MORSE ASSET MANAGEMENT, INC.
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July 20, 2021

2021 Q2 Investment Commentary

In the second quarter of 2021, the US markets continued to grind higher notching new all-time highs. Secular growth is back on track and leads the market. Cyclicals and small caps, while positive, have taken a back seat primarily driven by concerns in rising inflation and delta variant cases. Interest rates made almost as vicious a move as the prior quarter, but this time to the downside. Despite recent volatility, the fundamental outlook remains strong and immediate concerns will be transient.

The fall in interest rates caught investors off guard, much like the rise had earlier in the year, with the 10-year Treasury yield falling -31.6%, from a high of +1.74% to a low of +1.19%. While the volatility was unsettling, the recent movement is likely a reversion from an extreme back to a trend that the market can digest… a "goldilocks" balance of not too hot or cold extremes should allow earnings and economic progress to keep pace.

The secular rotation to growth stocks from cyclicals in the second quarter reversed the leadership change seen in the preceding two quarters. Despite the divergence in price performance, all sectors finished the quarter positive save for utilities, reflecting broad and persistent fundamental strength.

Organization for Economic Co-operation and Development's (OECD) May snapshot indicated that US Real GDP is projected to grow +6.9% in 2021, the fastest in over 30 years. The unemployment rate will continue to fall, workers are enticed back into the labor market. Rising wages, government transfers and accumulated household savings will continue to propel consumption.

According to Factset's Earnings Insight on July16, the S&P 500 is expected to report a year-over-year earnings growth rate of +69.3% for Q2 2021, notably above the estimate of +63.3% at the end of the second quarter on June 30. More S&P 500 companies are beating EPS and revenue estimates for the second quarter than average and defeating EPS estimates by a wider margin than average. The index is now reporting the highest year-over-year growth in earnings and revenue since 2009. Double-digit earnings growth is expected to continue through 2021. (Chart 1)

Positive earnings surprises will likely be near record levels but estimates and sentiment are finally starting to catch. We expect some market softness as record earnings results are not good enough for some market participants. With abundant liquidity and a strongly positive economic outlook we feel the path of least resistance is still higher.

Reflation policies, lockdowns, supply chain issues and the surge in pent-up demand releasing has resulted in a notable and concerning uptick in inflation. With certain commodities and products, like lumber or semiconductors, prices have gone exponential or become unavailable. These results are being felt in places we have become unaccustomed to seeing them… like exponential price moves in used cars or difficulty finding basic appliances.

Stepping back, consider the foundational equation of economics, the law of supply and demand. Whenever an imbalance occurs, price will adjust creating a corrective force until balance or equilibrium is reached. It is important to also remember extremes are temporary. When looking at

moving temporal data, it is important to zoom out and smooth the points so as not to miss the trend in the noise.

The Consumer Price index, a measure of inflation, recently printed a startling increase of +5.12% year over year. The Federal Reserve stated target is +2%. Some economists are sure this marks the end. But zooming out, consider the trend prior to the COVID-19 pandemic. Like interest rates, inflation fell to a recent extreme low and the subsequent reversion has been violent, overshooting to the upside, but not unusual in the process of finding equilibrium. (Chart 2)

Structural forces keeping inflation in check present before COVID, like technological innovation, have not stopped the external force from pausing progress. Thus, we continue to agree with the Fed that the inflation we are seeing is transient and does not require intervention at this time. The bond market, where investments specifically express this sentiment, agrees. The 5-year TIPS inflation breakeven is only +1.56%, well below the +2% target and even the average over the last ten years. (Chart 3)

Our investment playbook continues to focus on significant secular trends, durable and high-quality businesses, and above-average growth potential. We remain flexible and patient for the right opportunities.

We are disciplined, focused on the facts, fundamentals, and long-term trends most relevant to your investments.

Morse Asset Management Investment Team

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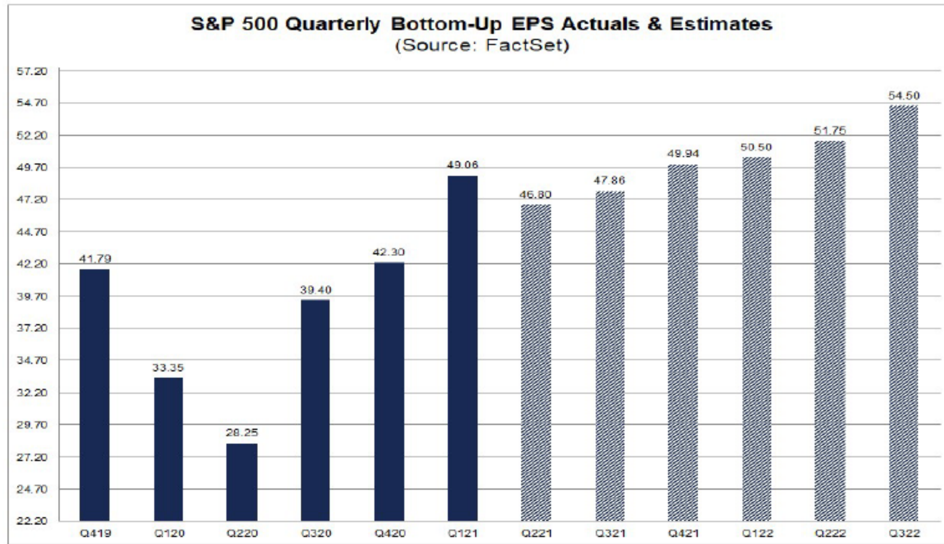

Source: Factset

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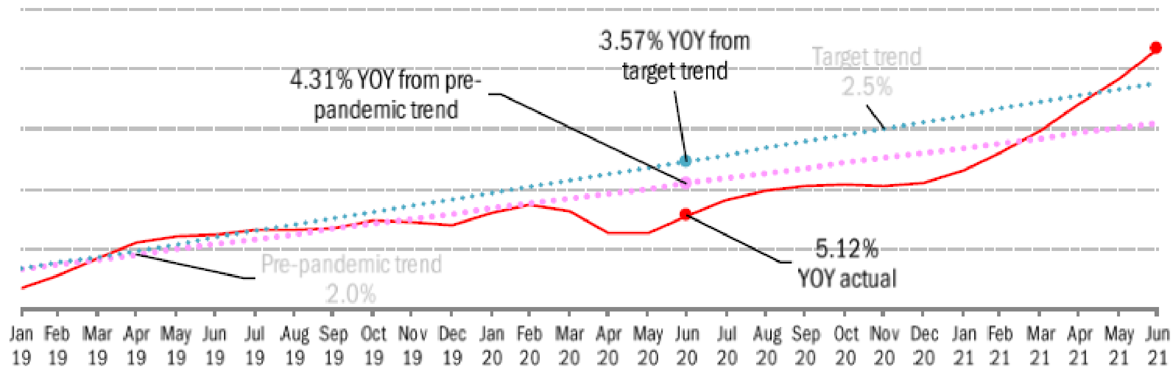

Source: TrendMacro, Bloomberg

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Source: TrendMacro, Bloomberg