Q2 2021

Maclura Investments

Quarterly Report

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Growth stocks, particularly large cap, returned to favor in the second quarter and narrowed the wide performance gap from the first quarter between the two investment styles: value and growth. The Morningstar US Market Index, which is a broad market index, was up 14.88% for the first half of the year, edging out the S&P 500 index which has returned 14.4% for the first six months. As illustrated in the table below, large cap growth was the preferred place to be during the second quarter, as small cap stocks relatively lagged as the threat of higher interest rates weighted on lofty valuations and more speculative names in the space.

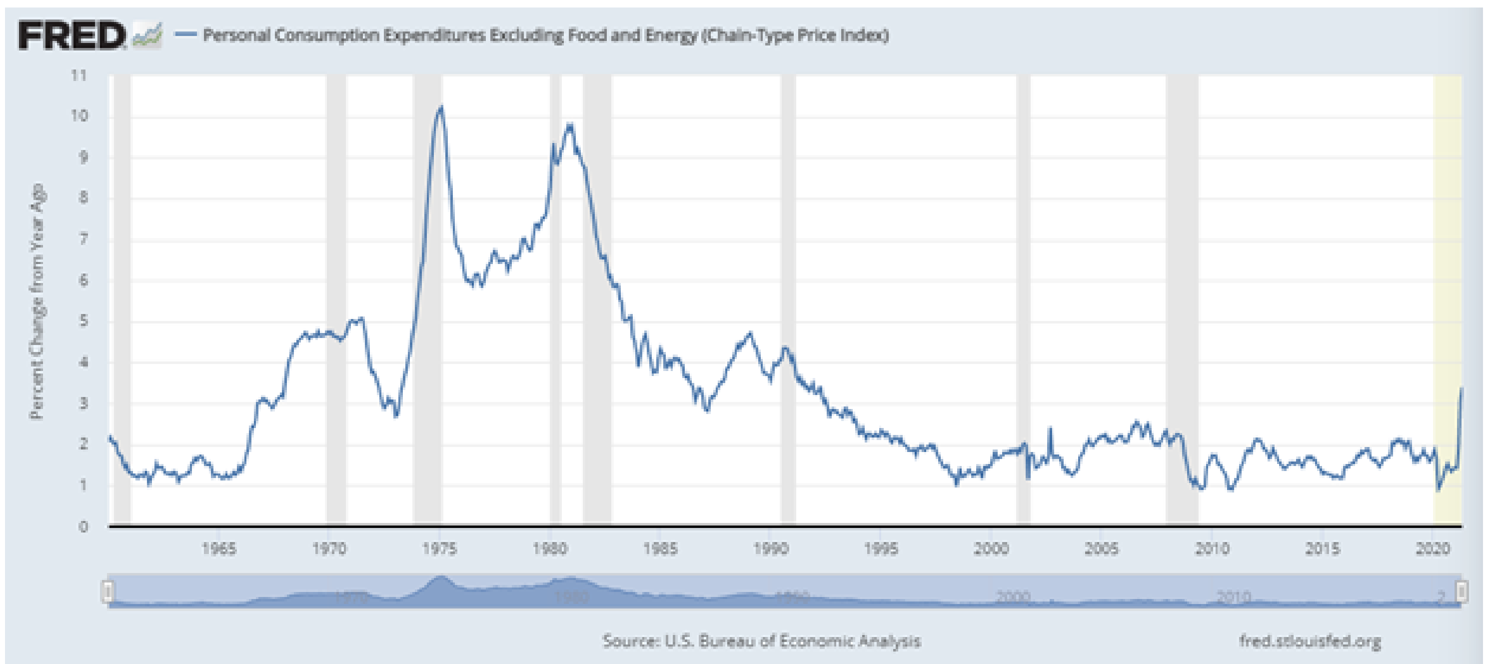
	Morningstar Index Market Returns	2015	2016	2017	2018	2019	2020	2021 1st Qtr.	2021 2nd Qtr.	2021 ytd
Growth	U.S. Growth	5.54%	3.16%	29.52%	0.78%	35.90%	44.65%	0.61%	13.90%	14.60%
Growth	Large Growth	7.71%	1.79%	31.15%	2.94%	33.81%	38.86%	-0.73%	15.42%	14.58%
Growth	Mid Growth	-0.71%	6.46%	25.67%	-3.16%	36.01%	46.17%	-1.62%	11.33%	9.52%
Growth	Small Growth	-0.18%	9.61%	23.77%	-5.67%	27.60%	43.52%	-0.42%	4.79%	4.34%
Value	U.S. Value	-2.16%	20.79%	14.23%	-7.51%	25.09%	-1.31%	12.49%	4.03%	17.03%
Value	Large Value	-1.43%	18.91%	15.09%	-5.90%	25.70%	-0.62%	10.13%	3.82%	14.34%
Value	Mid Value	-2.57%	25.21%	13.02%	-10.63%	24.81%	-3.76%	17.21%	4.19%	22.12%
Value	Small Value	-8.65%	27.96%	8.40%	-16.61%	19.96%	1.01%	21.41%	5.41%	27.99%

