2021

MID-YEAR UPDATE

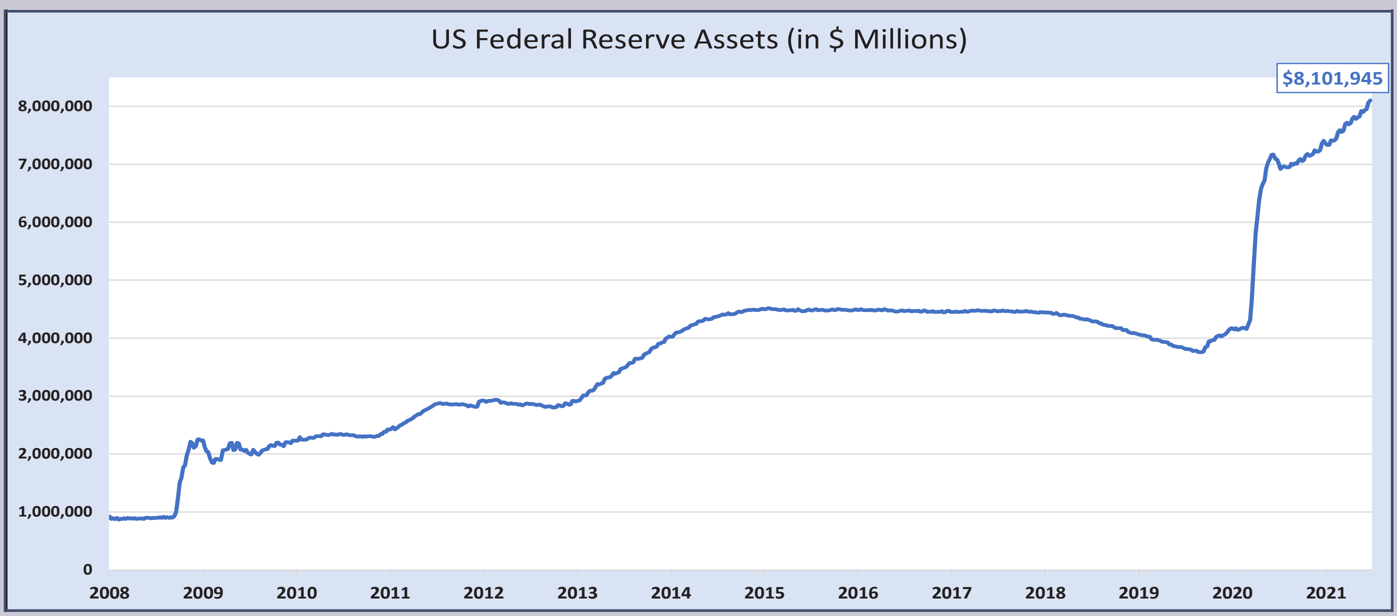
HANLON
Investment Management

EDUCATION SERIES - ASSET MANAGEMENT

The world is in the midst of a recovery in every sense of the word, as society re-emerges from the darkest days of the pandemic. Warm summer weather and vaccine dissemination have given the public confidence to begin a resemblance of normality, while officials continue many emergency measures to help shepherd the economy on a continued path of improvement. However, expanded unemployment benefits, eviction moratoriums, and fiscal relief are due to expire while dislocations still exist. Direct stimulus payments are only a patch on a broader wound that has affected many livelihoods and shuttered many businesses permanently. The new Presidential administration has allocated trillions to additional stimulus measures, with the unintended consequence of potential conflicting interests of millions of unemployed persons and cautious small business owners wondering about the sustainability of their craft beyond the mid-pandemic era.

ECONOMIC BACKDROP

The complete shutdown of the economy in 2020 has led to economic growth comparisons that the US hasn't seen in decades. The 1st quarter of this year saw US real GDP expand by 6.4%, accelerating from the 4.3% experienced in the 4th quarter of 2020. The expansion is expected to continue throughout 2021, with estimates for full-year GDP growth ranging in the mid-to-high single-digits. High levels of liquidity and pent-up demand have led to rising prices for commodities including energy, building materials, and even food. The personal consumption expenditures (PCE) price index, the Federal Reserve's ("Fed") preferred gauge of inflation, has increased by even more than would be expected when compared to last year, with the latest reading for May reaching 3.9%. The PCE being nearly double its



Source St. Louis Federal Reserve (FRED).

target has led economic observers to start speculating as to when, and in what capacity, the Fed may start to remove the monetary punchbowl of essentially 0% interest rates and monthly asset purchases of $120B.

