Q3 2021

Maclura Investments

Quarterly Report

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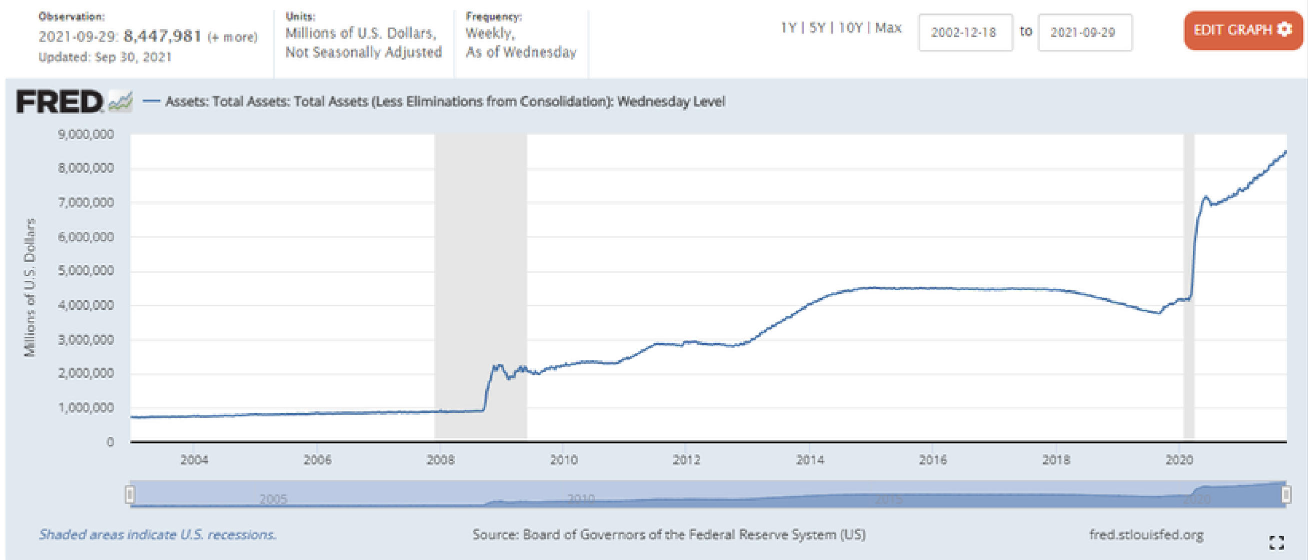
The S&P 500 and Morningstar US Market Indexes had lackluster returns for the quarter, barely recording positive returns of 0.53% and 0.03%, respectively. The third quarter had the makings of being exceptional up to the end of the first week of September. During July and August, most companies reported strong financial results that significantly beat expectations. Additionally, the Federal Reserve continued to be extraordinarily stimulative with its monetary policy, in light of relatively higher inflation than the economy has experienced in some time and a declining unemployment rate. The stock market peaked intra-quarter on September 3rd, with the large and mid-cap growth benchmark indices in high single digit returns for the quarter and small cap growth and value benchmarks in the low single digits.

	Morningstar Index Market Returns	2015	2016	2017	2018	2019	2020	2021 1st Qtr.	2021 2nd Qtr.	2021 3rd Qtr.	2021 ytd
Growth	U.S. Growth	5.54%	3.16%	29.52%	0.78%	35.90%	44.65%	0.61%	13.90%	1.50%	16.32%
	Large Growth	7.71%	1.79%	31.15%	2.94%	33.81%	38.86%	-0.73%	15.42%	2.35%	17.26%
	Mid Growth	-0.71%	6.46%	25.67%	-3.16%	36.01%	46.17%	-1.62%	11.33%	0.20%	9.74%
	Small Growth	-0.18%	9.61%	23.77%	-5.67%	27.60%	43.52%	-0.42%	4.79%	-4.50%	-0.35%
Value	U.S. Value	-2.16%	20.79%	14.23%	-7.51%	25.09%	-1.31%	12.49%	4.03%	-1.36%	15.44%
	Large Value	-1.43%	18.91%	15.09%	-5.90%	25.70%	-0.62%	10.13%	3.82%	-1.26%	12.89%
	Mid Value	-2.57%	25.21%	13.02%	-10.63%	24.81%	-3.76%	17.21%	4.19%	-1.49%	20.30%
	Small Value	-8.65%	27.96%	8.40%	-16.61%	19.96%	1.01%	21.41%	5.41%	-2.06%	25.36%

However, things deteriorated quickly in September, and by the end of the quarter, only large and mid-cap growth benchmarks reported a positive return (see above table). There were a multitude of factors that impacted the decline of the market in September as the Delta variant started to dampen the reopening momentum of the economy. But from a 60,000 ft perspective, there are two factors that will likely have ramifications for the market over the next year and beyond: the Federal Reserve monetary policy and the breakdown of the global supply chain.

Fed Monetary Policy:

While there are many levers the Federal Reserve can utilize to manage the economy through its monetary policies, its two primary policy tools over the past decade have been quantitative easing (QE) and short-term interest rates. As discussed in prior market commentaries, during the great financial crisis of 2008 – 2009, the Federal Reserve first embraced the concept of QE in order to inject capital into the economy by purchasing securities in the open market and encouraging lending and investment in an effort to energize the economy into a self-sustaining upward trajectory.



These purchases are then reported on the Federal Reserve's balance sheet, as indicated on the graph above. During the start of the Covid pandemic in 2020, the Fed started buying $120 billion of securities monthly, increasing the number of securities currently held by the Federal Reserve to approximately $8.5 trillion.