To put this first six months' stock performance into perspective, over the past forty years, the S&P 500 index has gained 10% or more 14 times during the first half of the year. While this past six months has extremely unique circumstances on what has influenced that outperformance, in eleven of those instances the index finished the second half of the year higher. A vast majority of the companies reported first quarter results that were much better than anticipated. In aggregate, companies reported earnings that were approximately 22% above expectations, which is much higher than the five-year average of 6.9%. While there are a number of variables fueling these outsized earnings surprises, the two driving tailwinds are the resilient macro backdrop being pushed by the massive fiscal and monetary stimulus and underestimating the end market demand for goods and services with the reopening of the economy.

2Q21 Takeaways

If there was one takeaway from the last quarter earnings season, it was the concern that market pundits and analysts were placing that companies were at "peak profit growth." In other words, future growth expectations would be at a lower rate than the previously reported quarter as there begins to be more distance from the events of the pandemic. During this quarter, companies were reporting strong financial results but had muted or down stock prices after the press release. Naturally the year-over-year growth rates will be lower from the peak reported due to the distancing of the depressed pandemic numbers. As companies report their 2nd quarter financial results, it is likely that this concern will be present but shouldn't have any lasting results on stock performance over the long-term. The peak profit growth should not be confused with "peak earnings," as companies should continue to grow earnings meaningfully above trend for the foreseeable future.

Before elaborating more on our future outlook for the market, let's first address the two main concerns on investors' minds: inflation and anticipating the future moves of the Federal Reserve. Inflation is one of the few things that everyone can agree upon; it is present and much more pronounced than in the past several years, if not decades. The chart below is the year-over-year change in the core Personal Consumption Expenditures, which is the measurement of inflation that is preferred by the Federal Reserve.



Since the financial crisis of 2007 – 2008, central banks throughout the world have had an accommodating monetary policy that has infused the world economy with a significant amount of capital in hopes of spurring economic growth. The initial programs, such as the $700 billion Troubled Asset Relief Program (TARP) and the $3 billion Car Allowance Rebate System (CARS, better known as "Cash for Clunkers") pale in comparison to the trillion-dollar programs now implemented. The global central banks are expected to acquire nearly $3.5 trillion of assets in 2021, after purchasing $8.5 trillion in response to the pandemic in 2020. The Federal Reserve balance sheet went over $8 trillion this past June, up from $4.1 trillion at the start of 2020. This doesn't include the estimated $17 trillion planned to be spent by governments throughout the world via fiscal stimulus programs. As per our previous market commentary in January, the world is awash with cash, with limited places for investment. Regardless of all of the capital that was created through the quantitative easing programs throughout the years that were expected to have an accelerant impact to inflation, it remained subdued throughout the world until recently.