Some believe that any tapering would start with the $40B in monthly purchases of mortgage-backed securities, as price increases have been particularly apparent in the housing sector. The pandemic has caused an abundance of re-evaluation of people's home lives, with many making the decision to move to the suburbs. Housing supply has been a particular issue for years but the pandemic had led to a shortage of building materials, such as lumber, and a shortage of labor. Low interest rates have helped with some affordability issues, though some reports have stated that financial institutions have begun to tighten lending standards amidst a boom of multiple-offer sale scenarios in many US markets. S&P CoreLogic Case-Shiller reported an obviously unsustainable 14.6% year-on-year increase in US home prices for April, so letting some air out of the balloon may be a good thing, but any significant correction in the housing market could dent consumer confidence and lead to obvious problems for the over-levered. The commercial property market is murkier, with some businesses choosing to move to indefinite remote work, depending on the industry. Some in the retail and restaurant industry have thrown up their hands and closed their doors, while others look to reduce their footprint. Others have benefitted from an abundance of liquidity access, choosing to give aging buildings a new face-lift or re-design according to public health best practices. This is likely to continue, with mall operators in particular getting creative with unused spaces.

Most businesses have realized that they've had to adapt to the new normal by embracing all things digital, which has created a boom in demand for all types of online services. From payment processing to logistics, the interconnectivity has driven a surge in demand and shortage of computer chips which have exposed supply chain weaknesses. Supply related price increases are expected to be transitory, however, which is why the Fed is not expected to move drastically to reduce inflation fears. Fiscal and monetary authorities are hoping that inflation comes in the form of higher wages for workers so that a steady but gradual increase in prices manifests in a sustainable manner. As it stands now, the official US unemployment rate is still 5.9% and likely understated due to the drop in the workforce participation rate since the start of the pandemic. Many of those people are in danger of getting left behind, especially if prices for basic goods continue to rise. News of a bipartisan agreement on infrastructure helps to improve prospects, assuming the bill eventually gets passed, even though the agreed-to outline is much slimmer and more-focused on traditional infrastructure than the one initially proposed by Democrats. A second piece of legislation is in the works which focuses on climate change and social programs, dubbed "human infrastructure", and is expected to be forced through by the reconciliation

process. Some are also expecting yet another pandemic relief package later this year, which may be necessary given the likelihood of a seasonal re-emergence in US COVID-19 cases in the fall and winter.

Overall, at Hanlon we believe the worst is definitely behind us as it relates to the pandemic and the economy, and that the US and many of the global economies are positioned for a robust, broad-based and durable economic recovery, of course not without its trouble spots here and there.

US EQUITY

The explosive growth in US large-cap technology sector revenue last year led to some frothy conditions in certain momentum areas of the market in late-2020. Rising interest rates in the 1st quarter of 2021 played a large part in the segment's year-to-date (YTD) underperformance, since highly priced companies with little or negative earnings are in fact long duration assets. Instead of this dynamic taking down the broader market, a rotation into underperforming value sectors signaled participants expected for the strength in the market to broaden out. They were right, as all the major sectors of the S&P 500 Index, except real estate (60%), had at least 75% of their constituents beat consensus 1st quarter earnings estimates, according to S&P Dow Jones. Interestingly, this did not stop the real estate sector from outperforming all the other sectors outside of energy and financials through the 1st half.

Financial sector equities have performed well, so far, benefitting from historically reasonable valuations, sizable dividends, and the steepening yield curve potential for boosting operating margins. Notable is that banks are in the best financial shape they have been in for decades, as evidenced by the recent regulatory stress test results, which were so good that many government-imposed limitations on dividend and share buybacks have been relaxed and even eliminated.

Small-cap equity indices such as the Russell 2000 benefitted from being more equally weighted amongst the sectors, outperforming the large-cap S&P 500 thanks to a higher weighting to value-like sectors and financials. The Financial Select Sector SPDR ETF (XLF) gained 25.5% while the SPDR S&P 600 Small-Cap ETF (SPSM) gained 23.4% YTD, through June 30th.

The energy sector has been on fire this year, with energy prices rising on the back of increasing global demand amid hamstrung domestic supply due to the broadening push to move to a more sustainable energy path. The largest energy companies have benefitted from this due to de facto limitation on oil upstarts increasing the value of current infrastructure, given the likely underestimation of the traditional energy runway and overall likelihood that they will play an outsized roll in whatever the future of energy production looks like. The Energy Select Sector SPDR ETF (XLE) is up over 45.1% this year, well outpacing the 15.3% of the broad S&P 500 Index.

