MALVERN CAPITAL MANAGEMENT

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Second Quarter 2021 Review and Market Outlook

July 2021

Second Quarter 2021 Review

Stocks continued in the 2nd quarter where they left off in the 1st quarter giving us solid broad-based gains. This quarter, large cap "growth" stocks outperformed large cap "value" stocks opposite of the 1st quarter where large cap value stocks lead the way. Technology stocks rebounded in the quarter leading the growth style to strong gains. The technology heavy Russell 1000 Growth Index returned 11.93% in the quarter while the Russell 1000 Value Index returned a modest 5.21%. Despite the resurgence of growth investing in the quarter, we believe that we are in a value market and value stocks will continue to do well. Year-to-date value stocks have outpaced growth stocks by over 4 percentage points.

Part of the reason for growth's leadership this quarter was due to the decline in interest rates. The 10-year U.S. Treasury Note yield ended the 1st quarter at 1.75% and fell to 1.44% by the end of the 2nd quarter. Growth stocks will tend to do better in a low or declining interest rate environment. Likewise, small cap stocks do well in a higher interest rate climate, much like "value" stocks. The rise in interest rates late last year and in the 1st, quarter of 2021 was favorable for small cap stocks. The small cap Russell 2000 Index returned over 62% in the 12 months ending June 30, 2021. However, small cap stocks posted rather modest gains in the 2nd quarter.

High quality bonds also recorded respectable gains as interest rates fell; just when everyone had given up on bonds, they advanced. With historically low yields common sense would dictate that the only place interest rates could go is up. But that was not the case. Less interest rate sensitive high yield bonds also did well.

Index Performance

Category	Representative Index	2nd Qtr 2021	Year-to-Date	12 Months	3 yr*	5 Yr*	10 Yr*
Mature US Large Companies	DJ Industrial Average	5.08	13.79	36.34	15.02	16.66	13.50
Broad US Large Companies	S&P 500 Index	8.55	15.25	40.79	18.67	17.65	14.84
US Small Cap Companies	Russell 2000 Index	4.29	17.54	62.03	13.52	16.47	12.34
US Mid Cap Companies	Russell Mid Cap Index	7.50	16.25	49.80	16.45	15.62	13.24
Largest 100 NASDAQ Companies	NASDAQ 100 Index	11.38	13.34	44.36	28.61	28.24	21.53
Large "Value" Stocks	Russell 1000 Value Index	5.21	17.05	43.68	12.42	11.87	11.61
Large "Growth" Stocks	Russell 1000 Growth Index	11.93	12.99	42.50	25.14	23.66	17.87
Developed International	MSCI EAFE Index	5.17	8.83	32.35	8.27	10.28	5.89
Emerging Markets	FTSE All Emerging Markets	5.16	8.10	38.76	11.64	12.40	4.30
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	1.83	-1.60	-0.33	5.34	3.03	3.39
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	2.74	3.62	15.37	7.45	7.48	6.66
Commodities	Bloomberg Commodity	13.30	21.15	45.61	3.90	2.40	-4.44
Total US Market (all cap stocks)	Russell 3000 Index	8.24	15.11	44.16	18.73	17.89	14.70
Real Estate Investment Trusts	Wilshire US REIT Index	12.84	22.78	37.52	10.06	6.36	9.38
Cash	US T-Bill 90 Day	0.01	0.02	0.07	1.17	1.10	0.58

** 3 year, 5 year and 10 year returns are annualized. All periods ending June 30, 2021.*
All returns include the reinvestment of dividends.

The low interest rates on bonds and the Fed Funds rate, along with massive government spending has led to inflation heating up this year. As such, commodities, an inflation hedge, have performed very well this year so far. The Bloomberg Commodities Index was up 13.30% in the 2nd quarter and 21.15% year-to-date. It must be noted that many of the commodities have recently fallen from their previous higher levels, but they have still performed well for the year.

