Inverness Counsel

1Q 2021 Commentary

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The Recovery Stocks Drove the Market Higher.

As we highlighted in previous commentaries, Facebook, Apple, Amazon, Microsoft and Google (FAAMG) all outperformed the S&P 500 and reached record highs in 2020 as the pandemic wore on. At their peak last year, these five mega-cap technology companies represented a record 23% combined share of the S&P 500 index. However, we also noted that for the stock market to continue to rally, other sectors would need to participate in the market upswing.

As a result, we adjusted our exposure to FAAMG and used this as an opportunity to add to exposures in the areas most affected by the pandemic and/or economic weakness (i.e., the recovery stocks). This has been a prudent strategy. With three vaccines now approved for emergency use, many of these reopening-linked industries have propelled the indices higher. In fact, from the stock market lows of last March, the S&P 500 is up 78% resulting in one of the biggest rallies we have enjoyed in decades (see Figure 1).

Figure 1

US Equity – Rolling 12-month Total Returns (January 1881 to February 2021)

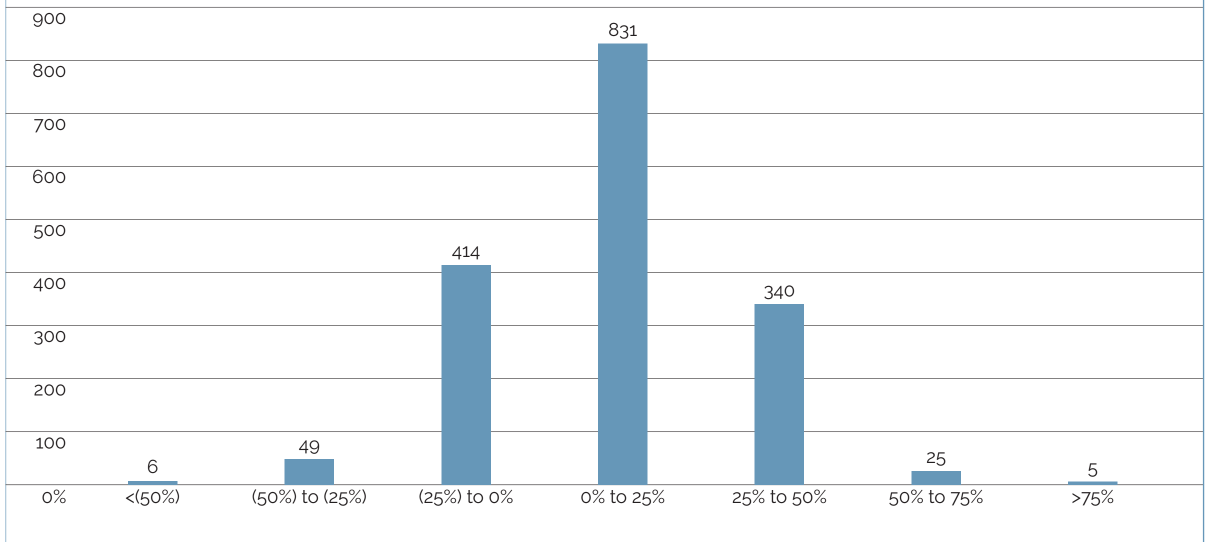

Figure 1 Source: Bernstein Monthly data from 31 January 1881 to 28 February 2021.

We have been encouraged by the broadening of stock market leaders. An improving economy has boosted the cyclical sectors (Energy, Financials, Industrials, Materials) which were laggards in 2020. This new focus on recovery stocks has resulted in a market rotation away from many of the growth stocks that led the way last year. We continue to find attractive new growth ideas, but we are being patient as this rotation away from growth is likely to continue for some time.

The S&P 500 index gained 6.2% on a total return basis for the quarter. The Energy, Industrials and Financials sectors led the way, while performance lagged in the Information Technology, Consumer Staples, Utilities, and Discretionary sectors (see Figure 2, orange). This is a mirror image of 2020 sector performance (see Figure 2, blue) and an important reminder of why we build diversified portfolios.

