruitment and retention of labor. While supply constraints will likely persist for several years, the labor market may resolve itself as vaccination rates grow and as employment benefits start to expire later this summer.

Investors will need to balance these challenges with the prospects of a lower return environment. Jason Zweig of the Wall Street Journal said it best. "In the face of prolonged low rates, all investors face three

[1] Paulsen, Jim. "Economic & Financial market Outlook". The Leuthold Group. June 2021
[2] Trennert, Jason. "2Q'2021 In Review" Strategas. July 1, 2021
[3] Gasparro, Anne and Maidenberg, Micah. "General Mills Warns of Inflation, Readies for Shifting Consumer Behavior". Wall Street Journal. June 30, 2021. https://www.wsj.com/articles/general-mills-warns-of-inflation-readies-for-shifting-consumer-behavior-11625066446

basic choices: you can raise your existing holdings of traditional risky assets like stocks, even though no one thinks they're cheap; you can add a bunch of new exotic bets and hope they don't blow up on you; or you can grit your teeth and stay the course, through a period of what may be lackluster returns, until interest rates normalize." He continued, "People are looking for the silver bullet, the magic wand, the get-out-of-jail-free card. There isn't one."[4]

While we continue to find attractively valued businesses, we are certainly taking a more cautious approach today. Afterall, the S&P 500 continues to trade at elevated levels based on multiple valuation metrics and the number of businesses trading at low valuations continues to shrink (See Fig. 1). Further, the speculative frenzy surrounding meme stocks and cryptocurrency remain at elevated levels. The frenzy reminds us that "doing what everybody else is doing at the moment, and therefore what you have an irresistible urge to do, is often the wrong thing to do at all"[5]. We are happy to invest in quality businesses with durable competitive advantages that for one reason or another are unloved and out of favor in the market.

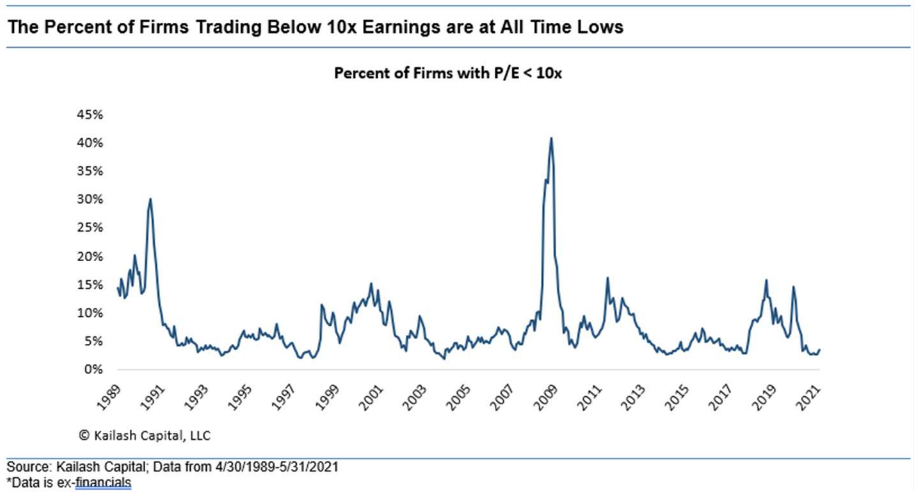

Fig. 1. The Percent of Firms Trading Below 10x Earnings (Source: Kalash Capital)

Jim Paulsen and investors can take comfort that sustained earnings growth will likely originate with the American consumer. The American consumer is nearly 70% of the economy and consumer confidence recently recovered to pre-pandemic levels. Sentiment is certainly on the side of the bulls.

Sincerely,

J. August Gerhardt, CFA

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[4] Zweig, Jason. "Wishful Thinking in a World Without Yield". Wall Street Journal. June 18, 2021. https://www.wsj.com/articles/wishful-thinking-in-a-world-without-yield-11624026610
[5] Fisher, Philip.

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