Graves Light Lenhart
Build. Protect. Thrive.

October 14, 2021

Graves Light Lenhart Q4'21 Client Newsletter

Main Points:

- The financial markets were largely flat during Q3'21 (Sept. end), due to weakness during the last few weeks of September. While it is difficult to identify the culprit for the late quarter softness, we have cautioned that market valuations do not have much margin for error resulting from changes in investor sentiment and/or the economic environment.

- We reiterate our commitment to structuring our equity exposure to be meaningfully different than the S&P 500. We plan to continue for focus on value-oriented domestic stocks along with a meaningful allocation to international equities. In addition, we plan to take advantage of the unusually attractive valuation of small-cap stocks relative to large-caps.

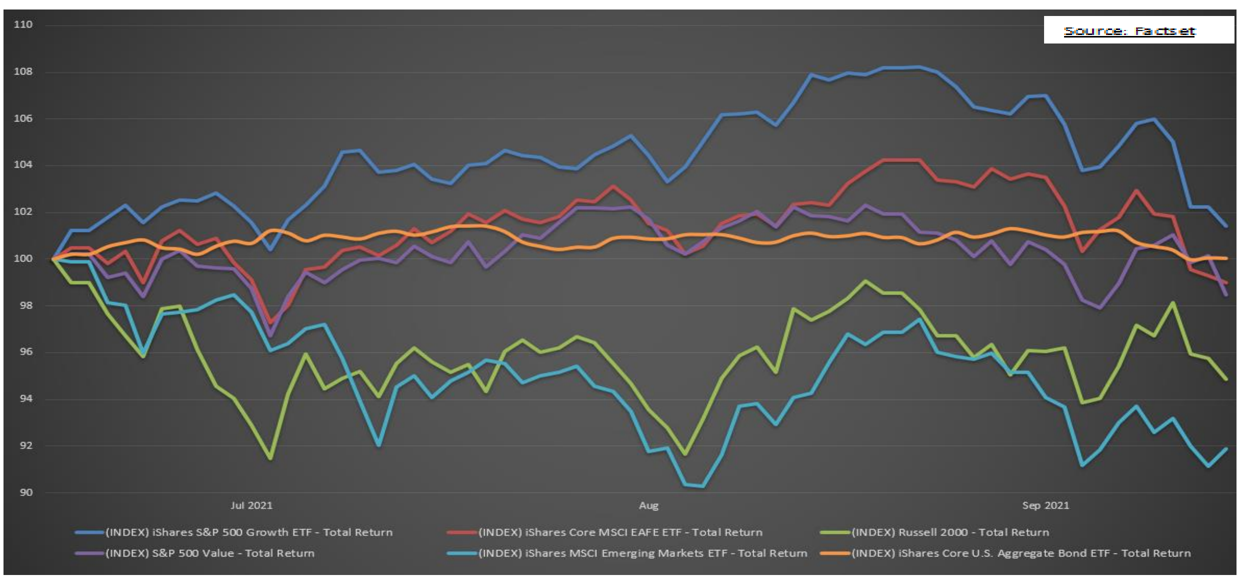
- At present, fixed income markets are experiencing a seismic shift as major central banks across the globe are setting the stage for a reduction in liquidity, mainly through tapering announcements (or at least hinting that they plan to taper). A normalization of interest-rates to higher levels over time would be consistent with a domestic economy which is being weaned away from central bank support. Importantly, we don't believe that inflation expectations need to move any higher for this rate adjustment to occur.

- As always, we are focusing our efforts on what we can control. We don't know what the markets will do over the next quarter, but we can improve the long-term prospects by controlling the price we pay for securities and focus on long-term financial planning issues such as risk management, realistic goals, and tax planning.

“The stock market is filled with individuals who know the price of everything, but the value of nothing.”—Phillip Fisher

Q3’21 ended with a whimper, befitting September’s reputation as the cruelest month of the year for the equity markets. The S&P 500 hit its maximum quarter-to-date appreciation of 5.8% on September 2nd, before sliding to finish with a modest return of 0.58% for the quarter. For much of the quarter, investors focused on the progression of the COVID Delta variant, which resulted in an “echo” of the Spring 2020 outperformance of large-cap growth stocks and longer-term government bonds. During the final weeks of September, however, market trends began to change without a discernible catalyst. It is possible that investor attention began to focus on the possibility of sustained COVID-related pressures on economic growth, Chinese debt and economic worries, US government machinations around the debt ceiling and taxation and spending priorities, etc. We continue to caution that market valuation levels provide very little “cushion” against changes in sentiment and/or the economic environment. As such, we expect the current quarter to be volatile but hope that we are wrong.

The S&P 500’s overall pedestrian 0.58% increase over the third quarter gives an incomplete view of the various segments of the equity markets. For example, small-cap stocks, as measured by the Russell 2000, fell 4.4% during the quarter while Emerging Markets stocks suffered an 8.6% drubbing. Many segments of the overall equity market were experiencing solid quarters into September (as illustrated below), led by the S&P 500 Growth index’s quarter-to-date return of 8.7% through September 2nd. The bond market was chugging along with a quarter-to-date total return of 1.0%, as measured by the Bloomberg Aggregate Bond Index, through the end of August.

