May 2021

# SOL CAPITAL MANAGEMENT COMPANY

## Client Investment Letter

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The continued recovery from the Covid recession translated into strong returns for global equity markets and negative returns for bonds in the first quarter. The "risk-on" reflation trade is under way, reversing long-established market trends that, to many investors, were beginning to seem like second nature. Unlike the past several quarters (and years), growth stocks did not beat value stocks, large caps did not outperform small, interest rates did not decline, and long-term bonds did not help portfolios. Whether this is the beginning of a longer-term movement or a short-term phenomenon amid the current economic backdrop remains to be seen. What the first quarter of 2021 truly showed investors, however, was the benefit of remaining well-diversified across all sectors and investment styles. It also demonstrated the benefit of prudently managing risk, especially in fixed income.

At moments such as this, it is important to maintain objectivity, not lose sight of your long-term strategy, and not get mired in uncertain distractions. In the quarter, the sharp contrast of a swift recovery in markets and an accelerating economy versus the rising risk of Covid reclosures (e.g., India) and expensive policy proposals (e.g., the U.S.) have some investors questioning if it is time to double-down, or head for the exits. To the fearful and greedy investor alike, we seek to temper expectations.

For those investors questioning the merit of remaining invested in equities, we would first point out that while valuations on the whole are higher than average, the market remains heavily concentrated at the top in the most overvalued names,[1] whereas the remainder is more fairly valued. Second, while there are certainly pockets of overvaluation (and overexuberance) that have garnered a lot of attention in financial and social media, these areas are not indicative of the overall equity market. Finally, and most importantly, while corrections are normal and should be anticipated over the near term, equities remain more attractive than fixed income, especially for the long-term investor.

To those seeking to make their portfolios more aggressive as the economic recovery gathers further momentum, we would remind them that in the short term the economy does not equal the market, and the market does not equal the economy. Markets are forward-looking entities, and over the past few months they have already begun pricing in the recovery and expansion we are currently witnessing in the real economy. While ultra-accommodative monetary policy may continue to support equities, any negative headlines, particularly related to Covid cases and vaccine rollouts in emerging markets - not to mention political jostling around additional spending and taxation plans - could trigger a short-term correction. The VIX[2] continues to be low, but we anticipate higher volatility as this recovery evolves. Finally, given interest rates are still low (by any historical measure) and equity markets are already fairly valued, future expected returns may be lower than they have been in recent years (see Appendix A).

In this environment, we believe it is better to be prudent. We are adhering to our clients' personalized investment strategies. We continue to rebalance portfolios to their long-term targets, putting them in line with what we believe to be an acceptable level of risk given each client's goals, time horizon, and liquidity needs.

[1] Over 25% of the S&P 500 is comprised of ten companies.

[2] The CBOE Volatility Index (VIX) measures the expected standard deviation of returns for the S&P 500 over the coming 30 days.

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# Financial Markets Performance

## Equities

Global equity markets continued to move higher during the first quarter, extending the strong gains achieved in the final quarter of 2020. The ongoing rollout of Covid vaccines alongside additional fiscal and monetary stimuli pushed many equity indices to all-time highs.

In the U.S., all major stock indices set new records during the quarter as investors focused on improving financial prospects as the economy shows initial signs of progressing from recovery to expansion. The relatively smooth Covid vaccine delivery, relaxation of social distancing measures, continued decline in unemployment, as well as the unleashing of pent-up demand and excess savings are all expected to generate a substantial increase in corporate profits over the next few quarters.

*"In the U.S., all major stock indices set new records during the quarter as investors focused on improving financial prospects as the economy shows initial signs of progressing from recovery to expansion."*

Performance across styles and capitalizations was uneven over the quarter (see Exhibit 1). Value stocks significantly outperformed growth and smaller companies outpaced larger ones. A few factors are driving this long-awaited rotation. First, because the bulk of the expected earnings and dividends for growth stocks are generally forecasted to be further out in the future (relative to value stocks), rising interest rates are reducing the present value of those cashflows, and therefore share prices. Second, inflation expectations are rising amid faster economic growth, which bode well for value companies, allowing them to potentially deliver more predictable cashflows in an uncertain economic environment. Next, as we have mentioned in several letters, growth stocks have seen an extensive period of outperformance (value stocks have just slightly underperformed historical returns). The outperformance (and by extension valuations)

