MALVERN CAPITAL MANAGEMENT

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First Quarter 2021 Review and Market Outlook

April 2021

First Quarter 2021 Review

We entered 2021 with an insurrection which included a group of people storming the U.S. Capitol. With the government then under lock down, we welcomed a new president a few weeks later. We also started off the year with a special election in Georgia which would decide which party would control the Senate. Both Democrat candidates won their election effectively giving control of the Senate to the Democrats, with the Senate divided 50/50 (Democrat Vice President Harris acts as the tie breaker). Democrats also control the House of Representatives and the White House giving Democrats the ability to put forth their legislative agenda.

Equity markets were unfazed by the happenings in Washington and we continued adding onto the advances from the fourth quarter through the end of the 1st quarter 2021. After many years of "growth" stock dominance, their leadership gave way to "value" stocks in the 4th quarter. This leadership continued in the 1st quarter with large capitalization value stocks outperforming large capitalization growth stocks by over 10 percentage points. Likewise, small capitalization stocks have been on fire for the past two consecutive quarters. Small cap stocks outperformed large cap stocks by over 6 percentage points in the quarter (as measured by the iShares Russell 2000 Index minus the S&P 500 Index). We expect to see value stocks continue to outperform growth stocks and small cap stocks to continue to outperform large cap stocks. Beyond value and small cap stock strength, all equities fared well in the 1st quarter. The S&P 500 Index (large cap stocks) advanced 6.17% and the MSCI EAFE Index (International equities) grew by 3.48%.

With the rise of the 10-year U.S. Treasury Note yield, the inverse effect of falling bond prices was realized in the 1st quarter. The Bloomberg Barclays U.S. Aggregate Bond Index fell by 3.37%. Lower quality bonds did have a positive quarter as credit spreads narrowed. The Bloomberg Barclays U.S. Corporate High Yield Index rose by .85%. Commodities, which have been dismal investments for many years, rose in the 1st quarter as the Bloomberg Commodities Index jumped 6.92%. However, is this a sign that inflation is coming back into the picture?

Index Performance

Category	Representative Index	1st Qtr 2021	Six Months	12 Months	3 yr*	5 Yr*	10 Yr*
Mature US Large Companies	DJ Industrial Average	8.29	19.91	53.78	13.61	15.99	13.09
Broad US Large Companies	S&P 500 Index	6.17	19.07	56.35	16.78	16.29	13.91
US Small Cap Companies	Russell 2000 Index	12.70	48.05	94.85	14.76	16.35	11.68
US Mid Cap Companies	Russell Mid Cap Index	8.14	29.67	73.64	14.73	14.67	12.47
Largest 100 NASDAQ Companies	NASDAQ 100 Index	1.76	15.08	68.88	27.01	25.22	20.18
Large "Value" Stocks	Russell 1000 Value Index	11.26	29.34	56.09	10.96	11.74	10.99
Large "Growth" Stocks	Russell 1000 Growth Index	0.94	12.44	62.74	22.80	21.05	16.63
Developed International	MSCI EAFE Index	3.48	20.08	44.57	6.02	8.85	5.52
Emerging Markets	FTSE All Emerging Markets	2.79	20.86	56.16	6.68	11.65	3.59
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	-3.37	-2.73	0.71	4.65	3.10	3.44
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	0.85	7.36	23.72	6.84	8.06	6.48
Commodities	Bloomberg Commodity	6.92	17.82	35.04	-0.20	2.31	-6.28
Total US Market (all cap stocks)	Russell 3000 Index	6.35	21.96	62.53	17.12	16.64	13.79
Real Estate Investment Trusts	Wilshire US REIT Index	8.81	20.36	34.74	9.04	4.96	8.48
Cash	US T-Bill 90 Day	0.01	0.04	0.10	1.32	1.11	0.58

** 3 year, 5 year and 10 year returns are annualized. All periods ending March 31, 2021.*
All returns include the reinvestment of dividends.

Investors eagerly await what new policy initiatives the Biden administration will bring to life which could include higher taxes on corporate earnings along with higher income taxes and capital gains rates on the wealthy. The new administration also promises a significant increase in spending which may be good for economic growth but at what cost? The Federal Reserve remains accommodative and corporate America is doing its part by growing earnings. We look forward into the rest of 2021 and explore the impact of fiscal and monetary policy on the economy, earnings and market valuations.