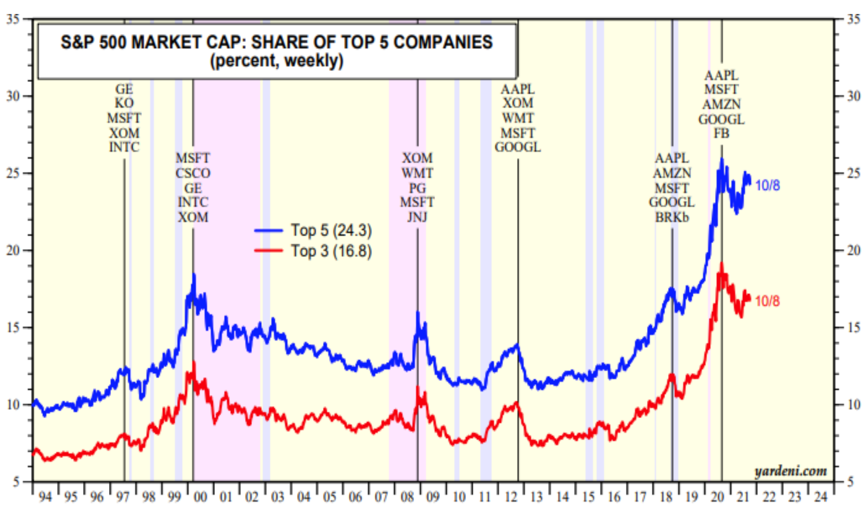


However, both the equity and fixed income markets experienced poor overall returns during September, especially during the last week or so of the month. The S&P 500 experienced a -4.65% decline for September. The S&P 500 Growth index fell -5.8% for the month, which cut its quarterly return to 1.87%. The S&P 500 Value index experienced a slight -0.85% decline over the quarter, including a relatively milder September loss of -3.29%. International stocks, as measured by the MSCI EAFE (Developed Markets) index, closely followed the performance of the S&P 500 Value index during the quarter with a similar overall loss of -1.1%. The performance difference between the EAFE index and the S&P 500 was largely explained by the strength of the US dollar ($); a weaker trade-weighted dollar benefits US holders of foreign assets and vice-versa. Fixed income did not provide a cushion against falling stock prices losing its entire quarterly gain of 1% from September 22nd through the end of the quarter. Commodities were the bright spot with a 6.7% gain for the quarter with 4.9% of the gain occurring during the final days of the quarter period when bond prices fell.

In our previous quarterly letter, we described the dramatic shift in relative equity market segment performance coinciding with the notable drop in the 10-Year Treasury on June 17th. During the September quarter, investor positioning turned solidly away from the so-called “re-opening trade” due to increased worries about future economic growth, especially concern about a potential Fed “policy error” of hiking rates too far, too fast. Since the onset of the COVID crisis, investment flows have been attracted to the so-called “FAANG” stocks, which are believed by many to have business models that will be able to survive, if not prosper, during both weak and strong economic environments.

Later in this letter, we explore the historical evidence which shows that the decade long outperformance of growth stocks has largely resulted from an unusually large valuation variance from historical norms rather than outsized earnings growth. We remain focused on the fact that many of these stocks remain very expensive relative to historical relationships, leaving such investments vulnerable to substantial losses. The chart on the right illustrates the association between the tremendous increase in global Central Bank liquidity and the increase in the market capitalization of the FAANG cohort since the aftermath of the Financial Crisis, which bolsters our concerns about the future stock price appreciation of these stocks.

The stock market remains top heavy with five tech stocks accounting for approximately 25% of the value of the entire S&P 500, which highlights the index’s sensitivity to large-cap technology stocks. However, many other growth-oriented stocks are trading at even higher valuations, with corresponding expectations for superior future operating results.

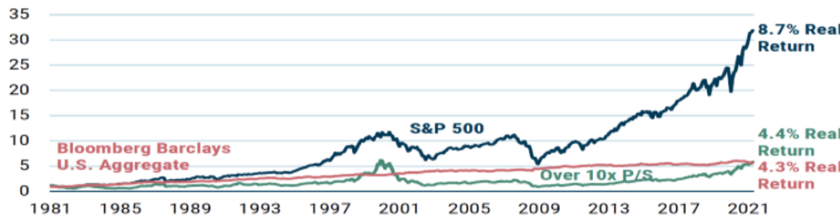


Note: Shaded red areas are S&P 500 bear market declines of 20% or more. Blue shaded areas are correction declines of 10% to less than 20%. Yellow areas are bull markets.
Source: Yardeni Research using Standard & Poor’s and I/B/E/S data by Refinitiv.

EXHIBIT 7: PERCENT OF U.S. STOCKS TRADING OVER 10x PRICE/SALES

Data from 1/1980-6/2021 | Source: GMO, Compustat

EXHIBIT 8: PERFORMANCE OF STOCKS TRADING OVER 10x P/S VS. INDEXES



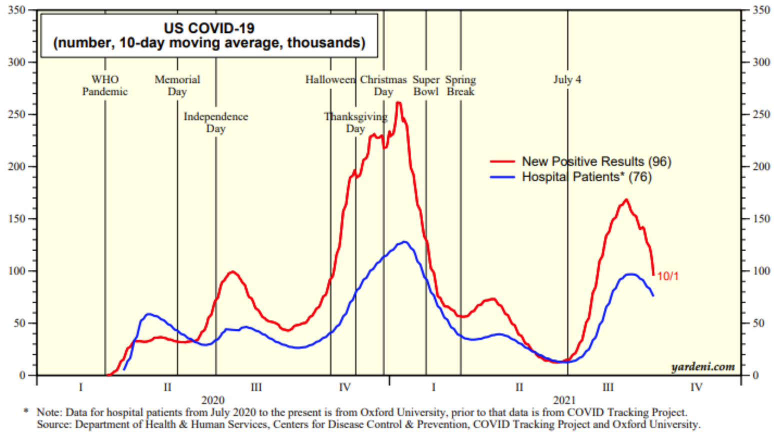
Data as of 6/30/2021 | Source: GMO, Compustat, Standard & Poor's
The over 10x P/S portfolio is a market capitalization weighted portfolio of all stocks trading above 10x trailing 12-month sales, rebalanced monthly.

