Davenport Asset Management Quarterly Update | Q1 2021

March 31, 2021

Equity markets continued their remarkable run in the first quarter as risk taking was in full swing. The S&P 500® Index and Russell 2000® Index gained 6.2% and 12.7%, respectively. It's hard to fathom how far we've come since early last year when COVID fears gripped the globe, businesses were shutting down and markets were in turmoil. Today, the narrative is markedly different as we are making significant vaccination progress, economies are re-opening and equity markets are near all-time highs.

Market Returns	Q1 2021	2020
U.S. Large Caps	6.2	18.4
U.S. Mid Caps	8.1	17.1
U.S. Small Caps	12.7	20.0
International Developed Markets	3.5	7.8
Emerging Markets	2.3	18.3
Intermediate Term Bonds	-1.9	6.4

Source: Morningstar Direct. Please see last page for index definitions.

The "re-opening trade" was in full swing for much of the quarter. That is, investors have been embracing areas of the market that were severely hurt by the pandemic and could see a meaningful recovery as pent-up demand is unleashed. These include consumer-facing companies in areas like retail, restaurants and travel, as well as more cyclical concerns such as industrials and banks. Concurrently, shares of many COVID beneficiaries (e.g. stay-at-home stories) have struggled. In recent quarters, we have been shifting our emphasis towards recovery stories within our portfolios and were pleased to see them show strong performance. While the earnings recovery for such stories is just beginning and may actually exceed expectations, we think many of them have quickly discounted significant improvement and now offer much more balanced risk/reward profiles.

In addition to prospects for a robust economic recovery, aggressive fiscal and monetary stimulus has clearly continued to support markets. Whether it is zero percent interest rate policy or stimulus checks, stocks and many other asset classes are floating on cheap and abundant money. A tidal wave of liquidity has given rise to fears of excessive inflation. Prices for many commodities are spiking. Moreover, the yield on a 10-year Treasury jumped from 0.92% to 1.74% during the quarter as investors demanded a greater return to offset higher inflation risks. The Federal Reserve (FED) seems to think inflationary pressures brought on by the economic re-opening may prove transient, and remains committed to using cheap money to promote full employment and sustainable growth. However, any change in their stance could prove disruptive to stocks, which have clearly become accustomed to supportive monetary policy.

In addition to unwanted inflation, persistent economic stimulus can also fuel risky speculation. As noted in our intra-quarter update, there has been evidence of speculative froth in corners of the market such as chat room stocks (e.g. the GameStop frenzy), SPACs (special purpose acquisition companies), bitcoin and high-growth "story stocks." In select cases, "price" and "value" seem to have become disconnected. Some have drawn comparisons to 1999 and the tech bubble. There are clearly areas of excess, but there are some key differences to consider. For one, interest rates are much lower now and supportive of higher equity values (fed funds rate was near 5% in 1999 versus zero now). Two, the equity risk premium (the spread between the S&P's earnings yield and interest rates) is actually above historical norms and implies stocks remain a relative deal versus bonds. The equity risk premium went negative in 1999, implying no incremental reward for the risk of owning stocks. To that end, we continue to see good value in a number of our holdings, including some recent purchases.

So where does all of this leave us? It's hard not to be excited about the near-term "Goldilocks*" scenario of strong economic growth and supportive fiscal/monetary policy. And, we continue to see value in parts of the market that haven't been quite as "hot" in recent months. That said, we are aware of heightened risks and recognize that even a slight shift in monetary policy could hurt markets. We still think it makes sense to expect more modest returns for many asset classes, including stocks, over a longer period. As noted in our year-end letter, we base this on elevated starting points/valuations relative to historical norms.

*The Goldilocks Economy term describes an ideal state for an economic system. In this perfect state, there is full employment, economic stability, and stable growth. The economy is not expanding or contracting by a large margin. A Goldilocks economy is warm enough with steady economic growth to prevent a recession.

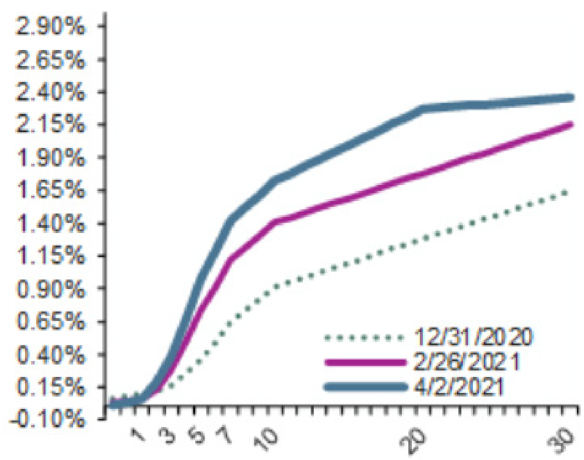
The overarching theme in fixed income markets during the first quarter was the move higher in U.S. Treasury rates. While absolute rates remain low by historical standards with the 10 year Treasury note yielding 1.7% at quarter end, it is important to not forget yields fell below 0.5% last summer. Consequently, this relative move has significantly hurt long duration assets. Fortunately, both the Short and Intermediate Duration models have modest interest rate risk but are not fully insulated from rising rates. Albeit, as new money is invested through sold, matured or called bonds, opportunities present to invest at these aforementioned higher rates.

