April 8, 2021

# Graves-Light Q2’21 Client Newsletter

## Main Points:

- Our market comments and recommendations can be found on pages 2 through 8. We have included an introduction to high-yield fixed income and bank loan securities, which we are considering for future investment opportunities.

- During Q1’21 (March end), the S&P 500 increased 6.2% with value stocks outperforming growth issues. Small-cap stocks were the starts of the quarter, with the S&P 600 Small-Cap index jumping 18.24%. The U.S. bond market, as measured by the Bloomberg Barclays Aggregate index, fell 3.4% during the quarter while the Bloomberg Commodity Index rose 6.9%.

- We believe the current and prospective massive government stimulus programs around the world are influencing asset prices. As a result, we believe such action have driven certain areas of the financial markets above what we consider to be fair value. Nonetheless, such dynamics could be in place for some time.

- The specter of inflation may become an increasing source of investor angst over the next few months. Therefore, higher inflation expectations could further pressure bond prices lower. Stock prices may prove resilient against such pressure unless annualized inflation increases exceed 3%.

- Our favored securities remain largely the same with an emphasis on stocks not categorized as large-cap growth and fixed income securities with valuations less sensitive to interest rate movements.

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## “Patience and diligence, like faith, remove mountains.”—William Penn

## Overview

Market trends during Q1’2021 (March end) were largely a continuation of those experienced since the “Pfizer” announcement on November 2, 2020. Small-caps and value stocks achieved double-digit returns during the March quarter, which dramatically outperformed the mid-single digit returns of both the S&P 500 and the EAFE index. The U.S. bond market, as measured by the Bloomberg Barclays Aggregate Index, suffered a loss of 3.4% during the quarter as benchmark interest rates moved while the Bloomberg Commodity Index rose 6.9%. In short, seemingly insatiable demand for securities combined with cheap money drove strong appreciation for a broad array of assets, including equities, bonds, housing, and even more esoteric corners of the market, such as bitcoin.

Over the first three months of the new year, there were several discernible shifts that occurred within both the equity and bond markets. For equities, market leadership continued to favor companies that should benefit from the continued reopening of the economy rather than the “stay-at-home” winners which flourished over most of 2020. For example, the Information Technology Index, which has often been cited as a “stay-at-home” beneficiary throughout the pandemic, strongly outperformed the broad S&P 500 Index by jumping 43.9% over 2020 as a whole(!). Subsequently, the tech index lagged during the first quarter of 2021 with a gain of 2.0% versus the underlying S&P 500’s return of +6.2%[1]. Conversely, the list of quarterly winners include industries which benefit from reopening the world’s largest economy, including Hotels, Resorts & Cruise Lines (15.6%), Financials (+16.0%), and the Energy sector (+30.9%) which are currently rated as value stocks.

Many investors are concerned about the possible after-shocks resulting from the massive stimulus programs currently underway both domestically and around the world. While the longer-term ramifications have yet to come into focus, the current market environment has been heavily influenced by governmental actions. When the world has an “excess” of liquidity, that money must find a home. Most typically this home is in investment assets of varying degrees of risk. Globally, there is so much excess liquidity in the market right now that it is having an upward price pressure on everything from sovereign bonds (lower yields) to stock markets. While negative news can certainly cause asset prices to decline, this liquidity provides a strong buoyant force inflating asset prices above what they would otherwise be, in our opinion, for a period of time.

Yet, many remain perplexed about stock prices at all-time highs while “Main Street” economic trends are supported by low corporate tax rates and government largess. Investors should keep in mind that these tailwinds may be reduced in following years. A useful framework to understand the apparent dissonance between the “real world” and Wall Street can be found in economic theory which revolves

[1] All performance related statistics in this letter are based on a total return basis (i.e. price change and income).

around the relationships expressed by the equation as follows: Money Supply x Velocity=Price x Quantity. Typically, central banks try to influence the money supply with an eye on how quickly money moves through the economy (velocity) to maintain price levels.