Approximately 25% of all US stocks are trading for more than 10X their trailing sales and much higher multiples of earnings and cash flow, with many years away from profitability. Essentially, buyers of such stocks are assuming tremendous future profitability growth to justify their current valuation. Alas, history shows that the subsequent future performance of such stocks has been poor. Over the past 40 years, stocks trading at 10X revenues have experienced 50% of the annualized real return (i.e. excluding inflation) of the S&P 500. In fact, the long-term return of such stocks has only matched that of the bond market with far greater risk and needed the strong returns of the past year to reach that low bar.

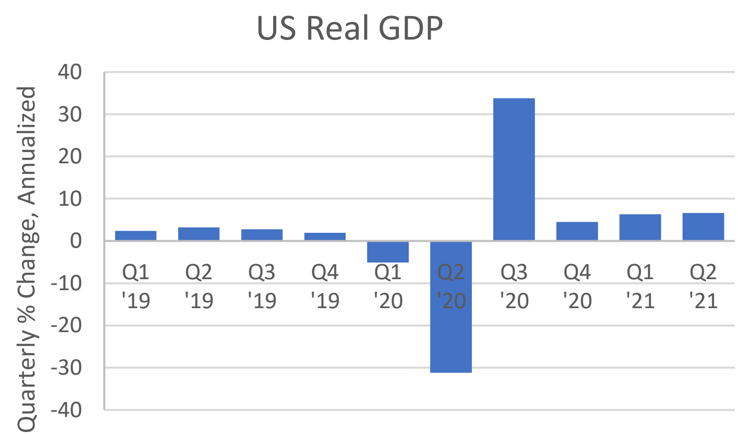
We reiterate our commitment to structuring our equity exposure to be meaningfully different than the S&P 500. Therefore, our strategy will likely lead to underperformance when large-cap growth stocks meaningfully outperform other areas of the equity market but should experience superior relative results if growth stocks face turbulence. Some vocal market commentators have started promoting worries over future stagflation, which is a 1970's era term describing poor economic growth, increasing unemployment, and troublesome inflation. At present, we do not believe stagflation to be a reasonable result as market indications, such as tight credit spreads and the recent outperformance of "reopening" stocks, are not signaling such an outcome. In addition, we have become increasingly interested in the potential opportunities currently presented by domestic small-cap and emerging markets stocks.

Economic Overview

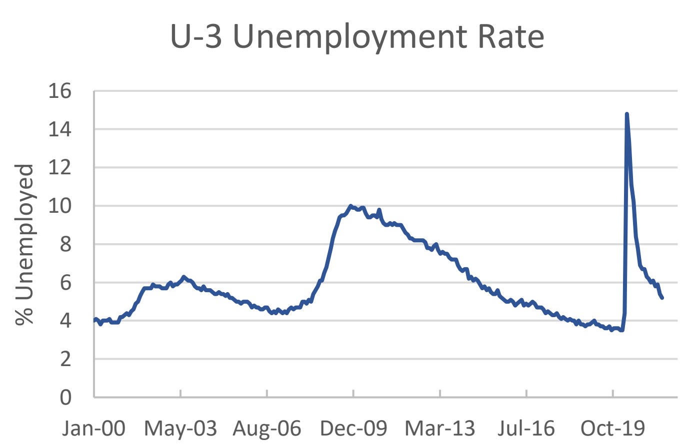
The economic discussion of the last six quarters has been largely dominated by COVID, and this will likely continue to be the case for a while longer. Hopefully, the forward-looking economic story will build upon a gradual reduction in the significance of the virus to economic activity (not to mention the hopeful reduction of the effect of the virus on human activity overall). However, at present many of the economic headwinds, tailwinds and crosscurrents still have their roots in the COVID crisis.



As Washington debates infrastructure-related spending, the effects of the fiscal stimulus of the last year and a half continue to provide lift to the economy, though the benefits of this previous spending will fade. In the 2nd quarter of 2021, US real GDP grew at a 6.7% annualized rate, more than double the average over the past 50 years. Reflecting the fading of the effects of the multi-trillion dollar fiscal stimulus of the past year, real GDP growth for the third quarter is expected to be somewhat lower. Evercore ISI, a leading economics firm, notes that strong US consumer confidence, strong S&P 500 earnings growth and other factors contribute to their forecast of 5% real GDP growth for the third quarter and 4.5% growth through 2022, with both well above the long-term trend. Meanwhile GDPNow, an economic indicator published weekly by the Atlanta Fed, estimates 3rd quarter GDP to be about 1.3%. The large spread of these two forecasts give a sense of the current uncertainty of economic forecasting, which is always challenging. Yet, it is worth pointing out that even the lower forecast is still projecting overall growth in the US economy.