INTERNATIONAL DEVELOPED MARKET EQUITY

Developed markets (DM) had kept pace with US large-cap until mid-June, notably lagging as European and Japanese real GDP slipped back into contraction during the 1st quarter of this year. The Eurozone recovery has suffered from fits and starts of COVID-19 measures, with the latest lockdowns having ended only recently. Earnings forecasts have continued to improve, however, with both 2021 and 2022 estimates rising as the ECB continues its emergency measures to subsidize any potential liquidity concerns.

Japanese markets ended June just under multi-decade highs despite uncertainty regarding rising COVID-19 case counts prior to the start of the delayed Olympic games. An expiring state of emergency is hoped to unleash a surge of pent-up demand for the Japanese consumer, who have an aggregate glut of savings. The sluggish economic rebound and measured inflation levels running below target has given the Bank of Japan the leeway to continue its large stimulus program.

Broad DM equities benefitted from the expansion of global liquidity and broad investor rotation into value sectors, as the asset class tends to offer higher dividends at relatively modest valuation levels. The iShares MSCI EAFE ETF (EFA) had a solid gain of 9.6% YTD, through June. The underlying index is trading near 16.5x expected forward earnings per share.

EMERGING MARKET EQUITY

Emerging markets (EM) have lagged their developed market peers YTD, with the asset class dominated by the performance of its largest constituent, China. Real GDP growth in China has trailed off since the initial and early recovery from the worst of the pandemic's economic effects. The 2.3% increase for the 1st quarter reflects the country's reigning in of emergency programs and the broader credit impulse in the central planners' efforts to avoid any potential economic overheating. Relations between the US and China have not improved despite recent dialogue, as a top-to-bottom review of policies toward China is still underway regarding, among other things, the effectiveness of the Phase 1 trade agreement. The new US administration has framed the argument less about the fine details regarding trade, however, and more about a fundamental divide between the basic principles of autocracy versus democracy. It remains to be seen if there will be a break from historical economic policy or if the concerns only go as deep as political messaging, but the rubber is starting to hit the road in terms of technological privacy. The implication is that a business manager's choice of software deciding which global power you are comfortable having potential backdoor access to your company's data.