The Marshallian K ratio, which is M2 Money Supply/Nominal GDP or the inverse of velocity, captures the propensity for excess money not absorbed by the real economy to impact asset prices. Currently, the M2 money supply indicator is up approximately 27% year-over-year, which is well in excess of economic growth. Therefore, this theory helps to explain the surprisingly strong stock market advance over the past twelve months as the huge increase in excess money that was not absorbed into the real economy "leaked" into financial assets.

## Economic Trends and the Threat of Inflation

The U.S. economy appears to be experiencing strong growth, which is directly related to the massive monetary and fiscal stimulus efforts of the U.S. Government. As Covid vaccines reach more people, the economy could experience historically strong growth through 2021 due to the confluence of stimulus and a further reopening of the economy, unleashing significant pent-up demand. However, there is some question about how the U.S. economy will behave during 2022 and beyond as the curtailment of government led support could result in a massive economic hangover.

Financial markets will be trying to price in any such future disruptions even as near-term economic statistics look strong. Successful investment often focuses on anticipating major trend changes which have not been properly discounted by other market participants. The current rich valuations across many asset classes have focused our attention on evaluating the risks associated with less than hoped for economic recoveries and/or an unexpected revival of long dormant inflationary forces. While we do not profess any special insights into market behavior over the next few months, it is reasonable to assume that equity markets may at least pause from the strong upward trends in place since the March 23, 2020 market bottom if growth prospects dim or inflationary trends lead to unexpected central bank actions.

International economic recoveries remain uneven with problematic vaccination trends, especially in Europe, coupled with depressing COVID infection rates and deaths in too many countries around the world. The science community has done their part with the development of quality options to provide robust resistance to the onset of severe COVID related ailments. Nonetheless, the continued mishandling of vaccine procurement and distribution abroad, coupled with those within the global population that are hesitant to take available vaccines, may "score an own goal" and let the virus regain the upper hand. We do not believe financial markets would look kindly on such a scenario.

## Inflation

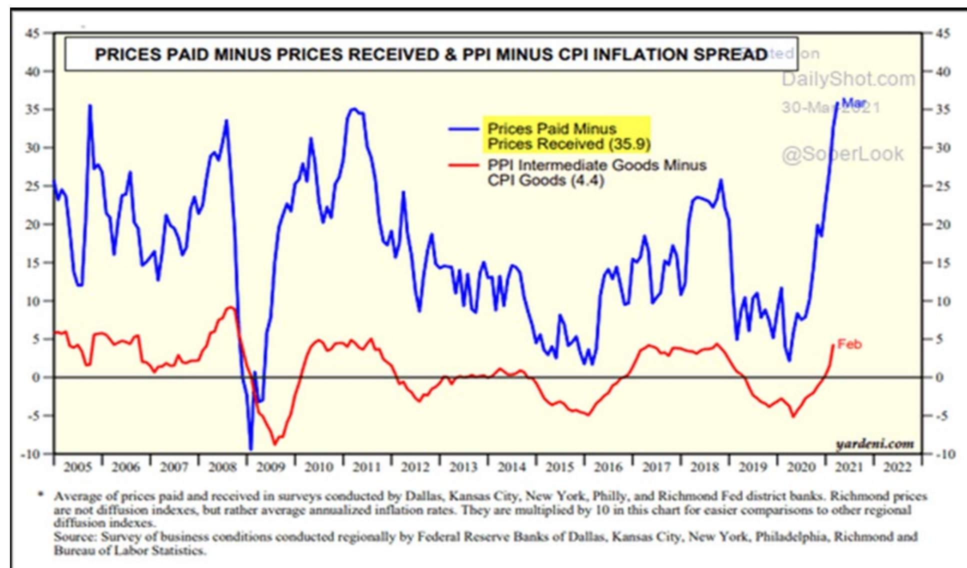
The specter of inflation may increase investor consternation in the months ahead and materially impact security prices. A formal definition of inflation focuses on a rate of increase in the prices of goods and services over a given period that leads to a decline of purchasing power (i.e. one is able to buy less per $1

over time). As such, household spending patterns may come under strains as needed items consume an ever-greater amount of income.