Inside

- The Market is Signaling a Return to Normal
- The Consumer Will Lead the Way
- Sector Rotation Driving the Market
- Course of Action

Figure 2

S&P 500 Performance by Sector

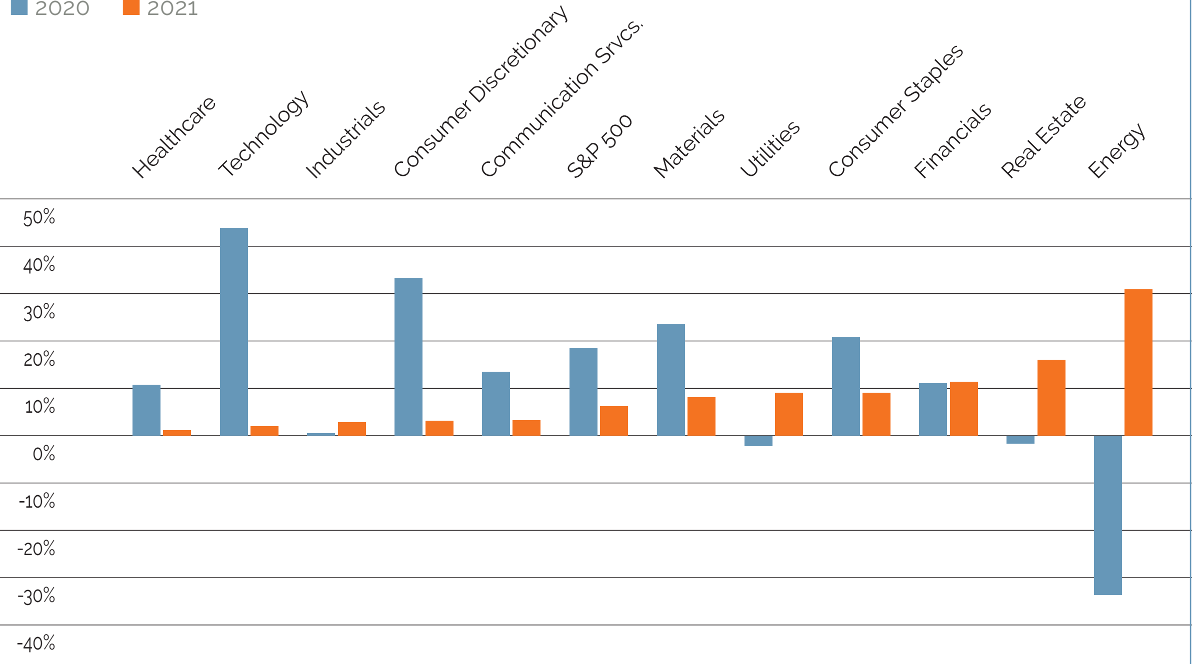

Figure 2 Source: Bloomberg. Data as of 3/31/21.

The Market is Signaling a Return to Normal

Indicators of key fundamentals continue to improve, including consumer sentiment, credit ratings, employment data and manufacturing metrics. A very strong economic recovery seems to be unfolding and the U.S. economy, as defined by Gross Domestic Product (GDP), is expected to grow by over 6% this year. We believe robust GDP growth will continue into 2022.

The Federal Reserve is expected to keep short term interest rates at very low levels and this has stoked some fears of future inflation. While the yield on the 10-year U.S. Treasury bond has nearly doubled since the end of 2020, the 2-year U.S. Treasury yield has remained about the same. Regardless, it is important to point out that both rates began the year at artificially depressed low levels.

The difference between these two rates is called the yield spread, which is used by investors to measure market sentiment of future economic growth and inflation. The current level is the highest we have seen in more than five years (see Figure 3). As you will note, this gauge has also been a reliable indicator for predicting economic recessions (the grey bars) as it was a widely cited indicator of the severe correction that occurred in 4Q 2018. We believe it is likely we will see some inflation as the global economy recovers, driven by transient supply and demand issues (the Suez Canal shutdown, semiconductor chip shortages, surging lumber prices, and higher oil/gasoline prices). The Fed is likely to tolerate this upward pressure for some time. At 1.7%, the 10-year yield has now recovered to where it was before the pandemic, but this is still a very low interest rate on a historical basis.

