EQUITY MARKET UPDATE

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February was a positive month for stocks; however, the back half of the month was filled with volatility as bond yields rose to their highest levels in a year. Economic data continued to show the economy is primed for recovery as vaccines are administered and stimulus checks are spent. Manufacturing data remains red hot, while production delays are lengthening due to supply chain disruptions. The biggest debate on Wall Street as we enter March is how much inflation will be generated as the economy reopens, and what effect will it have on stock valuations.

Economically Sensitive Stocks Boost US Markets

The S&P 500 gained 2.76% for the month. The index was powered by the energy and financial sectors which advanced 22.66% and 11.49%, respectively. A big drop in Apple and Tesla dampened results. Year-to-date, the index is up 1.71%; however, 52% of the return is attributable to gains in Alphabet and Microsoft.

The Dow Jones Industrial Average increased 3.43%. Large gains in Goldman Sachs and Caterpillar accounted for half of the return. The index is up 1.41% thus far in 2021.

The NASDAQ was the weakest performer in February, gaining 1.01%. Investor appetite for value over growth hurt the index. Like the S&P 500, the biggest detractors were Apple and Tesla.

Mid and small-sized companies once again saw the best results. The S&P 400 Mid-Cap Index increased 6.80%, while the S&P 600 Small-Cap Index zoomed 7.65%. Both indexes continue to benefit from a rotation towards more economically sensitive stocks that historically do well in the early stages of an economic recovery. Thus far in 2021, mid and small-sized companies are up 8.41% and 14.42%, respectively.

Foreign Stocks Also Increase

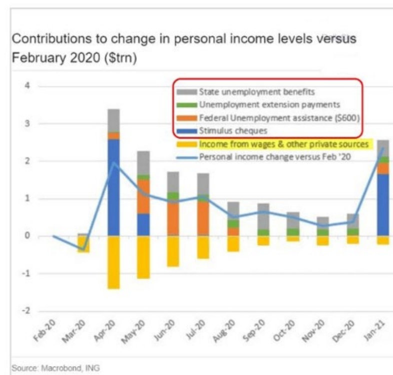
The MSCI EAFE Index advanced 2.27%. Investors were excited by better than expected GDP figures in the Eurozone. The results were led by Germany, which saw solid construction activity and an increase in demand for exports. Markets also cheered the Italian government for naming former ECB chairman Mario Draghi as Prime Minister. The biggest obstacle to recovery in Europe remains combating COVID-19. Vaccination efforts continue to be sluggish, so restrictions will likely remain in place until at least mid-March. Year-to-date, the MSCI EAFE Index has gained 1.19%.

The weakest return in February came from the MSCI Emerging Markets Index, which was up 0.77%. Chinese PMI softened again; however, figures remained in expansionary territory. It is important to note the data includes the Lunar New Year, so China will likely see a pickup in activity in March. Emerging market stocks continue to outperform US large cap indexes year-to-date with a total return of 3.78%.

FDA Approves 3rd COVID-19 Vaccine for Emergency Use

Johnson & Johnson's COVID-19 vaccine received approval for emergency use. The company plans to deliver 20 million doses by the end of March and 100 million doses by June. This news comes on the heels of Pfizer and Moderna boosting their production levels. President Biden says the United States will have enough vaccines for every American by the end of May. This is similar to the UK's announcement of every citizen being able to get at least one dose of vaccine by July. The healthcare industry's ability to ramp-up production is fueling market speculation that mobility controls will be relaxed soon, which should lead to an economic acceleration in the 2nd half of the year.

Vaccines Plus Improving US Economic Data Leads to Inflation Debate



Data showed US Personal Income jumped 10% in January because of stimulus checks and enhanced unemployment benefits. This resulted in retail sales increasing by 5.3%, significantly above the consensus estimate of 1.1%. Spending was positive in all 13 categories with department stores, electronics, appliances, furniture, and e-commerce seeing the strongest results. Consumers increased appetite for goods boosted the US manufacturing ISM index to 60.8, its strongest reading since February 2018 with healthy gains in new orders, production, employment, and exports. Supply chains remain stressed, so the prices-paid component sits at its highest level in 13 years. Service data is also at its highest level since 2015.

