DANN ASSET ADVISORS, LLC

Second Quarter 2021 Update

July 12, 2021

2Q21 Highlights

- Economic reopening, an accommodating Fed and fiscal stimulus drive stocks higher
- Inflation spikes with materials shortages, supply chain issues and rising labor costs
- Markets seem to agree with the Fed's assessment that inflation pressures will ease
- Bonds recover some of the first quarter's losses

The table below summarizes the performance of some key indices during the second quarter and year to date:

Market Performance Index	% Ch. 2Q21	% Ch. YTD
S&P 500	8.6	15.3
MSCI All Country World ex US	5.5	9.2
MSCI Dev. Markets (ex US)	5.2	8.8
MSCI Emerging Markets	5.1	7.5
US Aggregate Bond	1.8	-1.6
Liquid High Yield	2.3	3.0

Source: Morningstar, iShares

Equities. U.S. stocks continued a remarkable run, with the large-company S&P 500 index returning 8.6% and registering its fifth straight quarterly gain. Over these five quarters, the index returned just under 70%, benefitting from the combination of monetary and fiscal stimulus, the successful vaccine rollout and a recovering economy.

As has been the case since March of 2020, the market's continuing rise masked significant crosscurrents under the surface. Early in the recovery, large technology and other companies that gained business from the stay-at-home economy were the best performers. In many cases, these were higher-quality businesses that could withstand significant economic disruption. Later in 2020 and especially post the presidential election (as it became clear that additional fiscal stimulus would be enacted) many of the stocks hurt worst early in the pandemic began outperforming significantly, with prior leaders lagging.

As we discuss later, a move from more cyclical, lower quality stocks back toward high quality may have begun late in the second quarter. We note that from the Fed's June 16 meeting through quarter end, the Russell 1000 Growth index rose 3.6% while the Russell 1000 Value index fell 1.0%. We attribute this shift to the Fed's acknowledgment that it may raise interest rates earlier than previously anticipated. While the Fed's comments caused shorter-term rates to spike up, longer-term rates came down as investors seemed to conclude that current high inflation rates will ease as pressures from reopening the economy subside. Lower long-term rates generally are considered positive for growth stock valuations.

Similar to the first quarter, international stocks trailed the U.S. as many governments abroad had slower vaccine rollouts, which restrained economic growth. Unlike the first quarter, the Russell 2000 index of small company stocks lagged the S&P 500 with a 4.3% gain. Small stocks lagging may be an indicator of slower economic growth to come.

Fixed income. After a significant rise in the first quarter, 10-year treasury yields fell in the second quarter, declining from 1.75% on March 31 to 1.44% on June 30. We believe the decline at least partly reflects investors' belief that economic growth will slow later in 2021 and that the Fed will not let inflation get out of control longer term. In contrast to longer term rates, yields on the two-year treasury rose from 0.16% to 0.25%. Nearly all of this increase came following the Fed's June 16th statement that it may raise short term rates earlier than previously planned. With the decline in longer term rates, investment grade bonds as measured by the Barclays U.S. Aggregate Bond index recovered part of their first-quarter loss.

Market sectors[(1)]. Energy (+12.8%) was the market's best performing sector for the third quarter in a row as demand has rebounded more quickly than expected and producers have been slow to add production. Oil prices rose 24% during the quarter, reaching their highest level since fall 2018. Real estate investment trusts (+11.7%) and technology (+11.5%) were the second and third strongest sectors. Similar to energy, many REITs are benefitting from the economy's reopening. Technology had lagged early in the quarter but finished strongly as investors rotated back to higher-growth stocks toward quarter's end. Within technology, software and semiconductors had particularly large late-quarter gains.

Utilities (+0.5%), consumer staples (+3.1%) and industrials (+4.2%) were the quarter's worst performers. The first two sectors are considered among the market's most stable sectors; these typically lag when economic growth is strong. Industrials' performance was the mirror image of technology, with a strong start but weak finish to the quarter.

Portfolio Positioning

We made no significant changes to fixed income allocations during the quarter. For equity-only accounts, we sold a U.S. focused mutual fund that we had bought in 2020. The manager of the fund was more aggressive than we had expected in trading in and out of positions, and this made us less comfortable with his overall strategy. We also sold a financial stocks exchange traded fund (ETF). Proceeds from these sales were put into existing positions and a biotech ETF.

Analysis and near-term outlook. The economy has rebounded more quickly and substantially than we expected just three months ago. This is reflected in S&P 500 earnings estimates, with consensus estimates for the average of 2021/22 now being $202.57 vs. $188.50 in late March (a 7.5% increase; estimates provided by Yardeni Research). Higher earnings expectations certainly helped the market move up during the second quarter.

Early in the quarter, value and lower quality stocks led the market. In mid-May, this changed, with higher quality and growth stocks leading the way. The table below illustrates this using the Russell 1000 Value index and Invesco High Beta ETF (representing value and lower quality stocks) and the Russell 1000 Growth index and iShares Quality Factor ETF (representing growth/higher quality):

	Performance	
Index/ETF	4/1 - 5/16/21	5/17 - 6/30/21
Russell 1000 Value Index	6.1	-1.3
Invesco S&P 500 High Beta ETF	8.7	0.4
Russell 1000 Growth Index	3.5	8.1
iShares MSCI Quality Factor ETF	5.1	4.2

Source: Russell Indices, Invesco, iShares

Why this shift occurred and whether it continues will become clearer with time. We note that the turning point seems to have occurred at roughly the same time that investors' inflation expectations peaked[(2)] – at least for the near term. Regardless of the reason for this shift, we believe that the key issue for what works best in the market going forward is economic growth – will it continue exceptionally strong over the second half of 2021 and beyond or will there be a return to slower growth once expanded unemployment benefits end in September and consumers' pent-up demand from being locked down abates?

Three months ago, we thought the latter scenario more likely and that the market would begin discounting slower growth this summer with higher-quality stocks coming back into favor. As shown in the prior table, this may have begun occurring, and remains our base case. However, our confidence in this outlook is being tested as growth currently continues to outstrip earlier expectations. Among the key variables that we're monitoring for clues about the economy are:

- The price of certain commodities, including copper and lumber
- Inflation, especially in wages
- Corporate sales growth and profit margins
- Consumer spending
- Changes in Fed policy and implications of a possible infrastructure bill

(1) Market sector performance numbers based on Vanguard sector ETFs' performance.
(2) Wall Street Journal, June 2, 2021, Investors' Inflation Bet Loses Some Steam; YCHARTS 10 Year TIPS/Treasury Breakeven Rate Chart.