5
Market-Moving Events in 1Q 2021

5
Events We are Watching in 2Q 2021

Welcome to the Smith Capital Investors 5X5. We explore topics from the first quarter of the year and issues facing us in the second quarter of 2021. (Use the links above to jump to a section.)

Welcome to your first 5x5 of 2021.

The primary goal of this production is to bring our clients and investors closer to our investment process and to provide great transparency into what we are focusing on.

We hope you find the insights from the investment team to be helpful to your process. We are happy to get on the phone and discuss any of these topics in greater detail.

We also welcome feedback around how we can improve our communication and our content.

With great appreciation and gratitude,

The Smith Capital Investors Team

5 Market-Moving Events in 1Q 2021

1. Blue Wave – Implications

After a Biden win and a Georgia runoff election, we started 2021 with a ‘Blue Wave’ and the introduction of a $1.9 trillion relief bill. Once Washington has approved the relief bill, they will likely move on to the recovery bill, Build America Back Better. **Risk markets responded favorably to the outcome, Treasury yields rose, and growth estimates were revised higher.**

- **Democrats are utilizing “reconciliation” to pass the $1.9 trillion relief bill and likely the Build America Back Better bill.** Reconciliation allows Congress to pass legislation with a simple majority of 51 votes as opposed to the current 60 votes necessary to avoid a filibuster. Without reconciliation, the Senate would be dependent on 10 Republicans to pass the relief bill. Given that Congress did not pass a budget for 2020, they will have two opportunities for reconciliation which will likely cover both the relief and recovery bills.

- **U.S. GDP estimates revised higher and deficits growing.** Given the unprecedented level of both fiscal and monetary support throughout the pandemic, the U.S. is reaching a tipping point where the combination of continued fiscal support into city reopening and increased vaccine distribution will unleash pent-up demand starting in summer 2021. Full year 2021 GDP estimates are currently running near 6%. Under current legislation, debt-to-GDP is expected to reach 202% by 2051.

- **The reflation trade is back.** The initial reaction from markets was favorable for risk, Treasury yields rose, and inflation expectations moved higher. Inflation will be top of mind going forward as a combination of an accommodative Fed, pent-up demand and higher deficits may create future inflation. More on this in future communication.

BOTTOM LINE

The market believes in the reopening trade but is simultaneously aware of the unintended consequences due to the unprecedented levels of fiscal and monetary support, specifically inflation. The reality is that the recovery is uneven, there is a mismatch of resources, and the fallout from the pandemic has changed the landscape going forward. While we have proven that the economy can pivot quickly with technological advances, many of those advances are deflationary in nature. **2021 will continue to be a year of healing and global reopening, but at some point, in the not-so-distant future, we will be forced to address debt and deficits.**

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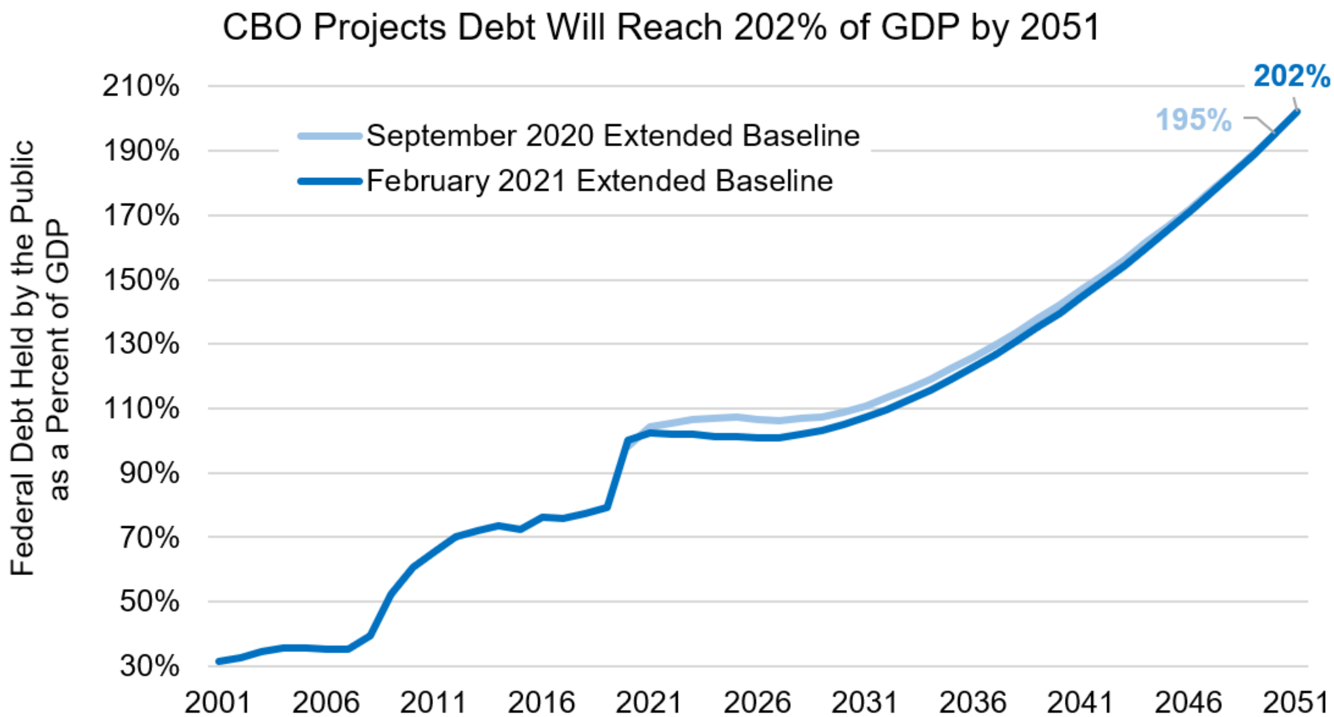

Source: Smith Capital Investors, Congressional Budget office and CRFB Calculations, 2/16/2021

2. Investing in the Era of SPACulation

When the Fed puts monetary policy on full throttle, things get interesting. In addition to a beneficial stabilization of the markets and economy, the liquidity gusher and ultra-low rates have reinforced the perception of the Fed "put" on markets, encouraged a 1999-like rally in technology stocks, fueled speculation by retail investors in cryptocurrencies and zombie equities, and contributed to a proliferation in SPACs with sponsors from all corners. In isolation, these events would not be too concerning or interesting, but in combination they amount to a flashing yellow warning light that investors ignore at their own peril.

