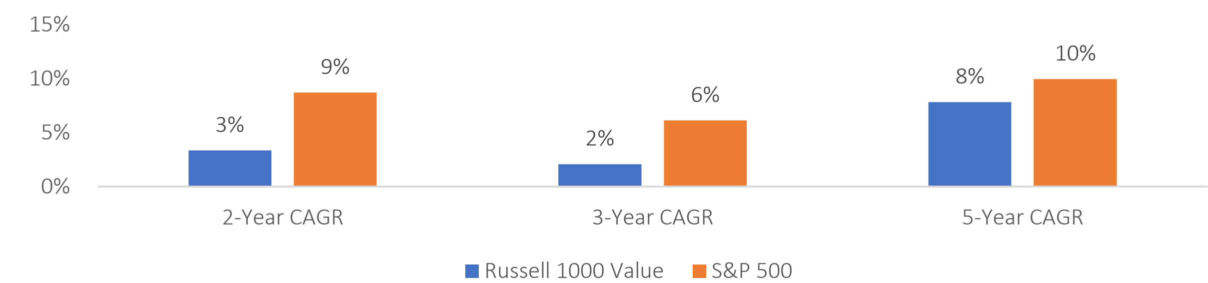
July 2021

Over the last year and a half, there was a singular question for investors and non-investors alike: **Will the world recover?** While recent COVID-19 variants have added some uncertainty overseas, that question appears to have been answered here in the US, with a population over half of whom are vaccinated, air travel above 2019 levels, and an economy that has excess demand rather than the alternative. The expected 2021 EPS growth rate of the S&P 500 is +37% and +46% for the Russell 1000 Value. On a 2-year CAGR, those are +9% and +3%, respectively.

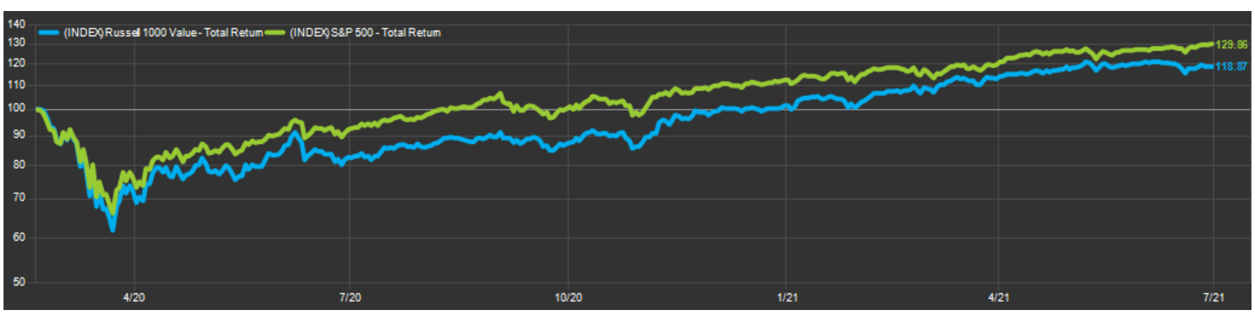
Consensus Estimated EPS Growth by Index Through CY2021



Source: Factset, Cornerstone Investment Partners analysis

Less than 20% of companies in each of the S&P 500 and Russell 1000 Value indices had 2021 EPS estimates revised downward YTD. Coincident and leading indicators continue to be strong. And the S&P 500 and Russell 1000 Value indices are up 30% and 19%, respectively, since before the pandemic drawdown in February of 2020.