Is Inflation Heating Up?

Inflation has been relatively low since 2009 in the aftermath of the "Great Recession." The Federal Reserve has a target inflation rate of 2% but it has made it clear in recent policy statements that it will allow inflation to exceed the target rate for a period of time before raising interest rates. The Fed is looking for an overall average of 2% inflation. There are signs that inflation is picking up, at least in the short-term. The yield curve has steepened whereby longer-term rates have risen and shorter-term rates have stayed constant. Commodity prices have been really hot. Lumber prices have soared. Building and construction materials are up significantly year-over-year. A precursor to a rise in inflation is the increase in the broad money supply, M2 (M2 is a measure of the money supply that includes cash, checking deposits, and easily accessible liquid money.) M2 is up 25% year-over-year although much of that increase occurred at the beginning of the pandemic. More recently the expansion of M2 has moderated some although it is still increasing. Price inflation almost always occurs when M2 increases. Furthermore, there have been supply chain disruptions whereby auto makers, for example, have had to cut production due to chip shortages. We also cannot ignore the fact that massive government spending occurred in 2020 as a result of the pandemic and we saw $3.1 trillion in deficit spending. There is more spending planned for 2021 and beyond; a $1.9 trillion stimulus plan and $2.25 trillion proposed in infrastructure spending.

Is inflation a short-term occurrence or can we expect it to linger for a longer period of time resulting in higher prices and much higher interest rates? There are strong reasons to believe that inflation will be transitory rather than sustained and not last beyond the next 12 months. Unemployment will remain high for the next few years as jobs incrementally return following the pandemic's recession. Productivity advances from technology have reduced production costs. Despite the move toward a national minimum wage of $15 an hour, there are no strong wage increases to expect over the next few years. The high minimum wage will probably lead to more technology spending to offset the effects on companies of any minimum wage increases. With a Federal Reserve target of 2% inflation, inflation may actually only reach 2.5% at its high in the next year before falling below target.

Although inflation will likely moderate over the next year, going out a few years there may be reasons that higher inflation could return. An aging population amongst developed countries may result in more demand for higher wages as fewer people are available for employment. Will productivity advances be able to keep up with the decline in the workforce in order to offset the potential for higher wages? We shall see. Inflation can be a terrible occurrence for consumers, especially retirees on a fixed income. It is likely that beyond the near-term spike, it should be restrained at least for a few years.

Investing in an Inflationary Environment

For the moment, let's assume inflation and interest rates increase, what is an investor to do? It is best to reduce exposure to growth stocks. Any stocks that are valued on some future expectation of earnings should be limited. Unfortunately, these are the very stocks that have been the leaders since the recovery from the "Great Recession." But for the near term, "value" stocks will likely outperform "growth" stocks. Growth stocks should not be avoided completely however. Investors should also focus on companies which have the ability to increase dividends every year. Financials, or banks, should do very well in a rising rate environment, with a rise in interest rates as a result of an increase in inflation. Small capitalization stocks should also do well. Commodities should perform well, especially natural resources. Emerging markets will benefit because many of these countries are tied to one specific commodity such as gold, oil, copper or coffee for example. Although investors should minimize their exposure to investment grade bonds, especially intermediate and

long-term investment grade bonds, high yield bonds are more resilient historically in an inflationary scenario. Investing in high yield bonds in this scenario leads to spread tightening, thus appreciation of those bonds. Floating rate notes will do well as should business development companies (BDCs) because they have a floating rate component as part of their structure. Stocks do perform well in an inflationary environment, but focusing on the "right" stocks and other investments including having the correct allocation, will allow investors to realize continued investment success.