- **History has taught us that episodes like these can go on for a long time**, until every last naysayer has been sucked into the market or humbled into a dark corner somewhere. (Reddit's investor vigilantes have already blown up the short sellers.) The Fed's desire to see the economy run hot may extend the window, and that is certainly how markets and assets are priced today. However, look out below if the market decides to force Jay Powell's hand.

- **If other eras are indicators, the credit markets will likely sniff out the end of this before equities**, as was the case in 1999-2000 and to a lesser extent in 2008. Are today's rising interest rates a harbinger of trouble as rising credit spreads were in 2000?

- **It feels like a lot is riding on this virtuous circle** (easy money, rising stock prices, increased speculation, repeat) and any unwind would feel very correlated and the Treasury market would likely be an early source of pain as opposed to a safe-haven asset.

BOTTOM LINE

Speculative market environments have a habit of outlasting their critics, and a purposely accommodative Fed may well create that outcome again. The warning signs are clear - the inevitable unwind will directly impact equity, Treasury, and credit portfolios. That is not to say one cannot or should not be invested in those markets, but a particularly healthy professional skepticism should be applied to one's investment process.

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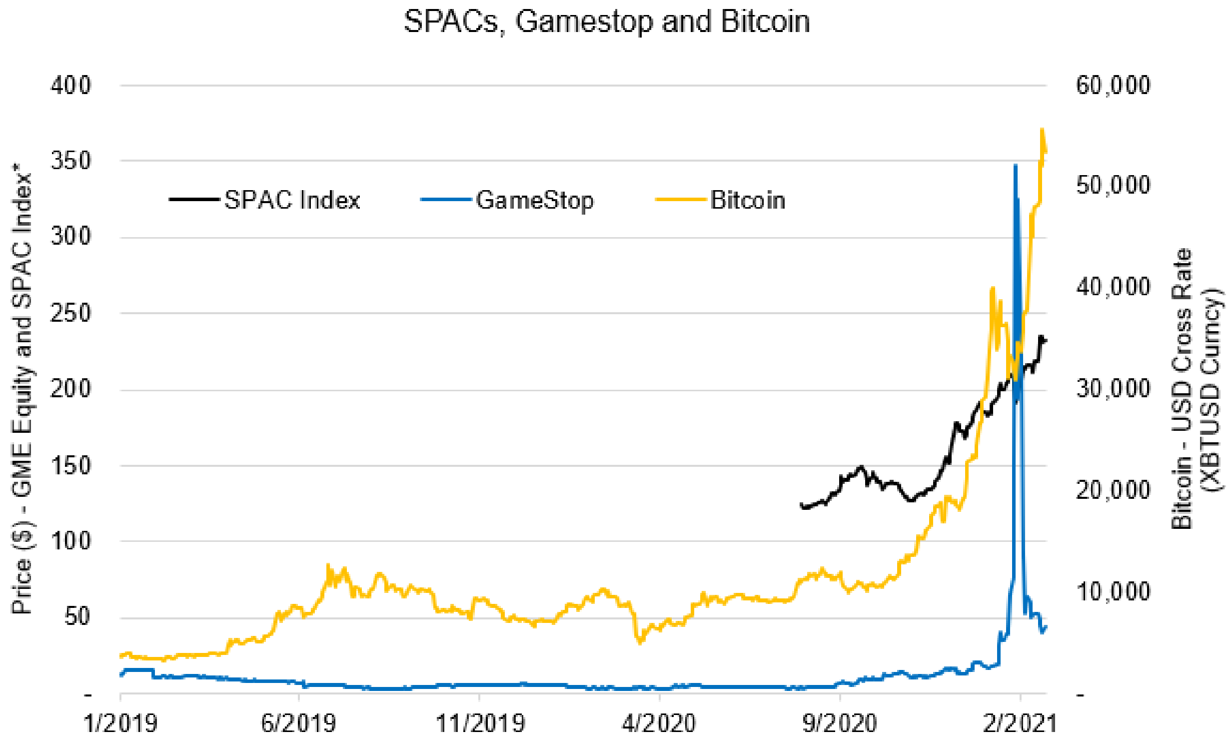

*SPAC Index price divided by 4 for scaling. True price at 7/30 inception was $500, represented as $125 above.

Source: Smith Capital Investors, Bloomberg, 2/22/2021

3. Credit Valuations – Where Do We Go From Here?

Many of us in the investing field grew up with the adage “Don’t fight the Fed”, which is another way of saying that monetary policy often has a strong influence on risk asset pricing. This timeless advice has proven to be a dominant theme in markets since the Fed announced unprecedented policy actions in response to the coronavirus pandemic. **While the tailwind of accommodative monetary policy undoubtedly provided a boost to corporate credit returns, the recent strong performance was also driven by historically attractive valuations, strong technical factors, and the expectation for improving fundamentals.** Following this strong performance, investors may be contemplating the prospective return potential for corporate credit. In doing so, it may be helpful to consider the current environment as it relates to valuations, technical factors, and fundamentals.

- **From a valuation standpoint**, corporate credit spreads have fully rebounded from the 2020 sell-off and trade on the tighter end of the historical range. As of 2/19/21, the option-adjusted spread (OAS) of the Barclays U.S. Corporate High Yield Index stood at 319bps, relative to a 10-year low of 303bps. The Barclays U.S. Corporate Investment Grade Index OAS stood at 89bps, relative to the 10-year low of 85bps. From an all-in yield perspective, both indices are at or near all-time lows.

- **On the technical side**, from a demand angle, high yield bond funds have reported outflows of -$2.4bn YTD (week ending Feb 17th) following inflows totaling $44.9bn in 2020. High grade bond funds have reported inflows of $50.5bn YTD following inflows totaling $210.6bn in 2020 (week ending Feb 17th). From a supply perspective, YTD high yield issuance totals $17.7bn net of refinancing activity, relative to $152.7bn in 2020. High grade net bond issuance stands at $48bn relative to net issuance $1.0tr in 2020.

