PENDLETON STREET
BUSINESS ADVISORS

Pendleton Street Advisors
1st Quarter 2021 Investment Commentary
April 16, 2021

Index Returns	1st Quarter	Trailing Twelve Months
S&P 500 US Large Cap Stock Index	6.2%	56.4%
Russell 2000 Small Cap Stock Index	12.7%	94.8%
MSCI All Country World Ex-USA Stock Index	3.5%	49.4%
Barclays Capital US Aggregate Bond Index	-3.4%	0.7%
US Core Consumer Price Index - (Inflation)	0.2%	1.3%

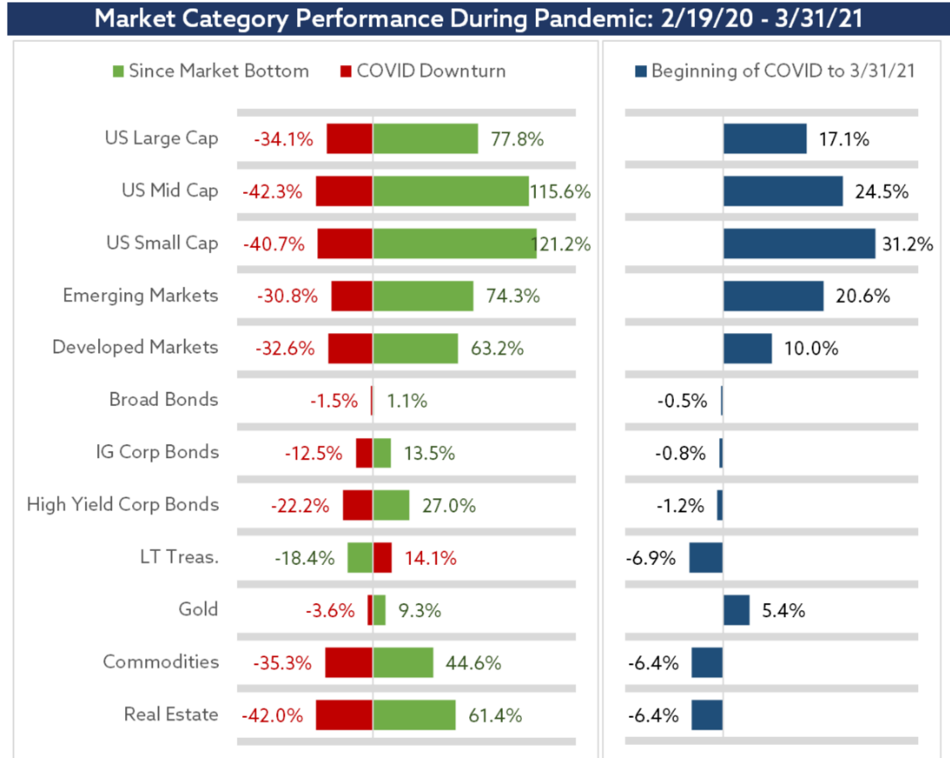
**All figures as of 3/31/21 unless otherwise noted.*

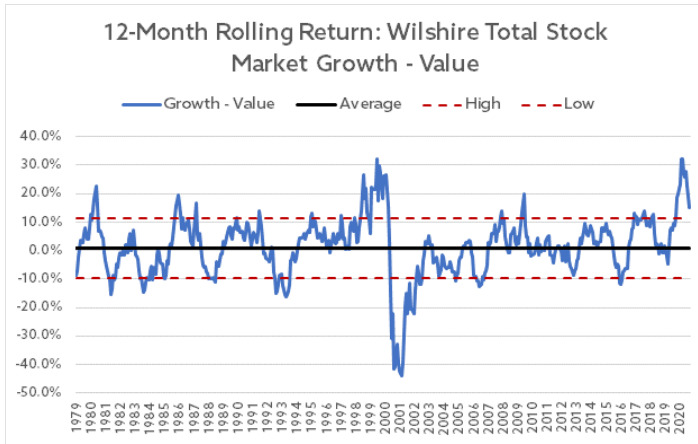
The first quarter of 2021 has come to an end, and we are now a little over a year into a bull market in equities that began on March 23rd of last year. Markets have been barreling full-speed-ahead in a half-speed economy, and investor sentiment/confidence has followed suit. Investors have been piling into stocks despite shaky economic conditions, in large part due to the perceived efficacy of government fiscal and monetary stimulus intended to counteract the negative economic impacts of Coronavirus. As we look forward, we focus on economic progress since the pandemic began, and what we believe must go right (*as opposed to focusing on what could go wrong*) for these trends to continue.

