2nd Quarter, 2021

Pavlic Investment Advisors

Client Review & Outlook

So far, this year is proving to be much less eventful than last year. We began 2021 cautious, yet optimistic that stocks would move higher on the backs of extraordinary stimulus measures and we expected that appreciation to be companied by heightened volatility. The "heightened volatility" thesis has yet to play out, however our bullish stance has proved correct. We have been in this business long enough to know, however, that a 10% correction in stocks will come when everyone believes it won't. When it does come, we will be ready to deploy cash into high quality growth companies that are selling at reasonable valuations.

The first few weeks of the second quarter were the most robust in the equity markets with few and very short draw-downs (meaning the change from a peak to a trough). In fact, the maximum drawdown, intraday, for the year is only 4% for the S&P 500, which occurred in the first quarter.

During the second quarter, growth stocks appreciated 11.2% and outperformed value stocks (+4.6%). The NASDAQ (+9.5%) outperformed the Dow Jones Industrial Average (+4.6%) and the Russel 2000, an index of small stocks (+4.1%). We are pleased to share that clients invested in our Core Equity Strategy have earned about 13.5% YTD, steadily outperforming the Dow and NASDAQ and just slightly underperforming the S&P 500. These results include a -1.0% drag from our defensive cash positions, which we are ready to deploy should Mr. Market give us the opportunity with a sizeable drawdown.

Stock Index Performance

(% Change in S&P 1500 for Avg/Median/% down)

	2Q 2021	YTD 2021
S&P 500 Index	8.2%	14.4%
Dow Jones Index	4.6%	12.7%
NASDAQ Index	9.5%	12.5%
Russell 2000 Index	4.1%	17.0%
S&P 500 Value	4.6%	15.6%
S&P 500 Growth	11.2%	13.2%
Average Stock	5.5%	22.7%
Median Stock	3.7%	16.7%
% of Stocks Down	37.0%	15.0%

In our bond portfolios, we have had a hard time finding new bonds linked to any measure of inflation. This gives credence to our strategy of buying bonds and holding them to maturity as we have already purchased inflation-linked bonds in our client's portfolios. Although we do not plan on ever selling these bonds, especially our largest bond holding, which is an issue from Morgan Stanley that pays an adjustable rate of interest equal to the rate of CPI (Inflation) +3.75%, we are comfortable knowing we hold bond investments that almost no one else is willing to sell or issue. Although the debate on whether inflation is transitory or more permanent remains the hottest topic in the markets, we are enjoying outsized returns in our bond portfolios driven by our CPI-linked bonds as the CPI reached 5.0% in the latest monthly reading. We remain steadfast in only purchasing investment grade corporate bonds as we try to maximize income. During the quarter, we were able to purchase more variable rate spread bonds at 4.0-5.0% yields, substantially better yields than US Treasuries, without taking on much additional risk.

Stock Market Review

Stocks continued their upward trajectory during the first few weeks of the quarter. However in the last two months

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Quarterly Review

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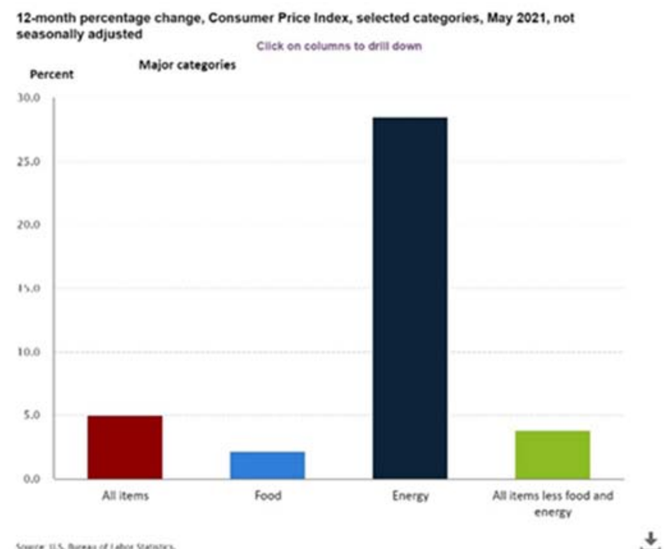
stocks have remained in a narrow trading range with few sustained, consistent moves to the upside or the downside. Underneath the hood, the baton was passed from value stocks to growth stocks as the 10-year Treasury yield fell from over 1.70% to below 1.50%. We capitalized on this change by purchasing Alphabet (Google) during the quarter. Since we bought it, it has appreciated 11.4% while the overall market has remained roughly flat during the same period. Other noteworthy stock transactions were the sale of AT&T after they announced a merger between Warner/Media (an AT&T subsidiary) and Discovery. During the merger presentation with the two CEO's—AT&T's said that, after the deal was consummated, AT&T would "right-size" the dividend. We, along with other investors, were holding AT&T for its elevated 7.0% dividend yield. We've heard the term "right size the dividend" before, and in our experience, that always means a dividend cut. Shares of AT&T are now 8.5% lower than the price at which we sold it. After positive feedback from you, we are continuing our <u>Top Five Financial Topics</u> of the quarter. Below is a summary of our thoughts on the pressing topics of the quarter:

1. Inflation. There is little debate that inflation continues to be the most hotly debated topic in the business press at present—and rightfully so. The latest reading of the Consumer Price Index (CPI) was +5.0% for May 2021 vs. May 2020—the highest reading we've seen in thirteen years! Interestingly, the breakdown of the BLS data by category shows that the inflation is largely coming from gasoline (+56.2% YoY), used vehicle prices (+29.7%) and transportation (+19.7%). The Federal Reserve and its Chair Jerome Powell continued to use the word "transitory", assuring the market that they will let inflation run hot for a period of time. Then, they expect it to cool back down to a more normalized 2-3%. We believe there are two factors to watch here—the "base effect," which is very pronounced when making year-over-year comparisons against a time when much of the global economy was in complete economic shutdown, and the less-transitory normalized inflation rate. We are giving the Federal Reserve the benefit of the doubt on the "base effect" when making May 2021/May 2020 comparisons. However, this thesis will quickly become stretched if we are still seeing 4-5% inflation readings in the third and fourth quarters of this year. Similar to the Federal Reserve, we have increased our inflation expectations to 3.0-3.5% for this year including the impact from the base effect, but we do expect the recent pace of inflation to subside as stimulus works through the system and enhanced unemployment benefits run out in September.



2. Housing – Red Hot, but set to cool. It's rare that we hold a client meeting where there isn't a story that starts with, "That house down the street got $$,$$$ over list price and they had multiple all-cash buyers to chose from!". Homeowners have fared extremely well over the last twelve months, especially those with larger living and outdoor spaces that have been in greater demand vs. high-rise urban condominiums. The material increase in home equity is bullish for the economy as homeowners psychologically feel wealthier—even if that wealth isn't liquid. We expect the housing market to remain very tight, simply because over the past decade there has not been enough housing construction to satisfy the demand. Finally, COVID ushered in the ability of high-paying tech, law, finance, and engineering workers to prove they could work 100% remotely—and most have done so for the last 18 months. Even in a hybrid work environment where one is in the office half the time and half the time at home, it can be just enough of a catalyst for a family to begin looking for a larger home.

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Quarterly Review

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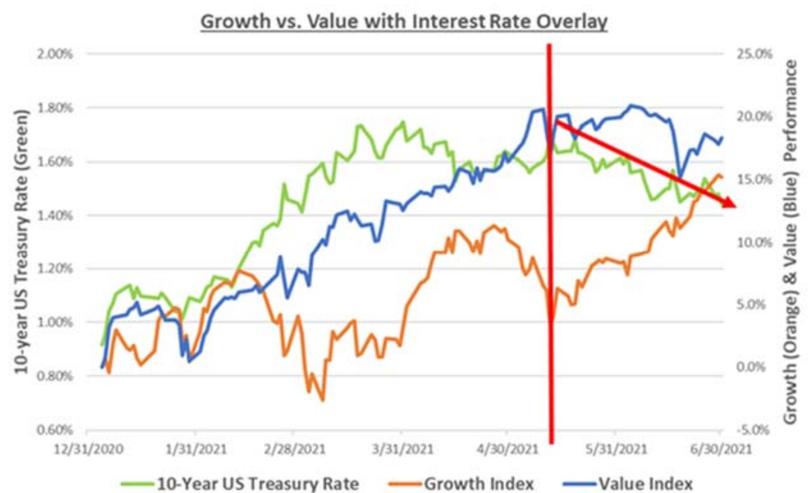
Nationally, home price are expected to increase 11-13% this year. For 2022, we expect the pace of home price inflation to moderate back to the 2.0%-3.0% level, similar to the overall level of inflation.

3. Interest Rates. We think that the 10-year US Treasury yield is the most important rate to watch, as many debt instruments for consumers, such as mortgage loans, as well as bond offerings from corporations are derived from this important interest rate. During the first quarter, the 10-year Treasury yield rose from 0.95% at the start of the quarter, to as high as 1.75% near the end of the quarter. Many experts were forecasting a 2.0% or even a 3.0% 10-year yield driven by rising inflation. However, the bond market quickly proved those prognosticators wrong. Since mid-May, the yield on the 10-year US Treasury bond has fallen from 1.7% to below 1.5%., and interestingly, that peak coincided exactly with the beginning of the outperformance of growth stocks over value stocks. Although we believe the 10-year yield can approach the 2.0%-2.5% range as the economic recovery continues to gain steam, we don't expect this to have recessionary implications. Remember, the pre-COVID yield levels of 2017-2019 were generally 2.0-3.0% and this was a very prosperous time for both stocks and the overall economy.