- **A potential proxy for the trajectory of corporate credit fundamentals can be seen in rating agency activity**. The ratio of upgrades to downgrades in high yield stands at 1.5x YTD, a marked improvement from the 0.3x tally seen in 2020. This trend is also reflected in a YTD rising star/fallen angel ratio of 2.3x vs 0.2x in 2020.

- All of this has occurred in the context of an improving fundamental outlook, acceleration in vaccination programs, and the impact of fiscal and monetary policy taking hold.

BOTTOM LINE

Looking at current valuations, technical factors, and fundamentals, corporate credit investors see a mixed message. Historically low spreads and yields are a potential cause for concern. That said, technical factors could remain supportive with elevated allocations to money markets a source of potential flows into corporate credit and muted YTD net issuance relative to expectations. On the fundamental side, we could be at the beginning of a rating agency upgrade cycle as the economy recovers and credit metrics improve from depressed 2020 levels. And we cannot forget that the accommodative monetary policy stance that served as jet fuel for the rally in risk assets is likely to stay in place in the near-term.

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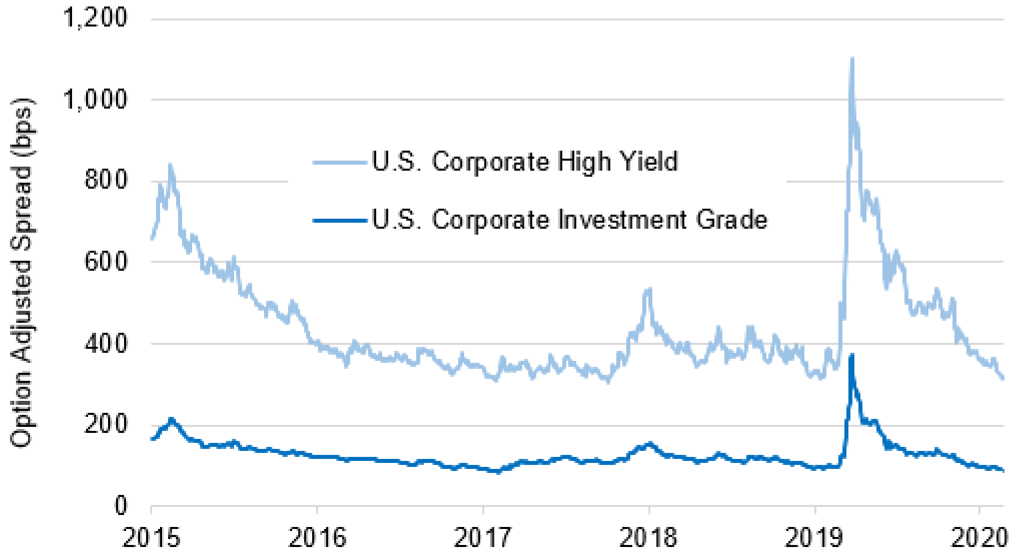
U.S. IG vs. HY Corporate Spreads



Source: Smith Capital Investors, Bloomberg, 2/19/2021

4. Yield Curve Games

On the heels of the Blue Wave reflation trade, the U.S. Treasury curve has bear steepened as the front-end is anchored to Fed policy and the long end reflects future growth and inflation expectations. The 30-yr yield is now pushing towards pre-COVID levels. **Given the starting point of low yields and long durations, the risk profile for long-end Treasuries has changed dramatically.**

- **The front-end of the curve remains pegged to the Fed Funds Rate.** The 2-yr U.S. Treasury currently sits at approximately 10 bps, this will likely be the case until the Fed is ready to hike interest rates.
- **The 5-yr point of the curve has become the pivot point.** While the 5-yr has moved ~40 bps higher in yield, it remains ~87 bps below pre-COVID levels.
- **The 10-yr is participating in the sell-off** but remains 30 bps below pre-COVID levels.
- **Long duration Treasuries offer little carry protection against price volatility.** The 30-yr U.S. Treasury has a duration of ~ 22.5 years and has sold off ~50 bps since the turn of the year, producing a -11.5% return YTD (02/23/21).
- **Further upward pressure on yields may trigger a risk off move** in equities and credit which might result in a rate rally and bull flattening from the curve – let us not forget December 2018.

BOTTOM LINE

The bear steeping move has been the trade *du jour* thus far in 2021 but we are reminded that patience is still warranted. In the near term, we will continue to register flight-to-quality periods in the market that will result in the long end providing insurance/protection against volatility. Additionally, the back-up in yields has provided an attractive outright entry point, specifically with foreign buyers. And remember that the cycle of rates moving higher can negatively impact risk assets, which then inadvertently creates a flight-to-quality move and brings buyers back into the market. In this uneven period of the recovery where we are taking two steps forward and one step back, **we recognize that we are moving between protection and preservation of capital - this is an important part of our active management process**. While we do believe rates will continue to move higher in 2021, we need to see further stabilization from the virus and a sustainable economic recovery.

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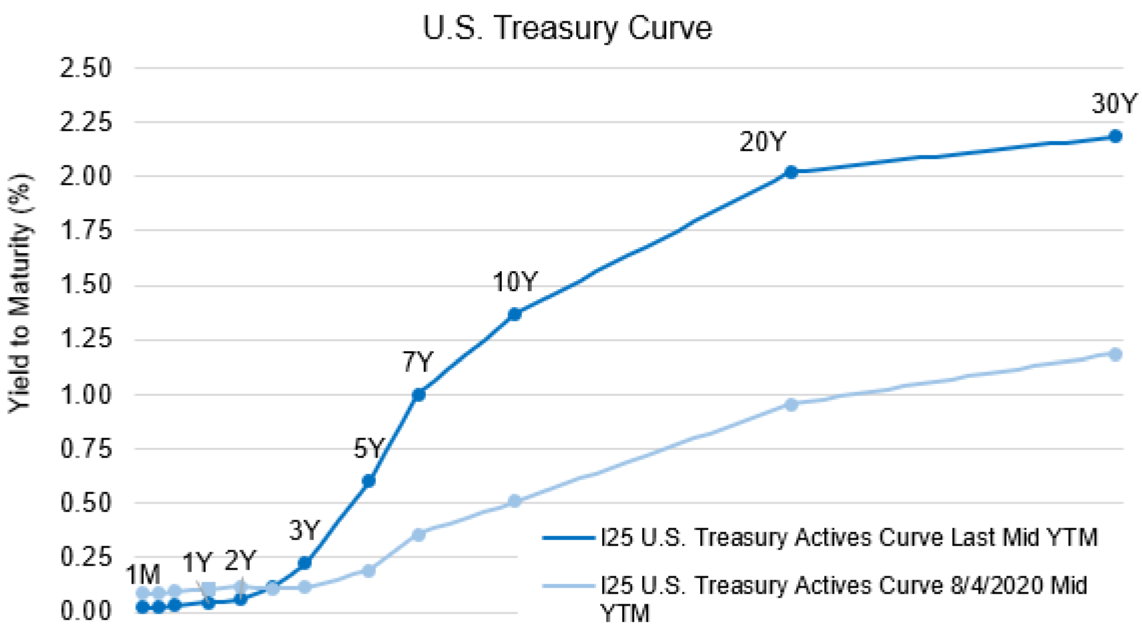