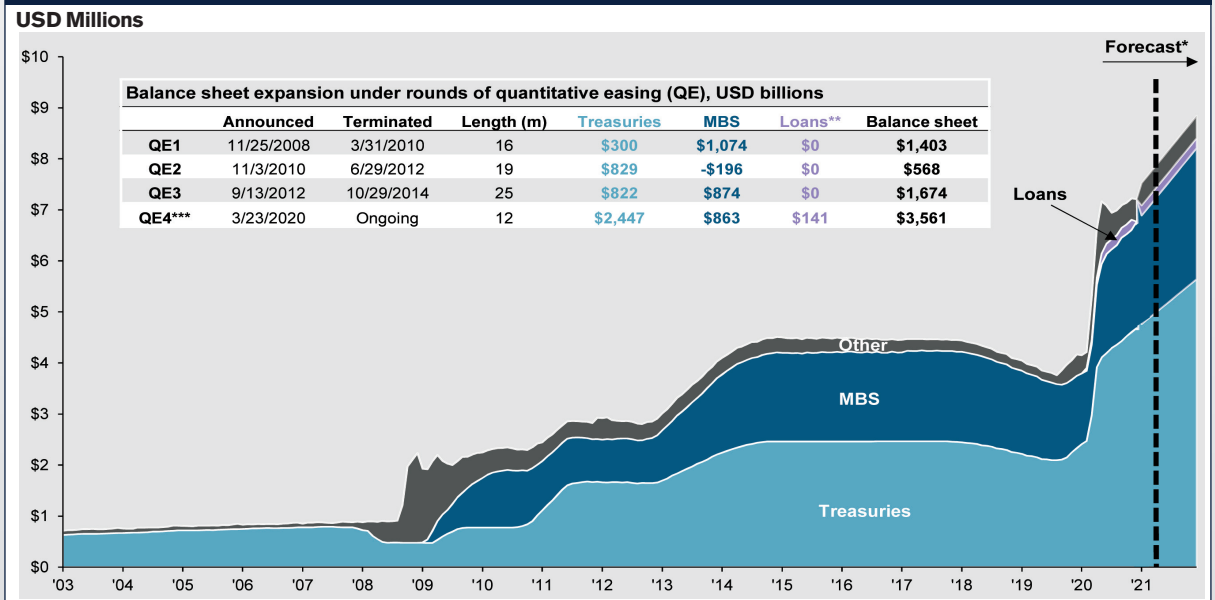
Monetary Policy and the Federal Reserve

The Federal Reserve has been quite accommodative since the start of the pandemic fueled recession and market sell off. In response to the recession, the Fed dropped the Fed Funds rate to 0-.25%. It also implemented Quantitative Easing 4, or QE4, whereby it would increase its balance sheet by buying Treasuries, mortgage-backed securities and loans with no set expiration date for the purchases. With these purchases, the Fed is effectively pumping the economy full of liquidity.

When will the Fed take away the punch bowl and end this party? In policy statements and public comments, it appears that it will keep interest rates low, near 0%, until 2023. Market oriented interest rates, that is longer rates than the Fed Funds rate, have been rising which has steepened the yield curve. The 10-year U.S. Treasury Note yield rose dramatically by 83 basis points (0.83%) in the first quarter 2021 to a rate of 1.75%. Nearly half of that move occurred during a two week stretch in February. The dividend yield on the S&P 500 Index ended the 1st quarter at 1.47% so that the 10-Year U.S. Treasury Note yield is now higher than the stock market's yield. The yield on the stock market has not been lower than the 10-year U.S. Treasury Note yield since well before the pandemic led equity market sell off began. We expect the yield on the 10-Year Treasury Note to continue to rise, perhaps as high as 2%. The higher the Treasury yield goes, the more of a headwind the yield will be for equity prices given the currently high historical valuation of the stock market.

In 2013, the Fed began to taper off its purchases within the then in effect QE3 program. The equity markets sold off when the tapering began in what was referred to as the "taper tantrum." Although there is no set expiration date for the QE4 program, some economists believe that the Fed could begin tapering the bond and other purchases as early as this summer. How will the stock market react as liquidity begins to dry up? Will we see another taper tantrum or some other response to the Fed's changing of policy course? Stay tuned.

The Federal Reserve Balance Sheet



Balance sheet expansion under rounds of quantitative easing (QE), USD billions

	Announced	Terminated	Length (m)	Treasuries	MBS	Loans**	Balance sheet
QE1	11/25/2008	3/31/2010	16	$300	$1,074	$0	$1,403
QE2	11/3/2010	6/29/2012	19	$829	-$196	$0	$568
QE3	9/13/2012	10/29/2014	25	$822	$874	$0	$1,674
QE4***	3/23/2020	Ongoing	12	$2,447	$863	$141	$3,561

Source: FactSet. Federal Reserve J.P. Morgan Investment Bank, J.P. Morgan Asset Management.

