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INVESTMENT PERSPECTIVES

>>THIRD QUARTER 2021

The dangerous allure of falling in love with a single stock

By Michael A. Tyler, CFA
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Diversification is a cardinal rule of investing: Never put yourself in a position where one holding can destroy your portfolio. Yet we do it anyway, and we delude ourselves that we're not enraptured by the whales in our portfolios: *I'm not in love, so don't forget it. It's just a silly phase I'm going through.*

That line may have earned 10cc a gold record, but it won't fly in the harsh reality of the stock market. It doesn't matter whether you inherited a large position from Grandpa 30 years ago, or got in early on a unicorn that just went public, or simply held onto a smaller holding that shot up in price — regardless of how that stock came to dominate your portfolio, it's a good idea to consider diversifying your risk.

JP Morgan recently published a study showing that from 1980 to 2020, 42% of publicly traded companies experienced negative absolute returns; in the context of three of history's strongest bull markets, two of every five companies still lost money for investors. Fully 66% fared worse than the Russell 3000 index: If you owned a big position in a single stock, you had a two-in-three chance of inferior performance compounded over 40 years.

But this one is different, you say. Facebook, or Apple, or Moderna — whichever company it may be — is an innovative firm that can stay a step ahead of the market. So too were IBM, General Electric, Digital Equipment, and many others that have been brought low. No company is immune.

Sometimes the tax consequences of selling shares would be painful. *News flash:* It's not your money! Under current law, the government is entitled to 15% to 20% of your stock's appreciation, but the feds delay asking for their share until you realize the gain. Yet investors are still seduced by the mirage of unrealized gains.

Uncle Sam's generosity may not last. President Biden has proposed raising the top tax rate on long-term capital gains to 43.8% from the current 20%. And if you expect to hold the stock for the rest of your life and then pass it to your heirs tax-free, beware that the cherished "basis step-up" may also be revoked. If you're truly not in love with that big position, now is a good time to prove it.

>> PERSPECTIVES ON THE ECONOMY

Growth rates may be slowing, but this expansion is durable

By Timothy Garvey, CFA
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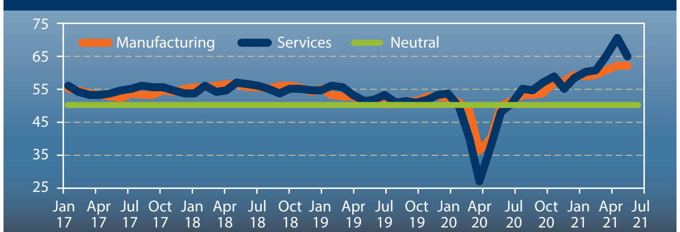
America's economic recovery has been both inspiring and impressive. This palpable turnaround is evident in weekly first-time unemployment claims that have returned to pre-pandemic levels. More jobs are coming back, most notably in the leisure and hospitality industries. The Institute for Supply Management surveys of manufacturing and services economic activity are at multi-year highs. Perhaps most importantly, consumer confidence is approaching pre-pandemic levels and retail sales are nearly 30% higher than they were a year ago.

Could it be that economic conditions are now too good? Have we reached peak growth? It's undoubtedly true that the torrid growth rates of the past year are not sustainable, simply because the comparisons get tougher as depressed 2020 results drop out of the data. Yet even if growth rates slow, we believe the underlying vigor can continue. Despite the strong recovery in the labor market, there are still over 7 million fewer jobs today than before than pandemic. The number of job openings is at a record high and the quits rate is elevated, suggesting people are confident in finding better jobs. The Markit surveys of purchasing managers suggest business conditions are solid, even though companies are facing significant supply chain disruptions and material shortages; as these issues are resolved, and as other economies around the world begin their delayed recoveries from the pandemic, we think production levels will catch up to soaring demand. Widespread vaccinations, lifted restrictions, high personal savings, and a return to growth overseas all suggest the momentum in consumer spending can continue. This expansion is durable.

PURCHASING MANAGERS INDEXES



Purchasing manager surveys are near record levels of optimism; any index reading over 50 indicates that corporate buyers are optimistic; under 50 indicates pessimism.

