Schroeder | Capital Management, LLC

Global Investment

Investment Review and Outlook – Summer 2021

The U.S. Economy:

The economy continues to advance steadily. Second quarter 2021 gross domestic product (GDP), the broadest measure of goods and services produced, registered an annual rate of 6.5% growth. This was up slightly from the 6.4% expansion rate for the first three months of 2021 but was less than the 8.5% estimated by economists. Retail sales results were especially strong, reflecting improving consumer confidence, while solid levels of manufacturing activity and an improving employment trend all contributed to Q2 results.

Homebuilding has also played a major role in the current economic recovery, although home sales have been impacted by surging construction costs and home prices, delays in the delivery of building components and a shortage of workers. Supply chain constraints have also been seen in semiconductor production and have limited the output of important industrial and consumer products, especially autos and appliances, that increasingly rely on enhanced memory capacity. These supply chain constraints, transportation bottlenecks and inadequate inventories, all very important to support the current wide-spread recovery across the U.S., limited economic expansion during Q2.

For the balance of 2021, further increases in both consumer spending and business activity are expected to support continuing economic expansion of approximately 7% GDP growth for the full year. Broad-based inventory replenishing will be a contributing factor.

Meanwhile, in the corporate arena, second-quarter earnings season has been progressing extremely well with nearly 90% of the S&P 500 companies reporting thus far beating Wall Street estimates. Strong earnings growth is also expected to continue for the balance of 2021, perhaps at a more modest rate than we have recently seen.

The Federal Reserve Posture:

Investors were generally encouraged by the Federal Reserve’s recent decision to leave interest rates near zero. It appears no changes are anticipated on that front until the Fed winds down the combined purchases of $120 billion per month of Treasury securities and mortgage bonds. There are no signs of immediate actions to slow or “taper” this activity. However, the central bank hinted that it would pull back this support once employment levels are closer to where they were before the pandemic. For now the Fed will continue to maintain a stimulative posture. This also supports Fed Chair Jay Powell’s desire to have heavy-duty stimulus measures in place, despite some inflation fears. This also takes into account the potential risk that the Delta variant of the coronavirus has the ability to slow the full reopening of the economy. Regarding inflation, the Federal Reserve is maintaining its position that the higher prices being experienced are largely pandemic-related and should prove to be temporary.

Inflation… “Transitory”or a Troubling Trend Developing:

One of the key risks to the continuing economic recovery is the possibility of a sustained rise in inflation. Evidence is already in place in the form of higher prices and shortages of industrial components, some building materials and food products. The latter has also been affected by worsening drought conditions in the western states.

It should be underscored that Federal Reserve Chairman Powell has offered the view that current pricing pressures are likely to be "transitory" until supply chains and demand are more in balance, following the dramatic disruptions caused by pandemic-related economic disruption. If he is correct, a positive economic scenario would likely unfold. However, many notable independent economists fear that the present inflationary trend may be with us for some time, impacting consumer purchasing power, U.S. businesses and ultimately economic expansion.

We have been concerned about the possibility of increased inflation and its impact on the economic recovery from the early months of 2021 when the economy was starting to recover rapidly from the shutdown. In addition, massive government spending was being put in place by both the Trump and Biden administrations, and this continues. Historically, this has tended to sow the seeds of increased inflation. In our last Investment Review and Outlook – Spring 2021, we stated the following:

> *"The economic progress that we have seen, especially recently, is being accompanied by rising inflation. Reports on producer goods, consumer prices and labor are currently showing emerging cost pressures. Recent surveys in the homebuilding and manufacturing sectors also suggest the same."*

A significant question is potentially what impact the current inflation trend would have on economic growth over the balance of the year and into 2022. Over the next few months, the answer is likely to become clearer.