The market has been anticipating two upcoming actions by the Federal Reserve: "tapering" and "lift off." Both will result in higher interest rates from their subsidized range to a more "normalized" range. Fed Chairman Powell has been clear that the monthly purchases will start tapering and cease from monetary policy by the middle of 2022. That will not change the extraordinary amount of stimulus in the economy until the Fed starts to implement a Quantitative Tightening (QT) policy of allowing the securities on its balance sheet not to be reinvested upon maturity. As illustrated in the Fed balance sheet graph, the last time its QE program ended in 2014, it took several years before QT started to reduce the money in the system and lower the Fed's balance sheet.

The "lift off," when used in reference to the Federal Reserve, refers to the timing of a change in its short-term interest rate policy; currently the Federal Funds Rate is 0.00% to 0.25%. Any upward move in this rate will increase interest rates throughout the yield curve.

The graph on the following page shows the movement of the US 10-year Treasury bond yield over the past 20 years, and relative to where the yield is currently, there is ample room for interest rates to go up before they should start to have a negative long-term impact on stocks. During the last Fed taper and reduction of its balance sheet (2015 – 2019), the 10-year US Treasury yield was in the range of 1.75% to 3.0% which gives a probable indication of where rates are likely to go over the next several years. Though the Federal Reserve policy doesn't have a direct impact on an individual company's fundamental performance, as an investor, understanding the future moves of the Fed will help prepare for broad moves in the market as investors reposition assets.

The Supply Chain Debacle:

After decades of moving towards a "Just-in-Time" inventory management system with a focus on the most inexpensive means of producing a product through the globalization of cheap labor, the world is witnessing a complete breakdown of the supply chain in all industries. At the start of the pandemic, the lockdowns boosted pent-up demand as consumers spent on goods (house improvements, fitness equipment, automotive) rather than services (airfare, restaurants, travel). The rolling lockdowns throughout the world slowed down areas of manufacturing and transportation that have yet to catch up with demand. Early in the pandemic, most were hopeful that there would be some form of normalization in the global supply chain network by late 2021. That now looks overly optimistic, as it could take years to return to normal. The "Amazonification" of the U.S. consumer hides the complexity of moving a product from point A to point B behind a simple mouse click and two-day delivery of merchandise. Nonetheless, the factors adversely impacting the global supply chain are so numerous that the solution to the bottleneck will have to be on multiple fronts.

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Within the international intermodal supply chain, the biggest concerns have been about the fundamental labor shortages, mostly on the back end; specifically, dray drivers and warehouse labor have been the real issue. Union Pacific Corporation (UNP) recently discussed at an investor conference that as it picked up the containers from the West Coast ports to take inland to the distribution centers, there wasn't enough takeaway capacity (drivers) to take the containers out of the intermodal yard to get them into distribution. Within the Chicago region where Union Pacific has four intermodal yards, as containers started to stack up, the Company opened two additional yards to be available for container inventory.

The shortage of labor is impacting everyone. In its latest quarter, FedEx (FDX) estimated that the impact of labor shortages on its quarterly financial results was approximately $450 million as a result of the widespread inefficiencies in its operations. While large numbers tend to grab the headlines, Corporate America rarely stands idle to wait for the problem to solve itself. Companies have been aggressively investing in automating their processes to reduce the human element within their operations. While not its first announcement of piloting autonomous and robotic solutions to their labor problems, FedEx announced in September that it has started to use self-driving trucks to haul goods between Dallas and Houston with autonomous vehicle startup Aurora. While initially each truck will have a safety driver within the cab, the goal is to haul goods between terminals without a safety driver by the end of 2023. Rail companies are adding significant automation to their intermodal facilities throughout the country to increase efficiency and deal with the labor shortages. As an example, rail company CSX Corp (CSX) is opening a new intermodal facility Carolina Connector that was originally estimated to create 300 jobs, but with the incorporation of new technology into the facility through automation over the past 5 years, it will create less than 10 jobs to manage the facility.

The pandemic and labor shortages have driven companies that were flush with capital to pull-forward innovation investment into their operations. Not all companies were capable nor had the foresight to make those investments, setting the stage for the next revolution in American business. Currently, with the shortage of everything, the expression of "the tide lifting all boats" is benefiting nearly everyone that has the capacity to supply products or provide services. Over the next decade, as inventories are replenished, the supply chain normalizes, and covid becomes less disruptive to the global economy, those companies that invested in operational efficiencies will dominate those that continued to do business as normal.

Current Positioning for the Future:

The majority of the investment decisions at Maclura Investments is based upon detailed fundamental analyses of individual companies and their positioning within the emerging economic conditions. Most of our holdings have a secular growth tailwind that will cause them to grow revenues regardless of the state of the economy. Nonetheless, while the Federal Reserve's actions will have minimal impact on most companies' financial and operational results, it will influence the general market direction in the short-term. Higher interest rates will result in lower valuation multiples, which was seen in the market during the third quarter with the underperformance of the high valuation small cap growth stocks. The Maclura client asset allocation continues to be weighted towards large cap stocks where the probability of capital appreciation will continue to be the highest over the next several years.

After a year of companies beating expectations, the market is likely to enter into a period of time where companies miss expectations based upon their inability to realize revenue due to supply chain disruptions or higher expenses related to raw materials or labor challenges. The financial results should be reviewed from the perspective that most companies will be underearning their potential, given the circumstances. As we communicated in our previous quarterly commentary, 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 and small cap companies in that environment, which is why we continue to favor large cap stocks into the foreseeable future.

While opportunities continue to be abundant in the market, we expect increased volatility over the coming year as capital rotation will cause short-term volatility in the market. Nonetheless, knowing the conditions facing the market, the long-term bias continues to favor an upward move in broad market benchmarks.

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