Inverness Counsel

2Q 2021 Commentary

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The Baton Gets Passed Again

At this time last year, we were close to the crest of the second wave of COVID-19 infections. At the same time, all 50 states were at least partially reopened and enormous stimulus plans from the Federal Reserve and Congress were beginning to take root. We highlighted that the stock market tends to do well as investors climb the wall of worry and noted some factors that should allow the rally to continue. The S&P 500 was beginning to price in a sharp economic recovery from the severe recession in the first half of the year and the five largest stocks in the S&P — Facebook, Apple, Amazon, Microsoft and Google (FAAMG) -- were leading the way.

In subsequent quarters, we commented on the record concentration risk associated with these five names, but also the higher valuations presented by "growth" stocks in general. These market dynamics provided an opportunity to increase exposures in the areas most affected by the pandemic and/or economic weakness (i.e. "value"/recovery stocks). We thought this barbell approach would serve our clients well as the end to the COVID-19 pandemic appeared on the horizon.

The stock market baton was passed to the "value" stocks after the first two vaccines were approved for emergency use last November. These stocks, found in the more cyclical sectors (Energy, Financials, Industrials and Real Estate), continue to be leaders in 2021 (see Figure 1.) We find this broadening of stock market leaders to be not only an encouraging sign but also an important reminder for why we build diversified portfolios.

Figure 1

Growth Stocks vs. Value Stocks

Russell 1000 Value | Russell 1000 Growth | S&P 500

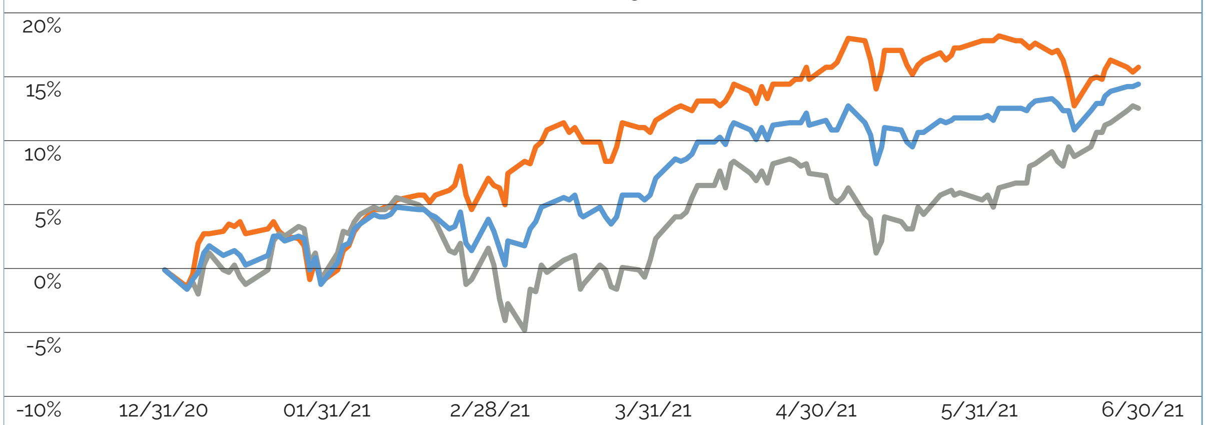

Figure 1 Source: Bloomberg. Data as of 6/30/21.

The S&P 500 ended the quarter at a new record high, up 15.2% for the first half of the year. During this quarter, Technology — which is the largest sector in the S&P – outperformed the index, along with Communication Services, potentially passing the baton back to "growth" stocks as the "value" in many of the recovery names has now been discovered. Our barbell seems to be a good approach for now, although our bottom-up process is finding attractive growth investments.