As background, at the conclusion of the first quarter in 2021, the Consumer Price Index (CPI) stood at 2.6%. Then, it was 4.2% in April, 5.0% in May and rose to 5.4% in June, the fastest pace in 13 years as the recovery gained steam. The spike in consumer prices included increases in vehicles and other durable goods, recreational activities, groceries, fuel, apparel and airline fares. It was a similar story on the producer goods side, where that index posted its biggest price increase in over a decade. As consumers, we are fully aware of this situation. Corporate America's costs have escalated significantly. And, this is continuing.

<u>The Delta Variant- Taking Center Stage…Is This A Possible Game Changer?</u>

For the first time in more than a year, we're feeling some hope—or at least cautious optimism—that the pandemic could recede into the background. However, a major concern right now is the Delta variant, a highly contagious SARS-CoV-2 virus strain, which was first identified in India in December 2020. It then rapidly became the dominant strain of the virus in both India and Great Britain. Subsequently, it's been detected in approximately 60 countries. In March, the Delta variant was detected in the U.S. and has become this country's most dominant Covid virus strain.

This week the Centers for Disease Control and Prevention (CDC) reversed itself and recommended that fully vaccinated people resume wearing masks indoors again in places with high Covid transmission rates. With summer in full bloom, and many returning to large gatherings for the first time since the pandemic took hold, the Delta variant has been spreading at an accelerating rate, particularly among those who have not received the vaccine. More alarmingly, the virus is occurring during peak warm weather when it is supposedly less active. This is unwelcome news for corporate America, where many were planning to start a gradual return to the office in September. Also concerning is the extent to which more stringent measures may be taken that could impact the ability of students to return to school, social activities of individuals and their freedom of movement that only recently resumed. As a result, there could be some slowing in the pace of business growth in the months to come.

Securities Markets:

Investor sentiment remains relatively positive, reflecting an improved outlook for the economy. However, the Delta variant of the coronavirus is starting to create sizable challenges in parts of the country, and this is of increasing concern.

The age-old saying "don't fight the Fed" still has to be one that investors take to heart. The highly accommodative monetary and fiscal policies over the last 17 months to combat the impact of the coronavirus on the U.S. economy and financial markets have pumped unprecedented amounts of liquidity into the marketplace. This has resulted in historically very low interest rates and has left investors with very few attractive alternative investments to stocks.

The stock market staged a pullback a couple of weeks ago, but quickly regained its footing. It was encouraging to see investors step in to buy equities, suggesting there is a good supply of capital on the sidelines waiting to enter the market on a price decline. The staying power of the bull market and the risk of being out of equities are understood by investors. This dramatic turnaround also suggests there may be more bullish action ahead as the second half continues.

During the balance of the year, the overall picture appears to be positive for the economy and the stock market, with some cross currents and periods of market correction to be expected along the way, as we continue to work through the current recovery from the depth of the pandemic's dramatic impact on our country. It will be critical that companies continue to meet expectations and provide upbeat guidance to maintain investor confidence and that the spread of the Delta variant eventually becomes contained along with a tempering of the recent inflation trend in the U.S economy.

Investment Strategy:

The overarching theme of Schroeder Capital's investment strategy that has been outlined in recent client letters continues to favor broad-based, economically sensitive companies that are closely aligned to the business cycle, as contrasted with high-profile growth companies that currently sport historically high valuations.

In recent months, we have favored investment exposure in cyclical selections including transportation and logistics-related, industrial materials, commodities and manufacturing. This will continue to be our emphasis with our present security holdings and for new portfolio positions that we identify. In addition, there are many consumer related opportunities that will benefit from a higher level of disposable personal income as the workforce continues to grow. This is already showing up in consumer spending patterns in areas such as apparel, autos, new and used vehicles, appliances, leisure products and entertainment related.

As always, we are very focused on security valuations, both relative and absolute, for new purchases as well as the sale of existing positions. Weighing capital risk vs. reward is the hallmark of our research.

G. Frederick Schroeder, CFA
President and Chief Investment Officer

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