The root cause of the inflation now being experienced throughout the world has led to another debate: is it "transitory" or setting up to be persistently above the Fed's goal of 2% inflation? Economists and Federal Reserve committee members are split on the assessment of the longevity of the current spike in inflation, as the "shortage of everything" seems to be the primary driver of higher prices. While the endless printing of money by world central banks led some to believe that the excess capital supply is the core driver of the current inflation uptick, the global supply chain disruptions, higher raw-material costs, shipping constraints, and a tightening labor market seem to be more logical primary drivers of higher costs for everything.

During this past March, the Suez Canal was blocked for six days after a container ship got wedged in the canal and halted all commerce transit through the canal. While this made headlines throughout the world, global ports were struggling well before the Suez Canal incident and have continued to have issues. Everything that could have possibly gone wrong with the global supply chain has gone wrong over the past year. The latest was when one of China's busiest ports (Yantian port) announced it would not accept new export containers in late May because of a Covid-19 outbreak. Though it had initially anticipated reopening after a few days, it took until the end of June to return back to normal. The magnitude of this partial closing and the ripple effect it will have likely won't be felt until towards the fall, as the disruptions will impact retailers as they restock warehouses ahead of the year-end holiday shopping rush.

During mid-June, there were 139 container vessels anchored off the coast of China, about 50 percent more than the average during the time period of mid-April to early May, according to Bloomberg analysis of vessel data. Even the ports in the United States are constrained with bottlenecks, not having enough workers to unload the vessels, lack of warehouse space throughout the country, and limited means of transporting freight across to its destination. Costco (COST) mentioned on their earnings call that the turnaround of a container from being unloaded at the dock, delivering its contents, and returning back at the U.S. port to head back overseas has gone from approximately 25 days to 50 days.

Littelfuse (LFUS), a supplier of circuit protection to the automotive industry, stated at an investor conference in June that it expects that 2021 worldwide passenger automotive production will be in the low 80 million range. For the three years prior to Covid, annual worldwide production ranged from 92 to 97 million. With the significantly lower auto production, the auto manufacturers are focusing on their higher-end vehicles, which are their higher profit margin vehicles as well as electrification vehicles (EV). None of the auto manufacturers are wanting to fall behind on the EV introductions, so though the shortages are impacting EVs as well, the auto manufacturers are putting priority on those ahead of a traditional vehicle if they can. This has resulted in a “seller’s market,” with a limited supply of new cars allowing dealers to generate record revenues while giving minimal discounts and rebates on the few new cars they have and drastically increasing the used auto prices. The Wall Street Journal recently reported that in June, 75% of vehicles sold in the U.S. were priced at manufactured suggested retail price (MSRP) or more, versus 67% at the end of May and 36% before the coronavirus pandemic. It appears that the auto market is following the bidding action that has been transpiring in the housing market for the past year.

Regardless of the various areas of inflation being reported throughout the economy, Federal Reserve Chairman Powell has logical reasoning to define the recent inflationary uptick as more “transitory” in nature, but it could last longer than expected. The reduction in supply is having a rationing effect on fulfilling demand, prolonging the recovery of the economy and the market. Nonetheless, there continues to be some short-term risk from the disrupted global supply chain as mentioned in our previous quarterly commentary about certain companies being negatively impacted by the inability to provide services or goods to the market, particularly in the retail, consumer services, and manufacturing sectors.

The second factor impacting the market going forward is what modifications the Federal Reserve will implement in its easy monetary policies: increasing short-term interest rates or tapering its asset buying program. The Federal Reserve is currently purchasing $120 million in government-issued and government-backed securities every month.

Through the multiple quantitative easing (QE) programs for the past 13 years, interest rates have been subsidized by the Federal Reserve through their endless supply of capital. Tapering and eliminating this monthly capital commitment will be the first action by the Federal Reserve to hopefully return to a more "normalized" policy, but this won't happen overnight. The most likely outcome will be a slow reduction of monthly purchases and then allowing the securities on the Fed's balance sheet to mature and not be reinvested. This is the policy that was implemented during the previous quantitative tightening (QT) program from October 2017 to July 2019, when it reduced its balance sheet by $675 billion. At the June Federal Reserve meeting, the committee members were "talking about talking about tapering." For the Fed not being a part of the Federal government, it definitely runs on a time table similar to the Department of Motor Vehicles. Interest rates need to rise before bonds can become an attractive investment for those needing income.

