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STRATEGIC CAPITAL MANAGEMENT, LLC

Q3 2021 Newsletter | Jeff Griggs, CFA

Due to the wide range of risk tolerances of our clients, some topics or asset classes may have more, less, or no importance to your portfolio. For a detailed analysis, give us a call, or request a detailed performance review.

Big Picture

Stocks rallied in Q2 for the fifth straight quarterly gain since the -20% crash in Q1 2020. Growth outperformed value in the second quarter, reversing a good bit of the lead value took in the first three months of the year. While inflation, peak growth, and peak policy narratives stirred up fear throughout the quarter, the post-covid reopening momentum won out. The Fed continues to fight inflation fears with a consistent message that price increases are simply transitory. Peak growth fears were offset by another robust earnings season, while peak policy concerns were offset by a bipartisan group of lawmakers supporting a framework for a physical infrastructure package.

The PCE rose +5.4% yoy, a concerning figure, however that is coming off June 2020, during the meat of the initial COVID-19 shutdown. Inflation is tricky. By traditional thinking, we should have had a decade of high inflation already. Since 2008, the inflation monster has risen to the top of the market's stack of fears many times, with top economists explaining the quagmire of conditions that lawmakers and the Fed have created through massive deficits, easy money policies, artificially cheap capital, and tight labor conditions. These economists wagged their fingers at us, warning of our impending hyperinflationary doom, and yet inflation ran well below expectations for over a decade. That is not to say that inflation is not a real threat, or that we will not experience market destabilizing inflation in the future, nor does it mean that I believe the Fed when they insist this is transitory. It is to say that inflation is tricky. A debate is raging among the smartest of the smart over what even causes inflation and when we should worry, for now, I think it is wisest to position portfolios as inflation-agnostically as possible, while continuing to monitor and respond to any inflationary surprises.

Looking Ahead

After an incredible start to the year (second best first half since 1998), it is as hard as ever to predict where stocks go from here. The S&P 500 ended the second quarter with a 21.5x forward P/E, high by any measure at 1.46 standard deviations over the 25yr average (16.7x). Valuations this high average 0% total returns over the subsequent 5yrs. However, the S&P 500 has changed dramatically over the last 5 years and it's hard to draw conclusions from the index anymore. The top 10 stocks in the S&P 500 have grown from roughly 17% of the index to 29% today and the valuations between these mega-caps and the rest of the index vary immensely. The forward P/E of the top 10 is 30x, while the P/E of the remaining stocks is 18.9x. The valuation dispersion in the S&P 500 has skyrocketed in the last year. To me this represents that while there are "bubbles" out there, it is far to simplistic to say there is a stock market bubble. With wide dispersion in valuations and earnings there are pockets of overvalued and pockets of attractive stocks. After a nearly decade long beta-driven bull market, today looks like a good opportunity for savvy stock pickers to prove their worth.

On the Fridge

US Equities

Once again US equities beat all other asset classes returning 8.9% in the quarter. As Buffet once said, it is wise to "be fearful when others are greedy, and greedy when others are fearful."

Real Estate

Real Estate was the top performing sector in the second quarter, returning 13.1%. That was good enough to put Real Estate at third place so far this year with a 23.3% return in the first six months. That places it just behind Financials (+25.7%), and yet still far behind the volatile Energy sector (+45.6%).

In the Dog House

Utilities

The utilities sector fell –0.4% in the second quarter, making it the only sector in the red. At just +2.4% year to date, there is no respite for the risk-averse investor looking for the stable earnings and high yield the utilities sector is known for.

International Bonds

Without hedging for currency risk, international bonds returned just 0.9% in the quarter. With rates as low as they are, that may not be far off of investors expectations coming into the quarter. But, it is fairly disappointing when the 10yr treasury rate fell 30bps and US government bonds returned 1.7%.

Links and Articles

The Ghost of Arthur Burns
A great read about the evolution of the role the Fed Chair plays in the economy.

Expect The Unexpected
Sarah Zhang of The Atlantic tells what to expect (or not) from the Delta variant.

Quant-based ETFs Are Beating The S&P
A quick article on the recent rise of so-called "smart beta" ETFs.

Should You Pay Off Your Mortgage?
Allan Roth makes a compelling argument for paying off your mortgage despite low rates.

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Performance

Stocks notched another great quarter with the S&P 500 rising 8.17%. Growth (IVW +11.7%) outperformed Value (IVE +4.5%) in the quarter reversing most of Value's outperformance from the previous quarter. Q1 earnings grew 10.9%, led by Consumer Discretionary (+20.7%), Information Technology (+22%), and Communication Services ---(+17.2%). The only sector to post a quarterly earnings retraction was the Industrials sector where earnings fell -0.4%. Q2 earnings have only just begun coming in, but the market is expecting 20.3% growth. Full year 2021 earnings are expected to grow 12.61%. With that kind of growth baked in, any Delta variant fears that threaten to slowdown or reverse the reopening will likely have major implications for the stock market. However, if the market does see the growth we're expecting it should help justify the valuations we are currently trading at.