If employment trends continue to strengthen, employees may find it easier to demand and receive wage increases but their standard of living may not improve if the inflation rate matches or exceed wage growth. Furthermore, increasing costs will weigh on corporate profitability which could lead to concomitant price increases as a reaction to higher input costs, leading to a vicious cycle.

The stringent COVID-related shutdowns which started during March 2020 caused massive economic declines and collapsed many commodity prices. As such, the year-over-year inflationary trends will likely be elevated for the next few months compared to the depressed year-ago price levels. The main question for the markets is whether such price pressures are transitory or become imbedded in the economic cycle.

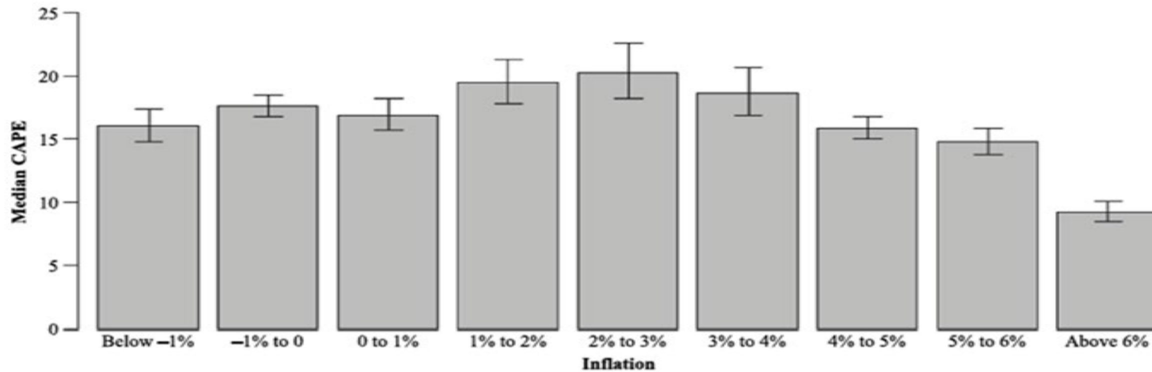
Broad-based commodity indices continued their months long upward trend as a confluence of rising inflation expectations, an improving demand landscape, and in certain cases, supply shortages, prompted higher raw material prices. The Bloomberg Commodity Index, which tracks a broadly diversified group of commodities including oil, grains, and industrial metals, expanded 6.9% during the first quarter.




The chart to the right shows the change in prices producers are paying to develop their products and services versus the prices those items can generate from a sale; the increase in the blue line is showing that input costs are rising much faster than sale prices. The red line in the chart represents the same dynamic as the inflation measure for production related inputs for goods not ready for sale, formally named the producer-price index (PPI) for intermediate goods, is running hotter than the prices paid by the consumer as measured by the consumer-price index (CPI). If these trends continue, corporate profit margins will compress and limit future earnings-per-share (EPS) gains. Future profit margin relief through meaningfully higher selling prices may drive inflationary trends for consumers above the comfort level of the Federal Reserve, resulting in more restrictive financing rates and lessened monetary support for the economy. This would add further impediment to higher future EPS levels.