Source: Smith Capital Investors, Bloomberg, 8/4/2020 and 2/19/2021

5. Expectations vs. Reality – You Are Here

When you look at a map, with the intention of plotting a course, one of the most important elements to know before you can start your journey is knowing where you are. Knowing your starting point is crucial to moving forward in any discipline. With a gearing towards markets, **scrutinizing earnings and carefully gauging reactions can be helpful indicators to what is priced in and what is not---indicators of where we are**. This is especially true given the generic strong rebound expected in corporate earnings vs. the much slower pace of the vaccine rollout and the lifting of societal restrictions worldwide.

- Earlier this month with **88.8% of the S&P (by market capitalization) having reported, earnings beat forecasts by 16.6%** where 78% of companies surpassed their own estimates. Generally stocks have continued their strong performance throughout this earnings season.*

- However, **companies that beat both revenue and EPS expectations underperformed the market by -0.4% (**compared to a historical average of +1.5%), and companies that missed on those same measures underperformed by -1.2% compared to a historical average of -2.5%. *

- **The companies that missed have been penalized less than those companies that beat their expectations.** It appears the market is putting much less stock in estimates in the current environment vs. normal periods. This comes despite cyclical highs on equity P/E ratios and new tights in IG and HY credit valuations.

BOTTOM LINE

We acknowledge that there are almost unprecedented levels of cross-currents and unknowns impacting the macro business climate and, with that, it is understandable that the importance of quarterly earnings vs. expectations should be diminished. However, overall market valuations across asset classes indicate something very different – a world where times are good, and uncertainties are low. Taken together, these **data points reveal important information about what is baked into the market regarding expectations and therefore shed some rays of light on where we are**.

* Credit Suisse U.S. Earnings Brief February 19, 2021

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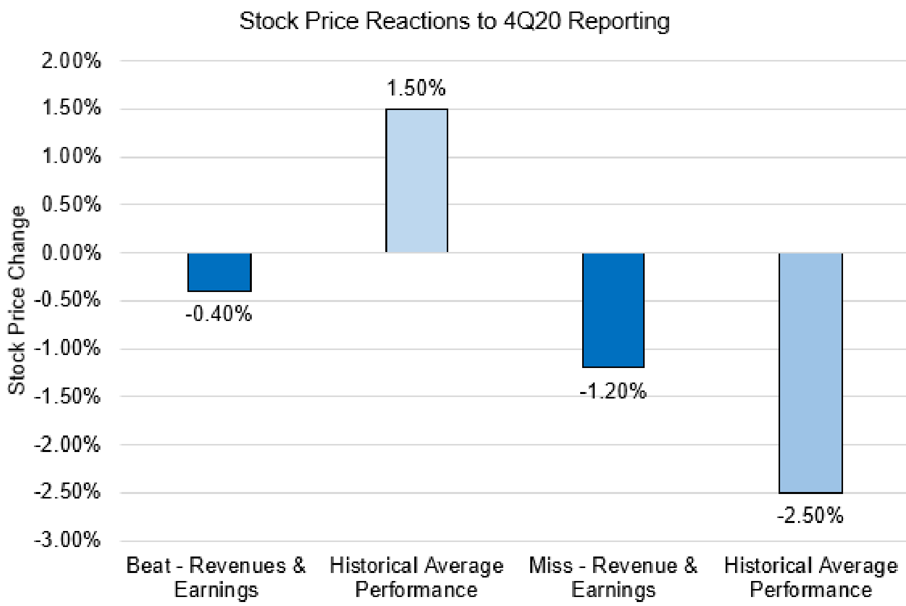

Note: Surprise calculated based on revenue beat/miss by +/- 0.25%, earnings beat/miss by +/- 1%. Price performance -1 to +1 days.
Source: Credit Suisse, Standard & Poor's, Thomson Financial, FactSet

5 Potentially Market-Moving Events We are Watching in 2Q 2021

1. What's UP with Rates?

Dueling dynamics continue to polarize participants within the Treasury market. On one side we continue to work through the virus, a slow vaccine rollout, and the impact of closures. This, in combination with massive liquidity in the system, could prove to be supportive of Treasuries. On the other side, we have pent-up economic demand, additional stimulus coming (more debt/larger deficits), and rising inflation expectations. Clarity on the agenda of the 'Blue Wave' has sparked a reflationary move and pushed rates higher, bringing fears of a 'Taper Tantrum'-like move front and center in the Fixed Income market.

- **The 'Blue Wave' kicked off the upward momentum for 30-yr yields.** The reflationary trade is alive and well, the 30-yr has sold off ~50 bps between year-end and the present as $1.9 trillion in additional stimulus is expected. As more government debt comes to the market, buyers may require higher yields as compensation for the increased supply risk.

- **With more stimulus and higher growth expectations comes higher inflation expectations.** Inflation expectations are moving ahead of the hard inflation data. The 10-yr breakeven reached 2.25% while the University of Michigan Inflation Expectations 1-yr ahead registered 3.3%, which compares to Core CPI at 1.4% YoY in January.