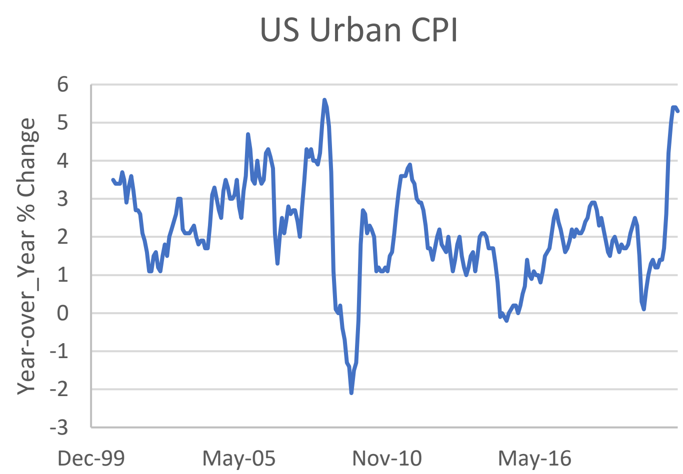


The labor market also continues to be markedly affected by the COVID crisis. After spiking to almost 15% in April of 2020, the unemployment rate has since declined rather steadily, to about 4.8% in September 2021. Although the rate of decline has dropped recently, it is running ahead of economists' forecasts from last year.



However, in a troubling trend, millions of individuals have left the workforce altogether – a phenomenon not captured in the unemployment rate (which only considers individuals actively looking for work). This is an important trend, as it limits the long-term productive capacity of the country if individuals are choosing not to work. In February 2020, the US civilian labor force (which consists of civilians that are employed or actively seeking work) was very near an all-time high of 164.5 million workers. In September 2021, the value was over 3.2 million fewer workers and 200 thousand fewer workers than the previous month. In our independent analysis, this reduction is disproportionately a result of older workers stepping out of the workforce. Presumably, this group is also disproportionately populated by those with sufficient savings to be out of work for an extended time (a presumption we cannot verify with available data). If this is true, it potentially exacerbates the skill mismatch between businesses currently seeking employees and the skills available in the US labor pool.

Interestingly, US real GDP, which represents the total value of the goods and services produced in the economy, is already greater than it was before the COVID crisis. This is irrefutable evidence that US productivity is increasing – more value is being created with fewer resources. The greater productivity increases, the less likely that inflation, which has been increasing over the last six months, will remain a permanent feature in the US. economy. To date inflation has indeed increased to an uncomfortable level, driven higher by worker shortages, COVID-related lockdowns in China, associated increases in shipping costs, and other factors. However, the highest recent year-over-year inflation rate is still slightly below the peak over the last 20 years, which occurred in 2008.



Over the course of the past year and a half, the Federal Reserve has roughly doubled the size of its balance sheet to $8 trillion. This $4 trillion monetary injection has provided substantial and needed stimulus to the economy, and still provides a strong economic tailwind. As a result of this unprecedented bond-buying from the Fed, the 10-year Treasury rate has been quite low for the past year and a half and was at a level of 1.52% at the end of the third quarter. This was near the high for the quarter, as the Fed has been openly discussing the timetable for "tapering" its bond buying program. This Fed intervention over the last 18 months has been a contributor to the increased inflation rate. This is another reason to watch inflation closely – if

higher inflation is perceived to be more persistent and less transitory than the Fed currently believes, that situation would induce the Fed to taper its bond-buying earlier. This will help tame inflation but lessen an important economic tailwind. While we do expect inflation to run for some time above the Fed's desired level of 2% inflation, we expect an inflation rate closer to 3% than the 8-13% levels seen in the late 1970s and early 1980s.

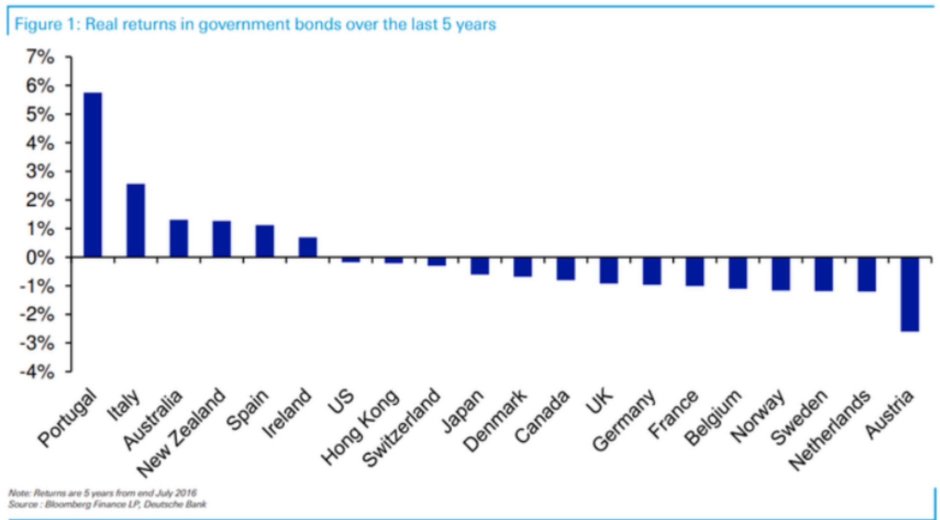
Currently, many inflation pressures do appear to be originating in China. When the global economy shut down, a great deal of natural gas production shut down with it. As the global economy opened back up, natural gas production has lagged worldwide, creating shortages and pressuring natural gas prices. Simultaneously, China has to an extent suppressed coal production in pursuit of emissions reductions (a substantial action, as coal accounts for 70% of China's power generation). The result has been rolling blackouts and high energy prices, with the result of increased manufacturing prices. This has been coupled with COVID-related shipping cost increases, exacerbating the situation as well. Growth in China has been forecasted to slow as a result but is still expected to remain above 5% next year.