Much of the current narrative centers on the collective impact of growth and inflation on interest rates. On the growth side, optimism centers around economies opening as vaccination efforts feed into global reopening themes bolstered by consumers primed with high levels of savings that is expected to flow into the economy. The inflation side of the equation raises concerns. Monetary and fiscal policy clearly prevented an outright economic seizure, but not without moral hazard. The Fed continues to penalize savers with its zero interest rate policy that has forced investors to reach beyond their natural risk tolerance. The Fed's ongoing balance sheet expansion cannot be ignored with monthly purchases of $120 billion pushing the Debt-to-GDP ratio ever skyward. Fiscal policy largely kicks the can down the road with debt funded stimulus programs that benefit from the Fed's market presence as the largest buyer and rate suppressor. Ultimately, you can only borrow your way out of a problem for so long. Sooner or later your lenders will need to be made whole.

U.S. Treasury Market

US Treasury Curve Yields

Maturity	Current Yields	Weekly Change (bp)	MTD Change (bp)	2020 Change (bp)
3 months	0.01%	0	-2	-5
6 months	0.03%	-1	-2	-5
1 year	0.06%	0	-1	-5
2 years	0.19%	5	6	7
3 years	0.38%	8	11	22
5 years	0.98%	11	25	62
7 years	1.42%	9	30	78
10 years	1.72%	5	32	81
20 years	2.27%	-1	23	83
30 years	2.36%	-2	21	71
2s-10s (bp)	154	0	26	74
2s-30s (bp)	217	-7	15	65



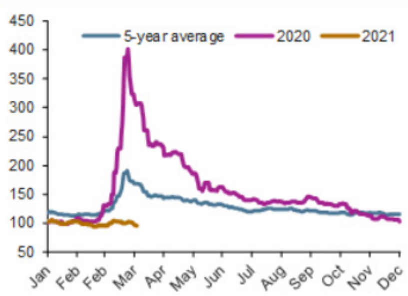
Source: CreditSights, Bloomberg. Data as of 04/02/2021

The front end of the U.S. Treasury curve remains pegged due to the Fed's ZIRP (zero interest rate policy) commitment. From the belly out through the long end of the yield curve, higher rates have impacted the market. For context, the 30 year Treasury bond has a duration of ~22 years and has seen its yield substantially rise in 2021. If it were to increase 1%, which is a very possible scenario, the bond's price would fall on the order of ~22%. Such embedded interest rate risk makes it less compelling to be constructive on duration in this environment. We do see tactical opportunity in the belly of the curve but are not looking to become outright duration bulls, instead we seek to capture more attractive carry.

Credit Markets

US Corporate Bond Indices (OAS)

US High Grade Corporate Master Index



Source: BofA/ML Indices (COAO), CreditSights.

US High Yield Master II Index

Source: BofA/ML Indices (HOAO), CreditSights.

		Change (bp)		
	03/31/2021	Week	MTD	YTD
High Grade	95	-6	0	-8
Financials	87	-4	6	-2
Industrials	97	-6	-2	-10
Utilities	109	-5	2	-10
High Yield	333	-15	-19	-53

Turning to the additional corporate spread compensation over Treasuries highlights continued risk on sentiment. It is possible for spreads to grind tighter. The conundrum is that credit profiles make the incremental yield pickup a tough value proposition to a rational investor at present market prices. We advocate carefully balancing limited additional compensation against downside risk. That said, there is a saying helpful in explaining this paradox… Don't Fight The Fed. Fixed income asset cash inflows from such a diverse investor base of ETFs, in addition to domestic and global mandates underpin a strong bid for corporate paper.

US IG Corporate Yield to Worst (%) by Rating, Tenor

Yield to Worst	Index	AAA	AA	A1	A2	A3	BBB1	BBB2	BBB3	BB1	BB2	BB3
Index	2.24	2.04	1.90	1.90	1.91	2.13	2.39	2.47	2.67	3.25	3.33	3.63
3 year	0.84	0.46	0.48	0.63	0.66	0.78	0.89	0.95	1.39	2.15	2.11	2.78
5 year	1.64	1.14	1.23	1.36	1.45	1.51	1.63	1.68	2.19	2.90	3.01	3.37
7 year	2.21	1.64	1.75	1.92	2.01	2.13	2.20	2.29	2.68	3.35	3.36	3.97
10 year	2.63	2.03	2.16	2.29	2.36	2.47	2.62	2.73	3.14	3.68	3.94	4.27
30 year	3.45	2.83	3.11	3.18	3.17	3.27	3.51	3.71	4.14	4.41	5.32	5.68

Source: CreditSights, BofA/ML Indices. Data as of April 2, 2021

Combining the recent move higher in Treasury rates with tighter corporate credit spreads has led to higher all in yields. Note that the table above is YTW (yield to worst), which is different from CY (current yield). As managers of total return strategies, we pay attention to both metrics. YTW is exactly what the name implies, the lowest possible yield received if a premium bond is held to maturity or called at a price below its current valuation.

As we continue to source new positions, our basis remains to capture higher yields without unnecessary duration or credit risk. With credit, we see value in lower rated short maturity issues, although the new issue market continues to see companies favoring longer term debt to term out maturity walls. In the secondary market, we remain diligent but have found limited liquidity in names of interest.

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