**Exhibit 1**

| Total Return* for Selected Equity Indices | First Quarter (12/31/20 to 03/31/21) % | Year-to-Date (12/31/20 to 4/30/21) % |
|---|---|---|
| S&P 500 Index | 6.17 | 11.84 |
| S&P 500 Growth Index | 2.12 | 9.14 |
| S&P 500 Value Index | 10.77 | 14.90 |
| Russell 3000 (Total U.S. Market) Index | 6.35 | 11.83 |
| Russell 2000 (Small-Cap) Index | 12.70 | 15.07 |
| Russell 2000 (Small-Cap) Growth Index | 4.88 | 7.16 |
| Russell 2000 (Small-Cap) Value Index | 21.17 | 23.62 |
| MSCI All Country World ex-U.S. Index (Net) | 3.49 | 6.54 |
| MSCI All Country World ex-U.S. Growth Index (Net) | (0.08) | 3.61 |
| MSCI All Country World ex-U.S. Value Index (Net) | 7.06 | 9.46 |
| MSCI EAFE (International) Index (Net) | 3.48 | 6.59 |
| MSCI Emerging Markets Index (Net) | 2.29 | 11.83 |
| MSCI ACWI Commodity Producers (Net) | 13.83 | 17.81 |

Source: Bloomberg LP. *Includes price appreciation plus dividends and/or interest.

## Financial Market Performance Cont.

of growth stocks became even more exceptional last year when those stocks were perceived as "immune" to the pandemic's effect on the economy. Reversion to the mean is inevitable and this may only just be beginning. Finally, the reopening of the economy is shifting fund flows back to more domestically oriented small-cap stocks which had struggled through the pandemic.

All S&P 500 sectors posted positive returns in the first quarter. The energy sector was particularly robust (+30.9%), as oil prices surged from the historic lows reached in the early stages of the pandemic. Financials and industrials also posted double-digit returns, benefiting from higher interest rates and the prospects of a strong pickup in manufacturing activity and massive infrastructure spending. Conversely, information technology stocks ended with only a slight gain as sentiment deteriorated.

Equities in developed markets outside the U.S. also advanced, albeit at a more modest pace. In Europe, optimism about economic growth, higher bond yields, and higher expected inflation pushed up stock prices despite a slower-than-expected vaccine rollout and an increase in infection rates that culminated in extended lockdowns. In Japan, equities were sharply higher in local currency terms, but a marked drop in the yen reduced returns for foreign investors. Significant stimulus measures (both at home and abroad) and low infection rates cemented investors' confidence, pushing Japanese equity prices to multi-decade highs.

Emerging markets stocks also advanced, but performance varied significantly across countries, resulting in a weaker outcome compared to developed markets. Chinese shares were flat, as some of the dominant technology firms (e.g., Alibaba, Baidu, Tencent) lost ground amid heightened local government scrutiny and the potential implementation of stricter auditing requirements on their U.S. listings. Conversely, Taiwanese shares posted positive, double-digit returns as local manufacturers benefited from the ongoing shortage of computer chips and the prospects of a global recovery later in the year. Brazilian stocks lost ground as infection rates intensified, inflation expectations increased, and the real ceded further ground to the U.S. dollar.

## Fixed Income

An unexpected rise in U.S. yields resulted in mostly negative returns for global fixed income markets (see Exhibit 2). Rising optimism about the pace of economic recovery contributed to increased inflation expectations, which weighed on bond prices.[3]

The bellwether Bloomberg Barclays U.S. Aggregate Bond Index fell 3.4%, its worst quarterly return since 1981, as longer-dated Treasuries and investment-grade bonds sold off. Securitized debt declined less due its lower duration profile and the Federal Reserve's continued commitment to increase liquidity should market conditions deteriorate. Global government debt also ended the quarter in negative territory, though most countries outperformed Treasuries. U.K. investment-grade bonds delivered similar negative performance while European investment-grade bonds were flat, as growth prospects on the continent treaded water.

