TJIM QUARTERLY INSIGHT

Second Quarter 2021

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The second quarter 2021 was another stellar quarter for US equities. Broad US equities, as measured by the S&P 500, were up over 8.5% in the quarter. After posting an already exceptional first quarter, the S&P 500 has now returned over 15% year-to-date. Since late-February, as inflation expectations have gone, so has the rotation in market leadership

What level of inflation we will we see and for how long, is at the forefront of investors' minds. In a recent interview, famed investor Stanely Druckenmiller described the inflation variable as "Without a doubt: inflation strong enough that the Fed responds to it (is the biggest risk to equities)". With so much of the equity markets trading at historically elevated valuations, should the Fed begin the process of raising interest rates, these valuations stand to fall considerably. Remember, the value of any security should be the value of future cash flows discounted back to the present at the appropriate discount (interest) rate. All else equal, as interest rates fall, the value of the security should rise.

Inflation has certainly been rising in recent months. In May, the Consumer Price Index reached 5.0%. That qualifies as the highest year-over-year inflation since 2008. Despite this, many economists argue this inflation is transitory and is largely due to factors related to reopening the economy post-covid restrictions. In fact, most of the pricing increase has come from components experiencing reduced output due to supply chain disruptions. According to Bloomberg Economics, "We estimate 52% of the month-over-month increase came from six components -- used cars, rental cars, vehicle insurance, lodging, airfares, and food away from home -- down slightly from 64% in April." (Bloomberg Economics, Shulyatyeva, Husby)

In a recent interview, St. Louis Fed President Jim Bullard expressed concern regarding one of these six components and the Fed's influence on price increases*; "I'm leaning a little bit toward the idea that maybe we don't need to be in mortgage-backed securities with a booming housing market and even threatening a housing bubble here, according to some people."*[1] In 2020 the Fed purchased 25% of the $3.82 trillion mortgage originations, exerting huge influence on the housing market.

[1](https://www.wsj.com/articles/fed-officials-debate-scaling-back-mortgage-bond-purchases-at-faster-clip-11624872602)

Though the Fed Board of Governors are far from consensus regarding this somewhat more hawkish point of view, there have been signals that the Fed will be taking a less accommodative stance over the coming quarters. The first step towards tightening their policies, and therefore pushing rates higher, could come in the form of tapering their $40 billion a month mortgage purchases.

To further complicate issues, the Fed has a lot more excess liquidity in the system than the last time they attempted to tighten monetary policy. The country needed an unprecedented level of government assistance to provide a stop gap due to the covid-19 pandemic. In response to the mandated shutdowns, the federal government injected trillions of dollars in the economy through extended unemployment insurance, direct stimulus to businesses and individuals, funds for state and local governments, and asset purchases by the federal reserve.

While much of these stimuli were needed to avert a human disaster, a lot of the stimulus wound up in the hands of individuals that were not in need. Some of those individuals used their "excess liquidity" to invest in things like stocks, crypto currencies, and collectibles (even digital collectibles!).

One such corner of excess likely enticing some of this excess liquidity is a kind of equity investment called a Special Purpose Acquisition Company (SPAC). SPACs have been around for a long time as a way to take private companies public without going through the traditional IPO process. However, in 2020 they became an investment du jour of sorts, as modern-day Robin Hood Chamath Palihapitiya (et. al) convinced many of these newly minted investors that SPACs are a way to "democratize" investor returns, giving small investors access to private equity gains usually reserved for the ultra-wealthy.

A noble sounding cause for sure, however many SPACs, are more of a compensation vehicle to bestow upon the SPAC sponsors a 20% ownership in the newly public company, rather than the marketing line of democratizing investing. As Stanford law professor Michael Klausner described them, "*There's a lot of money to be made in convincing people to believe in something new.*"

SPACs probably do not represent a systemic threat to equity market writ large. They are but one example of how excess liquidity has had the unintended consequence of creating asset inflation. In fact, as alluded to above, there are plenty of parts of the market that are reasonably priced. The median P/E on the S&P is currently 20x earnings, that is a historically rich valuation, but maybe it is appropriate given low interest rates. On the other hand, the top quintile P/E on the S&P 500 is trading in the 30x earnings range. These lofty valuations are likely symptomatic of this excess liquidity largely chasing after stocks with a good story, but little in the way of fundamentals underpinning these expectations.

Given the uncertainty facing the economy and markets, we believe conservative positioning remains prudent. With very low long-term rates and very elevated equity valuations, TJIM will add positions in selective opportunities across attractively valued equities, long-term Treasuries and corporate bonds. However, our overall equity portfolio positioning will likely remain consistent with a focus on high-quality companies that we feel will be resilient to, or benefit from, changes in these economic forces. Similarly, we will maintain a lower duration than the index in our fixed income portfolios, with a lower allocation to corporates and higher allocation to Treasuries.

As always TJIM appreciates the trust you place in us, and we will continue to be stewards of your capital by building diversified portfolios of high-quality securities that we believe will provide attractive risk-adjusted performance going forward.

Sincerely
TJIM Investment Team

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