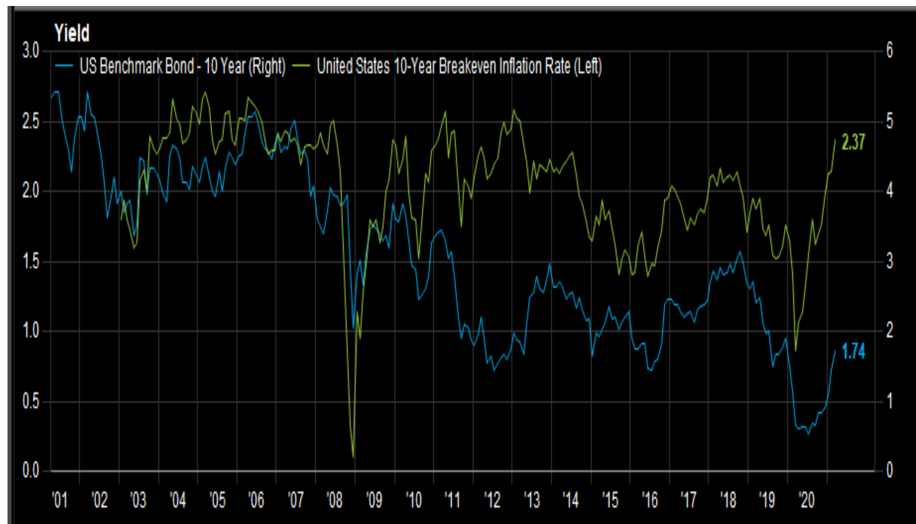
Rising inflation can have a deleterious impact on security valuation, as well. Historically, the stock market has achieved higher valuation levels when inflationary trends remain in the low single digits. The current CAPE multiple is historically high at 35X, which could prove problematic if inflation strengthens

and causes investors to judge each $1 of earnings-per-share worth less in real economic terms. As shown in the following chart, an inflation rate of 3% or more has been associated with subsequent lower valuation levels in the past.




Inflation trends are very important to the valuation of fixed income (i.e. bonds) securities. Bond yields are a function of expected inflation and the real interest rate, which more directly relates to an improvement in the standard of living. The prices of fixed income securities move in an inverse fashion to market interest rates. In general, bond prices increase/decrease as the fixed stream of interest payments over the life of the bond and the end-of-term principal repayment are repriced based on the current market rate.

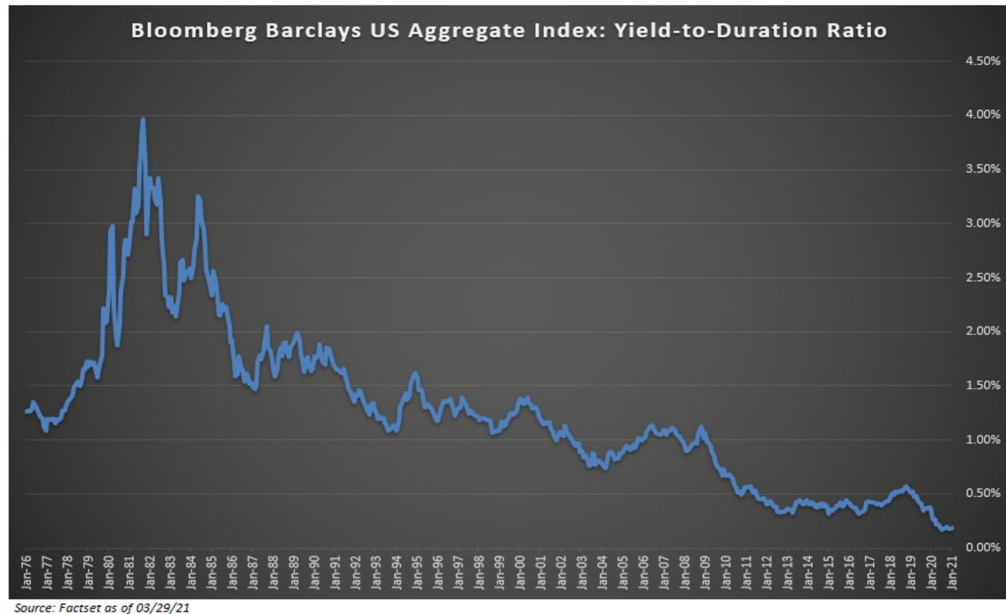
Over time, the expected trend in inflation should largely follow the trend of the 10-Year Treasury Note yield. The 10-Year breakeven inflation rate is a market derived measure of expected annualized inflation over the term period. As shown in the chart to the right, inflation expectations have risen much faster than the change in the 10-Year Treasury Note over the past 12 months or so, portending further pressure on fixed income assets.



