BLUE GRANITE CAPITAL, LLC

INVESTMENT COMMENTARY, JULY 2021

We hope you are enjoying your summer as life returns to a more normal pace.

Coming off the best first half for equities since 1998, there are a few facts worth noting. The S&P 500 Index has gained 98.28%, and the tech-heavy NASDAQ is up over 113% since the March 23, 2020 market bottom during the pandemic shutdown. Under any set of economic cycles, these are spectacular returns. In most 'normal' market cycles when GDP is growing at a reasonable level, stocks have always experienced significant corrections of more than 10%. However, this rally from the pandemic lows has been swift and unrelenting. We are still in the camp that stocks will pull back from their significant gains due to historically high valuations and a less than stellar sustainable growth outlook. Any pullback is generally healthy for the stock market as it removes excessive speculation and hits the refresh button to resume steady growth more correlated to the economy.

Over the past quarter, the Federal Reserve has received tremendous attention regarding their views on inflation. The June report for the Consumer Price Index (CPI) showed inflation has risen 5.4% year-over-year. This was the highest recorded CPI reading since 2008. Echoing that data, the Producer Price Index (business price inflation) is up 7.3% from a year ago. The Fed is sticking with their analysis that current elevated inflation readings are 'transitory' and will normalize. The crux of their inflation thesis is that prices are being compared to last year's depressed readings coupled with a surge in demand, temporary supply chain disruptions, and a labor shortage. We'd suggest however that the temporary inflation will last for an indeterminate amount of time. Further, higher prices for food, gas, and many other items (including the red-hot housing market, and new and used cars) hurt our pocketbook regardless of how long or short inflation lasts. Perhaps the most significant economic reading is the high level of job openings (8 million at last report). Employers may be forced to elevate wages to fulfill staffing needs. The resulting increased labor costs lead to higher corporate costs and are eventually passed on to the consumer. This is only one example of why inflation may persist: once a worker is hired at higher wages, it's unlikely their compensation could be reduced once inflation has subsided. The real issue is the Fed's timeline for 'transitory' if they believe inflation is artificially high and will ultimately normalize as we hit full employment and GDP growth settles back to more normal levels.

Why does all this matter? Because rising prices will compel the Fed to both hike rates and taper their extensive bond buying programs to combat inflation. Despite their transitory stance, the Fed has already telegraphed their inflation concerns with plans to raise rates one year earlier than originally planned in 2024. We think they should act sooner because 'temporary' inflation still impacts current purchasing power and is a detriment to economic growth. Perhaps the most troublesome aspect of the inflation story is that interest rates tend to rise while slowing the borrowing that normally fuels economic growth. Higher interest rates also attract bond investors as credit yields rise, and the upward trajectory of the stock market could come under pressure.

That said, as we are always hunting for value in high-quality stocks, we believe a pause in the equity markets would be helpful over time and beneficial for your long-term returns as the economy, inflation, and Fed policy realign. Further, a temporary pullback in equities shakes out heightened levels of speculation which are disruptive to healthy stock market cycles.

Regarding the current state of stock market indices; Apple, Microsoft, Amazon, Google, & Facebook, comprise nearly 22% of the S&P 500 Index. That level of concentration adds considerable portfolio risk for the average investor should they drop in value, because these stocks have similar weightings in so many index funds and mutual funds. As we go to press, President Biden signed an executive order aimed at these Big Tech companies, claiming they wield too much power and engage in anti-competitive practices. This executive order could rattle the major tech companies and negatively affect the entire technology sector.

In contrast, these 5 stocks comprise less than 15% in our average Blue Granite client portfolio. We are very comfortable with a reduced technology weighting which has provided our investors with steady returns while lowering downside risk and portfolio volatility. Nothing goes up forever, and the aforementioned 'gang of 5' tech stocks could fall from grace. We're mindful of the opportunities that we find in overlooked stocks and sectors and confident that capital will aggressively flow into these best-in-class, dividend-paying stocks as they rally.

As we begin the second half of 2021, the stock market is looking for clarity and leadership. The global economy is transitioning into recovery mode following the pandemic-induced recession. However, Covid concerns remain as new variants spread at accelerated rates and may for the second time present a hurdle to economic growth. Despite the recent inflationary economic reports, the bond market is possibly sending warning signals to the equity markets as investors have driven 10-Year Bond yields down to 1.13%, underscoring reduced confidence ahead. In our view, investors can benefit from a stock market that is transitioning from momentum stock leadership towards a greater focus on strong fundamentals and companies with sustainable pricing power that can weather a period of prolonged inflation. A perceived reduction in pandemic risks and the approval of a bipartisan infrastructure bill may also be catalysts for the next leg higher.

Please contact us if you have any questions and, as always, we thank you for your support.

Best regards,

Scott, John, Dave, Richard, & John