Fiscal Policy on Steroids

In December 2020, President Trump signed a covid relief bill into law which effectively was $2.3 trillion of stimulus pumped into the economy. When President Biden took office, he quickly passed a $1.9 trillion stimulus bill into law. Over the past four months we have seen $4.2 trillion made available to go into the economy. Not all of the money has yet to be spent from either law, but the money will be gradually flowing into the economy. Neither Trump's or Biden's stimulus plans included a way to pay for them other than through deficit spending.

Additionally, President Biden has proposed $2.25 trillion in infrastructure spending. A portion of it is intended to pay for repairing and constructing roads and bridges throughout the country. It is being presented as an infrastructure bill but much of the spending is going toward things that many would consider non-infrastructure projects. This money is intended to be spent over the next eight years.

Unlike the other two programs, President Biden has proposed a way to pay for at least part of the program. Included in the tax proposal is the raising of the corporate income tax rate to 28% from 21%. Also, there has been discussion of a form of alternative minimum tax on corporations and a global minimum tax. Families earning greater than $400,000 a year will also see their taxes increased. Tax increases do redirect money from businesses, investors and individuals to the government for it to spend.

These are proposals. Investors should be very careful investing or making any financial decisions until these proposals become law because we don't know what legislation will actually be passed into law. There is already push back from Democrat Senator Joe Manchin who would rather see the corporate tax rate at 25%, not 28%. A lot of things will change prior to these proposals becoming law. In fact, none of the proposals could go into law, although it is likely President Biden will get at least some of what he proposes. Also, it is highly unlikely that any tax law changes will be retroactive so investors will have plenty of time to prepare for any such changes.

Fiscal policy has been and will continue to be very stimulative to the economy. Even though the stimulus should be positive for economic growth it also could be inflationary, at least in the short term.

