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HORAN Capital Advisors

Quarterly Investor Letter

SUMMER 2021

"Life can only be understood backwards, but it must be lived forwards." Søren Kierkegaard

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Double Nickel

The first quarter of last year seems a distant memory, fading with the equity market recovery since the pandemic swoon. **As the right chart** shows, the S&P 500 Index has been up for five straight quarters. More impressive is the fact each quarterly return has been greater than 5%. This is only the second time this has occurred; the other time was in the 1953/1954 period. Ryan Detrick, Chief Market Strategist for LPL Financial noted in the next four quarters following the 1953/1954 period the S&P 500 Index returned 26.4%.

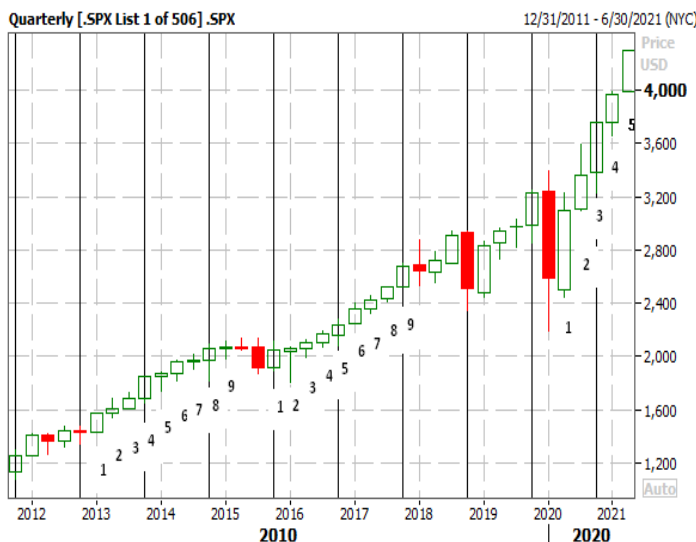
There are many studies supporting the adage that strength begets strength and certainly the last five quarters may portend further strength ahead. Positive economic data and corporate earnings strength provide a strong backdrop for continuing good equity market performance in the second half of this year. But using history as a guide, the market is unlikely to move higher in a straight line. Since 1980 the S&P 500 Index has averaged a 14.3% intra-year pullback while still generating positive returns in 31 of those 41 years. So far this year, the largest pullback has been only 4%, occurring in both early March and early May.

Contributing to the stock market's strength is the rebound in corporate earnings. **This chart shows** the return attribution for the S&P 500 and the market's total return this year has been driven by the growth in earnings as seen by the blue shading on the chart. Although the market's valuation remains elevated, the price earnings ratio for the market has actually contracted slightly this year and has been a detractor from overall market returns.

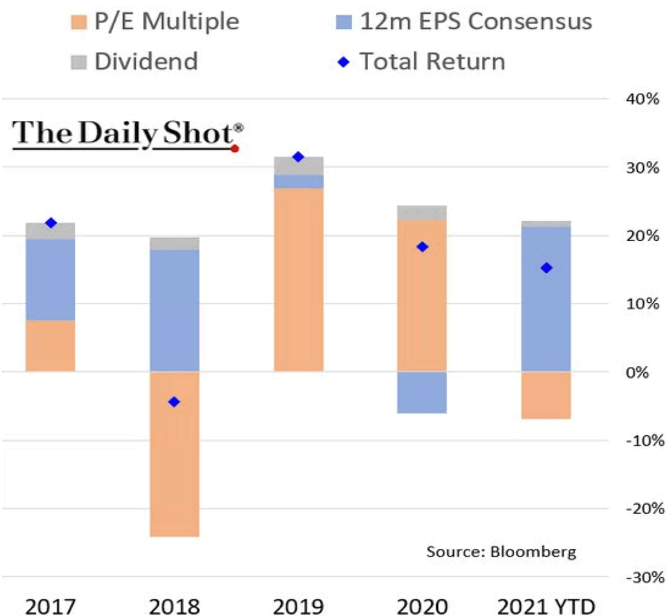
Broadening Asset Class Performance

In the second quarter investors continued to experience better returns in asset classes other than just the S&P 500 Index. The bar chart on the next page shows the S&P 500 Real Estate Sector Index generated the best return in the second quarter, up 13.1%, compared to the other asset classes shown.

