PRIVATE CAPITAL MANAGEMENT

Q2 2021 Commentary

July 2021

"Humility is not thinking less of yourself, it's thinking of yourself less."
– C.S. Lewis

MARKET RECAP

In the second quarter, global equity markets posted solid gains and reached new highs with little volatility. Business activity continues to surge, consumer sentiment is high, and corporations are growing earnings at a record pace. U.S. fiscal and monetary policy remain accommodative, further turbocharging economic growth. For the quarter, and as reflected in Figure 1 below, U.S. equities again outperformed their foreign counterparts, large cap beat small cap, and growth beat value. On a year-to-date basis, value has outperformed growth and small cap has outperformed large caps. Municipal bonds outperformed taxable bonds and high yield bonds continue to outperform investment grade. Taxable investment grade bonds had a good quarter but are still negative for the year. Credit spreads are currently near the all-time lows set in 2007 before the Global Financial Crisis. Counterintuitively, yields on 10-year and longer maturity U.S. Treasuries have fallen since the end of the first quarter despite rising inflation metrics and increased expectations for future economic growth. Investors are wondering if this reversal marks the end of the nascent reflation trade or is this merely a pause in rates moving higher as the economic rebound continues.

Asset Class	Benchmark	June	Q2 2021	YTD	12 Months
U.S. Large Cap Stocks	S&P 500 TR USD	2.3	8.6	15.3	40.8
U.S. Small & Micro Cap	Russell 2000 TR USD	1.9	4.3	17.5	62.0
Intl Dev Stocks	MSCI EAFE NR USD	-1.1	5.2	8.8	32.4
Intl Dev Small & Micro Stocks	MSCI EAFE Small Cap NR USD	-1.7	4.3	9.0	41.0
Emerging & Frontier Mkt Stocks	MSCI EM NR USD	0.2	5.1	7.5	40.9
Global Stocks	MSCI ACWI NR USD	1.3	7.4	12.3	39.3
U.S. Municipal Bonds	BBgBarc Municipal 1-10Y Blend 1-12Y TR	0.1	0.6	0.4	2.4
U.S. Taxable Bonds	BBgBarc US Agg Bond TR USD	0.7	1.8	-1.6	-0.3
U.S. High Yield Bonds	BBgBarc US Corporate High Yield TR USD	1.3	2.7	3.6	15.4
U.S. Bank Loans	S&P/LSTA U.S. Leveraged Loan 100 TR USD	0.1	1.1	2.2	9.4
Intl Dev Bonds	S&P International Sov Ex-US Bond TR USD	-2.0	0.6	-5.9	3.0
Emerging & Frontier Bonds	JPM EMBI Global Diversified TR USD	0.7	4.1	-0.7	7.5
U.S. REITs	MSCI US REIT NR USD	2.6	11.7	21.2	36.6
Ex U.S. Real Estate Securities	S&P Global Ex US REIT TR USD	0.1	7.6	10.1	33.0
Broad Commodity Futures	Bloomberg Commodity TR USD	1.9	13.3	21.2	45.6
Energy Partnerships	Alerian MLP TR USD	5.2	21.2	47.8	64.0
Gold	DJ Cmmdty Gold TR USD	-7.0	3.2	-7.0	-3.9

Figure 1. Source: Morningstar as of 06/30/2021.

SCARCITY ABOUND

U.S. economic indicators improved during the quarter fueled by strong consumer demand amidst an elevated scarcity of goods and services. The labor market continues to deliver contradictory readings and has a long way to go to pre-pandemic employment levels. June nonfarm payrolls beat estimates at 850,000, but the unemployment rate increased to 5.9% due to falling civilian employment. There are a record high number of job openings (9.3 million) and total hours worked have declined over the past three months. [1] So what is going on? Employers have had a tough time finding workers, in part due to enhanced unemployment benefits at the state and federal level. This has led to increased wage pressure, particularly in the high school educated demographic. This hiring difficulty has forced many businesses, especially in low wage sectors, to operate at reduced capacity. Enhanced unemployment benefits will roll off this quarter, which should drive workers back into the workforce and narrow the unemployment gap.

Both the ISM Manufacturing and Non-Manufacturing Indices posted strong growth in June, as gains were widespread across numerous industries. The June IHS Markit U.S. Manufacturing PMI registered 62.1, a record high in the 14-year series history. Supply chain issues, rising input costs, and scarcity of materials continue to be headwinds from meeting full demand.[2]

The Conference Board Leading Economic Index (LEI) paints a similar picture. In May 2021, the U.S. LEI surpassed the previous peak notched in January 2020, suggesting economic momentum is likely to continue.[3]

Persistently low inventory and low interest rates have driven significant price appreciation in residential real estate since the onset of COVID-19. Housing prices accelerated in April 2021 as evidenced by the 14.6% year-over-year gain in the S&P CoreLogic Case-Shiller U.S. National Home Price Index. This represents the highest annual gain in over 30 years of data.[4]

By many measures, the U.S economy is firing on all cylinders. Corporate profits are expected to post significant earnings growth in Q2 2021. It should be no surprise that U.S. equities are reaching new highs and are trading at above average multiples relative to long-term averages.