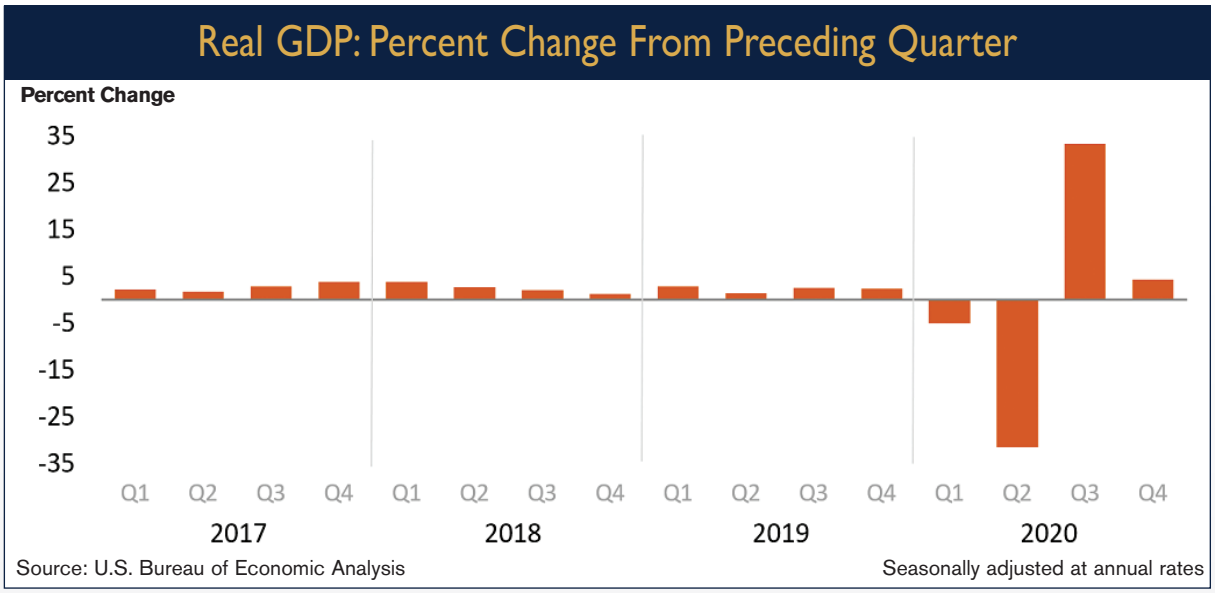
The Economy

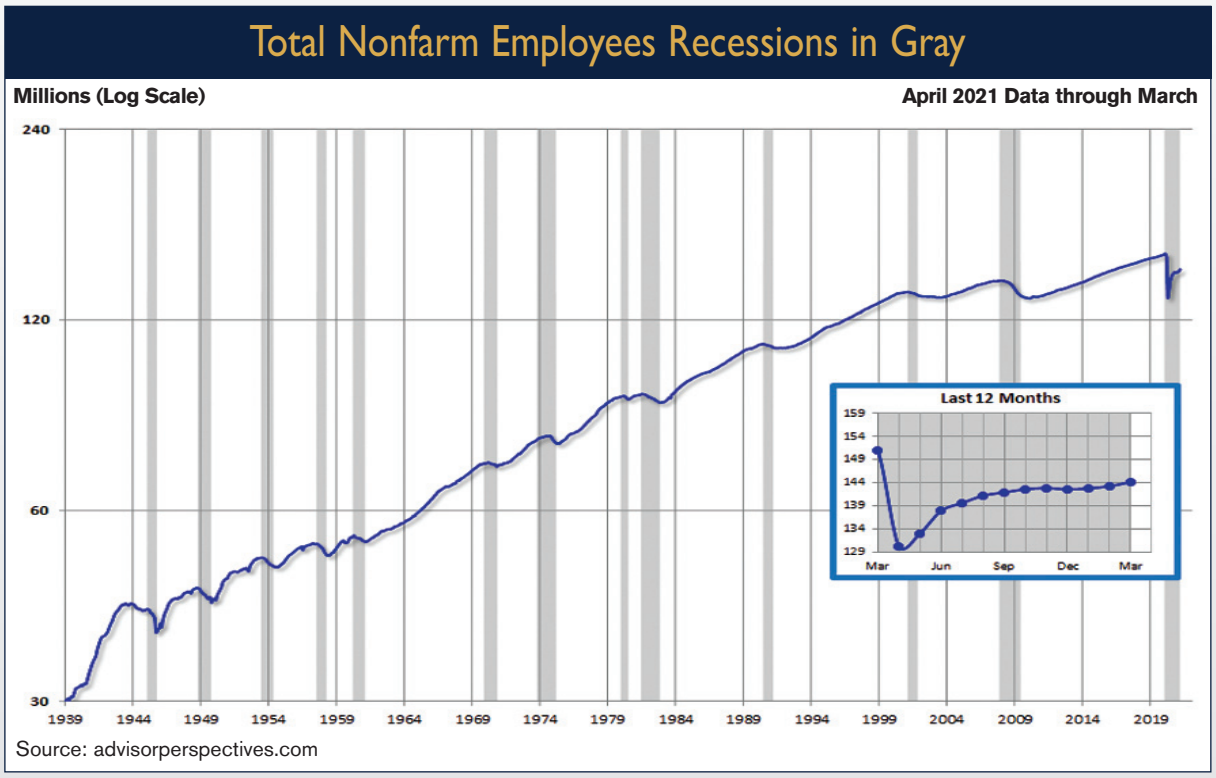
The last year has not been a typical or normal recession. In a "structural" recession, many of the lost jobs disappear forever and are subsequently replaced by new jobs that didn't exist prior to the recession. A "cyclical" recession occurs from the normal ebbs and flows of the economy. Jobs are lost but do eventually return. The current recession would be hard to classify as either structural or cyclical. The current recession resulted from a shut down or stoppage of the current economy largely mandated by state government officials. The economy was "humming" along with no signs of a slowdown in sight until the Covid-19 shut downs were implemented.

The latest recession's recovery is actually a "*re-start*" of the economy. Many of the lost jobs are returning or will return as the economy re-opens from the pandemic closures or lock downs. While many of these jobs return, the format of the jobs may change as the "remote" worker becomes more mainstream.