Figure 3

10-Year Treasury Minus 2-Year Treasury

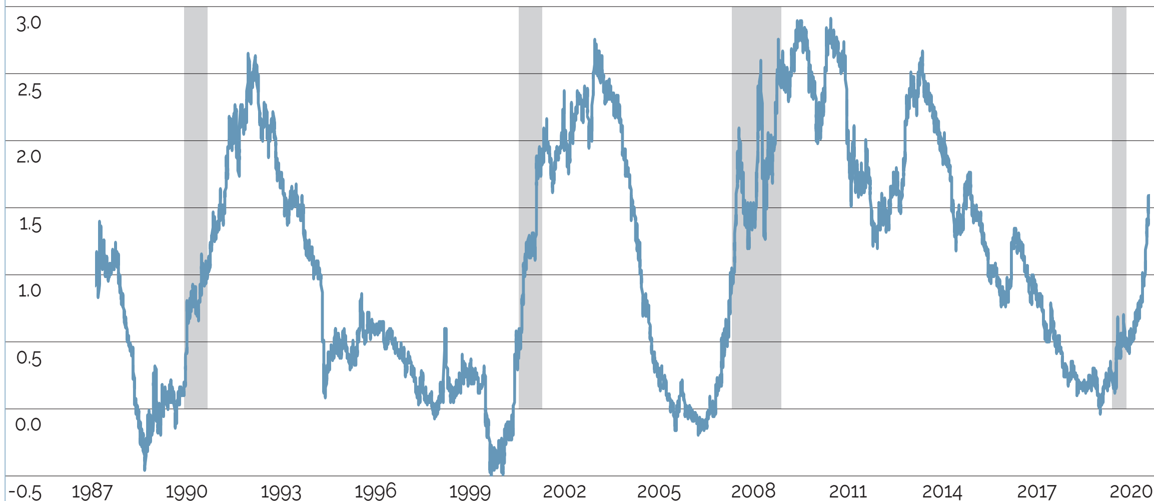

Figure 3 Source: Federal Reserve Bank of St. Louis. Data as of 3/31/21.

From the time of the Great Recession in 2008, the S&P 500 dividend yield has exceeded the 10-year treasury yield during a handful of pessimistic periods. Historically, the S&P 500 dividend yield has been lower than the 10-year Treasury yield, as the stock market offers an investor the potential to benefit from share price appreciation and dividends. Whereas the yield on the 10-year Treasury is the entire annual return an investor would receive over 10 years.

We have recently experienced one of these pessimistic periods – the fifth since 2008. Since last March, when the pandemic hit and the Fed rushed in to implement emergency interest rate measures, the dividend yield on the S&P 500 (currently 1.5%) has consistently exceeded the 10-year U.S. Treasury yield. However, as pessimism decreased, the 10-year yield has now recovered to a more normal level of 1.7%, once again exceeding the dividend yield on the S&P 500. This reversion is similar to what occurred in the previous four periods, all coinciding with substantial rallies in the S&P 500 and an average equity return of 50%.

Some market pundits view this move in rates as a signal of impending hyperinflation, but we view it as more of a return to normalcy. As the economy strengthens, we would expect the 10-year U.S. Treasury yield to move higher as its historical relationship with the current inflation rate (Core PCE) reverts to normal.

The Consumer Will Lead the Way

Consumer spending, which represents 70% of our economy, is expected to increase materially as the economy fully reopens. The average consumer is in very good shape. For most Americans, their home is their most valuable asset, and as home price appreciation serves to increase consumer confidence, it ultimately triggers higher levels of consumer spending. In this vein, housing prices have risen by record levels over the last 12 months, driven by low mortgage rates and the demand for second homes.

In addition, savings are at record levels. As we noted in previous commentaries, one of the most challenging and confusing realities of the pandemic-induced recession last year was the disparate impact on the general population. Households with incomes below $35,000 were hit the hardest, with more than 50% of workers in this bracket laid off or furloughed. In contrast, those households earning more than $75,000, and which account for the majority of consumer spending, reported significantly less employment disruption. This group also tends to benefit the most from rising home values and an appreciating stock market.

After a number of fits and starts with economic closures and re-openings, the return to normal is firmly underway. Consumers are awash with more than $1.6T of spending power (see Figure 4). Those who remained employed grew savings due to fewer purchases over the last 12 months, while those who were affected were given a bridge with substantial aid from the government. While higher income cohorts have a lower propensity to consume, one can infer that at least some of these funds will be utilized on travel, leisure, and restaurants, as consumers engage in revenge spending to make up for lost time. As we noted in our last commentary, consumers have also adopted new behaviors during the pandemic that have benefitted online retail and increased utilization of credit cards. Portfolios have meaningful exposure in these areas.

