WATERFRONT
ASSET MANAGEMENT

Summary

- S&P 500 continues to run; outperforming many other indices. Companies in the S&P 500 have done a good job growing faster than the economy.
- Inflation and Fed Policy continue to be a risk to markets moving forward.
- If it appears there was in fact a pull forward of demand and earnings growth is unsustainable, that will likely lead to a correction.
- International and emerging markets are behind the US in vaccinations and opening back up. This could result in opportunity for their markets to rebound as their populations receive the vaccine and begin the return to "normal."
- 2021 is off to a really good start for the various Waterfront Strategies. We have been hurt so far in 2021 with a meaningful allocation to international securities but that has been outweighed by a value tilt in the strategies. Looking forward, we are sticking with a heavy international allocation and value tilt for some of the reasons mentioned above.
- We are in one of those periods where it makes sense to have a little cash on the sidelines ready to buy a dip if one presents itself later this year. While no one can predict when exactly a market correction will occur, we believe the current levels in the market will be revisited even if stocks trend a little higher in the near-term. There really shouldn't be a fear of missing out mentality, at least not for domestic stocks.

Pulling Forward Everywhere?

Through the 1st half of the year, the S&P 500 has a 15% return, on pace for over 30% annualized. That is better than Europe and Emerging Market Indices, the former up 10.2% and the later up 7.6%. The 1st half continues what has been a consistent run of US stock outperformance over previous years. Over the past 5 years, the S&P 500 has an almost 18% a year annualized return while emerging markets are under 14% and EAFE is just over 11%. Over the previous decade, the numbers are even more glaring. An almost 15% annualized return for the S&P 500 vs under 5% for emerging markets and under 7% for EAFE stocks.[1]

The long-run average return of the S&P 500 is around 10% so 5 points of annual outperformance over the previous decade vs. historical is outstanding. This all happened through a decade that had one of the lowest economic growth rates in history. How is this possible? Part of the explanation is the companies that make up the S&P 500 have been growing at a faster clip than the economy, taking share from smaller private businesses and Covid very much helped to continue that trend. While that can explain some of the strong stock returns, the larger factor is the ever expanding multiple investors have been willing to pay for earnings. Microsoft is a

[1] Bloomberg

good example. It has done a nice job growing revenue and earnings over the previous decade, revenue up about 140% and earnings up almost 200%, but the stock has returned almost 1000%.[2] Due to strong revenue growth in the past decade, Microsoft is now a company with over $150 billion in revenue. The ability to grow revenue and earnings at a significantly faster clip than the previous decade is going to be challenging, yet investors are willing to pay almost 3x as much for that earnings growth then they were at the start of the previous decade. Investors have pulled forward the future returns in companies like Microsoft.

Microsoft is just one of many examples of companies that are executing very well, taking share and growing nicely that now have a very expensive stock price, when one considers traditional metrics such as earnings and sales multiples. The multiple expansion of US stocks is ultimately the biggest stock return story of the previous decade. Why are investors willing to pay so much? There is no one answer to that question but when one considers the reasons, Federal Reserve Policy has to be top of mind. Most people don't even realize that as of now with strong GDP numbers about to be released for 2Q, the Federal Reserve continues to buy $120 billion of securities a month. There is so much liquidity out there that 10 year inflation adjusted treasury yields are close to negative 1% and banks continue to buy them. Obviously, stocks can look appealing compared to negative inflation adjusted returns in the bond market. The federal government running massive deficits to fund stimulus payments to individuals is as of now being financed by the Federal Reserve. A good percentage of stimulus went to savings and savings can also mean investing in stocks.

All of this liquidity provided by the Federal Reserve won't last forever if the Fed is to maintain its credibility. If inflation proves transitory, the Fed has more time to adjust policy to something that is considered to be more normal. However, if inflation metrics remain stubbornly high into early 2022, the Fed will need to adjust policy or else risk losing credibility. When liquidity is drained from the financial system, this multiple expansion that has gone way too far for too long will end. This great pull forward that investors are investing into will cease. And at that point, the markets are in danger of a meaningful correction.

Inflation and Fed policy are not the only risk to stock market multiple expansion. While a stock's value is based on its lifetime of earnings discounted back to present, in the current environment investors seem to be expecting current earnings growth to be a good representation of future earnings growth. Of course, that is silly as cycles provide short-term swings. Apple is currently experiencing strong earnings growth on the back of the 1st 5G IPhone and strong demand for electronics during Covid but in the previous 5 years, Apple did not grow pre-tax income. It was able to grow earnings per share through share repurchases but now with the stock about 30x earnings, the ability to grow eps through share repurchases is going to be constrained. If, after the IPhone upgrade cycle ends, earnings growth slows meaningfully as is likely to occur, will investors be willing to pay such a high multiple for a low growth stock?

We are concerned that not only has multiple expansion pulled forward stock returns, but also that Covid and some other factors have pulled forward demand for many S&P 500 companies. If we get to 2022 and it appears there was a pull forward of demand and earnings growth rates are unsustainable, that likely will lead to a correction.