High-yield bonds produced mostly positive returns, with lower quality issues outperforming. This was driven by investors' appetite for yield and the asset class' relatively low duration. Emerging markets debt declined mainly due to rising U.S. yields, making U.S. debt appear relatively more attractive. A strengthening U.S. dollar was also a negative factor, as it increases debt servicing costs for emerging market issuers.

*"An unexpected rise in U.S. yields resulted in mostly negative returns for global fixed income markets (see Exhibit 2)."*

[3] Bond prices and yields move in opposite directions.

## Financial Markets Performance Cont.

**Exhibit 2**

| Total Return* for Major Fixed Income & Hedge Fund Indices | Third Quarter 12/31/20 to 03/31/21) (%) | Year-to-Date (12/31/20 to 04/31/21) (%) |
|---|---|---|
| Bloomberg Barclays U.S. Aggregate Bond Index | (3.37) | (2.61) |
| Bloomberg Barclays U.S. Government/Credit Index | (4.28) | (3.44) |
| ICE BofAML 1-3 year U.S. Broad Market Index | (0.10) | (0.04) |
| ICE BofAML U.S. High Yield BB-B Bond Index | 0.31 | 1.38 |
| JP Morgan Non-U.S. Global Bond Index (GBI) Hedged | (2.39) | (2.72) |
| JP Morgan EMBI Global Index in USD (Emerging Markets) | (4.75) | (2.92) |
| HFRX Equal Weighted Strategies Index (Hedge Funds) | 1.62 | 2.98 |

Source: Bloomberg LP. *Includes price appreciation plus dividends and/or interest.

## Global Economic Update

The rebound in global economic activity continues, albeit at varying speeds. How far each economy has climbed up the business cycle curve (see Appendix B) is significantly correlated with how successful their respective virus containment measures and vaccine distributions have been.

China leads the pack following a strong recovery in manufacturing last year, pushing industrial and housing activity above pre-pandemic levels. That said, the economic divide between other sectors is wide. Commercial leasing, hospitality, and restaurant activity remain 15-20% below their long-term trends, thanks in part to a household savings rate that stubbornly remains well above pre-Covid levels. Credit growth has also decelerated as policymakers shift away from near-term crisis management to long-term stability. The drive to restrain leverage (which is a longer-term challenge for the country) means China may not be the driver of global growth, as it was after the Global Financial Crisis.

North American economies are not far behind in the climb out of the Covid recession. In the U.S., the economy is steadily accelerating into the mid-cycle growth stage, propelled by immense fiscal stimulus and release of pent-up consumer demand. Manufacturing activity is at its strongest in nearly four decades and durable goods orders are back to pre-pandemic levels. Despite relatively high unemployment numbers (6.1% as of April 2021), businesses are observing increased difficulty in finding workers to fill key positions, suggesting wage growth may further feed inflationary pressures.

Europe has lost some momentum as its vaccine rollout stumbled and new virus cases emerged. Mobility measures have stagnated, the economy dipped back into recession in the first quarter, and it is estimated the region's recovery has been set back by several months. That said,

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the rapid recovery in services activity in Israel, the world's posterchild for successful vaccine distribution, shows the underlying potential for European economies over the coming months (see Appendix C).

Meanwhile, other regions – notably emerging markets – continue to struggle amid a spike in Covid cases and little access to a vaccine (or lack of an effective distribution network), with heartbreaking results. Some of the hardest-hit areas include major economies such as Brazil and India.

## Inflation Watch

With the enactment of the American Rescue Plan Act in March, the U.S. Congress has likely passed its final emergency relief bill. Over the course of 12 months, Congress has enacted six pieces of legislation that provided over $5 trillion in pandemic-related funding. An estimated 80% of these funds have already been or will be spent by the end of 2021 (see Appendix D). By design, these programs were front-loaded with provisions such as stimulus checks, enhanced unemployment assistance, transfers to state and local governments, and grants for small and distressed businesses. As we have commented in previous letters, these are "high-multiple" spending programs that have historically had a much greater impact on activity in the real economy, and by extension inflation.

