Davenport Asset Management
Quarterly Update | Q2 2021

June 30, 2021

Equity markets remained strong in the second quarter with the S&P 500® Index and the Russell 2000® Index gaining 8.6% and 4.3%, respectively. Year-to-date, the S&P and Russell finished the quarter up 15.3% and 17.5%, respectively. Most Americans are vaccinated, the economic recovery from COVID has been in full swing and corporate earnings have generally exceeded expectations. More cyclical and value-oriented sectors such as energy and financials have been very strong; however, we've seen concurrent strength in durable growth sectors such as technology and communication services. It seems investors have migrated from stay-at-home plays to reopening plays to now buying everything.

Market Returns	Q2 2021	YTD
U.S. Large Caps	8.6	15.3
U.S. Mid Caps	7.5	16.3
U.S. Small Caps	4.3	17.5
International Developed Markets	5.2	8.8
Emerging Markets	5.1	7.5
Intermediate Term Bonds	1.0	-0.9

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

Demand for many goods and services has been explosive as the economy has reopened. Government stimulus checks and elevated savings have left consumers flush with cash and ready to spend it. Businesses are also opening their wallets as they restock inventory and return to normalcy. This process has strained global supply chains and prompted a shortage of many goods and commodities. While toilet paper and hand sanitizer aren't problems anymore, short supplies of everything from cars to chicken wings are causing broad-based price increases. There also seems to be a shortage of workers in many industries as businesses are reopening faster than people appear to be willing to return to the workforce. This has put notable upward pressure on wages.

Not surprisingly, various supply/demand imbalances have given way to fears of runaway inflation. In fact, the consumer price index (CPI) rose roughly 5% in May, its biggest increase in 13 years. Excluding food and energy prices, the index had its biggest increase since 1992. The Federal Reserve has been targeting average inflation of 2% and is willing to temporarily accept something higher to ensure the economy is on sound footing. However, there are fears the Fed may have to tighten policy and raise interest rates if inflation gets out of hand. As we all know, accommodative policy has been an important crutch for stocks and other asset classes, so any change on this front could be disruptive.

At the moment, we seem to be stuck in limbo, waiting to see if inflationary pressures are lasting or not. For its part, the Fed views elevated inflation as "transitory" and a direct byproduct of short-lived supply/demand imbalances created by economic reopening. This view makes sense given that much of current economic data is distorted by the reopening phenomenon and may take time to normalize. Consumer demand should ultimately cool a bit, and supply chains will ultimately catch up. In other words, just as last year's economic data proved to be somewhat irrelevant as COVID wreaked havoc, the extreme strength we are seeing alongside COVID recovery could also be somewhat misleading.

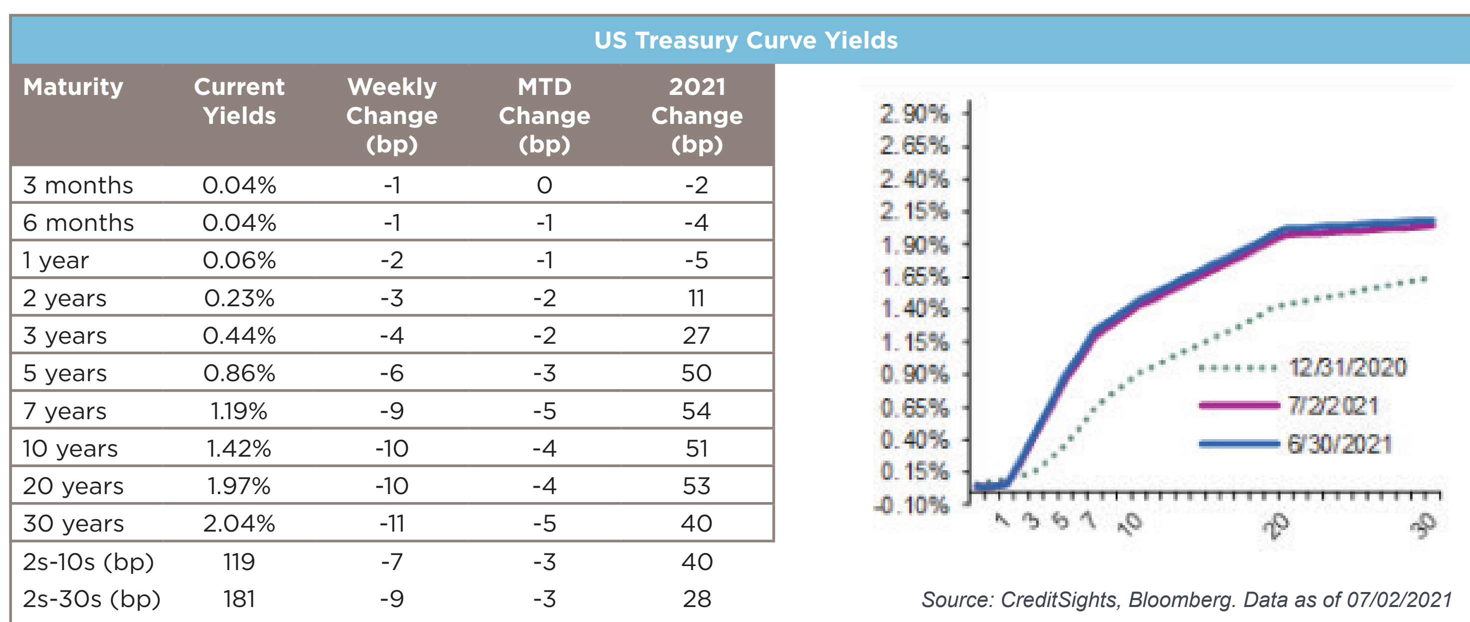
Our best guess is that we attain longer-term growth and inflation above pre-pandemic levels, but nothing so hot as to cause a dramatic or unexpected policy shift. The bond market seems to agree. To wit, a 10-year Treasury currently yields only 1.44%, a level investors surely would not accept if a CPI increase of 5% was viewed as sustainable (this would imply a "real" return of -3.56%). Reasonable inflation accompanied by solid economic growth should allow for only modest tweaks to monetary policy and be supportive of stock prices.

