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June 30, 2021

First quarter GDP was officially reported as 6.4% and the expectation is that Q2 was even stronger. As US vaccination levels rose from roughly 30% at the beginning of the 2nd quarter to more than 60% by the end, economic activity accelerated and is poised to remain strong for at least the balance of 2021. Our economic optimism from last quarter carries over into the 2nd half of 2021.

A solidly improving economic environment is generally good for equities although there are always nuances that can impact valuations. If investors fear that higher inflation will lead to higher interest rates, then PE multiples could decline even if earnings are rising.

We expect solid cash flow and earnings growth to continue as companies make strategic adjustments to the shutdown/startup nature of the past fifteen months. When an economy shuts down and then restarts, it's common sense to recognize there will be kinks in the system to be worked out. Smart management teams have prepared their organizations to manage through supply/demand imbalances as the economy normalizes. It is these price increases recognized during this unbalanced period that the Fed refers to as transitory inflation. Once the economy moves further towards normalizing over time, the kinks in the system (supply shortages) causing the transitory inflation will get worked out..

This is why inflation keeps getting so much attention. It slows growth as it impacts consumer unit demand as spending on goods and services becomes more expensive. It also impacts equity valuations if investors believe long term interest rates will go up as a result.

Even though there is quite a bit of discussion about potential inflation in the system, the investors that should care – the bond market – are investing as if inflation is a non-issue. After rising in the first quarter, the US 10-year Treasury bond yield fell 25 basis points in the 2nd quarter and is now under 1.5% again. German 10-year bond yields remained at negative 20 basis points and Japanese 10-year bonds stayed slightly above 0%. There's very little inflation expected by these investors.

We think it's probably more realistic to expect near term pricing spikes to decline over time as businesses adjust to a more normalized environment. We also believe that technology has been embedded even further into the core of the global economy and generally acts as a secular deflationary force. Also, we believe the magnitudes of year over year measurements during Q2 and Q3 may be exaggerated because of the reality of last year's shutdown. This impacts earnings comparisons as well as inflation measurements.

In this environment, we feel it is probably best to continue to have confidence in the businesses that are generating increasing cash flows on their income statements that strengthens their balance sheets and provides management with the opportunity to raise dividends. We have always tried to invest in solid management teams in part because we feel they have a good grasp of what's happening within their own industries; in the present moment that means we trust them to react appropriately to this complicated situation.

For the last six months of 2021, we look forward to continuing economic growth, a continued decline in the covid-19 virus, and a generally happier, more positive environment for all peoples around the world.

801 South Figueroa Street | Suite 2100 | Los Angeles CA 90017 | 213.612.0220 *t* | 213.612.-0329 *f* | sfeic.com

SEC Registered Investment Advisor