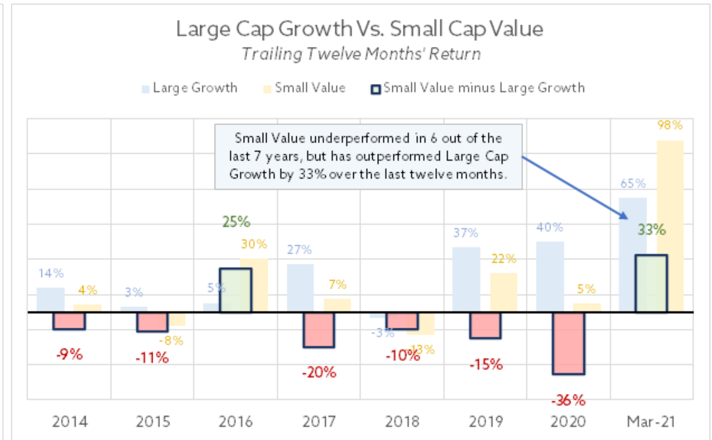
Market Summary:

Since the bottom of the bear market that ended on March 23rd of last year, most categories within equities have more than made up for what was lost during the bear market. Over the last 3 to 5 months, however, a couple of long-lived dynamics within equity markets have shifted:

- **Before:** The **bigger** the companies and the **higher** their expected **<u>Sales</u> growth**, the better the performance.
- **After:** The **smaller** the companies and the more they had been **beaten-up**, the better their performance.







Looking ahead, there are valid points on both sides of the argument of whether strong performance will continue:

- **A Few Arguments <u>For</u>**:
  - Market momentum is strong and bad news has just seemed to roll off its back;
  - The economy is well on its way to recovering from the COVID recession and is gaining momentum;
  - The Fed has indicated that it will continue stimulus measures until they are no longer needed;
  - The Biden administration is now pushing for a $2.9 Trillion infrastructure bill that could potentially be a catalyst for a strong wave of economic growth.
- **A Few Arguments <u>Against</u>**:
  - The economy has not yet recovered and pockets of recession remain;
  - COVID has continued to become a bigger problem outside of the US and will continue to influence overall economic health as non-US revenues make up around 50% of total Sales for S&P 500 companies.
  - The Biden administration has proposed changes to tax law that would disadvantage corporations and high net worth tax-payers, causing them to pull back on investment and stall the economic recovery and growth.
- **By the Numbers**: In aggregate, stocks are pushing up against the higher-end of almost every traditional valuation indicator (*see accompanying graphic: "S&P 500 Valuation Indicators…"*). Practically, this means investors are willing to pay a higher price per dollar of Earnings, Cash Flow, Sales, etc… because they either:

  a) Think that the current environment of low interest rates and low volatility are here to stay, uninterrupted ("*Don't Fight the Fed*").