- **The bond market does not like negative real rates.** The last year has registered negative *real* interest rates (nominal rates minus inflation) which has pushed investors out the risk spectrum. The reflationary trade has caused the bond market to move higher in yield quickly, which is starting to positively impact real rates. The balancing act will be an orderly return to positive real rates, reflecting future growth/inflation and a net positive for savers. We hope that the move does not disrupt risk assets. Previously, when we have reached reasonable, positive real rates, the bond market has been a buy. For today, we wait for validation.

BOTTOM LINE

Like prior periods of reflation, the bond market moves quickly and then waits for validation. Rates have **moved higher quickly and are now in the validation period - watch for improvement on the virus front, a return of both growth and inflation, and potentially higher risk asset valuations**. **We believe we are nearing an inflection point and are watching for signals in the coming months that challenge the current narrative and strongly anchored consensus** - remember that rate volatility can negatively impact risk assets, triggering a flight-to-quality move (rates rally). With the front-end of the curve pegged to the Fed Funds Rate, the market consensus has the long end moving higher in yield, creating steeper curves. **We are reminded that we must play smart offensive and smart defense in this market.**

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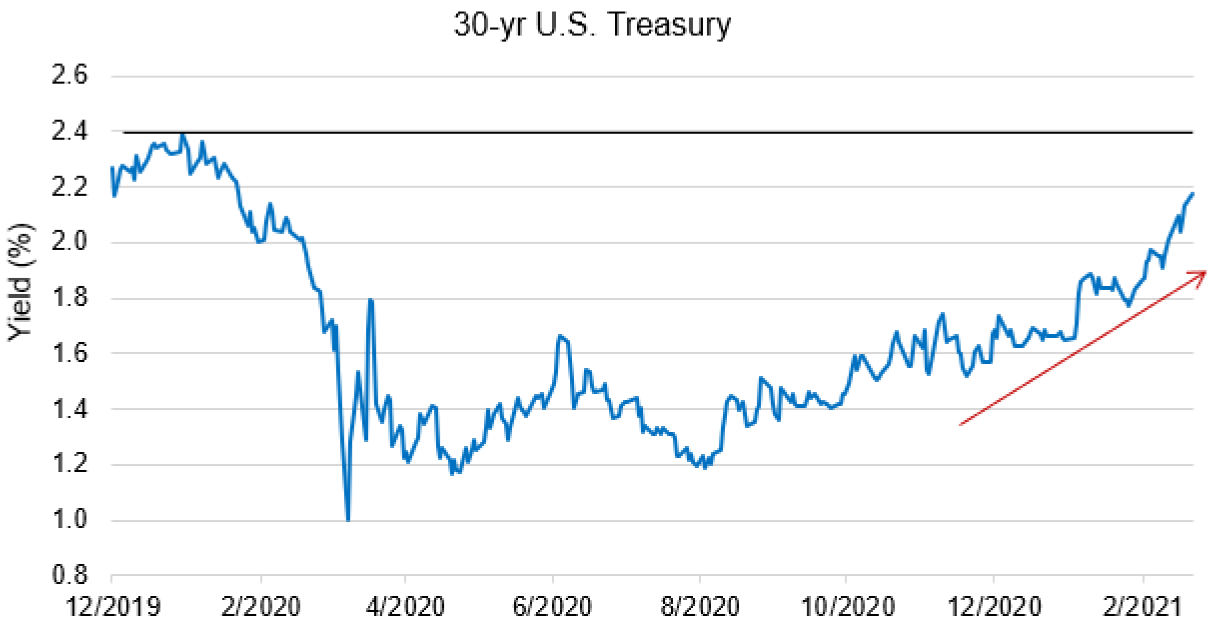

Source: Smith Capital Investors, Bloomberg, 2/22/2020

2. Inflation – A Monetary Phenomenon

Much of the recent market volatility and positive outlook is hinging on inflation. Inflation is “always and everywhere a monetary phenomenon” as we have multiple factors weighing on Fed Policy (hard data) as well as markets (expectations). Does it come down to the hard data (reality) or expectations? For today, expectations are running the show based on two things: 1) A post-pandemic growth reflation story, and 2) a Fed that has implemented its new policy around average inflation targeting, reinforcing that they will let inflation run higher than their prior 2% target.

- **The Reflation Trade:** Virus cases are declining; the global economy is reopening and pent-up demand is expected to be unleashed. This is further supported by the vaccine implementation accelerating, zero interest rate policy being reinforced, and a potential additional $1.3 to $1.9 trillion of stimulus in the pipeline.

- **Average Inflation Targeting:** Average inflation targeting means that after periods of below average inflation, the Fed will let inflation run above average for a period. The market is growing concerned about the Fed’s ability to manage a breakout to higher inflation.

- **Hard data remains below the Fed’s mandate:** Both Core CPI at 1.4% YoY and Core PCE at 1.5% remain well below the Fed’s mandate. They will see a boost in April-June data due to the base effect, but could fade over time, bringing both toward 2% near the end of the year.

- **Inflation expectations tell a different story:** The 10-yr breakeven rate reached 2.25% while the University of Michigan Inflation Expectations 1-year ahead reached 3.3%. Consumer’s and markets are “feeling” inflation, though the hard data would suggest otherwise.

BOTTOM LINE

The Fed believes that the upcoming inflationary pressures will prove transitory, the data suggests the same; however, inflation expectations are the driving force behind the recent market move. We have a series of conflicting signals, whether it be reflation, an increase in demand, stimulus/debt/deficits, supply chain disruptions, or expectations that the Fed will be behind the curve in their response. This is equally matched by the unintended consequences from COVID-19, lower productivity, technological advancements, demographics, and a massive global debt overhang. One thing is certain, the debate will make for interesting market outcomes going forward. We think this will be a central topic for the bond market over the next two quarters. Stay Tuned!

