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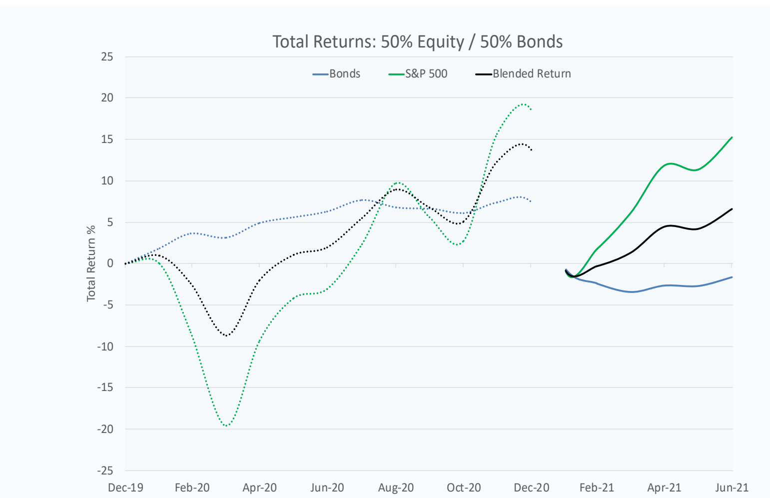
RYE, NY
914.282.0941
WWW.BLUMBERGADVISORS.COM

WHERE WE STAND – Q2 2021

The S&P 500 Total Return Index was up 8.5% (including dividends) in Q1 2021. See the solid green line to the right in the chart below. The Aggregate Investment Grade Bond Index (including interest) was up 1.8% for



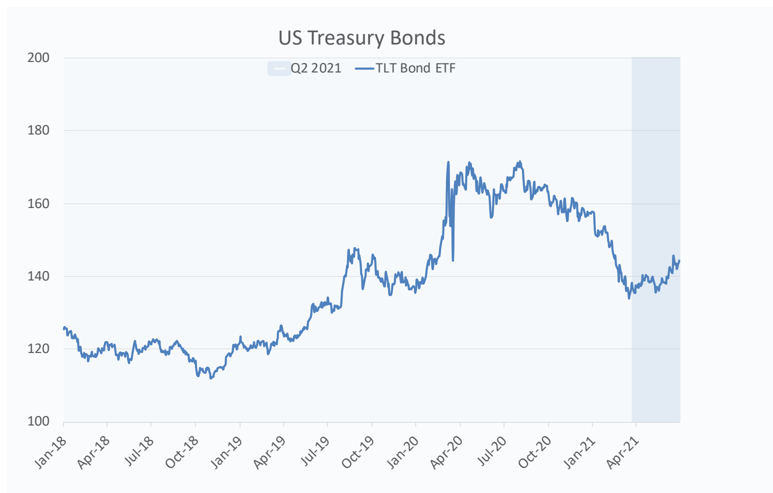
the quarter (blue line). If your portfolio comprised 50% S&P 500 and 50% Bonds, your YTD return would be 6.6% (black line). Data for 2020 is shown, broken lines, to the left.

Overview

The S&P 500 index was up 8.2% in the 2nd quarter, to new all-time highs and an exuberant 12% premium to its 200-day moving average. See the chart below. Quite the

opposite from the pessimistic 25% discount it traded at 15 months ago.

The long-term US Treasury Bond ETF halted its fall and rose 6.2% in the quarter as shown in the next chart. This price action reflecting the fall in the 10-year US T-note yield from 1.75% to ~1.48%.