Figure 4

Excess Savings ($B)

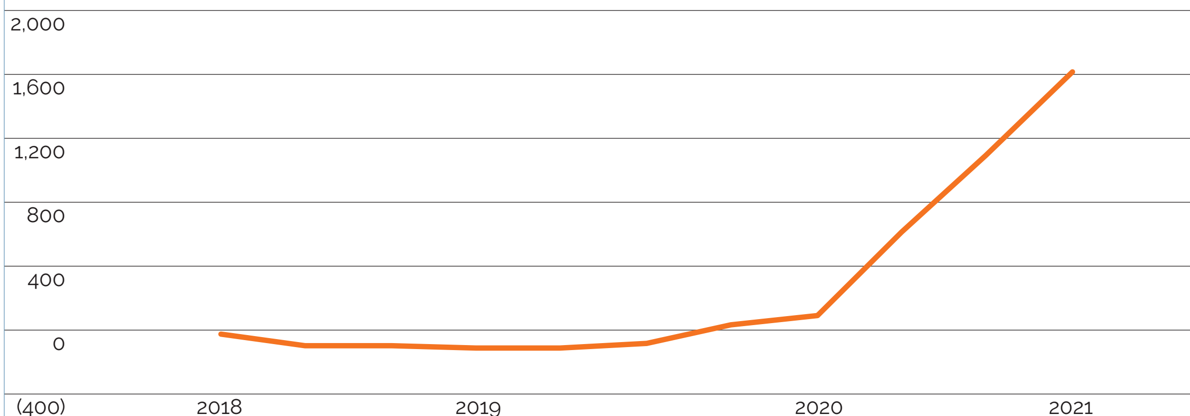

Figure 4 Source: BEA, Haver Analytics, Deutsche Bank.

Sector Rotation Driving the Market

As we noted in our 2Q 2020 commentary, about 40% of the market rebound at that point was attributed to the five largest stocks in the S&P 500 (FAAMG). We remarked that for the market to move substantially higher, we would expect to see broader participation from economically sensitive companies that were still well below their previous highs.

Since the announcement of the first vaccines in November, the market baton has been passed from growth stocks to recovery (i.e., value) stocks. After some initial bumps, the pace of inoculation is improving and this has been a positive surprise for the markets, driving the recovery stocks higher. More than 30% of Americans have now received at least one dose of the COVID-19 vaccine and the Biden administration is now targeting 200 million shots by the end of April. In addition, nearly 10% of the population has contracted the virus, although this figure is likely much higher, as the CDC believes that only 1 out of every 4.6 infections were reported. The market originally expected a return to normal in 2022, but we think this summer is increasingly more likely.

The rotation in the market has been swift and severe. For context, the 25 stocks in the S&P 500 with the lowest returns last year are all positive for the first quarter of this year with a median return of +32%. On the flip side, the best performing stocks from last year are underperforming with a median return of -3% to start the year. We have maintained a barbell approach with exposure to both categories.

Course of Action

Our approach is to invest in a core group of companies that we believe will create long-term value for shareholders while favoring the preservation of capital. Although our commentaries typically include many observations on the macro environment, we always rely on our bottom-up investment process to drive portfolio decisions. We then tilt portfolios based on our view of the global economy.

In the last two commentaries, we highlighted our additional equity exposure in areas most affected by the pandemic and/or economic weakness. Early this quarter, we added some additional names in this space. The rotation into these names has been powerful and we are happy to have this exposure. At the same time, the "value" in many of these names has been discovered quickly and the team is diligently watching these investments, anticipating that their prices may exceed the value of the underlying fundamentals.

Client portfolios have significant exposure in the Consumer Discretionary sector as we expect strong consumer spending to lead this economic recovery. We may look to exit some of these recovery investments if prices move too far, but at the same time we are aware that the pandemic has resulted in strong long-term trends for more goods being sold online and electronic payments being used in this process.

We are currently comfortable with the barbell approach, but we are constantly looking for opportunities to invest in high quality long-term growth companies at attractive valuations. Many of these investments are in the Technology and Communication Services sectors, and most client portfolios continue to have meaningful exposure in these areas. We believe we are at an inflection point for technology adoption, with the transformation in digital spending accelerating at a double-digit pace worldwide. We see a long runway for this secular trend as the pandemic forced many users to adopt new technologies even faster than expected.

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