Review & Outlook

WAYCROSS INVESTMENT MANAGEMENT COMPANY

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SECOND QUARTER 2021

Review and Outlook

As we move into the third quarter of 2021, we continue to experience unprecedented market and economic conditions, both domestic and international, driven largely by the ongoing COVID-19 pandemic. Economic impacts from individual and corporate behavior, as well as government policy, have affected consumption, savings, investment, and the adoption of new technology. The accelerated adaptation of technology supporting remote work and communication will ripple through the economy for months to come, significantly impacting productivity, and specific sectors like residential real estate, business travel (airlines and hotels, in particular), and commercial office space.

While the United State experienced some of the worst infection and death rates in the developed world over the course of the pandemic, recent mass vaccination has coincided with dramatic declines in both rates. Most parts of the country have re-opened, and while international travel is still depressed, domestic travel has ramped up to near pre-pandemic levels. The national mood is showing significant improvement.

Index Performance Data
Total Return as of 6/30/2021

Indices[1]	Q2 2021	Trailing 12 Months
CRSP U.S. Total Stock Market Index	8.29%	44.35%
MSCI Global ex-U.S. Total Stock Market Index	7.53%	39.87%
Bloomberg Barclays U.S. Aggregate Bond Index	1.83%	-0.33%

The high investor hopes for a full reopening, especially in the travel and entertainment sectors, have buoyed many stocks. Adding to this excitement has been the prospect that Congress may pass a significant infrastructure package. Anticipation of an economic rebound caused 10-year treasury rates to rise from below 1% at the beginning of the year to around 1.75% by the beginning of the second quarter. This sparked a lot of discussion about the prospects and implications of inflation. A particular concern was that the Federal Reserve Bank might respond by raising short-term interest rates and curtailing the purchase of bonds, both of which could push the stock market down.

Nevertheless, the second quarter saw a continuation of the market strength from the first quarter. The broad US market was up about 8%, and developed global markets were up 7.5% from April through June. However, these great returns masked some negative indicators lurking beneath the surface. While most economists anticipated that the 10-year interest rate would continue marching up to at least two percent, the opposite happened. Interest rates trended down all last quarter, ending at 1.45%. If the long-term view of the economy is positive, interest rates should be going up, not down. There was also a clear rotation in the market where mega cap stocks like Alphabet, Facebook, Microsoft, and Apple increased significantly, driving overall market returns higher, concealing relatively poor performance in cyclical areas like materials, industrials, and small cap stocks. In many ways, these trillion-dollar plus companies are viewed as consumer staples, with solid earnings through thick and thin. Microsoft Office and Google Workspace are the new toilet paper and toothpaste. It is in these companies that investors tend to hide out when they have concerns about future economic growth. So, while the broad market ended up over 8%, lower interest rates and market rotation indicate troubling underlying conditions.

Reports of ongoing supply chain failures; potential uncontrolled inflation; the reemergence of new, more aggressive COVID variants; and congress failing to pass, or significantly watering down, an infrastructure program are some key concerns driving the uncertainty.

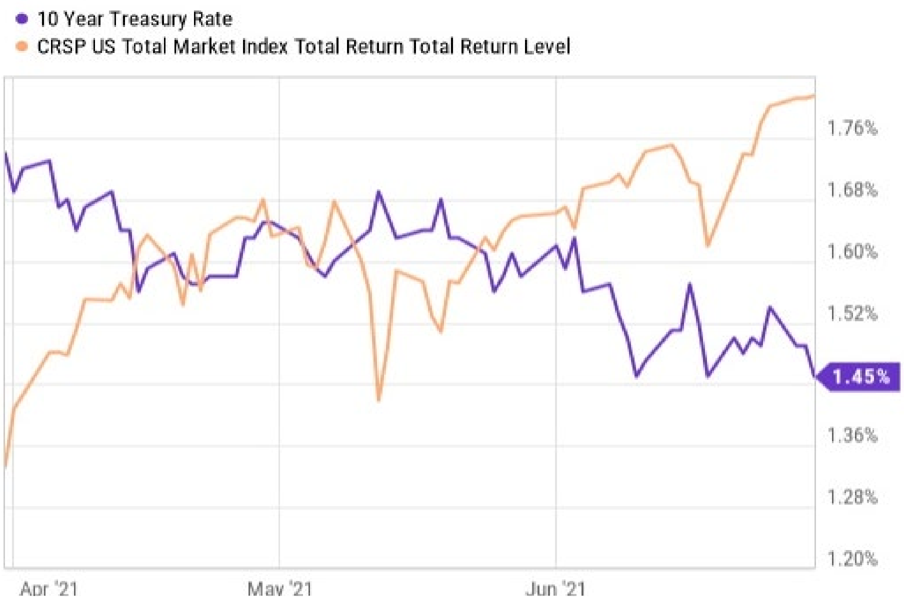
Despite some troubling indicators, we agree with the Federal Reserve's view that much of the inflationary pressure we are facing is transient, not persistent. From an investment management standpoint, we have refrained making any major changes to our clients' portfolios. A small shift has been to increase exposure to REITS with the view that their underlying assets and ability to increase lease rates will respond well to any short-term inflationary spikes. And we expect some robust economic growth, with cyclicals again gaining traction by year-end.

In Focus

Covid has played havoc with just-in-time delivery supply chains, and those shocks have led to price spikes in a number of areas of the economy. While sticker shock may seem increasingly common, there is often a unique set of facts underlying pockets of inflation. In many cases, there is good reason to think that prices will stop rising, or even decrease, in the coming months.

Economists argue that often the best cure for high prices is high prices, and we should see this play out quite a bit in the coming months. High prices create strong incentives to increase supply and price competition. The travel industry provides some good recent examples of this.

10-Year Treasury vs. Broad Market: Q2 2021[2]



One area of remarkable price hikes has been in the domestic car rental market. Anyone reading this who has rented a car recently may have experienced jaw dropping prices. In some cases, it is hard to find a car to rent at all. The reasons for this are multifold and compounding.

First, the pandemic created an existential crisis for most car rental companies. They sold off large portions of their inventories in order to generate enough cash flow to pay the bills, and stopped buying new cars. For a period of time, the general public also stopped buying new cars. In response, faced with a drop in demand and future uncertainty, car manufacturers cancelled orders for semi-conductors, or "chips", that are increasingly placed throughout modern vehicles.

When demand for cars bounced back much stronger than anticipated, the auto industry found themselves severely short of these necessary components. Since it takes a long time to design and manufacture automotive chips, and there is a serious shortage at the moment, car makers have had to curtail factory operations despite a growing demand for vehicles.

Part of the increased demand came from car rental companies, since reopening saw domestic travel closing in on pre-pandemic levels. Faced with the pleasant surprise of increasing domestic travel, car rental agencies found that they could not source new cars to buy. And because most of the car rental companies are in the same position, rental rates were pushed sky high.

It is expected that this supply chain mess will largely be cleared up in about six months. Chip makers will get back up to speed, as will car manufacturers, and the rental car companies will rebuild their inventories, which should push prices back down to more reasonable levels. In the meantime, the high price of car rentals will play a role in increasing rates of measured inflation.

1. Index price and performance data is provided by Black Diamond Wealth Platform, an SS&C Advent product.
2. Data for chart from YCharts.