MONETARY POLICY AND INTEREST RATES

There were several key takeaways from the Federal Reserve's June FOMC statement and summary of economic projections: First, the Fed expects higher GDP growth in 2021 as compared to March's projection. Second, the Fed revealed higher inflation expectations for 2021 and 2022. Third, a growing number of FOMC participants advocate for raising interest rates in 2022 with a majority of policymakers calling for higher rates in 2023. Additionally, the Fed reiterated it will continue buying $120 billion of Treasury and mortgage backed securities monthly, and will only reduce its current pace of bond buying with advanced notice. [5] However, persistently higher inflation could accelerate monetary tightening, but we do not anticipate this being likely to happen until 2022 at the earliest.

The bond market's reaction to June's FOMC minutes was unusual. Higher growth coupled with higher inflation expectations should result in higher long-term interest rates. Yet, the yield curve flattened following the announcement as longer-term yields declined and short-term yields were largely

[1] Employment Situation Summary. U.S. Bureau of Labor Statistics. https://www.bls.gov/news.release/empsit.nr0.htm. Accessed July 12, 2021.
[2] IHS Markit https://www.markiteconomics.com/Public/Home/PressRelease/fca84cfcbc154e05a2bd805b264290e5
[3] The Conference Board Leading Economic Index for the U.S. https://conference-board.org/pdf_free/press/US%20LEI%20PRESS%20RELEASE%20-%20June%202021.pdf. Accessed July 12, 2021
[4] S&P CoreLogic Case-Shiller Index. https://www.spglobal.com/spdji/en/indices/indicators/sp-corelogic-case-shiller-20-city-composite-home-price-nsa-index/. Accessed July 12, 2021
[5] The Federal Reserve Board. https://www.federalreserve.gov/newsevents/pressreleases/monetary20210616a.htm. Accessed July 12, 2021.

unchanged. Although this trend of a flattening yield curve was perhaps advanced by June's FOMC minutes, as shown in Figure 2 below, it was observable even before then; 10-Year Treasury yields and the 10-Year minus 2-Year Treasury yield spread began falling in early Q2 and the decline continued in June. There are many interpretations of this. The simple explanation is that future growth expectations are falling. This could be consistent with 'peak earnings' in the stock market as equities reach all-time highs and forward price to earnings multiples are above average. Another interpretation is that the Fed will continue to maintain an accommodative monetary policy longer than anticipated, keeping short-term interest rates low, and thereby making current yields on longer dated bonds relatively attractive to investors. Time will tell which is correct and we will continue to monitor Fed policy and interest rates.

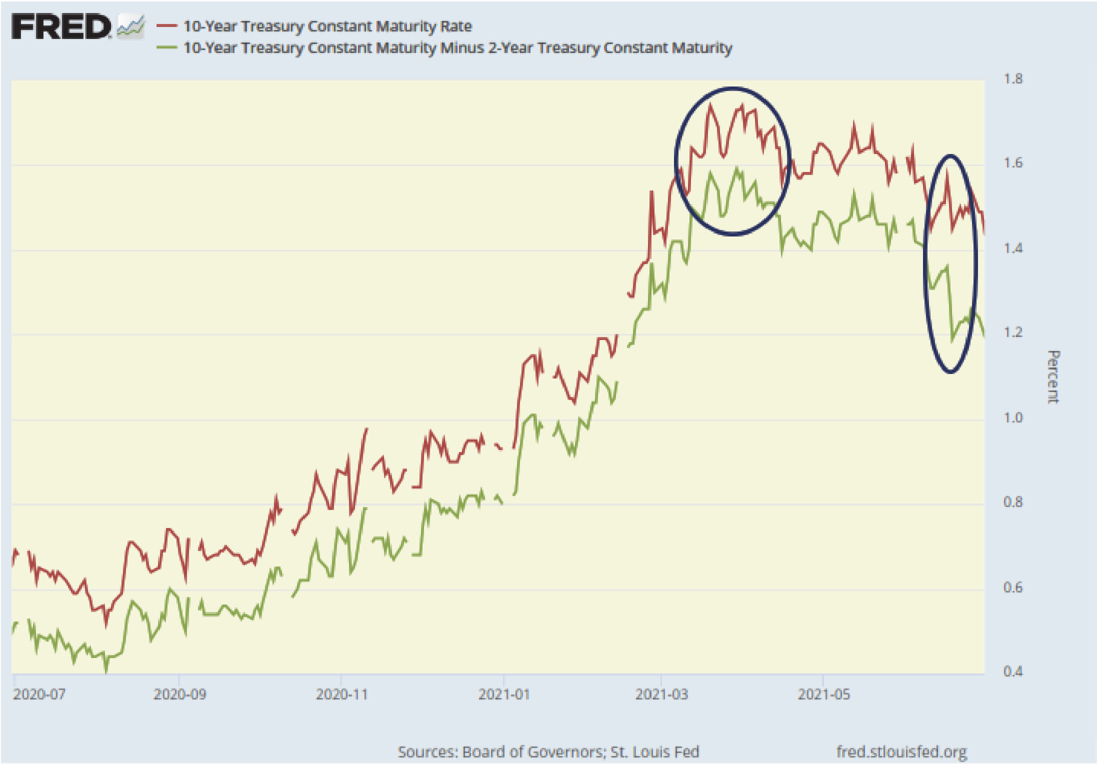

Figure 2.