As we enter the second half of the year, we are awaiting a bipartisan infrastructure bill to be passed and signed into law. It promises more government spending but also the creation of a lot of jobs. The economy continues to produce jobs at record pace so the influx of demand for even more jobs from the infrastructure bill may cause inflation to really heat up. There should also be some "market" pressure on the low level of interest rates even though we probably won't see movement on interest rates from the Federal Reserve this year. Nonetheless, stock prices should advance further this year given all of the liquidity in the economy and strong corporate earnings.

We will look at these topics a little more in detail as follows.

It's All About Inflation

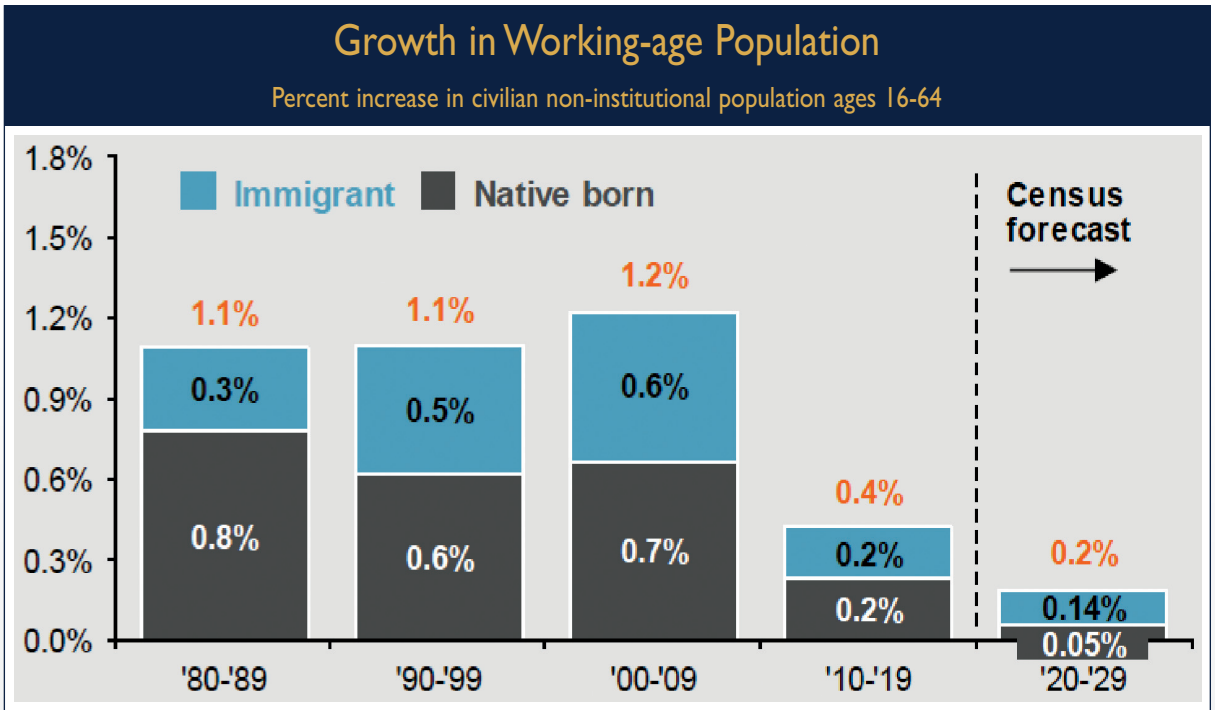
The Consumer Price Index (CPI) (is a measure of the average change over time in the prices paid by urban consumers) for all urban consumers rose by .6% for the month of May. The latest report also showed that the CPI was up 5% in the past year. After carving out food and energy, the CPI jumped .7% in the month of May and 3.8% in the last 12 months. The Federal Reserve has a long-term target inflation rate of 2%. However, the Fed has said it is willing to allow the inflation rate to exceed the target rate temporarily in the post-Covid era allowing for the economy to recover. The Fed states that the current high inflation rate is "transitory" or not permanent. There are great implications to the economy if the Fed is wrong and inflation is more than transitory.