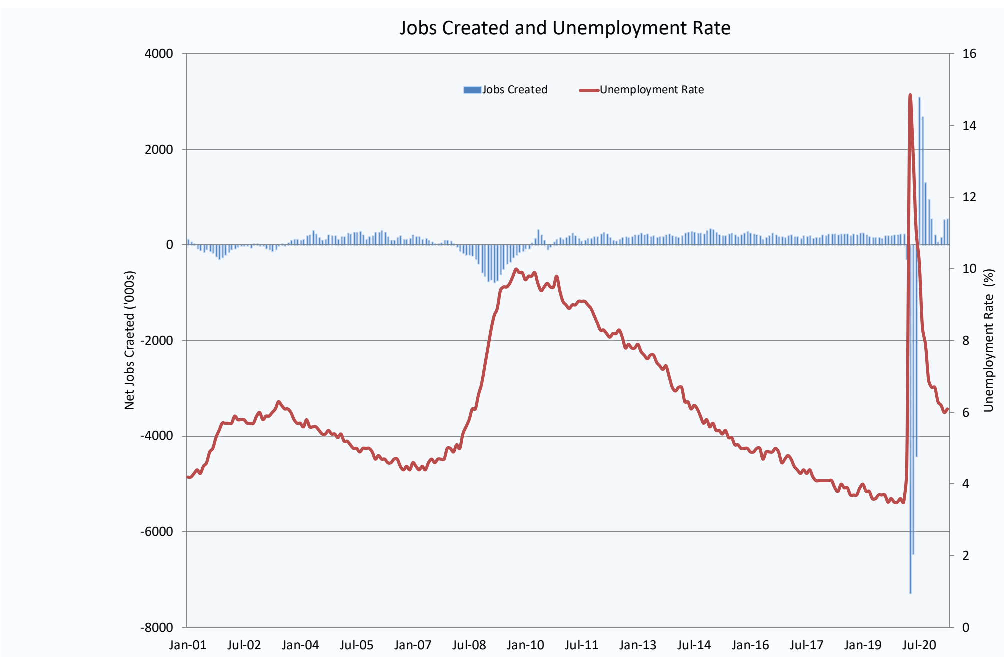
Growth stocks have outperformed value stocks markedly during the post-pandemic recovery as shown in the next chart. Growth stocks now trade at a lofty 43x historic PE

multiple and a 0.7% dividend yield as momentum investors disregard valuations and continue to treat past performance as indicative of future performance. Even value stocks at a 25x PE ratio, and a 1.9% dividend yield reflect the financial repression that the Federal Reserve is engaged in. More on this later.

For the S&P 500, our work shows that even as earnings estimates have improved in recent months, the forward PE ratio is 24X and the dividend yield is 1.3%.
Valuations are high, and volatility is suppressed, a direct result of the stance of the Federal Reserve's policy on interest rates.

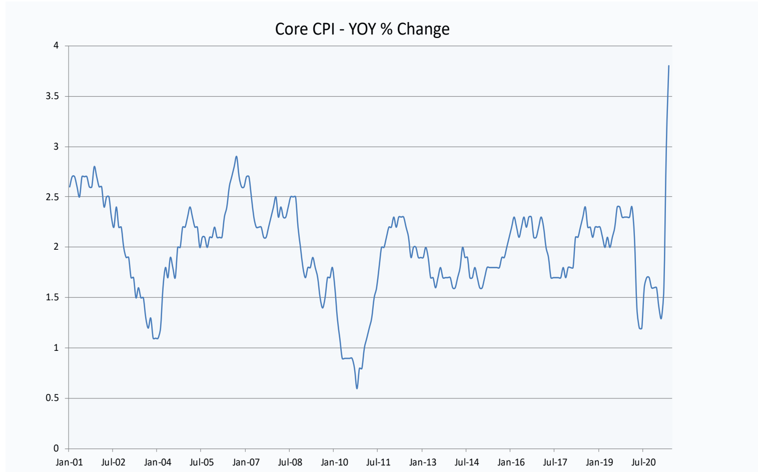
The Federal Reserve (Fed) has a dual mandate: ensure full employment and maintain 'ideal' inflation (not too much and not too little) and avoid deflation at all costs.

The next chart shows the extent of the job loss (in blue) during the pandemic and the subsequent bounce back, which one can relate to the last recession in 2007/8. The effect on the unemployment rate was massive (to ~15% red line). And although there has been an improvement in the rate (to just below 6%), the Fed apparently views further improvement as only possible if they continue with ensuring very easy financial conditions.