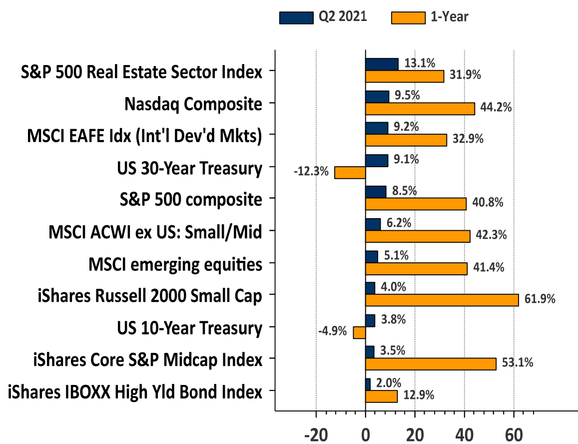
S&P 500 Index as of 6/30/2021



S&P 500 Total Return Attribution



Asset Class Performance



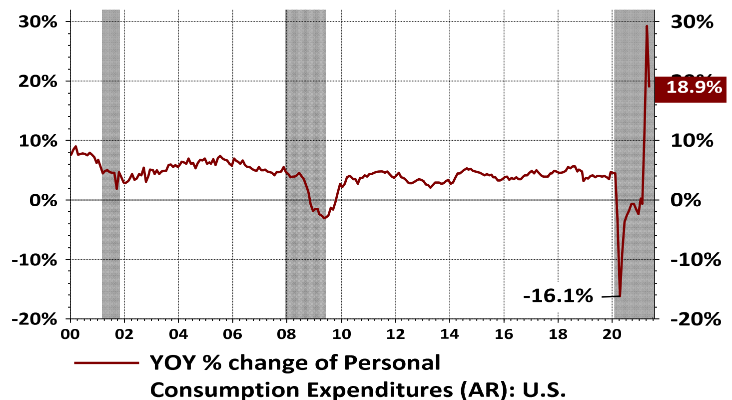
As of 6/30/2021 *Source: Refinitiv Datastream & HORAN Capital Advisors*

The real estate sector index is comprised of the 29 REITs in the S&P 500 Index. These 29 REITs cover a broad segment of the public real estate market, such as malls, cell towers, hotels, etc. As the economy improves, these so-called 'open up' stocks are attracting investors' attention. Also noteworthy is the strong performance in the quarter for some of the mega cap technology stocks. Our clients own three of the top four performing mega caps, i.e., Alphabet, Microsoft and Apple. In the quarter, fixed income returns improved with interest rates mostly declining. For the year, the 10-year U.S. Treasury yield peaked on March 31st at 1.74%. At the close of the second quarter the 10-year Treasury yield equaled 1.47%. This 27-basis point decline during the quarter translated into positive returns for some fixed income asset classes.

Increased Demand and Shortages

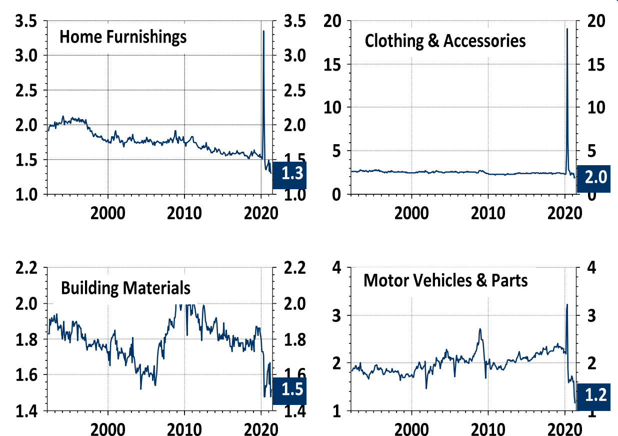
In the second half of last year, consumer spending was restricted due to the shutdowns instituted to contain the spread of the Covid-19 virus. As more state economies opened this year, consumers seemed to go on a spending spree to satisfy some pent-up demand. **The middle chart shows personal consumption** expenditures, which represents personal outlays, remains elevated at a year over year rate of increase of 18.9%. This increased demand, along with lower inventory levels, is resulting in shortages of products in some product categories. **The last chart shows the record low inventory** to sales ratio for a few of these product categories. Contributing to the low inventory levels is reduced supply in components that go into finishing some products. For example, a reduced supply of semiconductor chips is preventing auto manufacturers from completing production of cars and trucks. A part of the supply issue results from reduced manufacturing during the height of the pandemic. As economies reopened, spending resumed with a vengeance as consumers spent some of their stockpiled savings.