There are some factors that could lead to above trend growth even into 2022. While taxes and regulation have the potential to be obstacles for profit margins, new stimulus initiatives are good for broad economic growth and not just digital growth. This has the potential to help sustain profit margins and demand growth through 2022 even in the inflationary environment we currently are in. We believe the infrastructure bill and some sort

---

[2] Bloomberg

of reconciliation focused stimulus that addresses climate change among other Democratic priorities will get passed in the fall. However, that is not a guarantee, and if not, that puts some risk into the reflationary pro-cyclical investing theme that has helped along with tech to support the stock market.

Taking a step back, what is currently happening in our country needs to be considered. Covid was, and still is, in many countries a significant global shock. Yet, one has to question the extent of the response from the Federal government both on the fiscal and monetary side that continues today. It is not unreasonable for one to believe the response was too much. We now seem to have an economy that is addicted to deficit financed stimulus and that doesn't even yet include the massive amount of money the government is going to need to spend to address climate change. The billions spent responding to disasters along with the transition to clean energy are going to be inflationary. Anyone who believes there are no consequences to very large fiscal deficits is foolish. They are fine when the Federal Reserve and government are on the same page. But what happens if they are not. The last decade hasn't really presented us with that problem other than a brief period in 2018 that led to a market correction. Housing prices have risen to the point where affordability issues become prevalent (housing prices while not directly included in inflation metrics should be considered when one gauges inflation due to the ability to influence other measured metrics). The price of a new car is now on average over $40,000. Real (inflation-adjusted) wage and personal income growth is currently negative in months without stimulus. While signs of increased productivity are welcome, if that is not sustained, low economic growth with above trend inflation will set-in and that will start in the not too distant future. That is not a good environment for asset prices if the Fed is not helping to drive them up.

The US is lucky to have had such an ample supply of very good vaccines earlier than most. That along with stimulus did have the effect of pulling forward economic growth. Other countries are now swiftly getting their populations vaccinated and that bodes well for growth overseas. Besides, some of the Covid stimulus in places such as Europe has been delayed and is just starting to get going. These areas are in a far different position than the US. The broad economic growth the US is currently experiencing will be peaking and stalling while some of the best growth in places such as Europe should be on the horizon.

There are inflationary concerns globally but YOY inflation is much higher in the US than other locations. Because of that, inflation adjusted interest rates in the US are not nearly as competitive as they used to be. That factor along with improved overseas growth along with other factors such as trade deficit data should help to put a lid on dollar appreciation. We don't believe the dollar will appreciate and we do think growth overseas will surpass the US moving forward. Therefore, we have a meaningful overweight to international securities and an overweight to global growth sensitive stocks.

In our opinion, future stock returns have been pulled forward to the present by multiple expansion, future economic growth has been pulled forward by extensive stimulus and future earnings growth has been pulled forward by stimulus and other unique factors that shifted dollars around during Covid. This is not an environment to be aggressive buyers of US equities. A prudent move would be to raise some cash at the expense of taxes this year and have that available to buy any dips that may come about in the later part of the year.

Strategies Update

As a reminder, Waterfront offers several different strategies. We offer 8 different active mutual fund strategies that consist of several different fund managers in each strategy. All strategies are allocated to fundamental mutual fund managers. There are two equity strategies, one is US large cap focused, similar to the S&P 500 and one is very diversified, incorporating international securities and small cap securities. We offer 3 bond strategies, one takes credit risk but is short-duration, one will take modest credit risk but also will take interest rate risk and then one is aggressive fixed income. Then, there are 3 hybrid strategies, Dividend and Income, Absolute, and Balanced.

In addition to the 8 mutual fund strategies, we offer 4 Dimensional strategies and 4 ETF strategies. The 4 Dimensional strategies will allocate to Dimensional stock funds but will use non-Dimensional fixed income managers. Dimensional, as opposed to fundamental stock pickers, uses rules based stock picking and allocations skew towards value and small cap stocks, though we temper that effect with our allocation choices. The 4 ETF strategies utilize both passive index replicating ETF's and rules based active ETF's. The passive ETF's provide a growth bias while the active ETF's that we utilize, Avantis and Schwab, skew towards value.

Then, we offer the Opportunistic Strategy and Opportunistic Equity. They are individual security strategies that follow a fundamental approach to security selection.

2021 is off to a really good start for the various Waterfront Strategies. We have been hurt so far in 2021 with a meaningful allocation to international securities but that has been outweighed by a value tilt in the strategies. Looking forward, we are sticking with a heavy international allocation and value tilt for some of the reasons mentioned above.

A Note on Tactical Positioning

While many clients will own one or multiple strategies, we have always felt alpha can be added through tactical rebalancing, and we stay true to that. That means we rebalance if one class of securities significantly outperforms others in a strategy. It also means we often will raise cash at perceived market highs and look to invest that cash on market dips, whether that be in a strategy or a combination of individual securities or ETF's. We do this with a modest portion of funds and most funds continue to be invested long-term but it is our opinion, we can add a little extra return by trimming a portion and reinvesting. We are in one of those periods where it makes sense to have a little cash on the sidelines ready to buy a dip if one presents itself later this year. While no one can predict when exactly a market correction will occur, we believe the current levels in the market will be revisited even if stocks trend a little higher in the near-term. There really shouldn't be a fear of missing out mentality, at least not for domestic stocks.

Chris Harrington

Chief Investment Officer

Waterfront Asset Management