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Figure 2

2021 Performance by Sector

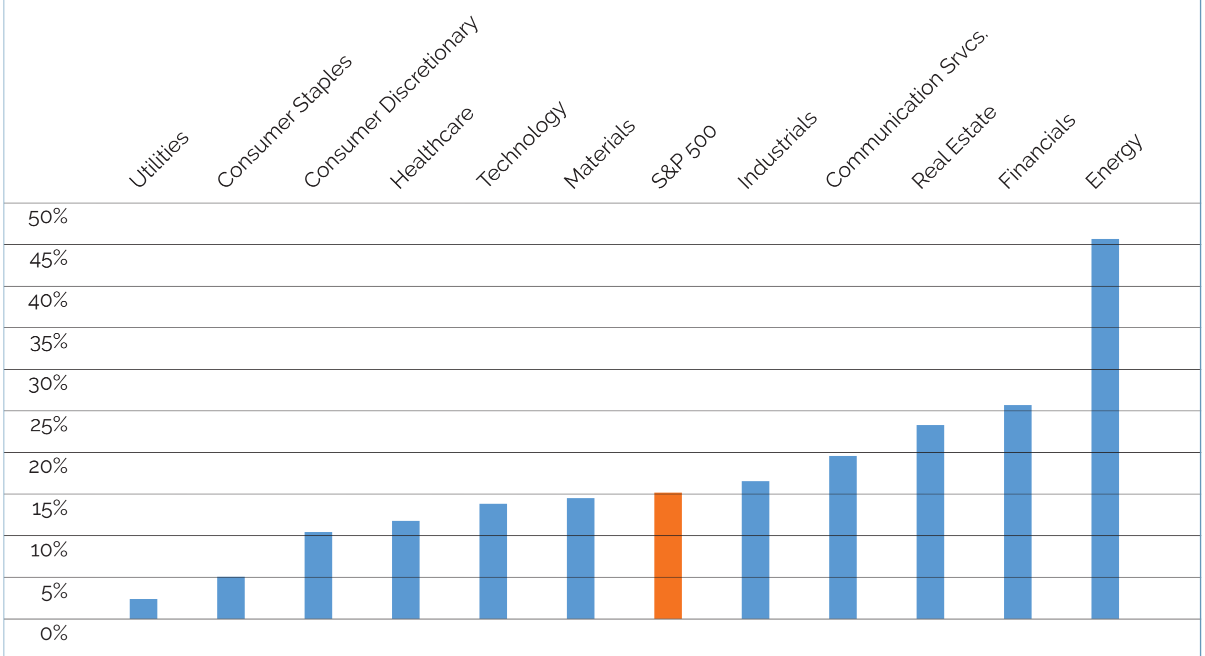

Figure 2 Source: Bloomberg. Data as of 6/30/21.

The S&P 500 index gained 8.6% on a total return basis for the quarter. The Energy and Real Estate sectors also led the way this quarter and are top performing sectors for the year (see Figure 2.) The Communication Services sector was also an outperformer this quarter and is now ahead of the index for the year. Consumer Staples and Utilities continue to be underperforming sectors, both for the quarter and year-to-date.

The U.S. Economy Comes Roaring Back

The outlook for 2021 remains bright. The U.S. economy, as defined by Gross Domestic Product (GDP), is expected to grow 6.6% this year with robust GDP growth expected to continue into 2022. Consumer spending, which represents 70% of our economy, is strong as the average consumer is in good financial shape. As we noted last quarter, savings are at record levels and consumer confidence remains high.

These results stand in stark contrast to this time last year. Many economists and policy makers worried it would take years for the economy to recover to its pre-pandemic levels. Now many of these experts are forecasting we will surpass those levels in the second half of this year. The speed and magnitude of this recovery has caught many off guard and this has resulted in widespread shortages of goods, raw materials, and labor. In addition, we saw the unemployment rate leap from a 50-year low (3.5%) to a 90-year high (14.8%) during the shutdown. Fortunately, the current rate is 5.8% and is expected to decline to 4.1% by the end of 2022. This is another positive development for the consumer.