Source: FactSet

Entering 2021, core fixed income markets were more exposed to interest-rate risk than at any other time in recorded history. A key metric used by fixed income practitioners to capture this data point is the "Sherman Ratio", which was named after DoubleLine's Deputy Chief Investment Officer Jeffrey Sherman. In essence, this metric indicates the level of yield investors earn for each unit of duration. As a reminder,

duration is simply a measure of a bond's sensitivity to a given move in interest rates. For example, the principal value of a bond with a duration of 6 years would gain 6% (excluding income) if rates fell by 1% or lose 6% of principal value if rates rose by 1% over a 12-month period.



Source: Factset as of 03/29/21

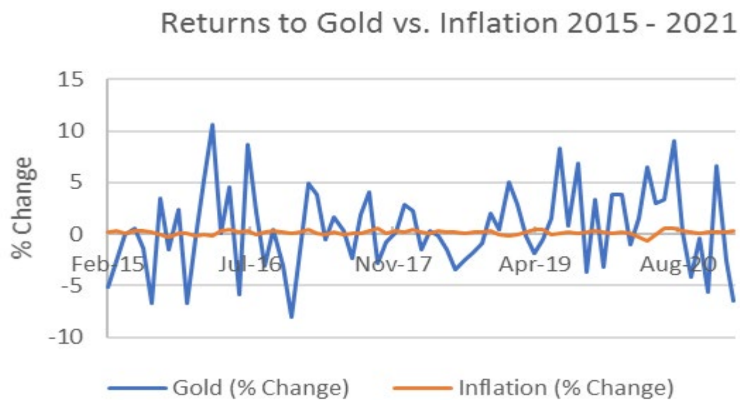
Following a multi-decade bull run for bonds, core fixed income markets entered the new year with near record *low yields* coupled with near record *high duration*, resulting in the unappetizing potential of income receipts to have little offsetting impact upon principal losses. While the drivers are manifold, the key takeaway is that core fixed income investors have never been more susceptible to losses from a potential move higher in interest rates than at any time in history. The chart above reflects this potentially perilous position for investors, as the Bloomberg Barclays US Aggregate's yield for each unit of duration entered the new year at a paltry 0.17%. As such, the "safe asset" may not prove to be safe if interest rates meaningfully increase.

## What To Do?

We continue to believe that equities are generally more attractive than bonds. In addition, our view remains that value stocks and international stocks offer more potential than domestic large-cap growth stocks, especially technology related shares. The comparative valuations of value stocks versus growth stocks remain attractive, which is more of a function of how richly priced growth stocks are relative to the rest of the market.

Our recommendations for long-term investors remain focused on moving away from both large-cap growth stocks and bonds, especially those with longer maturities, and introducing commodity exposure to improve potential inflation-adjusted returns going forward. We presented the rationale for these changes in our Q1'2020 client letter. That client letter is available for those who wish to delve deeper, but the abbreviated version is that a basket of commodities is a good way to hedge inflation. The motivation for undertaking such hedges has clearly not diminished given current market conditions.

This brings us to a particular commodity, gold. We frequently field questions about gold, and popular opinion often seems to come back to a belief that gold is a good inflation hedge. Unfortunately, it is not. To see this, consider the figure below, which shows the monthly evolution of the price level compared with gold. The monthly percentage change in the price level, in orange, is the monthly inflation rate, and the monthly percentage change in the value of gold (measured by the front-month futures price of gold) is in blue. The inflation rate has grown steadily and slowly over the last few years, growing at an average of 0.15% each month, with a notable dip last March. Meanwhile, gold has bounced up, down and everywhere in between, increasing by 0.45% each month, but with a standard deviation 19 times higher than inflation. Worse, gold and inflation most often move in different directions. Of the 73 months plotted in the figure, inflation and gold moved the same direction only 31 times (42.4%). As a result, the reliability of gold as an inflation hedge over the last 5 years has been worse than a coin flip with a negative correlation of –17.8% between those two series.




Gold has declined roughly 9% from September's $1,887.50 per ounce level to $1,715.6 per ounce at the end of March. Meanwhile, the Urban CPI has increased to 260.149 (note that they've moved in opposite directions, which to repeat, doesn't make for a good hedge).[2] That implies a "real price" for gold of 6.59. This is better than in September, but still quite a bit above its long run average of about 3.7 since 1975.