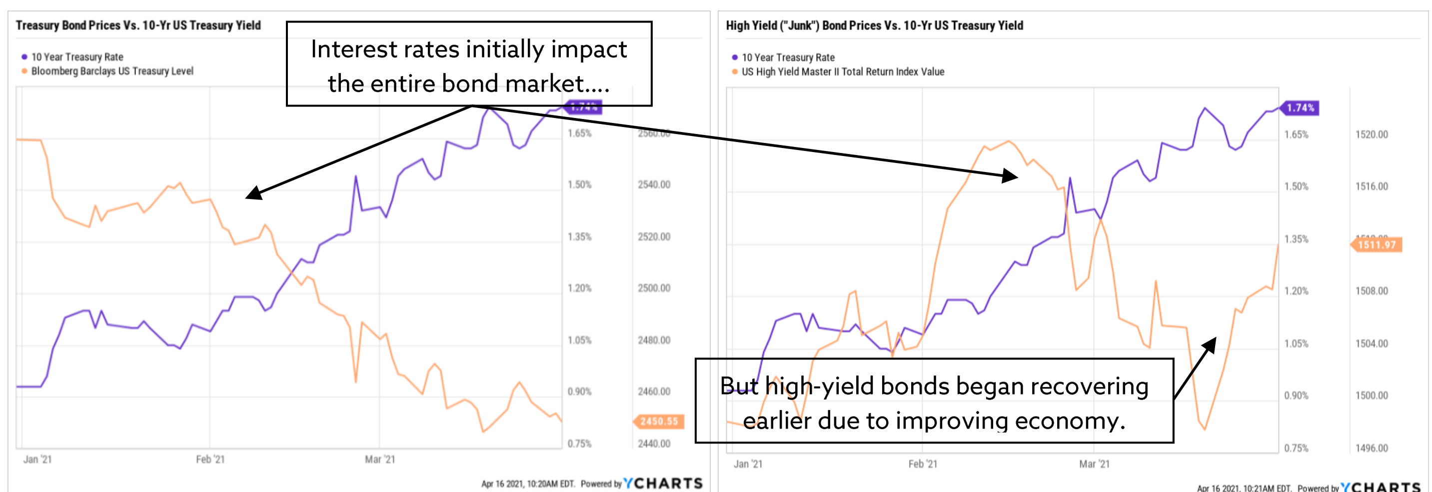
  b) Think that expected growth in Earnings, Cash Flow, Sales, etc… will exceed expectations ("*Growth at A Reasonable Price*"); or

  c) They are not really thinking much outside of a belief that when they are ready to sell, somebody will pay a higher price than they did regardless of underlying fundamentals ("*Speculation*").

Of those three options, we believe (b) **higher-than-expected growth is the most likely to deliver what is needed for investors to continue justifying these price levels**, (a) low volatility comes and goes and the Fed now risks overestimating its ability to control market volatility via market operations, and (c) speculation is a game of chicken we are not willing to join.

Bonds: Bonds offered moderate shelter relative to equities during the downturn but - along with Commodities and Real Estate - have since declined to prices below pre-pandemic levels. We believe bonds' underperformance is primarily due to the interest rate environment and inflation expectations, which we cover in more detail below.

Of note: People often think of US government bonds as "safe" and high-yield corporate bonds as "junk," but those characteristics do not always lead to the "junk" losing to the "safe" assets. For example, long-term government bonds (20-30 Yr maturity) have declined by -6.9% since 2/19/20, while high-yield bonds are only down by -1.2%. During a pandemic, one would expect "safe" bonds to provide more, well… *safety* than "junk" bonds. There are many reasons why this counter-intuitive result has occurred, but the important takeaway right now for investors should be to consider more than just the closest rule-of-thumb when setting expectations for how portfolio holdings "should" behave.

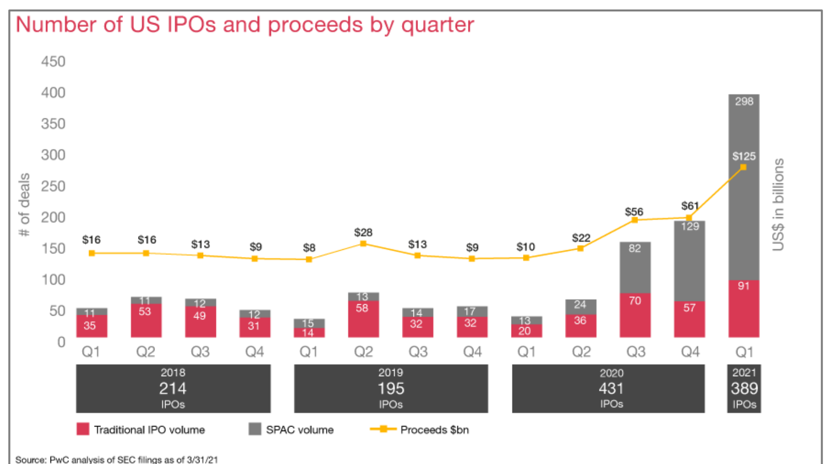


The Economy: Pandemic Recession + Economic Stimulus = Strange Behavior

If you have been following the financial news lately, you have probably observed the number of extra-ordinary market events increasing. Here are a few, with links to informative articles about them:

- January, 2021: RobinHood/Reddit(WSB)/Gamestop frenzy.
- January, 2021: Retail options trading volume surged.
- March, 2021: Archegos Capital implosion.
- Mid-Year 2020 To-Current: Suge of IPOs & SPACS.
- February – April, 2021: Inflation fears briefly drives Nasdaq 100 (large tech stocks) down by -10%.
- Current: Shortage of existing homes for sale & raw materials prices.

Why do we mention these events? **We believe these events all have one thing in common: they were all made possible by factors that began or became supercharged after the onset of COVID**: social distancing, widespread unemployment, 0% interest rate policy, waves of direct stimulus to consumers and liquidity from the Fed and other central banks to all corners of the markets.

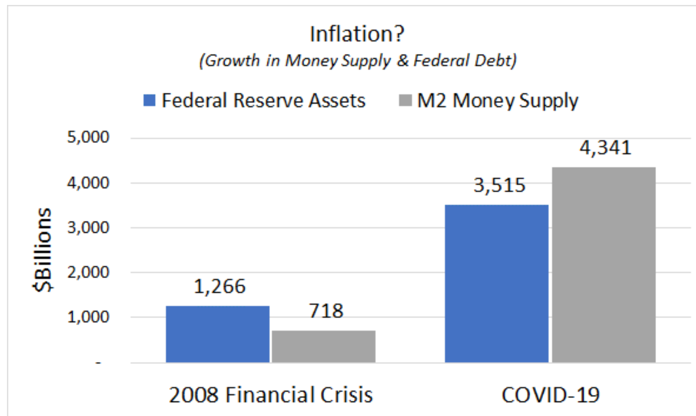


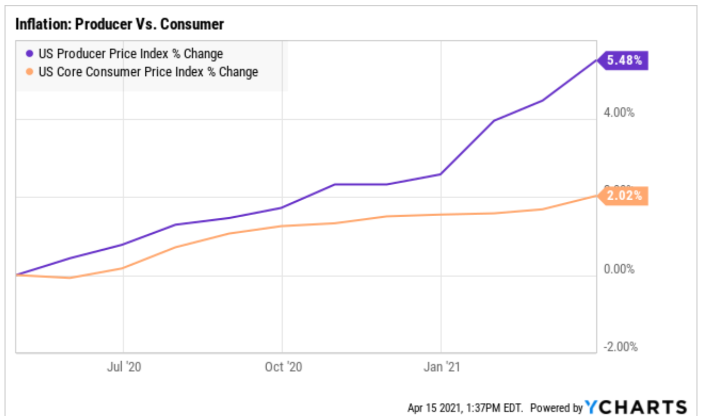
In other words, the current environments both in financial markets and society at-large have made it possible for investors to spend the time and resources necessary to quickly push concentrated areas of the markets to extreme levels (both up and down), and financial institutions to aide them via services such as commission-free trading, gamification of investing, sign-up and referral bonuses ("free money") for online trading accounts, widespread access to complicated trading instruments that only work with ample liquidity, and mainstreaming the utilization of complex corporate structures and financial strategies to bypass traditional public offering process.

But, the thing about extremes is that they usually represent a breaking point for the status quo. While these events are fascinating to us as investment professionals, they also serve a) as evidence that the extraordinary social and financial circumstances brought on by COVID are indeed causing structural changes in markets; and b) as clues regarding the longer-term impacts of continuing to flood markets with liquidity.

Zany market behavior indicates that investors are less concerned with managing risk, and more concerned with maximizing short-term returns regardless of the quality of the underlying investment. And while measures of consumer price inflation indicate that prices in general are not increasing significantly, it is becoming clear to us that the general public appreciates money less and less; and is willing to part with it more and more easily, with less and less information about where their money is going or how it is expected to earn a return… let alone **BE returned**.