Industry-level data is pointing to rebounds in prices in virus-sensitive categories (e.g., hotel rates and airfares) as the global economy reignites region-by-region. Company-specific commentary also suggests a faster pace of price increases in coming months due to supply chain disruptions. Manufacturers were already ill-prepared for the rapid recovery in consumer demand for goods, but now a shortage of shipping containers, especially for East Asia-U.S. routes, and congestion problems at ports in southern California are causing the longest delays in international shipping in nearly 40 years. We expect some of these costs to be passed onto consumers over the coming months.

Therefore, inflationary pressures are building in the near term, though they are likely to be temporary, with price pressures dissipating in 2022.[4] The Fed also believes this inflation, which is expected to rise above 3% in the next two quarters, is transitionary. Longer-term inflation rates are less certain. If Congress enacts a $2.3 trillion infrastructure bill similar to the American Jobs Plan that President Biden recently proposed, and/or the $1.8 trillion American Families Plan, spending from such plans would likely take a few years to ramp up. These plans, which are only proposals at this stage, would also require tax increases to finance that undoubtedly face an uphill battle in Congress. As such, markets are so far only pricing in mild and temporary inflation (in line with Fed expectations), but that could change with political developments in Washington.

*"…inflationary pressures are building in the near term, though they are likely to be temporary, with price pressures dissipating in 2022"*

[4] Source: Goldman Sachs Global Investment Research

# Investment Strategy

## A Brief Word About Overheating Markets

The advent of online brokerages and zero-commission trades, coupled with social media, rebounding markets, and stimulus payments have driven new money (and new players) into stock markets in recent months and years. In particular, access to cheap debt, the ease of information sharing, and unregulated investment "advice" have created bubble-like price dynamics in certain sectors.

Early in the quarter, investors went into hysteria around the astronomical rise (and subsequent implosion) of various "meme stocks." This type of trading was purely speculative in nature, driven largely by sentiment trending on social media rather than quantitative fundamental analysis. Retail investors, many new to financial markets, are also more aggressively using leverage than in the past. Margin trading is at historic highs and options trading, a risky way to "enhance" returns, has swelled in part due to increased demand from retail investors. We have also seen irrational exuberance unfolding in certain digital asset markets with significant celebrity presence, specifically non-fungible tokens (NFTs).

Additionally, there has been a lot of attention given to Special Purpose Acquisition Companies ("SPACs") in recent months. These shell companies raise investor capital in a non-traditional IPO (with fewer regulatory requirements) to acquire an unknown private company in the future. Typically, SPACs trade at a discount to their par value, reflecting the immense uncertainty surrounding the future acquisition target, the completion of a deal, and good economics from that deal. For the first time in history, the tremendous interest in this space led to 100% of SPACs trading at a premium to par value during the first quarter.

These are just a few examples of where we find evidence of overheating, excessive risk-taking, and to a certain extent greed, in the marketplace. However, these are rather niche areas and actors, with less impact on broader financial markets. Therefore, while bubbles are appearing (and popping) in isolated areas, we do not believe the market in general is in bubble territory.

*"...while bubbles are appearing (and popping) in isolated areas, we do not believe the market in general is in bubble territory."*

## Equities

We have now seen two consecutive quarters where value stocks have outperformed growth stocks. Again, whether this is the start of a reversion to the mean or an anomaly unique to the Covid recovery is still uncertain. As always, we continue to maintain a balance between the investment styles, looking for a blend of active and passive management. We like the cyclical nature of value stocks and look to their potential continued

## Investment Strategy Cont.

outperformance as the economy rebounds. Within growth we continue to favor more conservative strategies that look for quality earnings growth at reasonable share prices. Where appropriate, we are also looking to add exposure to opportunities in disruptive technology firms beyond the well-known (and more expensive) FAAAM[5] stocks.

International equities continue to offer more attractive valuations than their U.S. peers. We are especially encouraged by the potential for growth in emerging markets over the coming decades. That said, in the short term we expect more volatility and divergences in performance between regions as different counties are still grappling with the pandemic while others have moved on.