Total Return for the Russell 1000 Value and S&P 500 Indices Since 2/19/21



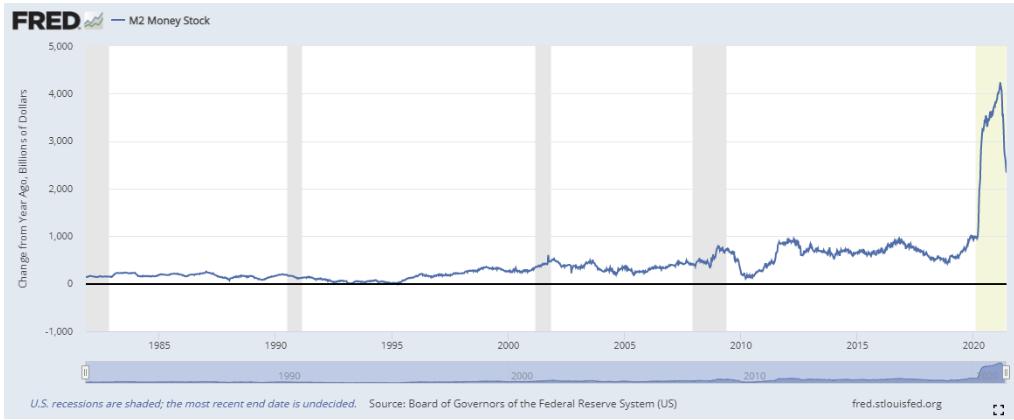
Source: Factset

Without this existential question affecting investors both professionally and personally, what's next? Since nature abhors a vacuum, the market is spontaneously generating a narrative to try to explain what is going on.

Given that inflation is the narrative that has been most on our minds, perhaps that first question needs to lead to another: **Is the world recovering too quickly?** With demand back and supply constrained, inflation has certainly returned. Regardless of whether inflation is transitory, companies in our portfolio have actively discussed the impact of rising goods, transportation, and labor costs on their operations. Many are raising their own prices in response.

Inflation is often considered a macroeconomic topic, but particularly today, it's both a macroeconomic and microeconomic issue. The pandemic cut demand and increased uncertainty significantly. At the macro level, the US Federal Reserve's response to the period of sustained low interest rates and significant influx of money supply created an environment that made higher prices more likely.

__Change in M2 Money Stock__



Source: Federal Reserve Bank of St. Louis

At the micro level, many companies made the rational (at the time) decision to cut production capacity and fixed costs. However, demand recovered more quickly than people expected, and when demand outstrips supply, prices inevitably rise.


The New York Times

How the World Ran Out of Everything

Global shortages of many goods reflect the disruption of the pandemic combined with decades of companies limiting their inventories.

Source: The New York TImes

Supply has proved to be harder to increase than it was to decrease. A great example of this is rental cars, as the operators sold off their fleets to shore up balance sheets, presuming a more protracted downturn. Instead, as leisure travel has returned quickly, consumers have seen prices triple. Processed lumber costs similarly rose on the back of construction demand and sawmill shutdowns. Semiconductor chip constraints have impacted industries as disparate as cars and refrigerators. These are admittedly the extremes, and over time, increased capacity will drive these goods markets to equilibrium again, but the eventual base price remains unknown.

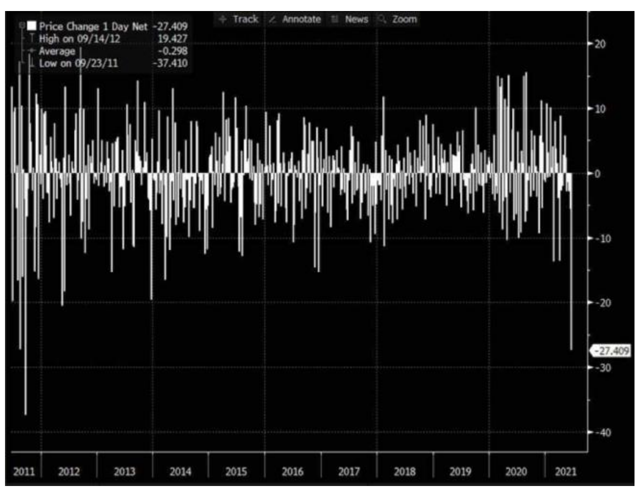
Labor costs have also increased, with supportive stimulus payments and unemployment insurance, combined with demographic shifts towards a desire to work from home, limiting the ability to fill many jobs, particularly in blue-collar and hospitality industries. $1,000 or even higher signing bonuses at fast food restaurants are not unheard of.

Source: Wall Street Journal

The sunsetting of some of these policies will encourage increased labor supply, but near-term trends are not supportive. Of course, like goods markets, increased availability of remote work reduces frictional costs to both employers and employees, possibly reducing wage costs but increasing attrition. We explored this topic and the positive impact of inflation on value-oriented stocks back in the fall, and the performance of our style was unsurprisingly strong while this was top of mind.