Personal Consumption Expenditures



Source: Refinitiv Datastream, HORAN Capital Advisors

Inventory to Sales Ratios



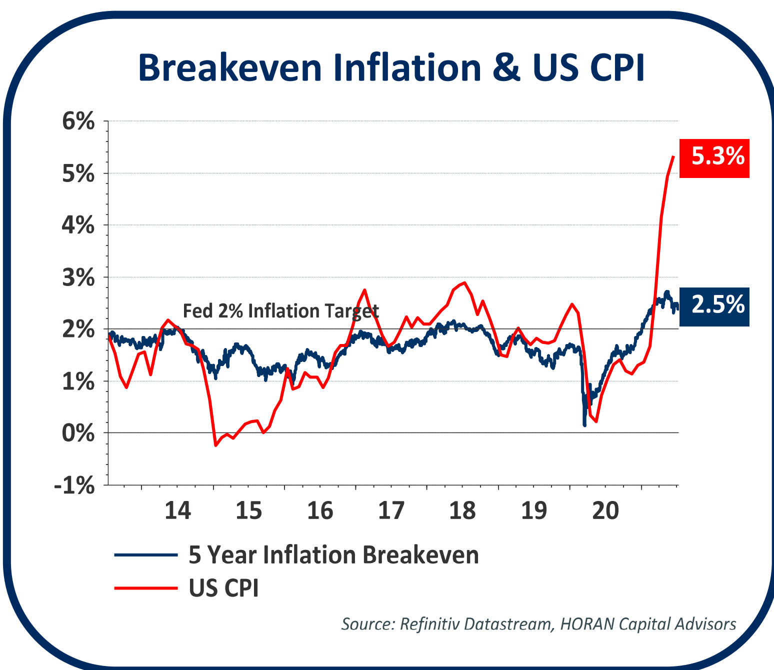
Inflation Station?

Turn on any financial news network in the first half of 2021 and you are almost sure to find a segment discussing the inflation environment. To sum up the current inflation debate, there appears to be two camps: those who believe the US is headed for years of higher inflation and those who view higher inflation as transitory. In fairness to both views, only time will tell. However, we can look to current inflation data to pit these claims against one another.

April of 2021 gave us our first glimpse of higher inflation data. April's Headline Consumer Price Index (CPI) showed urban consumers faced a 4.2% (3% excluding volatile food and energy prices) year-over-year increase in the basket of goods tracked. However, further inspection of the data is required for an accurate conclusion for this one data point. When looking at components, energy prices showed the largest percentage gain, up 25.1% (+49% jump in gasoline) year-over-year. Keep in mind the time period for comparison. Energy prices decreased dramatically in the February to June 2020 period due to a dramatic decrease in demand during the pandemic (no travel, industrial production dropping off, etc.). The second largest percentage increase was in used car and truck prices (+21% year-over-year). Airline fares jumped 9.6% for the measured period.

May of 2021 showed a continuation of CPI gains. Year-over-year CPI for all items rose 5% (3.8% ex-food and energy). Looking to components, a continuation of used car and truck price gains, energy prices, and airline fares moved the needle higher.

In our view, CPI is largely being driven higher by short-term issues. The previous section of this newsletter highlights the supply/demand imbalance being experienced in many parts of the economy. Housing, autos, energy prices, and even airline fares are being driven higher as supply struggles to meet demand. The bond market is also anticipating inflation data to normalize. **The below chart shows the bond market's** 5-year inflation expectation. Current inflation is tracking higher. However, the bond market continues to price in medium-term inflation that is more moderate. While no guarantee, the bond market's inflation expectations have typically been an indicator of future inflation rates.



International Markets

Just as the recovery has been uneven across sectors of the US market, the global equity recovery has been lopsided across geographies. The US equity market has been the best performer since the market low in March 2020 while developed international stocks and emerging markets stocks have posted strong returns but lagged the US. With similar vaccination rates, revenue growth and earnings growth metrics, one may wonder why the disparity in performance. One reason for this would be the sector weightings of US based indices versus international indices. It is no secret that the Technology and Social Media giants of the world were big beneficiaries of the "stay at home" orders enacted around the globe. Most of these companies reside in the United States in the Information Technology and Communication Services sectors.

Sector	S&P 500	World Ex-US
Communicatoin Services	11.1%	6.7%
Consumer Discretionary	12.3%	13.8%
Consumer Staples	5.9%	8.5%
Energy	2.9%	4.5%
Financials	11.3%	18.6%
Health Care	13.0%	9.3%
Industrials	8.5%	11.8%
Information Technology	27.4%	12.9%
Materials	2.6%	8.3%
Real Estate	2.6%	2.6%
Utilities	2.5%	3.0%

The left table illustrates the differences in sector weights for S&P 500 companies against the rest of the world. Investors have rewarded the Tech giants and placed a higher premium on their stock prices. Thus, a larger weighting towards these types of companies within an index would result in better performance. As the global recovery continues to unfold and broaden out, we would expect international stocks to present opportunities. A higher weighting to Consumer Discretionary may bode well for the resurgence of tourism. A higher weighting to Financials will likely benefit from economic rebounds as banks lend to businesses with growth prospects. Higher Industrials and Materials exposure means more cyclical exposure to broad growth. We continue to believe international equities can offer US investors diversification benefits.

Conclusion

The equity markets continue to climb the proverbial "wall of worry." Concerns over rising inflation, variants of COVID-19, and potential policy missteps from the Fed and Washington have had to compete with strong economic and earnings growth. Despite the backdrop, it is likely we still see an equity market pullback this year. We would view this as healthy market action after a big run. The world has changed in many regards, but one thing that has not is the need for investors not to dwell on where we have been, but where we are going.

Thank you for your continued confidence and support. We are always available to answer your questions and discuss our outlook further. Please be sure to visit us for company news, reports and our blog at www.horanassoc.com/insights/market-commentary-blog.

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