## Fixed Income

Anticipated higher inflation has pushed the 10-year U.S. Treasury yield up significantly in percentage terms, but the yield remains exceptionally low by historical standards (1.63% as of May 13). As bond yields are expected to continue their ascent, we remain extremely cautious on taking duration risk for the sake of downside protection. Even with current quantitative easing measures in place, there is now an additional $1.8 trillion worth of new Treasury debt that has to be absorbed by the market.[6] Furthermore, while we expect continued monetary support this year, the Fed is expected to begin tapering its large bond purchases early next year. Without the central bank as a ready buyer, bond yields across the board may need to rise to find new demand.

Issuance of new high-yield (below-investment-grade) debt has more than doubled year-over-year and credit rating upgrades continue to outpace downgrades so far this year. We feel comfortable reaching for yield via bond fund managers with flexible mandates that allow them to go farther down the credit spectrum, into bank loans, and/or into emerging market bonds. However, as monetary support is not permanent, these sectors remain risky, and active management is critical to separate the wheat from the chaff. Investors are starved for yield, but they should not let that hunger drive them to take on excessive levels of risk with assets that are supposed to protect capital.

Finally, for clients with liquidity needs, we have been adjusting our approach to cash management. Where we once felt comfortable holding several years' worth of planned withdrawals in a money market fund earning a decent rate of interest, with rates stuck at the zero bound (potentially for another two years), we are forced to look for alternatives. For such clients, we now prefer to keep very near-term cash needs in money market funds, and we are putting cash with a slightly longer horizon to work in short-term, high-quality bond funds and ETFs.

*"Anticipated higher inflation has pushed the 10-year U.S. Treasury yield up significantly in percentage terms, but the yield remains exceptionally low by historical standards (1.66% as of May 13)."*

[5]FAAAM refers to Facebook, Apple, Amazon, Alphabet, Microsoft.
[6]Black Rock

# In Conclusion

> *"We look forward to a return to "normal" over the next several months, but as always, we remain vigilant for increased market volatility."*

*Financial markets continue to react to the reflationary environment as economies pull themselves out of the Covid recession. Long-awaited rotations are being felt across the market as more cyclical sectors and styles outperform and safer assets underperform. Markets have already priced in much of the economic rebound we are currently experiencing, but they are not necessarily overvalued. There are pockets of hot air to avoid, but for the long-term investor with a well-diversified portfolio, these areas of overvaluation and excessive risk-taking are less of a concern.*

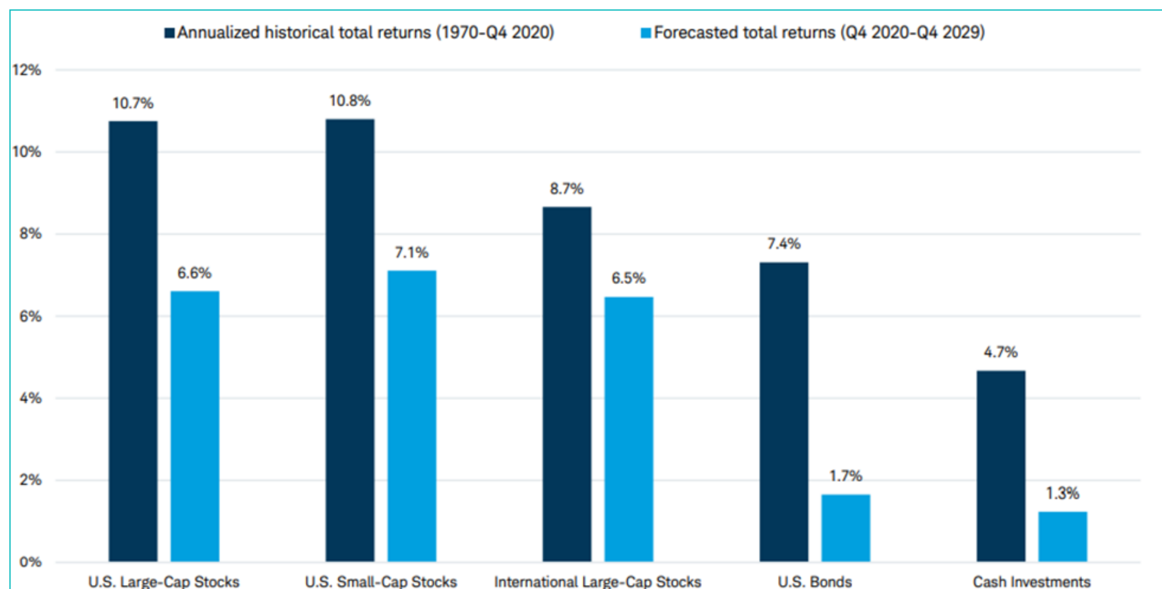
*We look forward to a return to "normal" over the next several months, but as always, we remain vigilant for increased market volatility. If there are any changes in your financial situation, liquidity needs, and/or investment goals, now is an opportune time to discuss them with us. If you have a question about financial markets or would like to discuss your portfolio in more detail, please do not hesitate to call us at +1 (301) 881-3727 or email us at client.services@sol-capital.com.*