European economies are also experiencing energy-related difficulties. These troubles are also related to the natural gas shortage and corresponding elevated prices, but the difficulties are substantially increased by a reliance on renewable energy sources such as wind that have been recently underproducing. European gas supplies are at very low levels, which could stress the European energy situation further. To date, the US has been much less affected by these multi-continental energy issues, largely because it is the largest global producer of natural gas.

Finally, one notable threat to market stability that arose this past quarter was the growing alarm over the Chinese developer Evergrande's financial liquidity. The deeply indebted developer is expected by many to default on its bonds (though as of the time of this writing, it had not – it had only requested a delay to pay the coupons it owes). The realization of this situation roiled global equity markets near the end of the 3rd quarter. Evergrande is a very large operation, and its potential insolvency could cause significant disruptions in the Chinese market. The fallout will depend upon the severity of Evergrande's situation, the reaction of the Chinese government, and the effects on other property developers in China. This situation has not yet fully come to a head and is one we will continue to monitor.

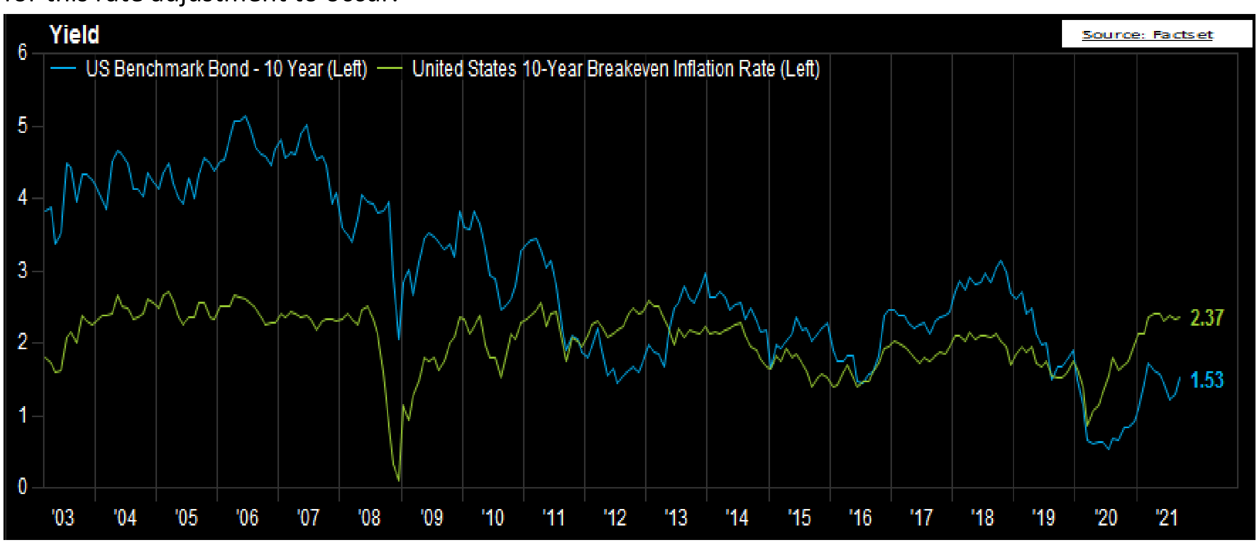
Fixed Income & Interest Rates

While high quality sovereign bonds have experienced multi-decade tailwinds as interest rates declined (remember: prices go up as rates go down), prevailing entry yields provided lower forward returns for many of these assets. As the following chart from Deutsche Bank reveals, real returns (i.e. excluding inflation) have largely been negative for high quality sovereign issuers over the last 5 years. The ability for these securities to compensate for inflation (no matter how low!), was inherently foregone given negligible coupons.



DEUTSCHE BANK

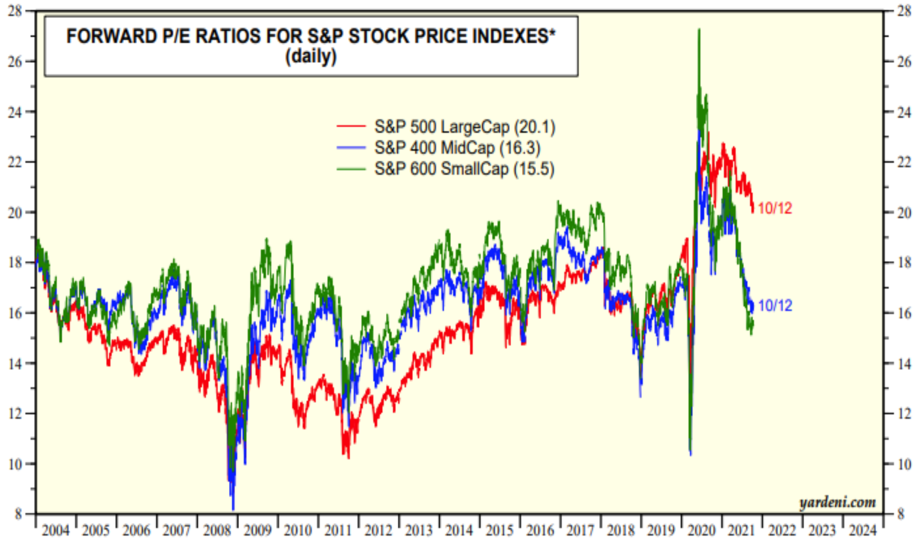
Directing focus to the US Treasury market, the chart below shows the US 10-Year breakeven inflation rate versus the nominal US 10-Year rate from March 2003 through September 2021. The 10-Year breakeven inflation rate is a market derived measure of expected annualized inflation over the term period. Historically, the nominal yield has compensated investors for *expected* inflation over 80% of the time. Prior to the first round of quantitative easing measures implemented by the Federal Reserve in 2009, this benchmark 10-Year rate consistently provided a positive implied yield when accounting for forward inflation expectations. This underpins our view that while near-term rate moves will remain unpredictable, a normalization of interest-rates to higher levels over time would be consistent with a domestic economy which is being weaned away from central bank support. Importantly, we don't believe that inflation expectations need to move any higher for this rate adjustment to occur.