In our view, we see inflation taking on three phases. The first phase is a shorter-term spike in inflation as we are seeing right now and would be consistent with what the Fed is saying. The second phase would be a return to the target inflation rate of 2%. We see this time frame from the first phase to the second phase occurring over the next six to 12 months. Finally, the third phase would see a return to an inflation rate in excess of the Fed's target rate. This phase would occur in three to five years and will be the result of an aging workforce and subsequent fewer workers available to fill job openings thus putting pressure on wages. It will also occur because of the expected high budget deficits and government spending. This phase, unfortunately, may be longer lasting. This should cause higher interest rates than we see right now as the Fed will be forced to put the brakes on with a higher Fed funds rates.

There are some signs that we may be seeing at least a slowdown in the rate of increase in prices. The Institute for Supply Management (ISM) reported for June that there was a slowdown in the rate of change for input prices, at least compared to May. Input prices still remain elevated but it is encouraging to see the rate of change slow.

Interest rates should remain low in the short and intermediate-term, but longer-term we could see a spike in interest rates as inflation returns in the third phase. At the present time we do not see adverse risk holding

intermediate or long-term bonds as there is limited upside pressure on interest rates. Lower interest rates will give way to higher rates if we in fact see a more permanent rise in inflation.



Source: JP Morgan Asset Management, Guide to the Markets, 3Q 2021, June 30, 2021.

The Federal Reserve and Interest Rates

The Federal Reserve's Open Market Committee concluded its June 2021 meeting by leaving the Fed Funds rate near zero percent. However, it did say that there could be two rate increases in 2023. The initial reaction to this assertion was a sell-off in equities. Prior to this meeting there was a feeling by many investors that rate increases would not occur until 2024. Furthermore, many investors were waiting for the Fed to begin giving guidance about when they would start "tapering" the bond purchases from "Quantitative Easing 4" (QE4). But no such guidance has yet emerged. The Fed is currently buying $120 billion of bonds per month as a part of its QE4 program. There is the upcoming Economic Policy Symposium in Jackson Hole, Wyoming in late August at which time, it is speculated, Fed Chairman Jay Powell may outline the Fed's plans for tapering the bond purchase program. How equity markets react to such plans will be closely monitored.

The Fed's dual mandate is price stability and maximum sustainable employment. Price stability means keeping inflation around its target of 2%. It has the challenging job of keeping enough liquidity in the system, post-Covid, while not letting the economy over-heat.

Despite the falling yields on treasury bonds this past quarter, we expect them to begin rising later this year especially if there are firm plans to begin tapering the Fed's bond purchases as we assume. We expect 10-year U.S. Treasury Note yield to rise to 2% from 1.44% (quarter end) by the end of 2021. We don't

believe such a rise will represent a headwind to equity prices beyond perhaps an initial negative reaction once tapering is announced.

"Growth" versus "Value" Stocks

With the aforementioned resurgence in growth stocks in the 2nd quarter, should we be tilting away from value stocks and over-weighting growth stocks? The simple answer is "no"; we believe that investors should maintain a neutral weighting between growth and value stocks. The growth revival is largely due to the decline in interest rates most notably the yield on the 10-year U.S. Treasury Note. At its lowest level last year, the 10-year U.S. Treasury Note hit nearly .50% so it is not impossible for yields to fall that low again. However, in our opinion the low yield last year was response to the outbreak of Covid in this country. Barring some catastrophic event, we don't see yields falling to that level again. Our point is, that yields may not have much further to fall limiting the interest rate catalyst to growth stocks. Also, two sectors we believe will be among the best performing this year are both value sectors; energy and financials. Rising oil prices will help propel energy stocks, and we believe interest rates will once again rise lifting financials stocks.