	2021 Q2	YTD	LTM	3yr	5yr	10yr
Cash	0.0%	0.0%	0.1%	0.0%	1.1%	0.6%
Fixed Income	1.3%	-3.2%	2.6%	4.2%	2.3%	2.1%
Fixed Income Blend	1.3%	-3.2%	2.6%	4.2%	2.3%	2.1%
Government	1.7%	-2.5%	-3.1%	4.7%	2.2%	2.8%
Inflation Protected	3.2%	1.7%	6.5%	6.5%	4.2%	3.4%
Municipal	1.4%	1.1%	4.2%	5.1%	3.2%	4.3%
Floating Rate	0.0%	0.1%	0.2%	1.3%	1.2%	0.0%
Corporate	3.5%	-1.3%	3.3%	7.8%	4.9%	5.2%
High Yield	2.7%	3.6%	15.4%	7.4%	7.5%	6.7%
International Bond	0.9%	-4.4%	4.6%	3.1%	1.6%	1.0%
Equity	7.5%	12.6%	39.9%	15.1%	15.2%	10.5%
Equity Blend	7.5%	12.6%	39.9%	15.1%	15.2%	10.5%
US Equity	8.9%	14.9%	42.5%	19.4%	18.2%	15.0%
Developed Markets	5.9%	10.3%	34.2%	9.1%	10.9%	6.2%
Emerging/Frontier	5.1%	7.6%	41.4%	11.7%	13.4%	4.7%
Alternatives	2.3%	4.5%	11.6%	3.8%	3.3%	2.2%
Alternatives Blend	2.3%	4.5%	11.6%	3.8%	3.3%	2.2%

US stocks fared the best, but it was a good quarter for bonds as well. Corporates returned 3.5%, while Government bonds returned 1.7%, modest compared to the equity returns we have been seeing, but stellar considering the yield-to-maturity on these indices. Still, after rising rates in the first quarter, bond investors remain largely in the red year-to-date.

	2021 Q2	6mo	YTD	1yr	3yr	5yr	10yr
Information Technology	11.6%	13.8%	13.8%	42.4%	30.3%	31.2%	22.0%
Financials	8.4%	25.7%	25.7%	61.8%	14.0%	17.1%	13.7%
Health Care	8.4%	11.9%	11.9%	27.9%	17.0%	14.1%	15.7%
Consumer Discretionary	6.9%	10.3%	10.3%	37.1%	19.4%	19.7%	17.9%
Consumer Staples	3.8%	5.0%	5.0%	23.3%	14.1%	8.0%	11.5%
Industrials	4.5%	16.4%	16.4%	51.5%	15.0%	14.4%	12.8%
Energy	11.3%	45.6%	45.6%	49.4%	-6.1%	-0.8%	0.0%
Utilities	-0.4%	2.4%	2.4%	15.8%	10.5%	7.4%	10.6%
Materials	5.0%	14.5%	14.5%	48.6%	14.9%	14.6%	10.1%
Communication Services	10.7%	19.7%	19.7%	48.4%	23.3%	10.9%	11.3%
Real Estate	13.1%	23.3%	23.3%	31.9%	14.7%	9.6%	11.1%

Source: Morningstar; The 1,3,5, and 10 year performance is annualized.

While they tailed their American counterparts, developed markets (+5.7%) and emerging markets (5.1%) performed nicely. Delta variant outbreaks threaten to disrupt that strength in emerging markets especially, but so far the market has shaken off the risk of a disrupted global reopening.

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Asset Class	Benchmark	Description
Cash	BBgBarc US Treasury Bill 1-3 Mon TR USD	Measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.
Fixed Income	BBgBarc Global Aggregate TR Hdg USD	The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers.
Government Bonds	BBgBarc US Government TR USD	The Bloomberg Barclays US Government Bond Index comprises the US Treasury and US Agency indices. The index includes US Dollar-denominated, fixed-rate, nominal US Treasuries and US agency debentures (securities issued by US government owned or government sponsored entities, and debt explicitly guaranteed by the US government).
Inflation Protected	BBgBarc US Treasury US TIPS TR USD	The Bloomberg Barclays US Treasury Inflation-Linked Bond Index (Series-L) measures the performance of the US Treasury Inflation Protected Securities (TIPS) market.
Municipal	BBgBarc Municipal TR USD	The Bloomberg Barclays U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.
Floating Rate	BBgBarc US Trsy Floating Rate TR USD	The Bloomberg Barclays US Treasury Floating Rate Index measures the performance of floating rate bonds issued by the US Treasury.
Corporate Bonds	BBgBarc US Corp IG TR USD	The Bloomberg Barclays US Corporate Bond index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.
High Yield Bonds	BBgBarc US Corporate High Yield TR USD	The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.
International Bonds	BBgBarc Gbl Agg Ex USD TR Hdg USD	The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers. This version excludes USD-denominated debt.
Equity	MSCI ACWI GR USD	The MSCI ACWI captures large and mid cap representation across 23 Developed Markets and 23 Emerging Markets countries. With 2,477 constituents, the index covers approximately 85% of the global investable equity opportunity set.
US Equity	MSCI USA GR USD	Captures broad US equity coverage. The index includes 3,108 constituents across large, mid, small, and micro capitalizations, representing about 99% of the US equity universe.
Developed Market Equity	MSCI World ex USA GR USD	Captures large and mid cap representation across 22 of 23 Developed Market countries, excluding the United States. With 1,023 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Emerging Market Equity	MSCI EM GR USD	The MSCI Emerging Markets Index captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 829 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Alternatives	Wilshire Liquid Alternatives TR USD	Measures the collective performance of the five Wilshire Liquid Alternative strategies that make up the Wilshire Liquid Alternative Universe, including the Wilshire Liquid Alternative Equity Hedge, Global Macro, Relative Value, Multi-Strategy, and Event Driven indices. This index is meant to provide a representative baseline for how the liquid alternative investment category performed as a whole. Constituents comprised of '40 Act mutual funds.
US Large Cap Equity	S&P 500	Widely regarded as the best gauge of large-cap US Equities. The S&P 500 is a market-weighted index that includes 500 leading companies and captures approximately 80% coverage of available market capitalization.