With potentially higher inflation looming, the challenge for investors will be maintaining the purchasing power of their funds. While inflation as measured by the Consumer Price Index Excluding Food and Energy remains tame, businesses have been experiencing a significant increase in input prices since the beginning of the year. If this trend of increasing producer prices continues (we see nothing interrupting it other than a significant decline in consumer demand), we expect the increase in producer prices to begin being passed along to consumers in earnest.

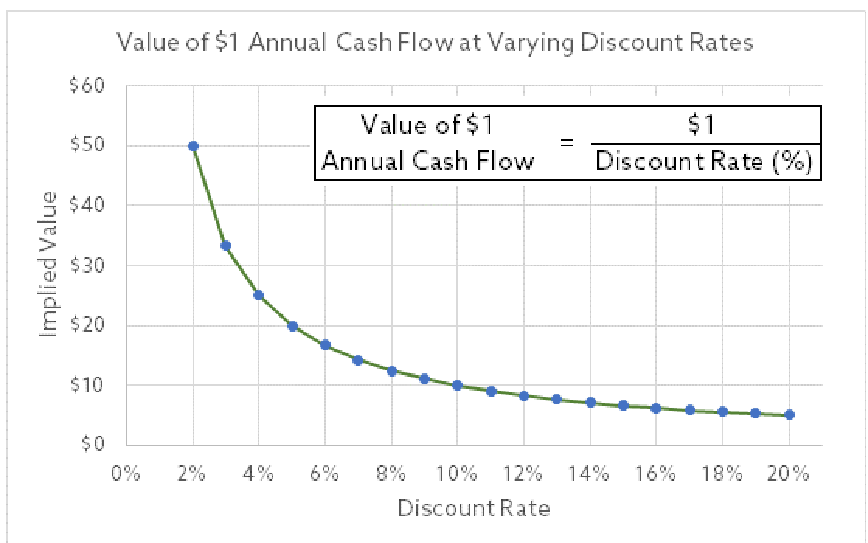


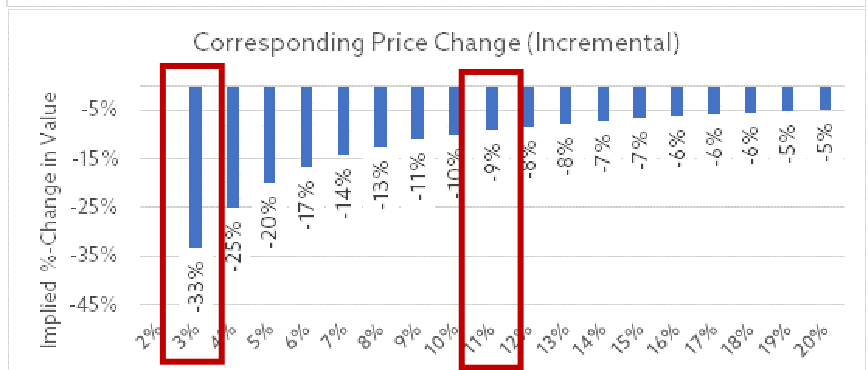


<u>What does increasing inflation accompanied by rising rates mean for investors?</u>

Over the short-term, inflation (*or more likely the fear of it at this point*) **is a headwind to stocks,** because higher inflation leads to higher interest rates; higher rates lead to higher bond yields, which leads to higher discount rates. Higher discount rates lead to lower prices for the same amount of Cash Flow (See accompanying graphic *"Value of $1 Annual Cash Flow…"*).

Rising inflation that leads to rising interest rates can be challenging in any environment, but <u>**the impact of changing interest rates is most pronounced when rates are low**</u>. Using our hypothetical company generating $1 Cash Flow/Year, if the discount rate moves from 2% to 3%, value drops by -33%. But, if the discount rate increases from 10% to 11%, value only drops by 9%. Because government bond yields are historically low, so are discount rates; which means <u>**stock prices are very sensitive to interest rate changes right now**</u>.





Over the long-term, inflation can be neutral or even a tailwind for the stocks of companies that are able to raise prices and maintain profitability.