In the 4th quarter 2020, the economy expanded as reflected by real GDP growth at an annual rate of 4.3% following an expansion of a 33.4% annual rate in the 3rd quarter. There is an expectation by many economists that real GDP growth will expand at an annual rate of 6.5% in the 1st quarter.

With the re-start of the economy, we saw a rather impressive jobs report for March 2021 as there was a net increase of 916,000 jobs, far above the consensus estimate of 647,000 jobs gained. The unemployment rate is 6% and is well off of the high from April 2020 when it reached 14.8%. The number of persons unemployed in the country stands at 9.7 million. Looking back to February 2020 prior to the pandemic, the unemployment rate was 3.5% and the total number of unemployed persons was approximately 5.7 million. As the economy re-starts many of the "temporarily" lost jobs will return. There is still a lot of work to be done but we are moving in the right direction.





Corporate Earnings Outlook

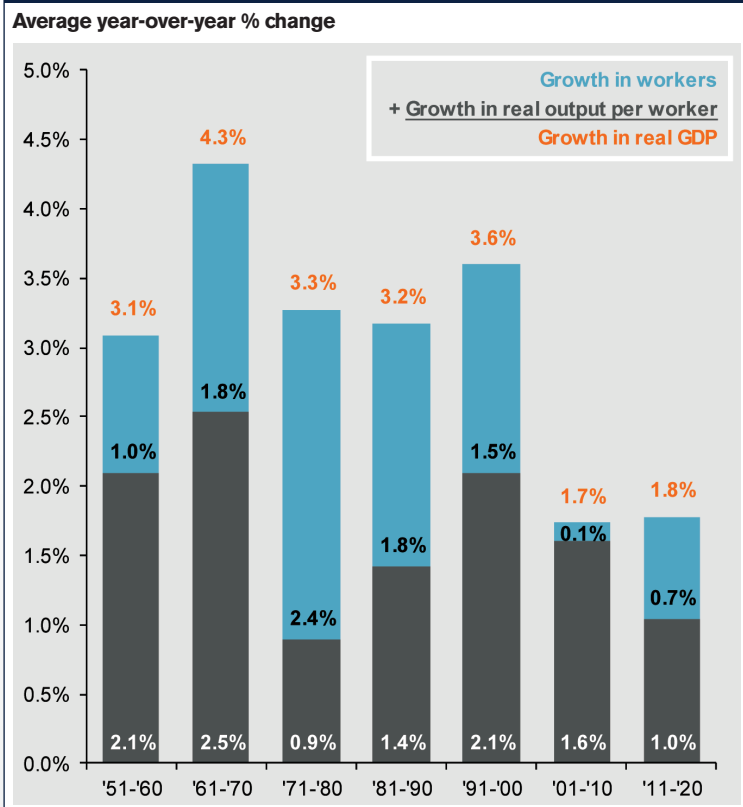
Analysts at the Standard & Poor's Corporation project full year 2021 earnings of the S&P 500 Index to be $172.47 per share. Last December these same analysts projected full year 2021 earnings to be $164.41. Over the past quarter, the earnings estimate has been increased by 4.9%. Further, full year 2020 earnings are expected to be $122.38 per share. The $172.47 per share represents a rather large increase in earnings year-over-year of 40.9% but would be reflective of the economic re-start we are expecting as more and more businesses re-open and workers return to work. Strong earnings growth will be needed to help propel equity prices higher over the coming months.

Market Valuation Looks Expensive

The current trailing price-to-earnings (P/E) ratio on the S&P 500 Index is 27.99. At the end of 2020 the trailing P/E ratio on the S&P 500 Index was 31.24. Although the market has gotten less expensive based on its P/E ratio since the end of 2020 because earnings have improved, it is still considered to be very expensive. The 12-month forward P/E ratio is 22.16 which is also considered to be expensive. Other measures of over-valuation are also present. For example, the "Buffett" Indicator (named for Warren Buffett's use) confirms that the market is very expensive.