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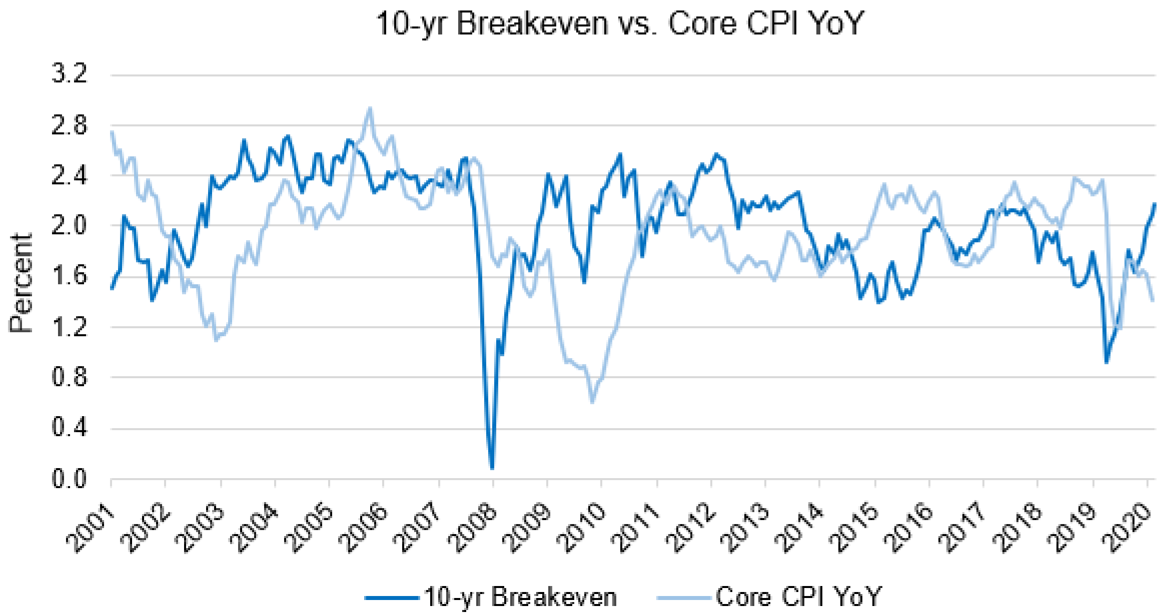

Source: Smith Capital Investors, Bloomberg, 2/22/2021

3. Massive Liquidity and Excess Capital

Time spent doing something can often lead to incrementally increasing confidence—whether it be in sports, investing, a job, etc. As the dust begins to fall back to earth from the initial blast of COVID-19 some companies have thrived while others have languished; nearly all businesses, however, have learned how to better live within and adapt to, in varying degrees, the environment they find themselves in. This has led **to increased confidence and we are seeing it through company actions**. **As we have worked through the reporting of 4Q20 earnings we have witnessed more companies providing guidance and gaining comfort in making increasingly large capital allocation decisions toward more shareholder friendly activity - whether it be conducting M&A, authorizing a renewed share repurchase program, tendering for or paying down debt, or reinstating or increasing a dividend, to name a few.**

For example:

- On Monday, 2/22/2021, **Kraft Heinz (KHC) announced a $1bn tender offer for its debt** (select 2022 to 2026 maturities) as it gains more confidence in the sale of its Planters business and its already robust Free Cash Flow profile going forward.

- Also on 2/22/21, **Goodyear Tire & Rubber (GT)**, a company that not long ago was focused on reducing cash outflows by cutting payroll expense and capital expenditures, **demonstrated a willingness to lever up the balance sheet by announcing the majority debt-funded acquisition of competitor Cooper Tire & Rubber (CTB).**

- On 2/2/21 **HCA Healthcare (HCA)**, following the repayment of CARES Act funding taken on at the height of COVID-related uncertainty, announced the **resumption of its previously suspended quarterly dividend, and the resumption and increase of its share repurchase authorization.**

BOTTOM LINE

Incremental capital allocation decisions can display increased company confidence in the fundamental outlook. At a high level, this increase in confidence does not surprise us as we would expect the more time spent in the improving environment to correlate with the higher degree of certainty. As investors, we note the increasing deployment of excess capital and its potential to drive divergent outcomes for corporate credit investors. Some companies will likely focus more on improving or repairing their balance sheets, while others will focus more on returning capital to shareholders. **With cash balances at multi-decade highs and uncertainty decreasing, we expect further deployment of excess capital and believe bond investors may be better served by aligning with management teams focused on balance sheet improvement rather than returns to shareholders. This reinforces our ‘Power of Zero’ theme that we have been highlighting over the years.**

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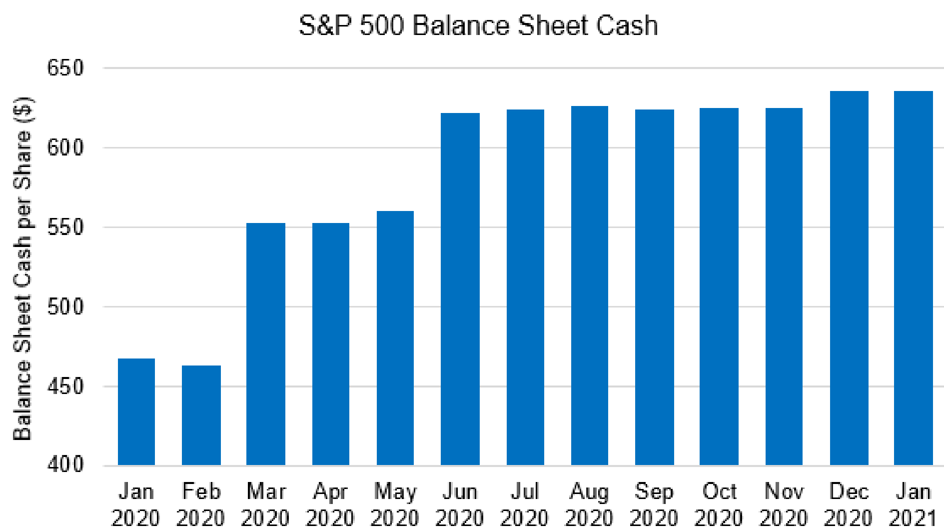
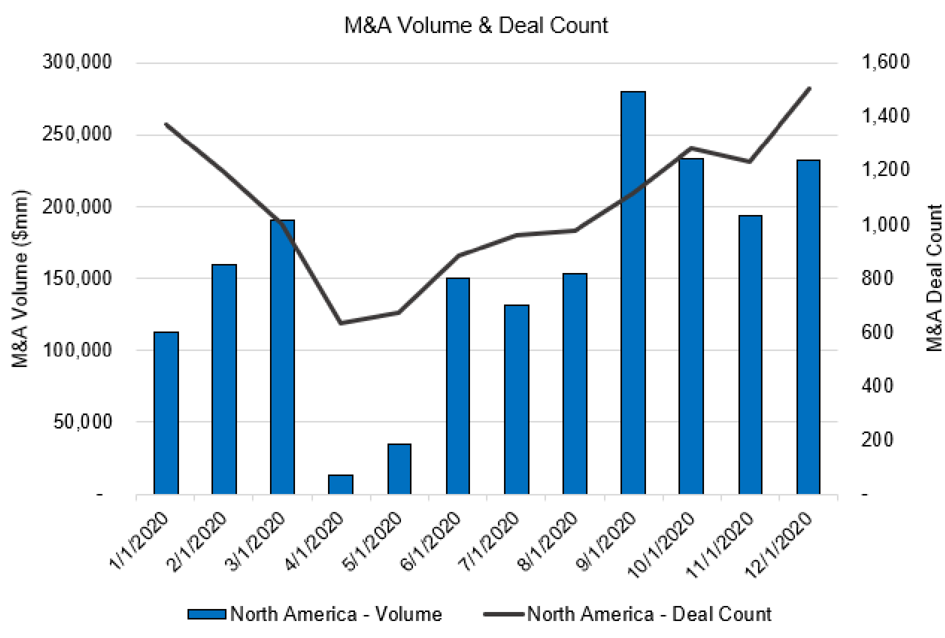