More Fiscal Policy Changes on the Horizon

A bipartisan group of Senators have proposed, and President Biden favors, an infrastructure bill. It is designed to repair our nation's roads and bridges, railways and broadband internet. Much of the bill targets "clean" energy and other projects throughout the country. The total cost of this bill is around $1.2 trillion over eight years and is far less than an earlier proposal which would have spent $2.25 trillion over eight years. The previous bill had called for higher taxes on corporations and the wealthy but the new bill calls for no tax increases. Rather it will be paid for by using unspent monies from the previous coronavirus law and unspent unemployment insurance as well as from sales from the strategic petroleum reserve. On the surface it does not call for any deficit spending. The bill will call for the creation of thousands of jobs to fulfill these projects.

Beyond the infrastructure bill, President Biden would like to increase taxes on corporations and the wealthy. The proposal would be to increase corporate income taxes from 21% to 28% and increase taxes on wealthy individuals earning over $400,000 a year. It is not likely that corporate income taxes will be raised as high as 28% because senator Joe Manchin, Democrat from West Virginia and a key swing vote in the senate, is opposed to raising corporate income taxes that high. A compromise of perhaps 25% is more likely on corporations. There does not seem to be much opposition to raising taxes on wealthy individuals.

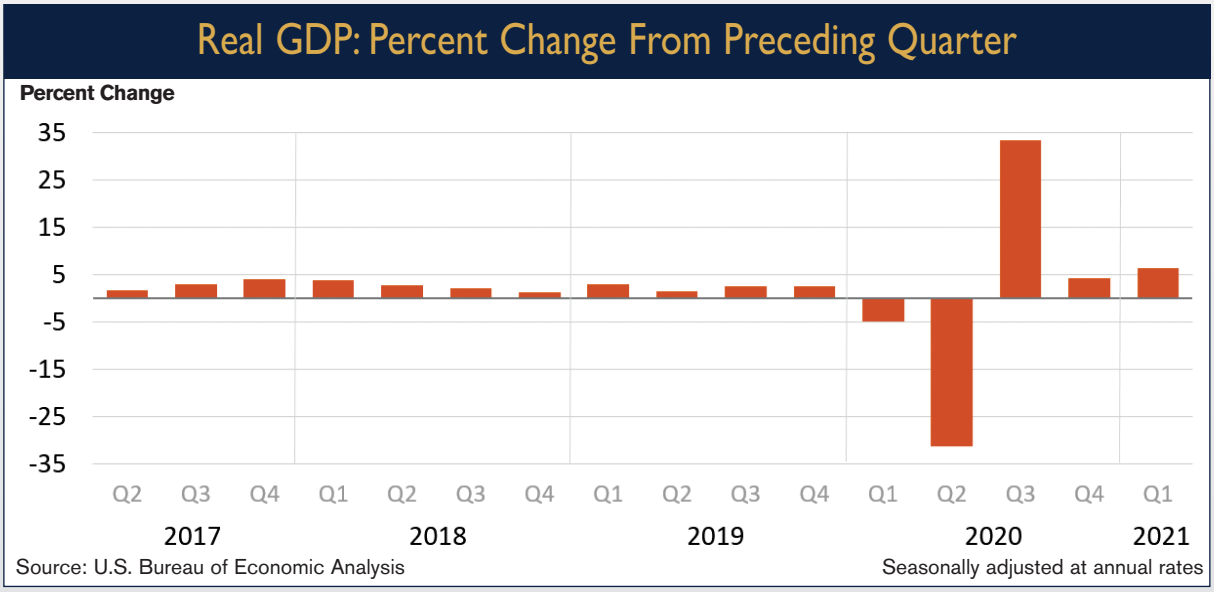
The implications of higher corporate income taxes on equities can be far reaching. Since 1993, the average annual corporate income tax rate for S&P 500 companies is 31.58% with the annual average rate falling to 18.02% for 2020. If corporate income taxes are raised, companies net incomes have to fall resulting in a need for lower valuations on companies, holding everything else equal. It is hard to project how much the valuation of corporations will have to fall in order to adjust for higher tax rates, but they will fall. Companies will quickly adjust to higher taxes through lower expenditures on research and development and lower wages to employees for example. But not all of the increase in corporate tax bills will be offset by lower corporate expenses resulting in some valuation impact.