As we mentioned, consumer spending has been robust. There are interesting examples of "revenge" spending, some of which we highlight below:

- According to McKinsey & Co, 66% of adults plan to treat themselves in celebration of the end of COVID-19 restrictions
- The TSA screened 2.15M people on July 1, 2021; this is up 3% from July 1, 2019
- Lamborghinis are sold out for 2021
- Pool builders are booked well into 2022
- Cruise line cumulative bookings for 2022 are 10-15% above 2019 levels
- Home Depot's year-to-date foot traffic is an average of 17% above 2019 levels
- Based on the latest OpenTable data, U.S. restaurants have now eclipsed 2019 volumes

Watching Inflation Indicators

The Federal Reserve is expected to keep short term interest rates at very low levels and this has stoked some fears of future inflation. We noted last quarter that it is likely we will see some inflation as the global economy recovers, driven by transient supply chain and demand issues. Headline consumer prices rose 5% year-over-year in May, the fastest pace since August 2008 and higher than Wall Street expectations. The 3.8% rise in the Core Consumer Price Index (CPI), which excludes food and energy prices, was the sharpest increase in nearly three decades and yet the 10-year U.S. Treasury yield moved lower after this report (see Figure 3.) This would imply that the bond market was expecting even higher inflation, perhaps making this fear overblown.

Figure 3

U.S. 10 Year vs. CPI

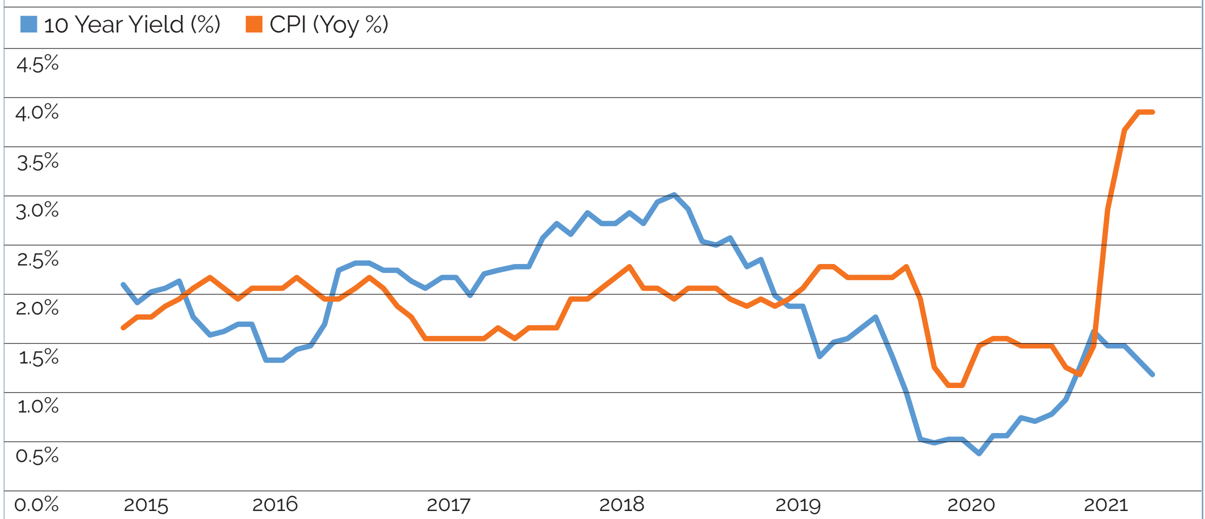

Figure 3 Source: Bloomberg. Data as of 6/30/21.

Eventually demand slows, due to cost pressure. Conceivably, we are beginning to see signs of this. The Fed has stated they believe inflation is transitory and they are likely to tolerate levels above 2% for some time. Below are some of the indicators we are watching (see Figure 4.) While oil prices continue to be at elevated levels and gold seems to have peaked for now, lumber seems to be going through a classic boom and bust commodity cycle.

