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While today's high valuations by definition mean prospective returns are low, the promise of endless easy money and an improving economy continue to pressure market participants to dismiss the traditional valuation measures that historically dictate price behavior. Despite the fact that the disconnect between prices and earnings is at its most extreme level in history, it's become increasingly difficult for investors to defer to prudence as they look around at the incredible gains achieved by those who have thrown caution to the wind.

Market leadership remains concentrated among a handful of stocks which depend on intangible assets and double-digit growth expectations as far as the eye can see. It's never been more acceptable for public companies to forego current profits in pursuit of a larger prize down the road, and so the line that distinguishes winners from losers based on earnings power and cash flow generation has effectively disappeared. The momentum behind the mega-cap technology stocks has been largely driven by two factors: 1) the notion that underlying companies are so good that nothing bad could ever happen to them, and 2) massive flows into passive equity funds, which enable these names to command a disproportionate share of major stock indices. This past week, Facebook, with its grow-at-any-cost culture became the fifth company to join the $1 trillion valuation club, underscoring the incredible influence of this small set of stocks.

Taking a broader view of recent market activity, the beginning of the second quarter marked what could ultimately be the peak of a relatively short-lived inflation trade which began last summer and was reflected by the outperformance of cyclical, low-quality equities that were poised to benefit the most from an economic recovery. The rotation towards deep value in sectors such as hotels, restaurants, and airlines temporarily put an end to a decade-long dominance of groups which investors tend to prefer in periods of low GDP growth and suppressed interest rates: growth-oriented tech names, and to a lesser extent the defensive groups that make up the bulk of our portfolios. We are now seeing this theme unwind.

Although we would not be surprised to see sporadic revivals in the inflation trade as the year unfolds, as nothing ever happens in a straight line, we continue to believe that our current "3-D economy" (defined by debt, demographics, and digital disruption) is inherently disinflationary. Supply chain bottlenecks driven predominantly by government-incentivized labor shortages are not going to be enough to bring about a new era of inflation reminiscent of the 1970's. Vivid images of the traffic jam of container ships off the coasts of Oakland and Long Beach have fed the inflation narrative but are a prime example of acute disruptions that will be nothing more than short-term phenomena.

Indeed, there are certain sectors that will take years to build back the capacity needed to meet demand that was pulled forward by the evolution to a more stay-at-home lifestyle, but these are exceptions and not necessarily indicative of broad dynamics. The CEO of Intel recently indicated it would take multiple years for the semiconductor industry to meet the surge in demand for chips in the automotive sector, given the amount of time it takes to bring a new foundry online. Elsewhere, the price of oil has also been marching higher as the lack of E&P investment over the last decade is beginning to skew the supply/demand balance that's kept oil prices range-bound in recent years.

During the second quarter various segments of the market began to sniff out the fact that the "inflationista" trade may have gotten ahead of itself. Lumber prices have fallen 50% from their peak, the 10-year Treasury yield has retreated to 1.47%, copper has fallen by 10%, corn and soybeans by 20%, and many stocks in the highly-cyclical materials group have also dropped significantly. In the financial sector, banks have been using their bloated balance sheets to gobble up treasury bonds while their outstanding credit exposure to households and businesses has been in steady decline. Looking at corporates, share repurchases have returned in a big way, highlighted by Apple's recent announcement of a fresh $90 billion buyback program. And finally at the household level, savings rates, calculated as a percentage of disposable personal income, seem to have found a bottom at 12%, well above the pre-pandemic level of 7%. When looked at together, these trends are far from supportive of a pro-cyclical, inflationary position.

If in fact we are returning to a muddle-along economy, the question becomes how to position oneself for investment success. The consensus belief is that the technology sector is the obvious beneficiary when inflation concerns and growth expectations recede, under the notion that investors reach for secular growth in periods when broad economic growth is non-existent. It may well be true that the market hasn't fully priced in the growth potential of the high flying technology names, but the success of these stocks remains pinned to outsized growth well into a distant future of which we have very little visibility.

In our view, on a risk-adjusted basis the healthcare sector is the most attractive way to play the rotation out of economically-sensitive, inflation-linked assets. The group has lagged

the S&P 500 by roughly 20% since the market hit a bottom in March of last year, and even though the sector accounts for 19% of profits in the S&P 500, its weight within the benchmark has fallen to below 13% — the lowest level since 2013. To put it simply, there's a large disconnect between the earnings power of this cohort and its performance.

Part of the reason the sector has underperformed is the Biden administration and Congress have made it clear, with rhetoric, they want healthcare prices to be reined in for average Americans. This has been a longstanding message from Democratic leaders but the reality is there's been no actual policy proposed that is cause for major concern in the industry, and to the extent the pharma industry may have to help pay for an infrastructure bill in some capacity, we think the risk has largely been baked in.

Looking beyond the overhang of political risk, the tailwinds for the industry are massive. Aging demographics and growing demand for improved medicine, diagnostics, and wellness will undoubtedly drive higher healthcare spending over the long-term. On a shorter-term basis, the industry should benefit from consumers resuming routine check ups and elective surgeries as the reopening progresses. Finally, it must be said that the pandemic is not, unfortunately, in its last throes. Hundreds of thousands of new cases of Covid-19 are still appearing daily, along with a steady flow of new variants of the virus, some of which could reverse the progress made with existing vaccines and diagnostics.

Investing can be defined as positioning capital so as to profit from future developments. The challenge lies in not knowing what the future will bring. In a low-growth, low-return world we prefer to bias our portfolios towards secular growth, tangible value and income-generation. In our view, these qualities are best exemplified in the health care group.

We hope everyone's summer is off to a wonderful start. As a reminder, we are all happily back in the office and are looking forward to meeting with many of you in person, for a welcome change, in the coming months.

Peter C. Hatfield, CFA®, CFP®

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