When observing High Yield (colloquially "junk bonds") market credit spreads, which represents the premium investors receive to be compensated for default risk, we have witnessed a range-bound trend over the last 6 months. At September-end, the Bank of America US High Index was trading with an option-adjusted spread of 3.15%. While near its 10-year lows, this relatively "tight" level of spread represents a combination of low implied default forecasts, strong demand for the asset class and the improved quality within the issuer base. While we recognize the long-term merits of the asset class, we do not see current yield levels as adequate for the risk assumed. We continue to diligently monitor the High Yield, Short Duration High Yield and Floating Rate bank debt markets for a more appealing entry point.

Asset Allocation

For the past several weeks, financial markets have been largely rangebound with seemingly random day-to-day relative performance gyrations between market segments. We believe that Delta-related economic weakness will be reversed in coming quarters. We plan to continue for focus on value-oriented domestic stocks along with a meaningful allocation to international equities. In addition, we plan to take advantage of the unusually attractive valuation of small-cap stocks relative to large-caps.



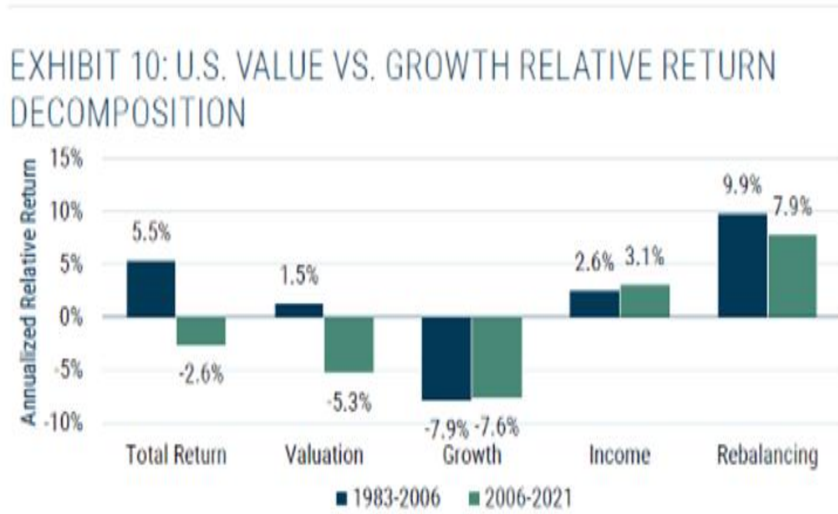
* Daily stock price index divided by 52-week forward consensus expected operating earnings per share.
Source: I/B/E/S data by Refinitiv and Standard & Poor’s.

As shown in the chart to the right, the S&P 600 SmallCap index (green line) is trading at a substantial discount to the large cap dominated S&P 500 (red line), which was last seen during the dot.com bubble.

Historically, small cap stocks trade at a premium to the market, highlighting the unusual current environment. In addition, the S&P 600 SmallCap’s P/E multiple on expected 12-month EPS is close to the average of its historical range, unlike most segments of the overall equity market. We’ve made a tactical adjustment to focus on the S&P 600 Small Cap index versus the similarly positioned Russell 2000 as the Russell universe is more exposed to lower quality financial characteristics and could experience greater volatility.

The growth vs. value tradeoff since the start of the COVID pandemic has been closely linked to the movement of the 10-year Treasury yield, with growth outperforming as yields decline and value during periods of increasing interest rates. Many rationales have been put forward to explain and justify the outperformance of growth stocks with most focusing on duration arguments, superior earnings growth, and less sensitivity to overall economic growth. None of these arguments pass using a full set of historical data, in our opinion.