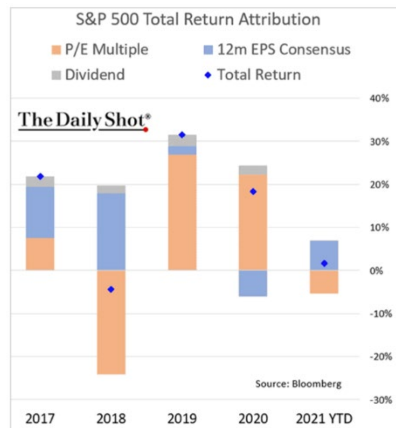
What really captured investors' attention is data showing the savings rate has skyrocketed to 20.5% of disposable income from 13.4%. This means consumers have plenty of dry powder to spend as lockdowns ease. It also raises serious questions about the wisdom of another giant stimulus package, and whether inflation may be running hotter than the Fed is advertising. Jerome Powell told the US Senate Banking Committee that inflation will pick up in coming months as the economy reopens, but the Fed does not foresee it getting to "troubling levels." He reiterated that interest rates will be kept at 0% until the end of 2022 at the earliest, and the Fed will continue purchasing $120 billion in assets each month "until substantial further progress" has been made in the unemployment rate, which he claimed is "still a long way" away.

Better than Expected Earnings, Along Late Month Sell-Off, Lowers PE

The market closed the books on another earnings season that saw 79% of S&P 500 companies beating the consensus estimate for profitability. This was the third highest percentage beat in history, and it showed how resilient corporations have become at managing through crisis. Year-over-year earnings grew 3.9%, which marked the first annual earnings gain since the 4th quarter of

2019. To put these numbers into context, analysts were expecting earnings to decline by 9.4% at the beginning of earnings season.

Better than expected profits mixed with improving economic data, increased vaccination efforts, high consumer savings, and the potential for additional stimulus sparked a rally in long-term interest rates with the 10-year US Treasury hitting its highest yield since pre-COVID. For months, I have been writing about the market needing interest rates to remain low to justify the valuation in many high-flying growth stocks. The quick run-up in rates during the second half of February led to increased volatility in the stock market. From February 12th (the date of the personal income and retail sales data) until month-end, the S&P 500 declined 3.07%. When digging deeper into the numbers, growth stocks lost 5.57%, while value was flat. I have mentioned in my last several letters that the spread in valuation between growth and value stocks in future earnings forecasts is near the widest level in history; therefore, the rotation trade has room to run if the vaccines prove to be effective and the economy heals.



Increased profits and a late month sell-off caused the S&P 500's PE ratio to tick down slightly to 21.52x forward earnings estimates. If you fast forward to the 2022 and 2023 profit forecasts, the index trades at 19.26x and 17.33x, respectively. All these valuations are well above the historical median of 15.84x.

All these indicators signal the market has baked-in much of the upcoming improvements for the economy; therefore, stocks are vulnerable to further consolidation or pullbacks in the next few months. We expect volatility to remain high as we enter the full reopening of the economy.

Our Outlook & Strategy

Our outlook remains unchanged. We believe the effects of COVID-19 will linger well beyond the time in which the virus is contained; therefore, the new "normal" will look much different than the world we saw prior to the virus. First, we have accelerated the time frame on the use and adoption of mobile technologies for education, shopping, entertainment, etc. We have also adapted to a non-centralized workforce. This will put pressure on commercial real estate values as office footprints and the number of retailers shrink. Next, companies across a wide range of industries have seen the risks associated with having too much manufacturing capacity centralized in China. There are likely to be serious conversations in board rooms across the US and Europe on whether several regional points of manufacturing are better for business and political relations than supplying the entire globe with products from a single country of origin. We have seen a push by both the Trump and Biden Administrations to encourage more domestic manufacturing of semiconductors, medical equipment, and other items deemed to be of national security importance. A shift from the current model will have significant ramifications for the future growth of the Chinese economy, along with the cost of goods and services sold. We believe future healthcare spending will increase as we replenish healthcare supplies used during the pandemic and boost R&D to solve other illnesses. Finally, these structural changes, along with the large stimulus responses and government deficits will result in central banks wanting to keep 0% interest rates in place for a very long period.

Given these various scenarios, along with above average valuations, we remain highly selective about which stocks to own. Our portfolios are currently utilizing a barbell approach in which we are overweight companies benefitting from long-term secular trends in technology and healthcare, while also owning financially strong cyclical stocks that can produce top-line revenue growth and sustainable cash flows during the next economic cycle.