The Economy Keeps Growing

The economy continues to expand post-Covid at a healthy pace. For the 1st quarter 2021 real Gross Domestic Product (GDP) grew by an annualized rate of 6.4%. This followed growth in GDP for the 4th quarter 2020 at an annualized rate of 4.3%. The 1st quarter increase demonstrates continued economic recovery from the reopening of businesses across the country as well as continued government response and assistance post-Covid. According to the Bureau of Economic Analysis real GDP growth was propped up by increases in personal consumption expenditures (PCE), non-residential fixed investment, residential fixed investment, federal government spending and state and local government spending. These increases were offset by decreases in private inventory investment and exports. This steady growth in GDP is a healthy tailwind for equity prices.

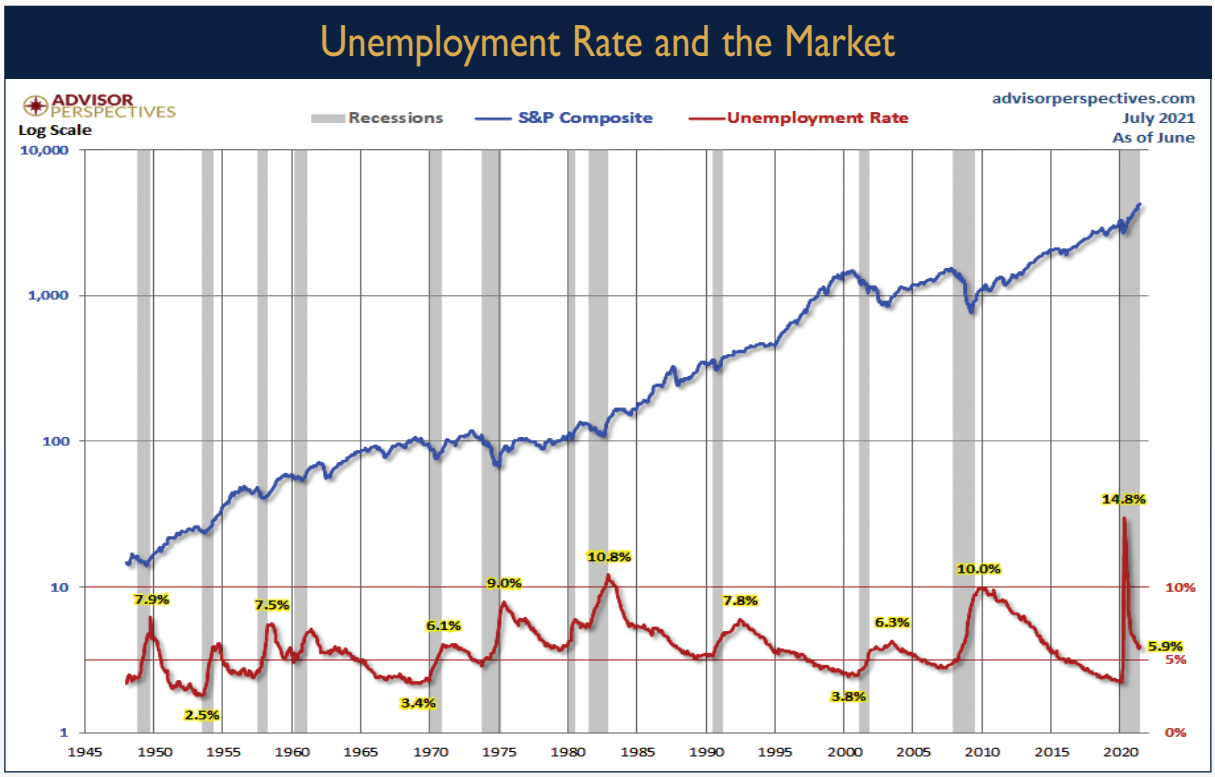
Unemployment is also improving. For the month of June, non-farm payroll reported an increase of 850,000 jobs with the unemployment rate little changed at 5.9%. Since hitting an unemployment rate peak of 14.8% following the outbreak of the pandemic in April, 2020, the trend has shown a steady improvement in the jobs picture. Anecdotally, many businesses have complained that they cannot find workers to fill available jobs. Even by offering higher wages, it is a struggle to fill jobs. Many of these business owners blame the continued job openings on generous government benefits for the unemployed. This may be true, but there are probably a lot of people still concerned about returning to work post-Covid.