*With our best regards,*

*SOL Capital Management*

# Appendices

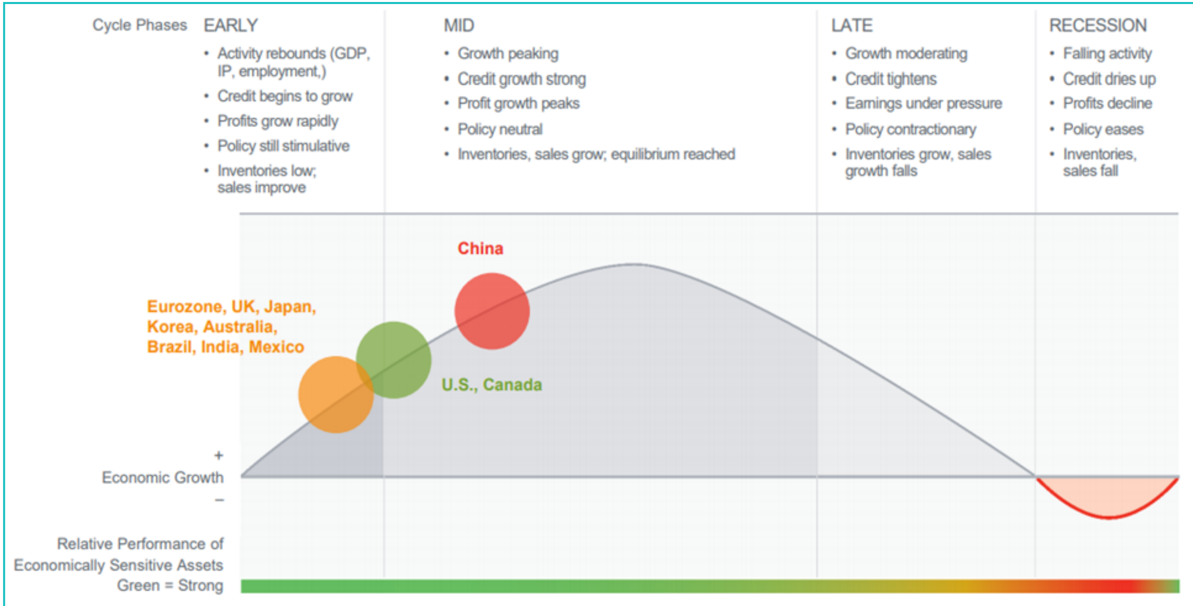
### Appendix A: Expected Asset Class Returns




Source: Charles Schwab, Data as of December 31, 2020.