## Closing Thoughts

Equity prices have experienced tremendous growth over the past year. Our preferred market sectors have outperformed since Pfizer's surprise announcement in November. The valuation of many financial assets remains rich. However, our long experience in the financial markets helps steel our nerves against basing major portfolio decisions solely based upon a single criterion.

Markets will move in unpredictable ways over the upcoming quarter. Our goal is to systematically improve our clients' odds of meeting their long-term goals. As such, we want to emphasize that our goal is to focus on what we can control, which is premised upon long-term financial planning issues such as risk management, realistic goals, and tax planning.

[2] Here we are using the 2nd month futures contract for reference, to align the values with the 2020 Q4 newsletter. The Urban CPI reported is from the Feb 28, 2021 release, the most recent available at the time of this writing.

As always, we sincerely thank you for the opportunity to the help shape your financial future. We treasure the opportunity to help secure retirements, provide legacies for children and grandchildren, and afford the opportunity for our clients to focus on what is meaningful in their life story.

Best regards,

| Asa W. Graves VII, CFA | Jason Fink, PhD | Ash Heatwole, CFA |
|---|---|---|
| Chief Investment Officer | Director of Research | Portfolio Manager &<br>Assoc. Dir. of Wealth Management |

## Addendum: Introduction to High-Yield Bonds

"High yield" bonds have several monikers, few of them flattering. The most common synonym one comes across is "junk bonds." The "junk" status and the "high yield" nomenclature are indeed two sides of the same coin – with higher risk comes higher return, on average.

High yield bonds work similarly to "investment-grade" bonds. A company borrows a certain amount of money by issuing bonds, and they agree to pay "coupons" of a certain amount (typically) every six months until maturity of the bond, when they are required to pay back the designated amount (often referred to as the "principal" of the bond, or its "face value"). What distinguishes high yield bonds is that the companies that issue them are less creditworthy than "investment-grade" bonds. Stated simply, there is a greater chance that they will default on their obligations. Market participants naturally require greater expected returns in order invest in these bonds, to offset that heightened default risk.

Between 1981 and 2019, high-yield bonds defaulted at a rate of about 4% per year. By comparison, investment-grade bonds only saw default rates of about 0.09%.[3] However, during times of stress, default rates can be far higher than the averages, and high-yield bonds in are much more likely to default in such times. For example, during the height of the financial crisis in 2009, 9.95% of high-yield bonds defaulted while 0.33% of investment-grade bonds did. This understates the defaults in investment grade bonds, however, since most companies deteriorate gradually. As they do, their once "investment-grade" bonds usually transition to "junk" status before they default. But the point remains, high-yield bonds default much more often than investment-grade bonds. When bonds do default, the loss to the bondholders are rarely 100% since bonds are often secured by company assets. A rough approximation of the recovery rate is about 50%, but these rates are highly variable from default to default. A little basic math can easily show that high-yield bonds can live up to their "junk" moniker. With a default rate in 2009 of about 10%, and if the recovery rate for those bonds was about 50%, then we can see that the average high-yield bond lost about 5% of its value in 2009. Of course, these losses were "lumpy" – any one bond either made its payments or it did not.

Of course, in 2008 the S&P 500 lost about 37% of its value, so we are all comfortable, to varying extents, investing in assets that are riskier than junk bonds. The key to the magnitude of the losses in any asset class comes down to portfolio management – in 2008 investment grade bonds were up a bit over 5%, partially offsetting the loss in stocks. It is the composition of the entire portfolio that is key. Along these lines if an investor buys a single high-yield bond, the return may be quite good – unless the bond defaults and the investor loses 50% or more of their money. On the other hand, if an investor buys 100 high-yield bonds, and 10% of those bonds default while averaging a 50% recovery rate – now we are back to the situation in which the investor faces a 5% loss. Further, the investor is being compensated by higher rates being paid by the 90 bonds that did not default. If those 90 bonds are paying 2.5% higher than comparable "safe" bonds, then the investor is really facing a loss of about 2.75%. No one likes a loss, but if these are roughly the numbers at the height of the financial crisis, it certainly is not catastrophic. Just as it is beneficial to hold a portfolio of stocks to the minimize the damage that a meltdown in any one stock may

[3] Source: "Default, Transition and Recovery: 2019 Annual Global Corporate Default and Rating Transition Study"

present, it is beneficial to hold a portfolio of high-yield bonds to help mitigate the risks that any one company could default.