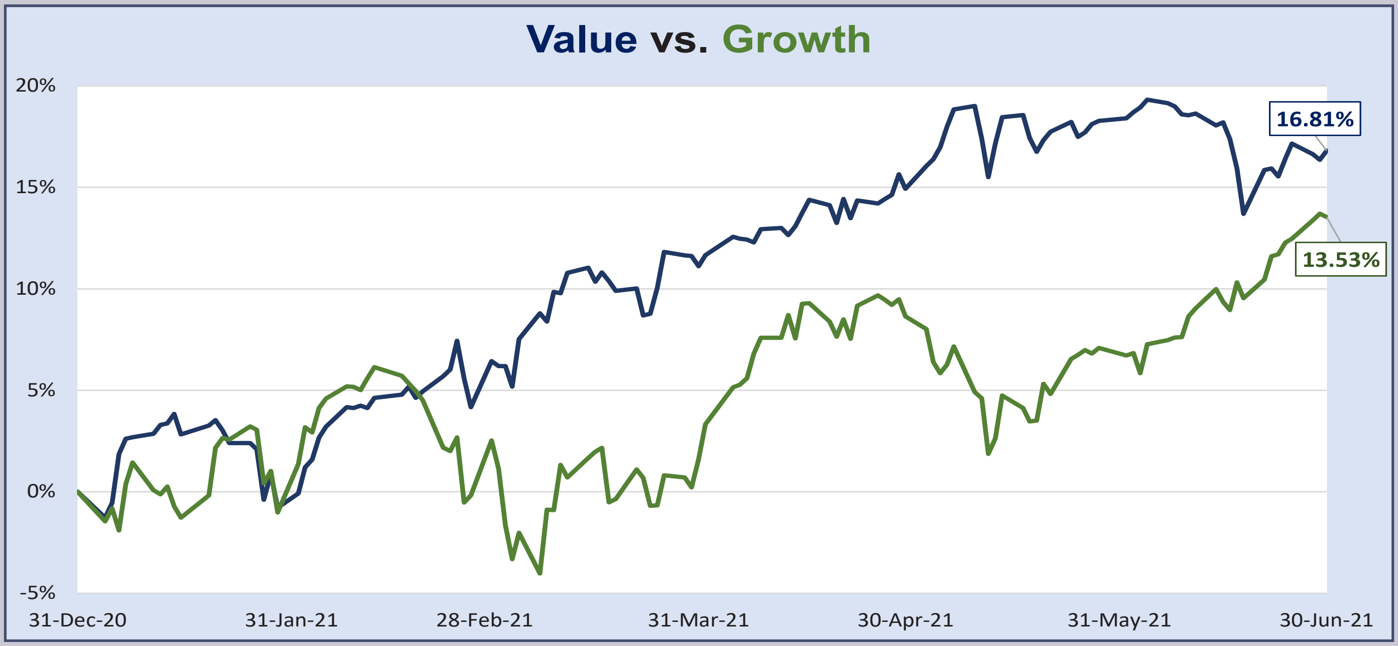


Chart created by Hanlon with data provided by Investors FastTrack, using Vanguard Value ETF (VTV) to represent value and Vanguard Growth ETF (VUG) to represent growth.

Other major EM countries have continued to struggle with controlling COVID-19 due to lack of access to vaccines, sub-standard healthcare infrastructure, as well as seasonal considerations. In India's case, a delayed broad surge in cases caught the nation by surprise after thinking that they had avoided the worst of the pandemic. Also, as Asia's second largest fuel importer, high energy prices have cut into fragile consumer budgets and hampered India's burgeoning middle-class.

The iShares MSCI Emerging Markets ETF (EEM) has increased by a solid, but underperforming, 7.2% for 2021 through June 30th.

FIXED INCOME

Broad bond markets have struggled through the 1st half of this year, but mainly during the 1st quarter, as broadening optimism for growth and inflation led to rising interest rates and the increased risk of an abrupt sell-off for long duration investments. The yield on the 10-year US Treasury Note nearly doubled from 0.91% at the start of the year, to a late-March peak of 1.75%. This was a substantial move, considering the Fed was still active in purchasing across the yield curve, and led to speculation as to whether they would employ some sort of yield curve control due to the de facto tightening of financial conditions. The 10-year yield would settle near 1.47% by the end of June, however, as the surprisingly hawkish forecast of two interest rate hikes by 2023 from the Fed's June meeting brought in long-bond demand from skeptics about monetary policy efficacy facilitating a continued bullish steepening of the Treasury yield curve. Basically, market participants began to think the Fed would choke-off the economic recovery, and therefore they saw the potential for a recession and thought long bonds were cheap at current yields and drove the yield down.

Corporate bonds have fared better than Treasury bonds, with those with higher yield spreads such as high yield bonds outperforming due to less exposure to duration risk. Spreads have continued to tighten so far this year, as fears of credit risk waned inversely of risk asset prices. Broad investment grade corporate bonds had returns between those of high yield corporates and Treasury bonds, as the iShares iBoxx US Investment Grade Bond ETF (LQD) closed June with -1.8% for the year so far. The iShares US High Yield Bond ETF (HYG) gained 2.6% during the same period, compared with the -7.9% return from the long duration iShares 20-year+ Treasury Bond ETF (TLT). The yield curve started to flatten again after the last Fed announcement and should be telling as to whether the market thinks the monetary authority will be able to both keep the recovery on a sustainable path and not tighten policy too quickly.