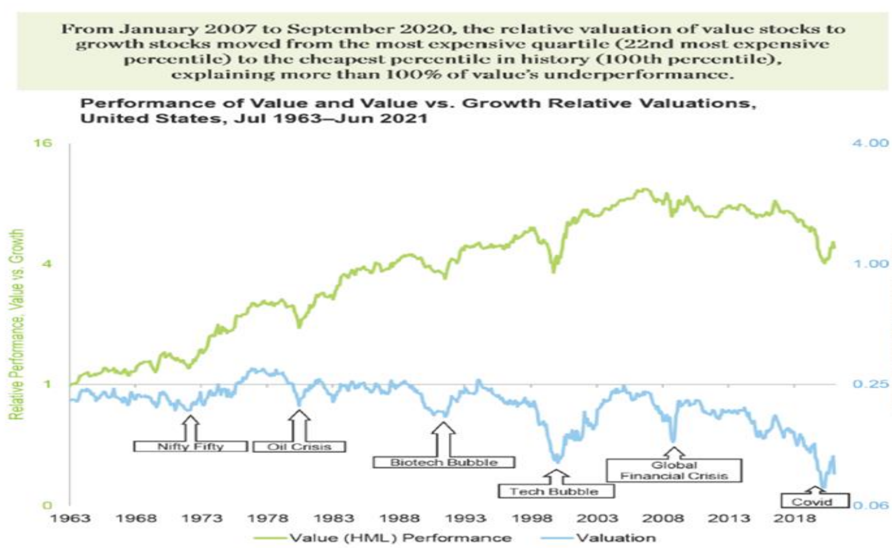
Over the past few years, growth stocks have experienced outperformance in conjunction with declining long-term interest rates, which has been explained as a duration effect. Essentially, this argument is based on the same mathematical relationship used to calculate the change in the principal value of fixed income securities in relation to interest rate movements with the market price of the security enhanced by lower interest rates and vice-versa. Since growth stocks are purchased based upon the belief that superior profitability will occur over the long-term, the duration argument suggests that lower interest rates (i.e. the rate used to discount the cash flows) will increase the present value of the expected future profitability. However, the correlation between the movements of long-term interest rates and changes in the relative performance between growth and value stocks has vacillated wildly over time and has achieved an average correlation of 0 (i.e. no relationship) since 1983. As such, we do not believe this to be a valid explanation.



As of 1/31/21 | Source: Worldscope, Compustat, MSCI, GMO
U.S. Value defined as the cheap half on market cap within the U.S., U.S. Growth is the expensive half on market cap within the U.S.

Superior earnings growth doesn't explain the performance divergence either. Value stocks handily outperformed growth stocks by 5.5% per year over the 1983-2006 period only to underperform by 2.6% annually from 2006 through January 2021. The relative value vs. growth return decomposition chart above shows that the earnings growth advantage typically enjoyed by growth stocks has not expanded relative to historical precedent. Nevertheless, the market has dramatically bid up the valuation of growth stocks, which has more than explained the performance variance between the two factors.

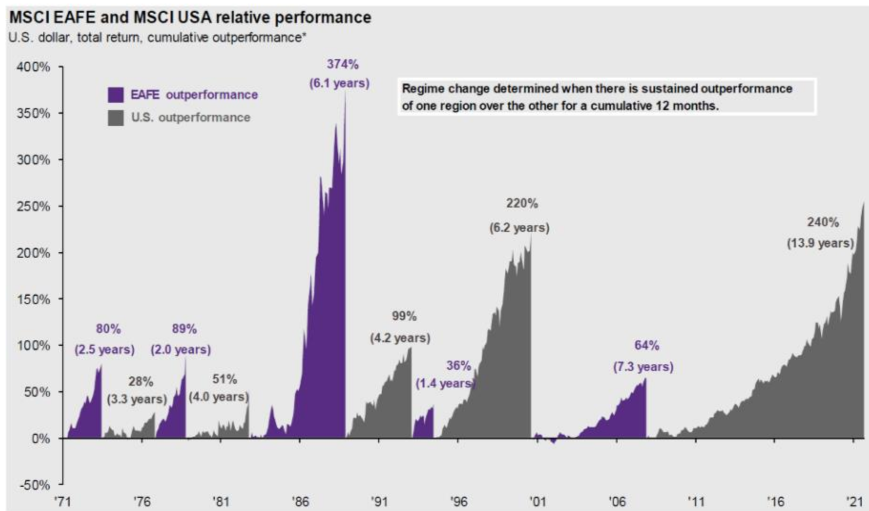
While we can't find a convincing justification for the superior performance of growth stocks, we can observe the current valuations ascribed to these market favorites. The following chart presents the classic book-value based valuation framework showing that value stocks are trading near their cheapest relative valuation in almost 60 years, which is confirmed by many other valuation methodologies. As such, the expectations currently embedding within growth stock prices could lead to truncated future appreciation and/or substantial risk these expectations are not realized.



Note: Value is defined using the classic Fama–French price-to-book value-based definition. The relative valuation of value stocks versus growth stocks is also based on the long and short portfolios' price-to-book value ratios.
Source: Research Affiliates, LLC, based on data from Compustat and CRSP.

Currently, market participants are questioning the future path of the global economy, largely due to both softening economic growth and political reorganizations within the important Chinese economy. At this point, we do not view the likely fallout from the demise of leveraged real estate developers to develop into a financial crisis, largely because the Chinese government will force the financial system to restructure debt payments and coerce other operators to absorb parts of the companies in trouble. However, the unfolding situation has our attention, especially regarding spillover events that could weigh on future economic growth.

International stocks are priced to offer potential returns in excess of those expected from the S&P 500. However, the performance of such stocks remains underwhelming so far in the current cycle. The various national experiences with COVID helps explain some of the underperformance. Domestic political maneuverings, energy shortages, and debt concerns within China have adversely affected Asian and European exporters to the county. Furthermore, the strength of the US dollar ($) has diminished the return to US based investors. Nonetheless, international diversification has proven to be valuable in the past and we continue to believe their less demanding valuations will prove to be valuable in the future, as well.