Bottom Line: Determining which companies can adequately manage and/or benefit from generally rising prices (*i.e. inflation*) will be a strength for investors who can do it going forward, and is a factor we consider carefully before initiating or exiting a position.

A New Asset Class?: Besides what we covered above, one potentially interesting by-product of the current environment is the emergence of an entirely new and potentially viable Asset Class: Cryptocurrencies. We have been interested, but extremely cautious regarding cryptocurrencies since they first hit our radar in 2017. Since then, market caps for the two most-established/utilized benchmark coins, Bitcoin and Ethereum, have grown from $350 Billion to $1.5 Trillion.

The widespread adoption of cryptocurrencies as a medium of exchange and a store of value rather than just speculative instruments within the financial system is a necessary step in taking this asset class from "interesting" to "investable" and that shift began happening more quickly last year as the pandemic took hold and the move to online vs brick-and-mortar sales accelerated. For example, over the last year and a half, many large and small consumer-product companies have begun to accept Bitcoin as payment; large eCommerce and payment processors such as PayPal have begun to custody and facilitate investment and commercial transactions using Bitcoin; and cryptocurrency exchange company Coinbase went public via Initial Public Offering (IPO) with a total market cap of $68 Billion.

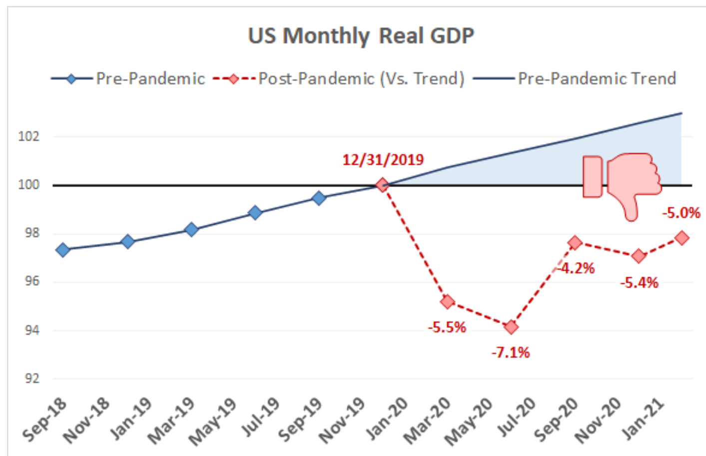
Currently, there are no exchange-traded securities focused on holding cryptocurrencies that we could add to portfolios. A growing number of fund providers have applied for approval from the SEC to offer funds that would hold a diversified portfolio of cryptocurrencies. We are working diligently to adequately understand the technology behind cryptocurrencies, and the dynamics of the market for them so that if and when this asset class becomes investable, we can make an informed decision about whether it has a place in our clients' portfolios. Going forward, we will be making it a point to discuss this with you directly.

Our firm values frequent communication with you to discuss changing conditions and to ensure that we understand and stay updated on your objectives. Our client-service staff will be reaching out to you as usual to schedule a meeting. If you would like to set up a meeting sooner, please contact us at your convenience. We look forward to hearing from you.

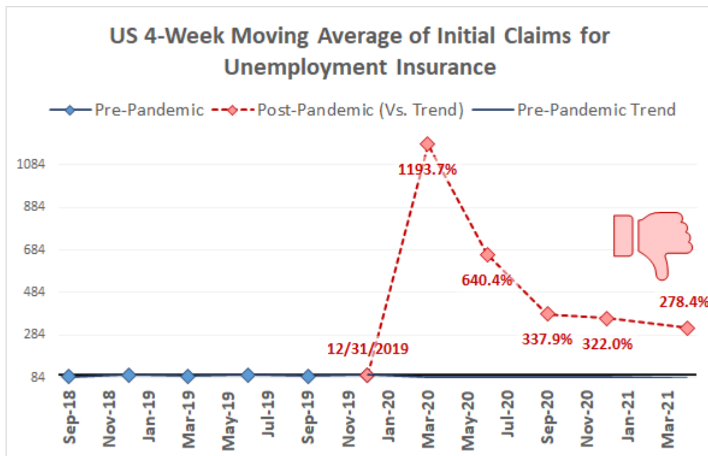
Contact: Matt A. Morley
Chief Investment Officer
Pendleton Street Advisors
Website: www.pendletonstreetadvisors.com

Are we there yet?