Positioning for the Third Quarter and Beyond

In our 2021 outlook at the beginning of the year, we guided to an expectation that the market would return in the double-digits for the year. The two factors mentioned in our 1Q market commentary as influencing the achievability of that outcome remain on the forefront: the normalization of the supply-chain and the movement of interest rates, particularly long-term rates. A change in Fed policy is coming, it is only a matter of time. It will be measured in glacial speed. Given the maturity of the bull market and pending slow ending of the Fed's accommodating monetary policy, we have positioned client portfolios over the following market cap ranges, depending on risk profile and investment cycle.

Allocation Across Market Cap	Allocation Range	
Large Cap (>$35 billion market cap)	53.7%	70.6%
Mid Cap ($5 - 35 billion market cap)	21.8%	31.6%
Small Cap (<$5 billion market cap)	7.3%	13.1%

For the near-term duration, companies are evaluating the procedures, technology, and policies that were implemented during the past year to determine the effectiveness of going-to-market. In a world where everything is in limited supply, there won't be much differential between companies, but once the supply chain normalizes, the companies that adopted an omnichannel approach and productivity enhancements to their operational structure will capture market share away from the capital-starved companies that were limited in their innovation advancement. There will likely be a significant operational performance gap between large cap versus small cap companies in that environment. Additionally, in a rising interest rate environment, long duration cash flows (emerging companies yet to be profitable) will be at a valuation disadvantage to profitable companies.

Maclura Investments

At Maclura Investments, our process leads us to classify each investment as Durable, Thriving, Emerging, and Cyclical growth after qualifying it through foundational factors. The investment process is summarized on our website (www.maclurainvestments.com) under the Process tab. Durable growth companies typically grow their revenues in the high single digits on a consistent basis, regardless of the economic conditions. Thriving growth companies are typically in their earlier stage of development growing annual revenues in the double-digits. Cyclical companies are more volatile, with revenue growth ebbing and flowing with the trajectory of the economy. The vast majority of investments within client portfolios are within companies that are currently profitable, but occasionally we come across an Emerging company that is compelling enough to include in client portfolios. And while presently they may not be profitable, the window to profitability is within the close foreseeable future. At this juncture in the economic cycle, the weight to emerging growth names will be limited as interest rates increase and we wait for a valuation correction within this category. As the economy matures, the allocation to the Cyclical growth style will be reduced and reallocated to the other three categories until the cycle starts back over again.

Growth Style	Allocation Range	
Durable	45.1%	61.5%
Thriving	15.6%	22.2%
Cyclical	17.6%	29.0%
Emerging	0.9%	4.3%

Sector Allocation	Allocation Range	
Technology	24.0%	29.4%
Healthcare	17.1%	21.1%
Industrial	15.3%	19.6%
Financial	13.5%	16.5%
Consumer	7.5%	12.4%
Materials	2.1%	5.9%
Energy	2.1%	6.0%
REITs	1.2%	9.6%

Sector allocations vary depending on the income needs of the client, but all clients have exposure to the five core sectors on which Maclura Investments focuses: Technology, Healthcare, Industrial, Financial, and Consumer. Additionally, with the rising raw material costs, a portion of client portfolios are allocated to energy and materials. Energy is a volatile sector and within the Maclura Investment methodology is a sector that is typically held for months and not years, to participate with the rising demand from re-opening economies. The majority of exposure within the energy sector is within the services and midstream assets.

While opportunities continue to be abundant in the market, we expect increased volatility for the remaining six months of the year as market pundits, economists, and investors debate the inflation and Fed policy moves. Nonetheless expect a bias to an up market with a potential of broad market benchmarks being up over 20% for the year.

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