The return to high yield bonds tends to be related to the "spread" of these bonds relative to the safest bonds available: U.S. Treasury bonds. The spread is just the yield on a typical high yield bond minus the comparable-duration U.S. Treasury yield. For example, as of March 26, the 10-year U.S. Treasury bond was yielding about 1.67%. High-yield bonds on that date yielded about 4.32%. Therefore, the spread between the two was about 2.65%. A great deal can be learned from this spread, and it turns out to be a key predictor of future high yield bond returns. Presently, this spread is relatively low, indicating that returns to high yield bonds are likely to be relatively low moving forward.

However, in an environment with relatively low expected returns across assets moving forward, high yield bonds provide another potential class of assets to consider in the context of well-diversified portfolios. Challenging times for asset returns require solid portfolio management. Solid portfolio management balances the risk of the portfolio with the returns, and a key component of that overall risk are the correlations of the assets within the portfolio. As the table above indicates, high yield bonds have a positive but relatively low correlation with several important asset classes. Taken together with information from the yield spreads above, we see that high yield bonds have the potential to reduce risk and enhance returns, given the right environment and in the context of a well-managed portfolio.

| | Correlations of 5-Year Returns | | | |
|---|---|---|---|---|
| | *Inv. Grade Bonds* | *EAFE Stocks* | *S&P 500* | *Commodities* |
| *Inv. Grade Bonds* | 1 | | | |
| *EAFE Stocks* | -0.22 | 1 | | |
| *S&P 500* | 0.03 | 0.62 | 1 | |
| *Commodities* | 0.55 | 0.32 | -0.08 | 1 |
| *High Yield Bonds* | 0.34 | 0.47 | 0.44 | 0.28 |

Bank loans are a related asset class. Several cost-effective funds bypass the bond market entirely and invest in loans made directly to companies that are secured by company assets. These loans are senior to bonds in the corporate capital structure – meaning they get paid out before bonds do, and so are less risky. Further, the coupons of these holdings are tied to a floating rate, meaning that if rates go up, so do the payments. This has the effect of lowering the duration of the bonds, thus helping to mitigate the

duration risk discussed previously. Like high-yield bonds, these funds may have a place in the broader context of a well-positioned portfolio in the right environment. We are patiently waiting for better valuation parameters to invest in these asset categories, but we believe that presentable investment opportunities may arise during the current quarter.

***DISCLOSURE***

Stocks offer long-term growth potential but may fluctuate more and provide less current income than other investments. An investment in the stock market should be made with an understanding of the risks associated with common stocks, including market fluctuations. Stock dividends are not guaranteed. Investments primarily concentrated in one sector may be more volatile than those that diversify across many industry sectors and companies. The technology industry can be significantly affected by obsolescence, short product cycles, falling prices and profits, and competition from new market participants. Global/International investing involves risks not typically associated with U.S. investing, including currency fluctuations, political instability, uncertain economic conditions, different accounting standards, and other risks not associated with domestic investments. Investments in emerging markets may be subject to additional volatility. Stocks of small and mid-cap companies may also be subject to greater risk than that of larger companies because they may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

The value of fixed income securities will fluctuate with changes in interest rates, prepayment payment rates, exercise of call provisions, changes in the issuer’s credit ratings, market conditions, and other variables such that they may be worth more or less than original cost if sold prior to maturity. There is also a risk that the issuer will be unable to make principal and/or interest payments. Although treasuries are considered free from credit risk, they are subject to other types or risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate, and deflation risk, which may cause the principal to decline and treasury securities to underperform traditional securities.

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