The Fed has a dual mandate: full employment and stable prices. To protect the employment side of its charge, the Federal Reserve had just last year suggested that they would evaluate inflation over a path, rather than simply a single point in time. This led investors to anticipate the risk that inflation would overshoot, as the Fed would be more accommodative to growth in the economy. We have seen this with a steeper, more normally-shaped yield curve, as longer-duration risk reasonably required a higher rate of return to make up for it. However, with just a few governors implying that interest rates could rise just a little bit in 2023, the market suddenly changed its tune during the June meeting. Long rates fell as the fear of unchecked inflation magically disappeared, and the curve flattened faster than it has done in a decade.

Weekly Change in the 30-Year / 5-Year Treasury Yield Spread



Source: Bloomberg

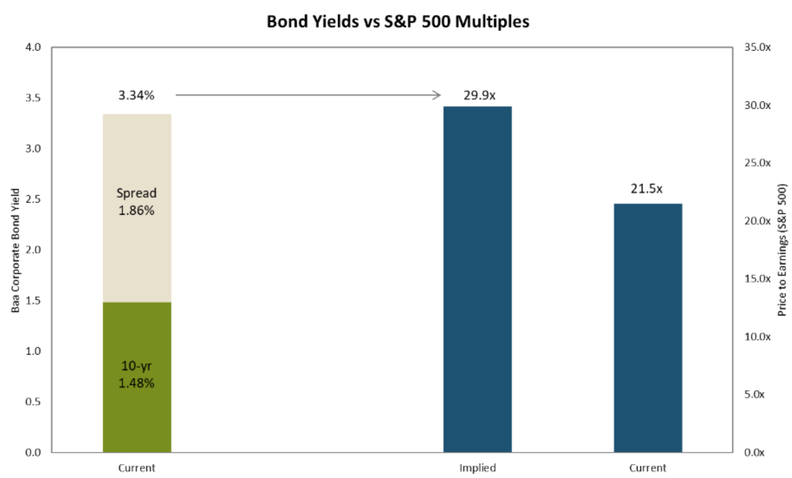
In response, Growth stocks' lower presumed discount rates and terminal values again took over the market. Overall, the Russell 1000 Value rose 5.2% for the quarter, while the S&P 500 was up 8.6% as growth-oriented companies diverged from the broader market in June.

It's not just central banks making a significant impact on markets, but central governments as well. The Biden administration has (not unexpectedly) taken several steps, including executive orders and personnel decisions, that suggests it will take a much more active role in regulating and managing corporate strategic actions. China has recently punished some of its most prominent technology companies, seemingly trying to make it harder to list overseas. And in the face of domestic oil and gas investment uncertainty from both government actions and ESG activism, recent OPEC discussions are driving the commodity markets.

It has never been more important than it is today to focus on stock selection. Even with the market uncertain of itself, valuations are inexorably rising upwards. Traditional forward valuation metrics like price/earnings, dividend yields, price/book, and price/cash flow are more than one standard deviation above their 25-year averages. Our Fair Value Model suggests our 800-stock universe is 15% overvalued, the highest level since the early 2000s, and there are less than 325 companies below their Fair Value, a conservative estimate of intrinsic value.

But equities remain less expensive than bonds and adjust to inflation in ways that bonds cannot.

Comparison of S&P 500 P/E and Implied P/E Multiple of Baa Corporate Bonds



Source: Cornerstone Investment Partners, Federal Reserve Bank of St. Louis

We know that today's perceived certainty in a market that should be more uncertain can be frustrating, but it is times like these that active equity management should distinguish itself. Unlike passive indices that are effectively momentum factor portfolios with a significant weighting to a few mega technology-oriented companies, Cornerstone can choose the stocks we own for clients, identifying those with embedded characteristics and business models that can respond well to inflation, regulation, and other risks. More importantly, we can choose among the stocks that trade at attractive valuations using our Fair Value Model that has an almost 35 year history through a range of market environments.

Please feel free to reach out – we'd love to discuss the market and our portfolios with you.

Sincerely,

The Cornerstone Investment Partners Team