On the other hand, it's hard to imagine policy becoming incrementally accommodative from here. Further, the S&P's returns over the last 3 and 5-year periods have exceeded historical norms in large part due to "easy" Fed policy. Although somewhat justified by low interest rates, the S&P now trades at 21.5x earnings estimates for the next 12 months, above the 20-year average of 15.7x. For these reasons, we remain of the opinion that market returns should moderate from recent levels. We think returns can remain attractive, but the odds of repeating the turbocharged gains of the last few years seem low. We think our stock selection process should allow us to shine in this type of environment as company-specific fundamentals play a bigger role than macro factors that have dominated market sentiment for some time. We also are keeping our eye on emerging concerns such as new COVID variants and the potential for rising taxes, but remain optimistic about the companies we own in our portfolios.

Inflation was the word of the second quarter. Both discretionary and non-discretionary prices experienced pricing pressure. On the supply side, logistic challenges, rising labor costs at the lower end of the job market and stubborn input costs persisted. Turning to demand, a ready and willing consumer backed by ample savings and stimulus dollars have become a large component in the post-Covid landscape.

Whether inflation is transitory or proves more stubborn is the conundrum challenging investors and central banks. The Fed has been in the transitory camp for some time but sent recent signs of a shift in thinking. The primary monetary tools remain accommodative with Fed Funds holding short term interest rates extraordinarily low and continued massive quantitative easing (QE) intact. At the margin, the Fed indicated a potentially accelerated Fed Funds liftoff but remains data dependent. Additionally, while small in scale, the Fed announced plans to cease its involvement in corporate debt and ETFs.

U.S. Treasury Market



US Treasury Curve Yields

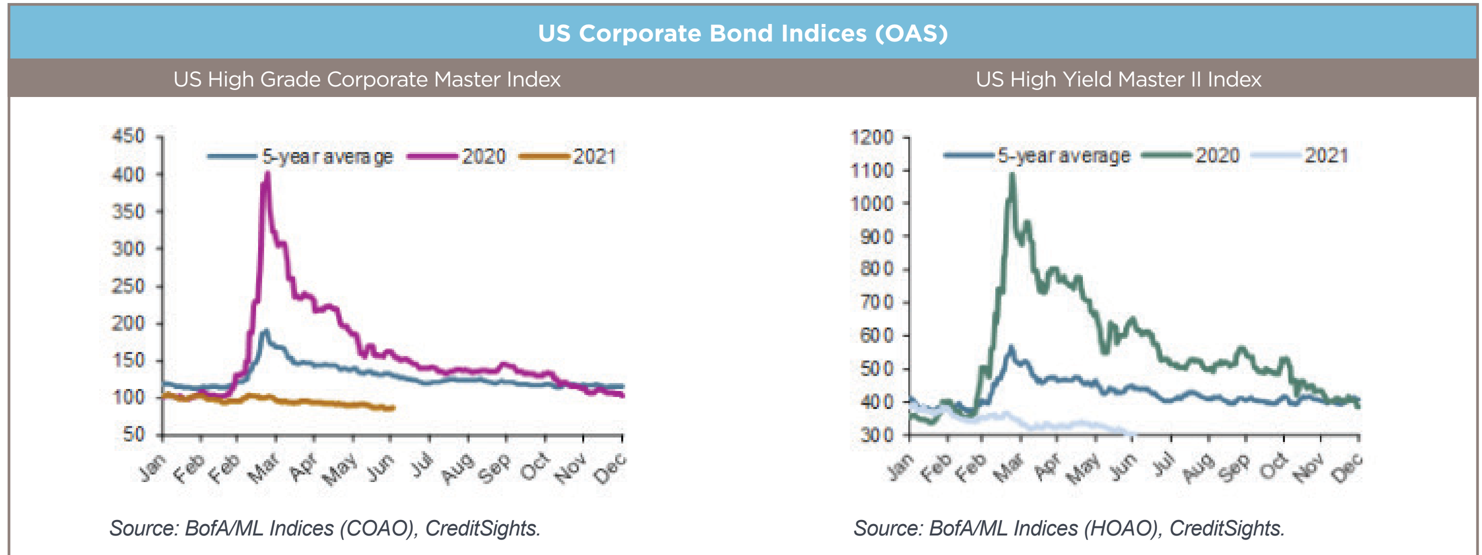
Maturity	Current Yields	Weekly Change (bp)	MTD Change (bp)	2021 Change (bp)
3 months	0.04%	-1	0	-2
6 months	0.04%	-1	-1	-4
1 year	0.06%	-2	-1	-5
2 years	0.23%	-3	-2	11
3 years	0.44%	-4	-2	27
5 years	0.86%	-6	-3	50
7 years	1.19%	-9	-5	54
10 years	1.42%	-10	-4	51
20 years	1.97%	-10	-4	53
30 years	2.04%	-11	-5	40
2s-10s (bp)	119	-7	-3	40
2s-30s (bp)	181	-9	-3	28