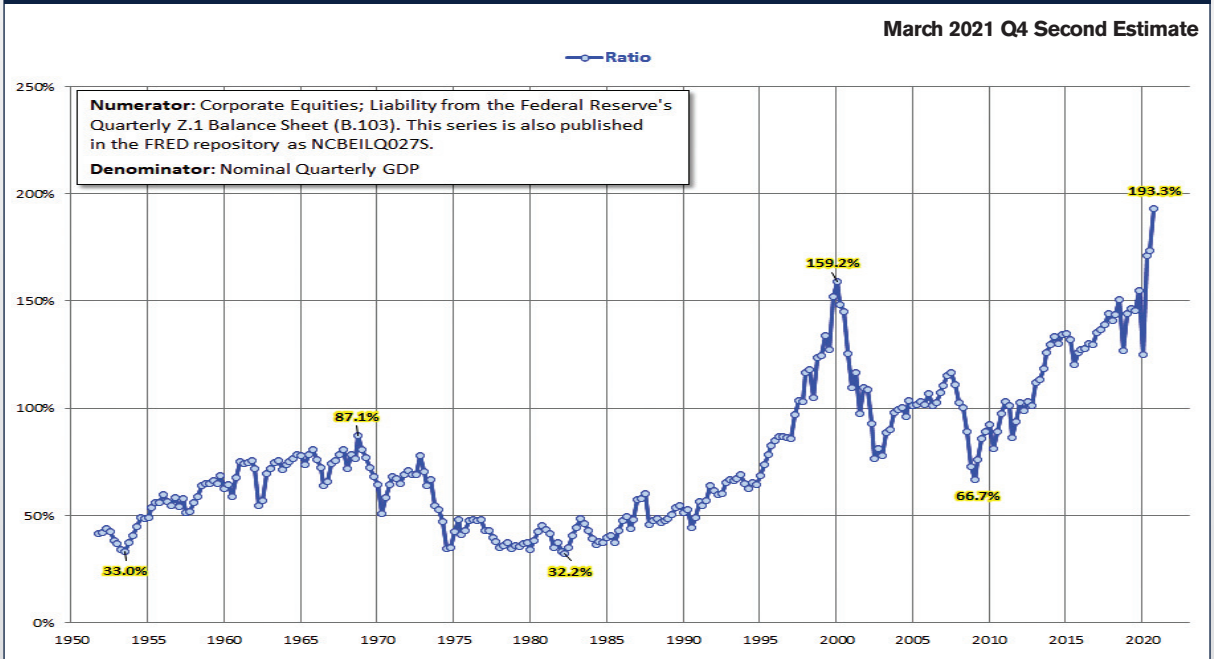
Low interest rates, QE4, liquidity provided by the Federal Government and a lack of alternative investments justify the high equity valuations. With very low interest rates and the rising yield on longer-term government bonds, the bond market does not appear to be a good alternative to the stock market as it usually is. We are in some unprecedented times with the financial markets.

Drivers of GDP Growth



Source: *JP Morgan Guide to the Markets*, March 2021.

The Buffett Indicator: Corporate Equities to GDP



Source: advisorperspectives.com

Conclusion

The year-end rally for equities continued through the 1st quarter 2021. U.S. small capitalization stocks did incredibly well with the Russell 2000 Index rising 12.7% while the previously high-flying Nasdaq stocks realized modest gains in the quarter with the Nasdaq 100 Index advancing 1.76%. Rising interest rates in the 1st quarter adversely affected bond prices.

There are signs that inflation is heating up. Given the high level of unemployment, it is not likely that inflation will persist for a long period of time. But in the long term it could return because of a shrinking workforce here and in other developed markets.

Monetary policy remains very accommodative and fiscal policy is very stimulative. Tax laws may change but investors should be wary of assuming that proposals will actually become law entirely as proposed. Additionally, any new tax laws will not likely be made retroactive.

A "re-start" of the economy is expected as currently closed or limited operating businesses return to full operations. Jobs have been returning. This was not a "structural" recession where jobs disappear for good and are eventually replaced with new jobs. Rather, many jobs that were lost will return.

The equity markets appear to be expensive. Low interest rates, QE4, government spending as well as strong and improving corporate earnings should keep equity prices elevated despite traditional measures of over-valuation.

As such, we are here to listen, counsel and provide direction to all of our clients.

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President & Chief Investment Officer

Michael P. Czajka
Chief Executive Officer