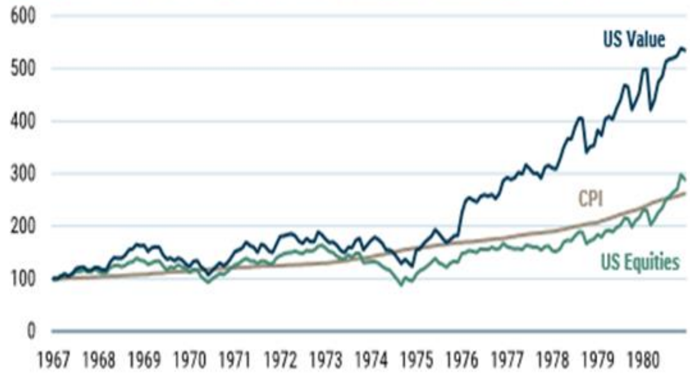
Source: FactSet, MSCI, J.P. Morgan Asset Management.
*Cycles of outperformance include a qualitative component to determine turning points in leadership.
Guide to the Markets – U.S. Data are as of September 30, 2021.

Emerging market stocks appear to be attractively positioned. As the associated chart shows, the price performance of Emerging Market stocks is approaching 20-year lows relative to the S&P 500, which reflects past traumatic periods, such as the Long-Term Capital Management (LTCM) Asian-related crisis and the terrorist attacks on September 11, 2001. While we have concerns about the situation within China, students of market history realize that markets can over-react and provide attractive risk-return possibilities.

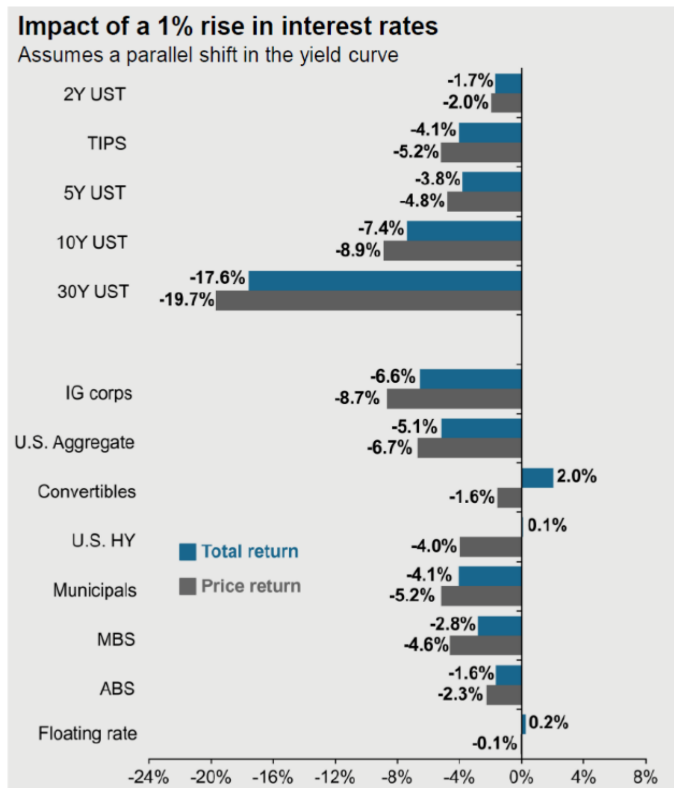
Source: BofA Global Investment Strategy, Bloomberg

Commodity exposure has proven beneficial with the pickup in inflationary pressures. However, we are hesitant to add further exposure until we gain more clarity on the economic environment. In the meantime, value stocks have performed well during past inflationary periods and could provide additional offsets if the magnitude of inflationary pressures persist for longer than market participants anticipate.

EXHIBIT 10: EQUITIES DURING THE HIGH INFLATION ERA



Source: Ken French, Global Financial Data, GMO



The story is different for fixed income securities. Currently, high quality bonds are trading with negative real interest rates (i.e. the market rate minus the imbedded inflation adjustment). At this point, the jury is still out regarding medium to long-term inflationary trends. Yet, a normalization of real rates alone would result in substantial losses in the "safe" bond holdings in a traditional balanced portfolio. The table to the right shows, a 1% increase in interest rates over 12 months would result in a 5.1% loss in the bond market, as measured by the benchmark Bloomberg US Aggregate Bond Index. Of course, interest rates could move dramatically higher in an inflationary environment, leading to even greater losses. To be clear, we view fixed income as a ballast against equity volatility, but we continue to implement defensive bond positioning within client portfolios given the current risk profile of the asset class.

Closing Thoughts

Many financial assets are carrying expensive valuations but there are still opportunities, in our opinion. For decades, markets have enjoyed the tailwinds from steadily declining interest rates. Potentially higher interest rates will likely not be as friendly to asset prices. However, the transition of interest rates from a friend to a possible foe will most likely be driven by the magnitude and duration of inflationary pressures. Unfortunately, clarity on the inflation front will take months due to disruptions in supply chains coupled with the complicated methodology used to calculate pricing pressures. In addition, changes to both economic and taxation policies further muddle attempts to discern the future landscape. As always, we are focusing our efforts on what we can control. We don't know what the markets will do over the next quarter, but we can improve our clients' long-term prospects by controlling the price we pay for securities and focus on long-term financial planning issues such as risk management, realistic goals, and tax planning. We are fully aware that our future is firmly tethered to our clients' successful financial lives. Thank you for letting us share in your journey.

Best regards,

Asa W. Graves VII, CFA	Jason Fink, PhD	Ash Heatwole, CFA
Chief Investment Officer	Director of Research	Portfolio Manager & Associate Director of Wealth Management