Source: CreditSights, Bloomberg. Data as of 07/02/2021

Treasury rates remain at higher levels on a year-to-date basis. During the second quarter, the yield curve structure flattened with the front end rising, while the rates came in (fell) out the curve. The move higher in short term rates is largely attributable to Fed willingness to accelerate Fed Funds rate hikes. Further out the curve, more factors come into play including growing Covid-19 Delta variant concerns and an economic outlook that looks very different without the monetary and fiscal support unleashed in 2020.

Rates remain at historically low levels, which exacerbates the situation. At such low levels, small shifts have a more pronounced impact on both markets and sentiment. The 30 year Treasury bond yielding less than 2% again is extreme and largely driven by the flight to quality trade as well as momentum investing. The biggest takeaway is that rate volatility will persist and with it comes tactical opportunity and secular duration risk.

Credit Markets:



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

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

		Change (bp)					Change (bp)		
	07/02/2021	Week	MTD	YTD		07/02/2021	Week	MTD	YTD
High Grade	87	1	1	-16	Utilities	104	1	1	-15
Financials	75	-1	0	-14	High Yield	304	0	0	-82
Industrials	90	1	1	-17					

Credit spreads remain extremely tight across ratings and maturities. It is tough to have strong conviction on the rally continuing from already rich levels. We remain selective in where and how we reach for yield. While we don’t anticipate spreads gapping out significantly in the near/medium term, adding higher rated credits or even Treasury bonds reduces credit risk and allows for rotation into lower rated credits when appropriate.

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

	AAA	AA	A1	A2	A3	BBB1	BBB2	BBB3	BB1	BB2	BB3	B1	B2	B3
Index	1.87	1.74	1.77	1.75	1.93	2.18	2.24	2.41	2.77	3.06	3.30	3.74	4.04	4.60
3 year	0.46	0.52	0.63	0.64	0.77	0.84	0.89	1.24	1.77	2.05	2.43	2.99	2.75	3.86
5 year	1.02	1.12	1.21	1.32	1.37	1.48	1.54	1.96	2.32	2.62	3.06	3.54	3.91	4.93
7 year	1.48	1.57	1.74	1.80	1.90	1.97	2.04	2.43	3.00	3.31	3.66	4.13	4.58	4.73
10 year	1.70	1.86	1.96	2.06	2.16	2.32	2.43	2.83	3.15	3.61	4.02	4.29	4.83	5.09
30 year	2.55	2.81	2.90	2.87	3.00	3.19	3.38	3.78	4.01	4.87	5.14	5.08	4.55	5.96

Source: CreditSights, BofA/ML Indices. Data as of June 30, 2021. Ratings represent ICE Indices Composite Rating Algorithm; See Important Disclosures for more information.

The table above reflects the challenging confluence of low Treasury rates and tight corporate spreads leading to low yields across the corporate debt market. An important takeaway from this table is that with such a small income cushion, investors must be cautious on duration extension and stepping too far down in credit spectrum.

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Convert each rating to numeric equivalent (AAA = 1; Aa1/AA+ = 2, etc.)

- Calculate simple average and round to nearest integer
- Convert back to alpha composite rating

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