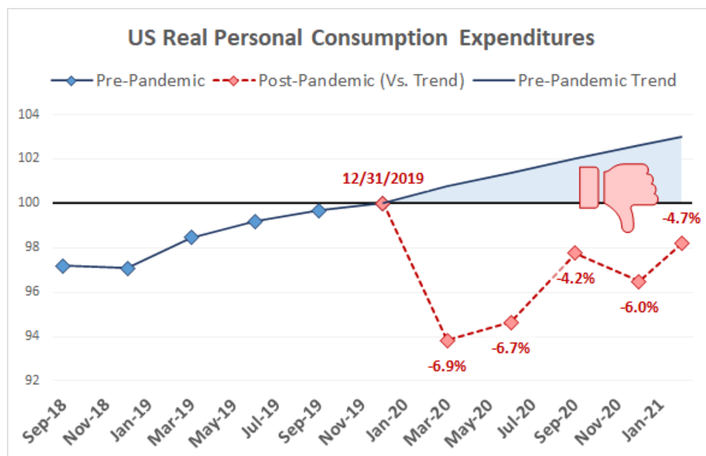
Selected Economic Indicators and their distance from pre-pandemic levels.

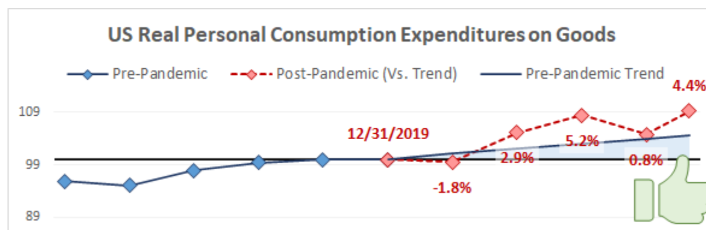


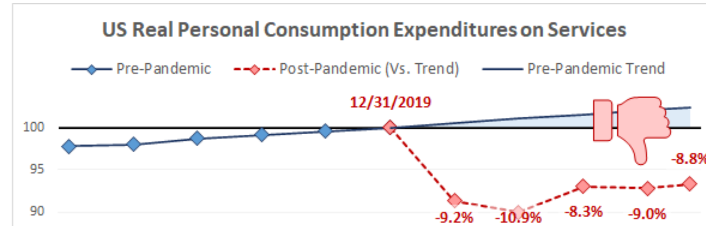
Indicator Source: Macroeconomic Advisers. Index: 12/31/19 = 100



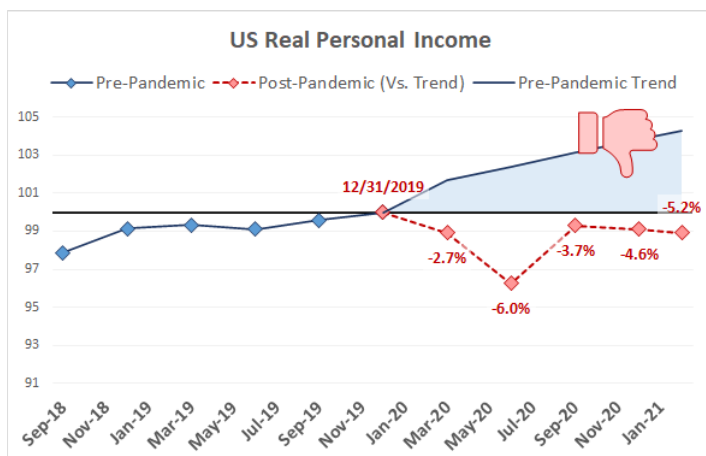
Indicator Source: Department of Labor. Index: 12/31/19 = 100







Indicator Source: Bureau of Economic Analysis. Index: 12/31/19 = 100



Indicator Source: Bureau of Economic Analysis. Index: 12/31/19 = 100