WAGES AND INFLATION

Market observers wonder if rising inflation is transitory as the Federal Reserve would suggest or if persistently high inflation is here to stay. Both the Consumer Price Index and the Producer Price Index posted above average year-over-year gains for May at 5%[6] and 6.6%,[7] respectively. For reference, inflation has averaged 2.3% for the past 30 years with the highest 12-month gain of 5.6% occurring between August 2007 and July 2008.[8] Another data point we are watching is wage growth, which has ticked higher in recent months. Intuitively, in lower skilled industries, wages should rise to a market clearing level that employers

[6] Consumer Price Index Summary. U.S. Bureau of Labor Statistics. https://www.bls.gov/news.release/cpi.nr0.htm. Accessed July 12, 2021
[7] Producer Price Index Summary. U.S. Bureau of Labor Statistics. https://www.bls.gov/news.release/ppi.nr0.htm. Accessed July 12, 2021
[8] Morningstar Advisor Workstation. Index: IA SBBI US Inflation (USD)

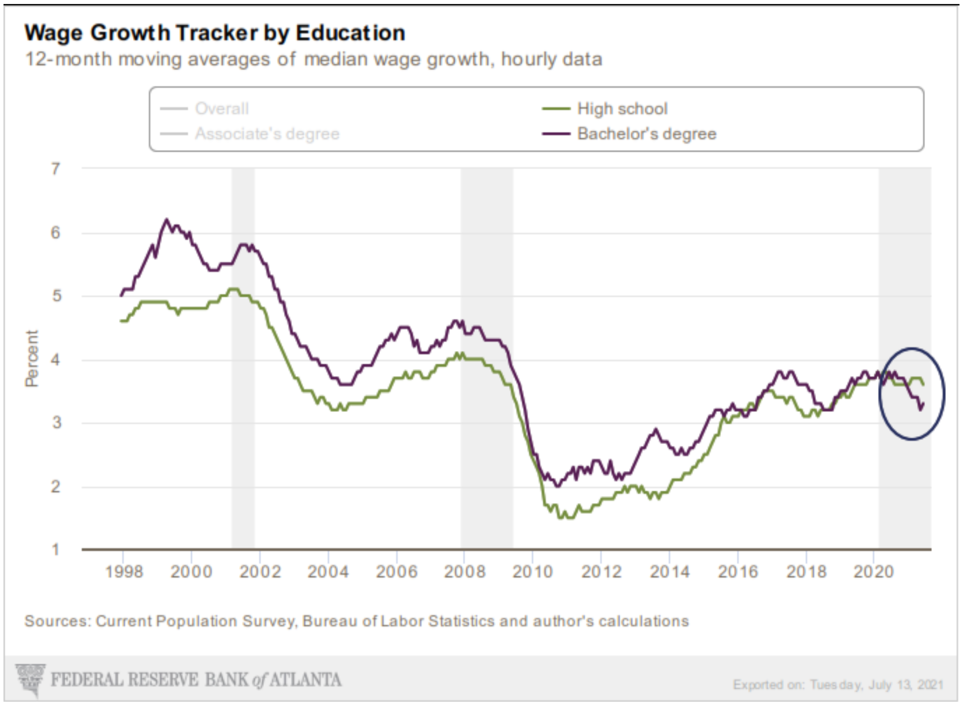

Figure 3.

can afford to pay and workers will accept. While we do not appear to be at this level yet, it is interesting to observe that wage growth for high school level educated workers has surpassed college graduates. As evidenced by the Atlanta Fed Data shown in Figure 3, this is a rare occurance. Macroeconomic theory suggests that upward pressure on wages should lead to higher inflation levels in the future.

PORTFOLIO POSITIONING

With global equity markets delivering a years' worth of returns in just 6 months and traditional fixed income offering relatively low yields, many investors are wondering how to position their portfolios going forward. Will the reflation trade resume and long-term interest rates continue to rise? Will growth stocks reclaim the limelight and lead the market higher in the second half of 2021? Will COVID-19 variants create additional government mandated lockdowns?

We believe the best answer is to stay the course with a well-constructed portfolio that can deliver positive long-term returns regardless of the changing business cycle. We are rebalancing portfolios at the margin and not abandoning portfolio diversifiers such as fixed income, all with the goal of positioning our allocations to withstand the next market selloff. At the same time, we continue to look for opportunities in less efficient asset classes like private real estate and private credit to take advantage of the potential for advantageous returns.

Thank you for your continued support and trust.

Sincerely,
The Private Capital Management Team

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