Source: IHS Markit

>> FOCUS ON EQUITIES

Can the dog days of summer be good for the stock market?

By Allen Laine, CFA
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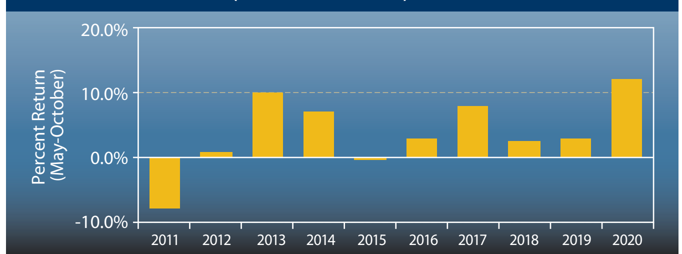
Markets have rallied strongly since the lows established in the first quarter of 2020. Massive fiscal stimulus and ultra-low interest rates buoyed the economy and consumers until mass vaccinations finally corralled the pandemic. While lower vaccination rates internationally and virus mutations are still a concern, it seems that the economy remains on track for a return to normalcy. The summer of 2021 almost feels like pre-pandemic times, as we enjoy cookouts, ballgames, and vacations again.

So what does an improving economy mean for the stock market? Is the old investment adage "sell in May and go away" relevant as we enter the dog days of summer?

The thought behind the saying was that investors and traders would spend less time doing their business activities during warmer months and more time heading to the beach or venturing off on vacation. The pattern held true for a long period of time until recently. The evidence had shown that on average lower returns were indeed achieved during the May through October timeframe as compared to November through April. However, in the past decade the pattern has been broken; in fact, most years since 2011 have witnessed positive stock market returns over the summer and fall months. In a world with information disseminated in milliseconds and an "always connected" lifestyle, the effect has eroded over time.

The key for market performance is earnings growth, not the calendar. When business conditions are improving, consensus analyst EPS estimates will be revised higher as the year progresses. Fearful of an uncertain outlook, companies have continued to guide financial expectations conservatively. Barring any setbacks, they have substantial positive operating leverage as the reopening continues. That should lead to more positive estimate revisions, and in turn, stock market appreciation. Of course, management teams will need to navigate inflationary pressures and perhaps virus disruptions along the way. While the markets could take a breather this summer, especially after their very strong run over the last year, accurately timing a correction is difficult at best. Fortunately, the intermediate term outlook is much clearer as the global economy gradually returns to normal and earnings estimates grind higher.

S&P 500 RETURNS (MAY-OCTOBER)



Contrary to conventional wisdom, the stock market has gone up in eight of the past ten summers.

Source: FactSet

>> FOCUS ON FIXED INCOME

Don't worry about the Treasury rally

By Tom Bussone
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American bond markets have been sending confusing signals to investors all year. Long-dated U.S. Treasury yields are well off their 2021 highs, despite inflation hitting levels not seen since 2008; typically, bond yields rise when inflation accelerates, because higher prices erode the purchasing power of a bond's future cash flows. However, there are several factors causing Treasury yields to move significantly lower this year.

Federal Reserve officials seem to have convinced the markets that high inflation is "transitory," as pricing pressures are expected to normalize and growth starts to moderate. Also, the Fed remains very accommodative as it continues to purchase $80 billion of Treasuries each month. Lastly, U.S. debt yields — e.g. 1.45% on the 10-year note — look very attractive compared with other sovereign debt: More than $13 trillion of foreign debt is yielding below zero.

When money flows into Treasuries, it is usually a caution sign for risk assets because it suggests that investors are concerned about future economic growth. Yet credit (corporate bond) markets show no signs of weakness. High-yield spreads have tightened to levels not seen since 2007, sending the average junk bond yield to near an all-time low of just below 4%. Low-quality credit is expensive, but as the economy expands it can stay that way for an extended period. In the current environment, investors should be more concerned about interest rate risk than credit risk. The Treasury rally isn't an indication that the U.S recovery is stalling or that investors need to shift their portfolios to be more defensive.