4. The Rotation from Growth to Value. The value vs. growth debate shifted in November, 2020 when human tenacity and ingenuity triumphed over the global pandemic with multiple biotech firms, such as Pfizer/BioNTech, Moderna, and Johnson and Johnson, announcing vaccines with over 90% efficacy rates. The rotation from the growth winners of the last decade (that "winning" was especially pronounced during the worst of the COVID lockdowns) into the value laggards began at that mid-November moment and carried through to mid-May of this year. However, in the last six weeks, growth stocks have strongly outperformed value stocks as the 10-year treasury rate fell from 1.70% to under 1.50%. This decline in the yield indicates that bond investors believe that the Federal Reserve (along with our prior forecast) is correct: inflation will be transitory, albeit hotter than we have had over the last decade. We continue to maintain a healthy balance between the high quality growth stocks that have carried us far for many years and high quality but lower valuation cyclical stocks that trade at discounts to intrinsic value and benefit from a rising 10-year treasury yield, increasing inflation, and higher demand for hard goods such as energy and materials.



5. Stimulus—infrastructure bill in sights. Although we are hesitant to pontificate on anything political until both sides are done haggling (or getting their respective pork into the bill), in the next quarter, it is likely we will have additional stimulus in the economy in the form of an infrastructure bill. We believe the most important thing to keep in mind is that the relative size of this bill is expected to approve $500-$700 million of spending over the next 10 years. This is peanuts compared to the COVID-related stimulus of roughly $7 trillion in 12 months (includes both the expansion of the Federal Reserve's balance sheet and the direct-to-consumer payments sent from our Federal Government.) We view this additional spending as a positive for stocks and the economy as we upgrade our transportation infrastructure in the US. However raising corporate tax rates or increasing the government's debt to pay for it are offsetting negatives for stocks and the economy.

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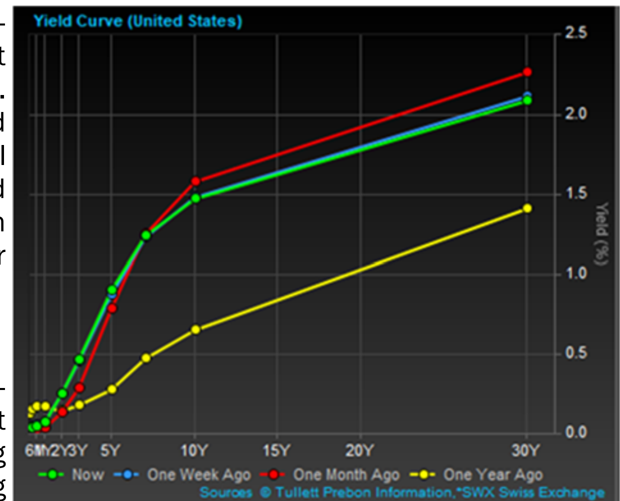
Bond Market Review



Bond yields fell slightly through the quarter. As previously mentioned, the 10-year US Treasury yield fell from as high as 1.75% at the beginning of the quarter to 1.48% at the end of the quarter. The Federal Reserve controls the short end of the yield curve and has committed to keeping the short end, also called the Federal Funds Rate, near 0% "for the next two to three years." The Fed also continues to purchase $120 billion of securities per month including direct corporate bonds, which has the effect of further compressing yields.

While yields on investment grade corporate bonds remain somewhat uninspiring, our goal remains to maximize coupon interest while minimizing risk. Bonds that we recently purchased during the quarter include a Morgan Stanley variable rate bond maturing in 2028 with a current yield of 4.5%. Further, as the yield curve continues to steepen, these bonds will pay even greater rates of interest than they do today due to their steepener variable rate structure. As a reminder, we purchase only investment grade rated bonds and we lower risk and transaction costs by holding them until they mature. Our bond strategy assumes that the stimulus will lead to higher growth and periods of higher inflation, albeit not hyperinflation. It further assumes the Fed will keep short end interest rates low for at least several years. We believe that spread bonds that pay greater rates of interest when the yield curve steepens or inflation rises and are excellent ways to take advantage of the current bond market environment.

2021 Outlook

One of the oldest adages on Wall Street is, "Don't fight the Fed". We think this should be expanded to "Don't fight the Federal Government." Whether one believes the extraordinary amount of stimulus offered to the market was rightly or wrongly placed, the bottom line is, looking back, there is no question it has been a boon for the stock market. Although we don't believe the stimulus induced move is necessarily over, we do believe the reaction in stock prices has already been fierce, and, as such, further stimulus induced gains are likely limited going forward. Economic activity should continue to improve with an over 7.0% GDP increase expected this year. Unemployment rates should drop as expanded unemployment benefits expire, and inflation should peak at about 5.0% and settle back to the 2.0-3.0% in the second half of the year.

Overall, we continue to expect that stocks will be higher at the end of this year versus where we started the year and that bond yields will continue to rise on the long end, albeit at a slower subdued pace versus what we witnessed during the first quarter. We are trimming stocks that we believe have reached full value and are awaiting a broader market correction (~10%) to put more cash to work.

As always, if you would like to discuss your investments, please don't hesitate to call or email so we can arrange either a phone, video, or in-person meeting.