Figure 4

Commodity Prices (Normalized Growth %)

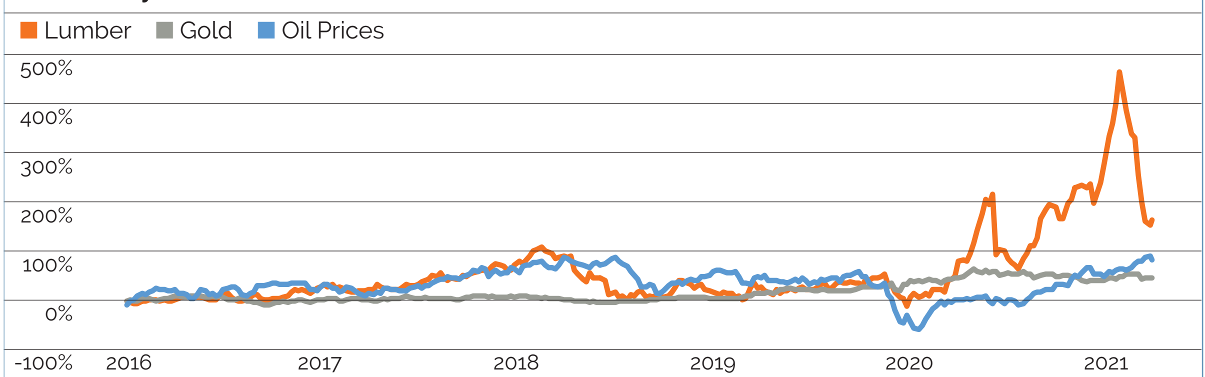

Figure 4 Source: Bloomberg. Data as of 6/30/21.

Semiconductors Are the New Oil

Over the past few decades, investing in energy (oil and gas) companies proved to be lucrative as these businesses experienced durable growth and impressive profitability. That's because the use of oil has been pervasive. For example, the vehicles most of us drive require oil for fuel, lubrication, and tire construction. The roads we drive on are built from oil. Even the plastics we use every day, are petroleum-based. However, oil is slowly being phased out for more environmentally focused products like electric vehicles, asphalt road alternatives that use household refuse, and plastics that are plant-based. Semiconductors or "semis", which control the flow of electricity within circuitry, have been following a very similar pattern to that of oil in its hay day. Semis are used extensively in modern vehicles. They are also found in products like computers, smartphones, televisions, toasters, and street lights. While the world's modern conveniences of yester-year were made possible by oil, the next generation of modern conveniences are being enabled by semiconductors.

The U.S. Government over the last few years has recognized the importance of semiconductor technology and has sought to secure our supply chains with an initial $50 billion investment in the industry. Leading semiconductor manufacturers like Taiwan Semiconductor, Intel, and Samsung plan on spending close to $80B over the next 5-7 years on new manufacturing facilities in the United States.

This impact on the Energy sector and the emergence of semis can be seen in the current S&P 500. In 2008, with oil prices peaking at $145 a barrel, the Energy sector weighting was ~13% of the S&P 500. Its current weighting is ~3%. In contrast, the semiconductor industry weighting is now ~6% of the index. We think this weighting will only increase over time given the importance of semis in today's economy. Since most client portfolios have significant exposure to this area, they should benefit from the continued growth, and use, of semiconductor technology.

Course of Action

The S&P 500 has increased by 96% from the bottom we experienced in March 2020. As discussed, our barbell approach includes exposure to both "value" and "growth" companies. This approach has benefitted portfolios as the number of potential market participants broadened and we experienced swift and dramatic rotations in market leadership. Based on our fundamental research, we believe the "value" in some recovery names has now been realized and we have exited some of these positions. This has resulted in the barbell beginning to tilt back a bit towards growth.

Overall, we constantly look for opportunities to invest in high quality companies with durable, long-term trends at attractive valuations. Many of these investments are focused on the Technology and Communication Services sectors, in which client portfolios have had significant exposure for many years. That said, we are at an inflection point in the adoption of technology. There will be an acceleration in dollars spent on digital transformation, and at a double-digit pace globally, for years to come. We see a long runway for this secular trend as the pandemic forced user adoption of new technologies to be even faster than expected. Given the market rotation we experienced again this quarter, we were able to increase exposure in these areas, including to semiconductors.

Client portfolios also have significant exposure in the Consumer Discretionary sector, as we expect robust consumer spending to continue to lead the economic recovery. The pandemic has resulted in strong long-term trends for more goods being sold online, as well as electronic payments to be used in this process.

Important Disclosure Information