As to the second mandate, inflation, there has been an overshoot to the upside as shown in the next chart.

The Fed maintains that these inflationary pressures are 'transitory' and will revert to the ranges of this century (~1% to ~2.5%) over the next few months.



Based on the Fed's 'forward guidance', expectations are that interest rates will only begin to be raised in early 2023. This expectation is not cast in stone and can change at any time. If for example, the inflation narrative moves from 'transitory' to 'entrenched', the Fed will shift its forward guidance quickly and acknowledge that it needs to taper its bond buying program (which muscles long term rates lower) and raise the base rate sooner than is currently forecast.

As discussed in previous reports, policymakers have created an unprecedented environment of exploding fiscal deficits and rampant money creation: a policy of economic triage, the repercussions of which are to be dealt with in the future. We have also discussed how speculators get that if inflation remains under control, the Fed is locked into their current policies, even if it means the creation of investment bubbles. SPACs, 'meme' stocks, crypto currencies, volatility sellers and no-profit tech stocks...all exploded higher in Q1, even though none of these entities have profit or cash flow for investors to base their valuations on. Suddenly commission free trading and heavy marketing by app-based trading platforms, have lured individual investors into a gamification of trading and so-called investing. However, under the surface, in Q2, the boil has come off many of these investment vehicles, some having drawdowns of as much as 35-50%. For the broader market though, investors and speculators are relying on easy money to be around for years to come, and therefore, for momentum in the markets to be to the upside.

Where We Stand

Valuations matter in making investment allocation decisions.

Our internal model based on an in-depth analysis of the S&P 100 shows an expected IRR of -1.0% p.a. on a 2-year horizon, unless earnings growth outpaces current expectations and/or PE ratios rise from already lofty levels.

As far as bonds are concerned, forward returns look meager too (given current 10-year yields at below 1.5%) unless there is a collapse in risk assets that cause a flight to quality in treasury securities. (In that environment corporate debt will lag the performance of treasury securities).

To put this in perspective, at the beginning of this bull market, back in 2011-2013, the expected IRR for equities in our model was 8-10% p.a. with 10-year yields at 1.5%.

So, today, our internally generated equity risk premium (ERP - the amount equity investors are compensated for taking on equity risk vs bond risk) is (-1.0% minus 1.5%) or **negative** 2.5%. Back in 2011-13, it was (9% minus 1.5%) or **positive** 7.5%.

Bottom line, as to be expected, equities were extremely attractive in 2011-13 (and even up to early 2017) and are not so today.

Back then, if you asked an equity investor: would you be happy earning the 6.5% long-term historic equity return (that is the norm), the answer would have been: absolutely! Especially given how challenging the previous 15 years of equity investing had been.

Today, these returns seem pedestrian, as they typically do in late cycle valuation blow-offs.

GMO, a respected multi-billion asset manager and valuation expert, run their own models and for a while now have been pointing to excessive valuations and sub-par future returns for most mainstream asset classes, as they did, correctly in 1999 and 2007. See the chart to the right. They go further out than we do (7 years), and the chart to the right shows, the expectation for forward returns for various asset classes. The picture isn't a good one for investors especially those that deem it appropriate to reach for returns this late in the cycle.

Our approach will continue to be one of recognizing these limitations on forward returns. In the current environment of an accommodative Fed, when valuations get excessive as they are now, we will emphasize capital preservation (and take small profits as we did in the past quarter) and when valuations become attractive (as was the case a year ago) to shift that emphasis to opportunistic risk asset acquisition (as we did in March/April last year).

The last 6 months have not provided us with too many of these opportunities because volatility has been extremely, and inordinately, low, but we do expect volatility to pick up later in the summer. We will do this with the aim of achieving 6.5% annual returns while the current late cycle environment prevails.

Our true emphasis, however, is to set ourselves up for the next investment cycle (which although long in coming, is certain to arrive) where equity risk premiums move again in favor of equities, and we find solid opportunities to build on gains we have made in this cycle.