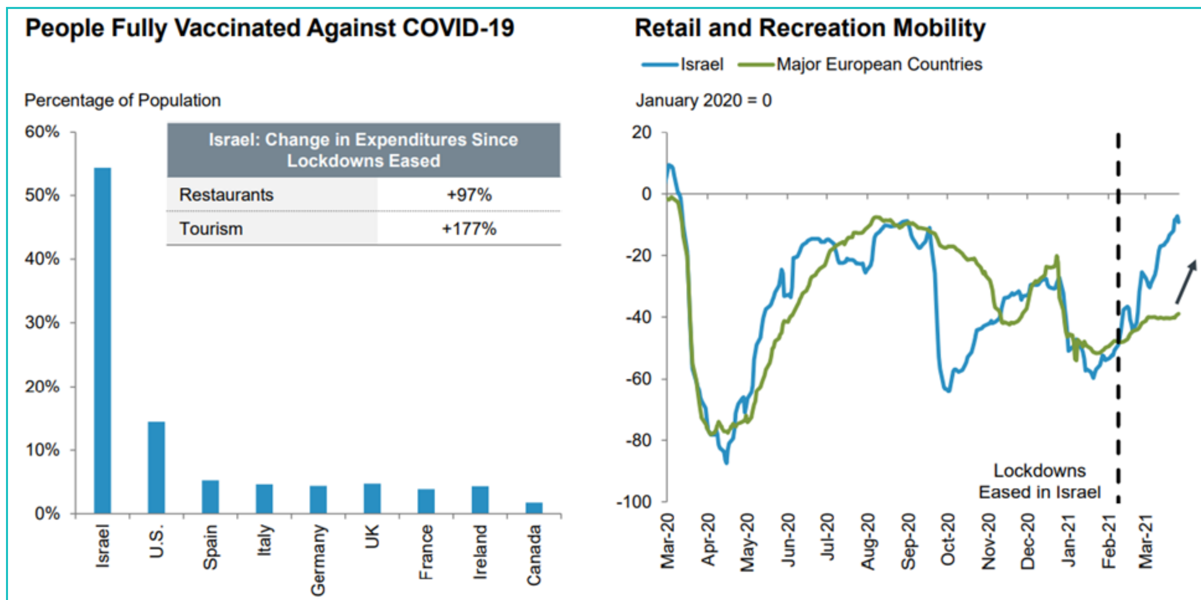
# Appendices Cont.

## Appendix B: Global Business Cycle in a Multi-Speed Recovery




Source: Fidelity Investments. Data as of 31 March 2021.

## Appendix C: Israel's Vaccinations Point to Global Rebound in Services




Source: Fidelity Investments. Data as of 26 March 2021.

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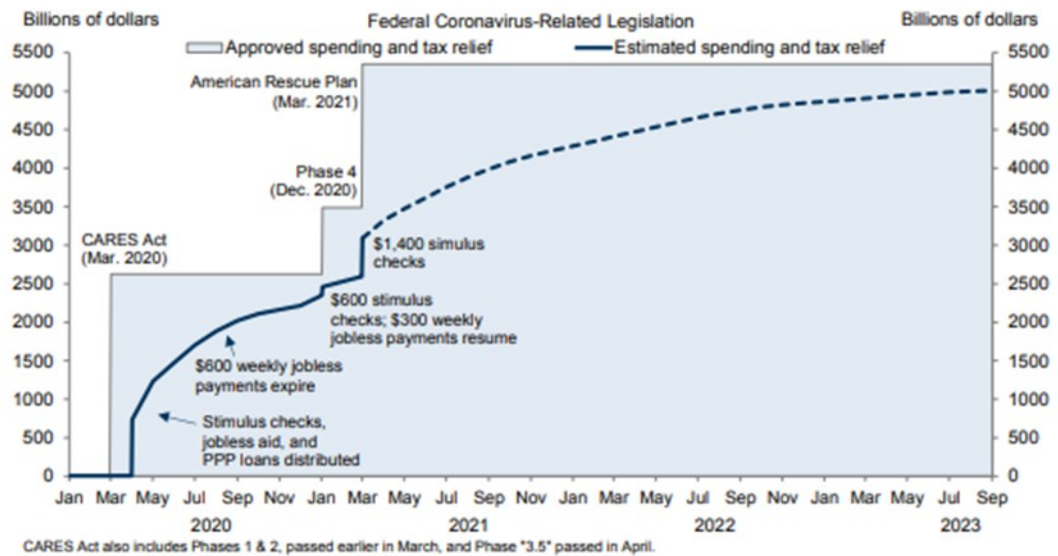
# Appendices Cont.

## Appendix D: Federal Coronavirus-Related Legislation




Source: Goldman Sachs Global Investment Research

## Important Disclosure Information

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