Source: Smith Capital Investors, Bloomberg, 2/19/2021



Source: Bloomberg 12/31/20

4. The Great Mortgage Trade – Or Is It Just A Duration Thing?

There has been much talk over the attractiveness of mortgages as we entered 2021 and performance this year would indicate this was well deserved, with the Bloomberg Barclays U.S. Mortgage-Backed Securities Index outperforming the Bloomberg Barclays U.S. Aggregate Index by ~125 bps YTD. In a year where fixed income investors will be hard-pressed for returns, we think a much deeper look at this asset class and its recent performance is warranted. What factors have driven this recent outperformance and how likely is this to continue going forward?

- **The Bloomberg Barclays U.S. MBS Index has outperformed the Bloomberg Barclays U.S. Aggregate Index 'Agg' by ~125bps YTD**, however, excess returns are much smaller at only ~20 bps. This indicates MBS outperformance has been driven almost entirely by its very short starting duration. The MBS Index OAD has averaged 2.2 years in 2021 vs. the Agg Index at ~6 years, suggesting that the quick 45 bps increase from 10-yr U.S. Treasury yields materially impacted returns.

- To further this point, when **Bloomberg Barclays U.S. MBS Index returns are compared to the Bloomberg Barclays 1-3 Yr Gov/Credit Index, which has a much closer duration of 1.9 years, MBS has underperformed the comparable duration benchmark by ~25 bps YTD.**

- **Looking forward at potential excess returns,** MBS valuations appear very stretched - OAS is currently ~15 bps and nominal spreads are ~40 bps. These are both the lowest we have seen since 2016. Additionally, negative convexity (potential mortgage duration change dependent on interest rate moves) is at the highest level since 2016. Interestingly, in 2016 the excess return for the MBS Index was ~-15 bps. Could it be that the short duration advantage YTD evaporates as yields move higher and durations extend?

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BOTTOM LINE

The recent performance of mortgages has been driven by a duration differential rather than excess outperformance from the asset class. At current stretched valuations and elevated convexity risk levels, we do not see this outperformance being sustainable going forward. Simplistically, for this outperformance to continue the recent sharp move higher in interest rates would need to continue. However, MBS durations have already started to extend due to convexity impacts. Within the mortgage sleeve of our portfolios, we have focused on mitigating the impact of negative convexity. We believe this not only creates better outcomes across a wide range of potential future scenarios, but also makes the management of aggregate portfolios a more straightforward task.

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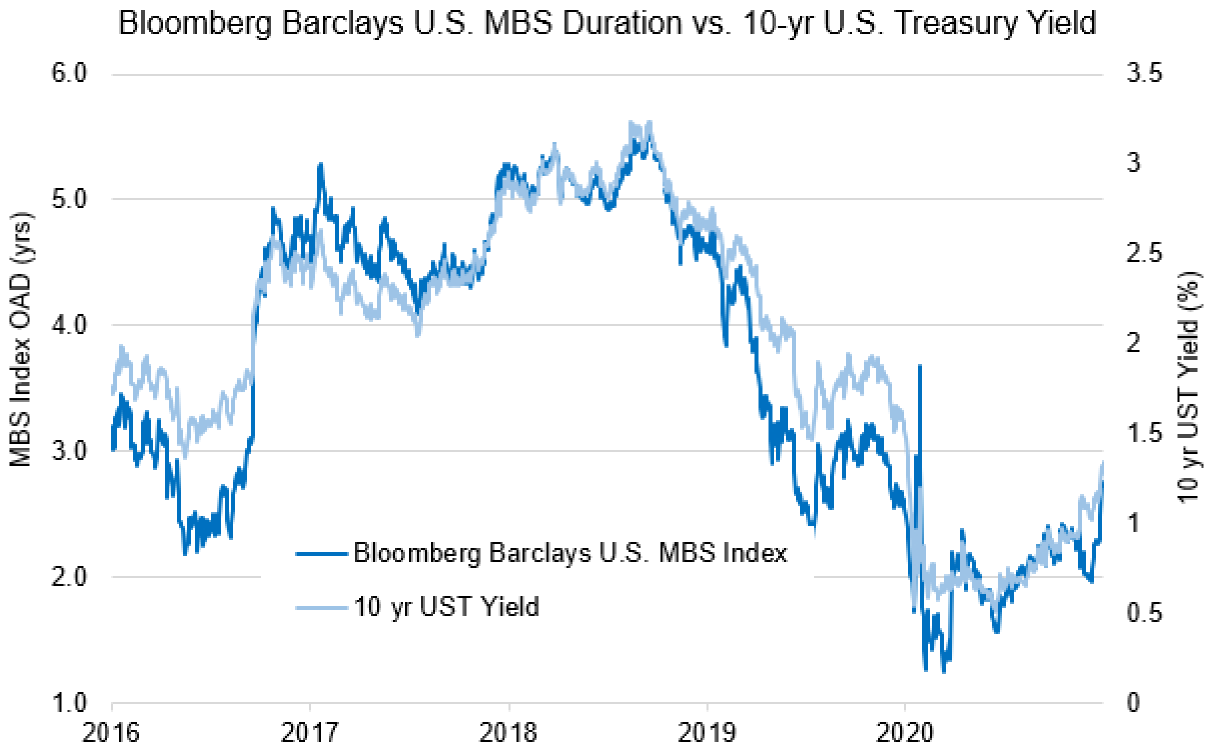