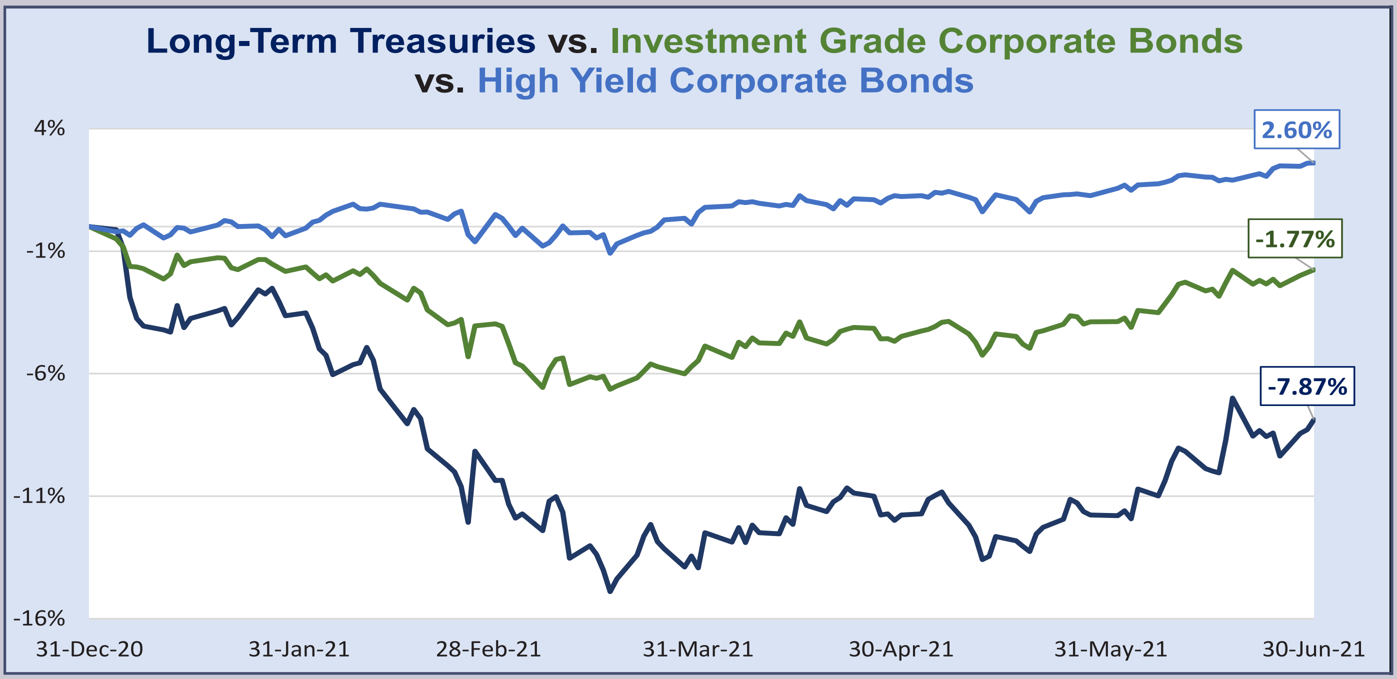


Chart created by Hanlon with data provided by Investors FastTrack. Long term (20+Year) Treasury Bonds represented by iShares Long Term Treasury ETF (TLT), Investment Grade Corporate Bonds by iShares US IG Corporate Bond ETF (LQD), and High Yield Corporate Bonds by iShares US HY Corporate Bond ETF (HYG).

COMMODITIES AND ALTERNATIVES

Raw inputs have had a strong start to the year thanks to extra liquidity accelerating the rebound in demand for goods after the lost year of 2020. The broad supply of commodities was also curbed during the shutdown, due not only to uncertainty but pandemic safety operational and logistical issues that were not easily reversed even as the global economy began to emerge from the strictest lockdowns. The price for lumber, for instance, has had a wild ride since starting 2020 near $400 per thousand board ft and rising close to $1,700 in mid-May 2021. It has fallen precipitously since then, closing June near $715, but is still roughly 75% higher than the beginning of 2020 despite now being lower YTD. Other industrial commodities, such as steel and copper, are also up significantly since the pandemic with substantial gains in 2021. The broad Refinitiv/CoreCommodity CRB Index is up by just over 27% YTD.

Oil prices, as previously mentioned when discussing the energy sector, have been in a steady uptrend YTD. Though oil has benefitted from the rebound in demand, the supply factors are more idiosyncratic than the broader supply crunch of raw materials. Beyond the self-imposed production cuts from the members of the Organization of the Petroleum Exporting Countries (OPEC), the environmental push by governments and financiers have made traditional oil infrastructure investments almost unviable, thus creating upward pressure on current prices. Predictions for the pressure to maintain or increase are widespread as the demand for oil and oil-based products increases with the rebound in global demand.

FINAL THOUGHTS

Now that future earnings expectations have largely caught up with broad market prices, much of the underlying economic forces have been heavily supplemented by unprecedented amounts of monetary and fiscal support. These responsible authorities are looking to reduce these unsustainable efforts but not do so in a way that renders those earlier efforts moot in the end. We do not know what success in that endeavor looks like, but we suspect that while authorities have in recent history proven to be a successful backstop in thwarting systemic breakdown, that bouts of volatility will surely occur with sometimes surprising levels of amplitude. We at Hanlon will be diligently patrolling the marketplace for signs of distress and attempt to tactically combat sources of consequential risks of all sizes of probability.

Now, as we move forward beyond the darkest days of the pandemic, it is good to take stock of those things that are most important. Time with our friends and family should under no circumstances be taken for granted, whilst let us not underestimate the profound impact that our sincere respect and empathy for others can achieve. We can challenge ourselves to embrace the fragility of our lifestyle or even life itself, not as some bleak perspective, but as a cheerful reminder of our great fortune to be able to take it all in.

Thank you, as always, for the opportunity to let us serve you.

Sincerely,

Sean Hanlon, CFP®
CEO and Co-Chief Investment Officer

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