A strong economy also augurs well for continued equity price advancement.



Corporate Earnings are Impressive

Corporate America is impressively making money. In late December, 2020 analysts at the Standard & Poor's Corporation projected full year 2021 earnings to be $164.41 per share for the S&P 500 Index. These same analysts now project full year 2021 earnings to be $187.30 per share. This is an impressive increase in the



projected earnings per share for the year. To put the earnings projection in perspective, the full year 2019 earnings on the S&P 500 Index (before anyone had heard of Covid) were $157.12. If we achieve the $187.30 per share projection, this represents an earnings' increase of 19.2% over the last two years. The increased projection says a lot about how companies are doing this year. This is the result of the post-Covid rebound, people going back to work, low corporate tax rates and growth in the economy. These strong earnings numbers will further act as a tailwind for equity prices going forward.

Market Valuations Look Frothy

Many of the traditional measures of market valuation show that the S&P 500 Index is very expensive right now. The "Buffett" Indicator, Q ratio, CAPE ratio, the Price/Earnings to growth ratio and a simple measure of price/earnings ratios all are at very extreme readings. Due to improving and growing corporate earnings, the trailing price/earnings (P/E) ratio has been declining over the past few quarters even while the market continues to rise. The current trailing price-to-earnings (P/E) ratio on the S&P 500 Index is 25.64 (price of the S&P 500 Index on 6/30/21 divided by the estimated trailing 12-month earnings on the Index). The trailing P/E ratio at the end of last quarter was 26.44 and at the end of the year it was 30.69. This is an impressive drop in the trailing P/E ratio over the past few quarters. The forward P/E ratio is 21.85 (using the quarter-end price divided by the estimated next 12-months' earnings estimates). Even though the trailing P/E ratio has been declining in recent quarters it is still reflecting an expensive market but not as expensive as it showed at the end of 2020. The average trailing P/E ratio over the past 20 years has been 19.05 (average of the quarter-ending P/E ratios over the last 20-years).

Although the market appears to be very expensive at present, perhaps the low interest rate environment and

quantitative easing justify the markets' high valuations. The dividend yield on the S&P 500 Index is just slightly below the yield on the 10-year U.S. Treasury Note. The dividend yield on the S&P 500 Index is 1.38% (6/30/21) versus a 10-year U.S. Treasury Note yield of 1.44%. The yield parity makes it difficult to rationalize a case for owning bonds over stocks, making bonds a less attractive alternative to stocks. Nevertheless, a sudden and deep correction could occur. Any such correction would be short-lived in our opinion.

Conclusion

Inflation is here at least in the short-term with some signs that it may even be waning. Although it may not be permanent, we believe there is a good chance inflation will return in the long-run due to an aging population and massive government spending. The Federal reserve has a dual mandate of price stability and maximum sustainable employment. Its primary tool to control inflation is to change the Fed Funds rate which is currently near zero. It is now stating that it may raise interest rates as early as 2023 and we will very likely start hearing about its tapering of the current quantitative easing program as well.

The "growth"/"value" debate continues. Value stocks had a great 1st quarter but growth bounced back nicely in the 2nd quarter. We maintain a neutral weighting between the two styles.

Expect more government spending with the likely passage of an infrastructure bill. Such additional spending could help fuel the inflation scare. But such a bill is long overdue and is needed to fix our crumbling roads, bridges and highways. The economy is strong and infrastructure spending may amplify an already tight labor situation.

Corporate earnings are growing and growing strongly. However, the equity markets appear to be expensive at this time. However, compared to bonds, equities still make a reasonable investment.

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

James L. Olsen, CFA, CFP®
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