Source: Smith Capital Investors, Bloomberg, 2/22/2021

5. Should We All Abandon the Bond Market?

We have highlighted over and over the importance of the direction of rates and the shape of the curve as key risk factors in fixed income markets. While they are always important factors, the recent low yields and long durations amplify the risk. We have specifically highlighted the duration of the 30-year Treasury reaching levels previously used to describe common equity duration.

In addition to low U.S. Treasury yields, credit and mortgage spreads have returned to the all-time tights, leaving little room to cushion against the dollar price moves associated with moves higher in interest rates. So, the logical question is raised - should we just abandon the bond market?

There is a little nuance to the answer:

- Over the last 15 years, unconventional monetary policy has produced a targeted outcome of negative real rates (the nominal rate minus the core inflation rate). Note the graphic below that highlights the last three periods of negative real rates. Negative real rates do not serve the investor well as the yield earned is less than the inflation rate, thus eroding purchasing power over time. The negative real rate also amplifies the direction of rates as a primary factor in total return outcomes. Bond investors do not like negative real rates and the market tends to stage quick reversals, back to positive real rates, as optimism around economic growth and higher inflation expectations play out.

- We believe the U.S. Treasury market is in the early stages of another one of these episodes - repricing for positive real rates and reflecting optimism around future economic growth and the potential for rising inflation.

- As we approach positive real rates, the bond market becomes much more attractive. But that does not answer the question!

- We remind investors that over the last 20 years there have been 29 episodes of rates moving higher and lower by over 85 basis points. Many of those moves were fueled by expectations, both positive and negative, around future growth and/or inflation expectations. We think this will continue to be the case, albeit with much greater volatility and shorter cycles (more on the speed of capital in a future write up).

- At current valuations we are hard pressed to show a high level of enthusiasm around the return profile in the bond market. But we also know that there will be significant fits and starts to the recovery. Historically, bonds have played an important role in defusing risk asset volatility and have served as a ballast in the portfolio when uncertainty emerges. **That proverbial ‘portfolio insurance policy’ that fixed income provides is getting cheaper and cheaper by the day and the returns profiles are getting better and better as yields trend higher.**

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BOTTOM LINE

We share a high level of caution and a growing defensiveness around the bond market based on what we see playing out. We believe that not having the right style and/or process in place could result in some very undesired outcomes – note the 30-year U.S. Treasury is down 11.5% YTD - and **continue to believe that the bond market will serve its role when volatility and uncertainty return.**

So maybe the right question is not whether we should be abandoning the market, but instead asking 'are we taking the right risks in fixed income, considering where we are in the cycle?'

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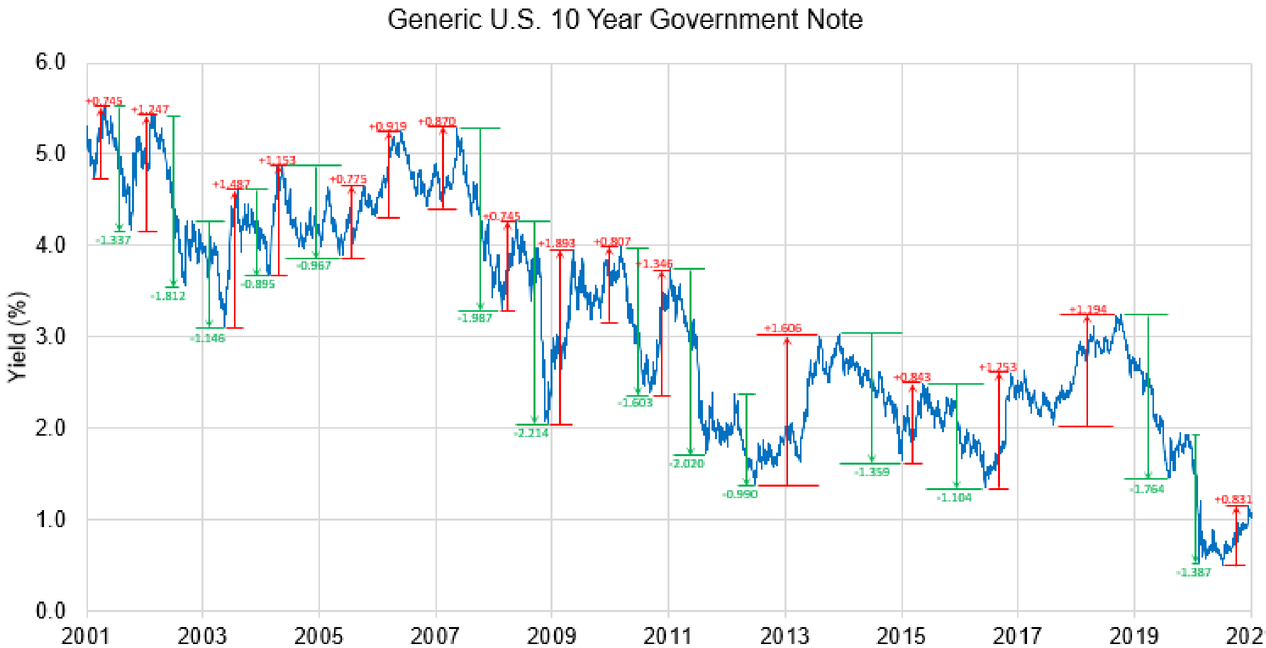
Real 10 Year Yield Based on Core CPI U.S.

Source: Smith Capital Investors, Bloomberg, 1/29/2021



Source: Smith Capital Investors, Bloomberg, 1/29/2021

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